



Statement of the
AMERICAN PUBLIC POWER ASSOCIATION
For the
HOUSE COMMITTEE ON ENERGY AND COMMERCE
SUBCOMMITTEE ON ENERGY
Hearing on
“Federal Energy Related Tax Policy and Its Effects on Markets, Prices, and Consumers”

Submitted March 29, 2017

The American Public Power Association (APPA) appreciates the opportunity to submit this statement for the record in relation to the House Energy and Commerce Committee’s Subcommittee on Energy March 29, 2017, hearing on “Federal Energy Related Tax Policy and Its Effects on Markets, Prices, and Consumers.”

The energy-related provisions in the tax code generally come in the form of tax credits and accelerated cost-recovery and depletion.¹ The Joint Committee on Taxation estimates that these provisions will reduce federal tax liabilities of business and individuals by roughly \$77.5 billion over the next five years. Public power utilities cannot directly benefit from these provisions, but can indirectly benefit, for example through power purchase agreements from entities that do directly benefit. Public power utilities can issue New Clean Renewable Energy Bonds (New CREBs) (with an estimated 5-year tax value of \$600 million). These provisions generally are intended to encourage investments in specific technologies or fuels. In some instances, the influence of tax policy is estimated to be far more substantial than regulatory regimes intended to accomplish similar goals.²

The tax code also acts to impede investments by imposing more stringent private use rules for electric energy-related investments financed with municipal bonds. These rules serve to discourage certain types of energy-related investments by public power utilities. These energy-related provisions notwithstanding, the single most important provision of the tax code affecting public power utility investments in generation, transmission and distribution facilities is the tax exemption for municipal bond interest.

¹ There is also an exception from corporate taxation for certain publicly traded partnerships, the tax expenditure value of which is comparable to other significant energy-tax provisions.

² Trieu Mai et alia, National Renewable Energy Laboratory “Impacts of Federal Tax Credit Extensions on Renewable Deployment and Power Sector Emissions,” 13 (2016) (estimating annual average renewable energy additions will be 10,600 MWs greater as a result of tax credit extensions); John Laron, et alia., Rhodium Group, “What Happens to Renewable Energy without the Clean Power Plan?” (Feb. 25, 2016)(<http://rhg.com/notes/renewable-energy-without-the-clean-power-plan>) (estimating that annual utility scale solar and wind capacity additions will total roughly 20,000 MWs in 2019 and 2020 and roughly 5,000 MWs in 2021).

Background

APPA is the national service organization representing the interests of over 2,000 municipal and other state- and locally-owned, not-for-profit electric utilities throughout the United States (all but Hawaii) referred to collectively as “public power utilities.” These utilities deliver electricity to one of every seven electricity consumers (more than 49 million people). Public power utilities serve some of the nation’s largest cities, but the vast majority of APPA’s members serve communities with populations of 10,000 people or less.

Public power utilities are diverse in structure. Some are vertically integrated, i.e., they own electric power generation, high-voltage transmission, and lower-voltage distributions facilities. Others own distribution resources, but rely on third-party providers to generate and/or transmit the electric power they use. Finally, some public power utilities have been formed to serve as wholesale providers of power to other public power utilities.

For a variety of reasons – including private-use restrictions on tax-exempt municipal bond financing – public power utilities, on average, sell more electric power to ultimate customers than they generate. While public power utilities serve about 14.5 percent of the nation’s homes and business (roughly 22 million electric meters total), these utilities generate about 9.9 percent of the nation’s power (more than 400 million megawatt hours every year).

Municipal Bonds

Since their establishment in the late 19th century, public power utilities have largely relied on municipal bonds to cost effectively raise capital needed to build generation, transmission, and distribution facilities that serve their communities. These projects require substantial upfront commitments of capital, but also tend to have long useful lives. Bonds are a responsible way to finance these costs and repay them over time. This allows the investments to be made and ensures that those customers who are benefiting from the investment are paying for it through their rates. From 2006-2015, nearly 1,400 power-related municipal bonds providing roughly \$110 billion in new money financing were issued.

This is especially important since state and local governmental entities—including public power utilities—have limited means to raise funds for their communities’ capital needs. They cannot issue stock and a local bank loan is rarely an option given the size of the investments required. Moreover, they generally do not use, or even accrue, accumulated cash surpluses in part because doing so would require rate payers to pay the cost of investments from which they may never benefit. Conversely, municipal bonds allow issuers to build long-term projects financed upfront by investors and the debt for which is repaid by residents over the useful life of that investment.

Interest on municipal bonds is exempt from federal taxation,³ and has been since the creation of the federal income tax in 1913.⁴ In contrast to other “tax expenditures,” however, the federal tax exemption of municipal bond interest is part of a trade-off – state and local governments are likewise prohibited from taxing interest on federal debt.⁵ While congressional agencies largely ignore this reciprocal arrangement

³ I.R.C. § 103(a).

⁴ Revenue Act of 1913, 38 Stat. 114 (Oct. 3, 1913).

⁵ 31 U.S.C. § 3124(a).

when discussing taxation of municipal bonds, the state and local tax exemption has been well-guarded and maintained by Congress.⁶

Likewise, Congress has honed the original exemption from federal tax for municipal bonds, limiting the entities that can issue tax-exempt bonds, the purposes for which the bonds may be issued, and the investment of bond proceeds. Specifically, these laws seek to prevent state and local governments from issuing bonds which finance a facility serving a private activity – rather than financing a facility serving a general public purpose. Generally, if more than 10 percent of a bond finances a private activity and more than 10 percent of the repayment of the bond is tied to revenues from that private activity, then the bond does not qualify as a government purpose bond, but is a “private activity bond,” which is subject to federal income tax.⁷

However, private use rules for power-related bonds are stricter, in effect a “negative tax expenditure” relative to the commonly applied private-use rules. This additional private use limit is just five percent for any power output facility for which the private use will exceed \$15 million. In addition, only up to \$15 million in private use is permitted for all issuances for any one project.⁸

Furthermore, Internal Revenue Service (IRS) implementation of these private-use rules prevent issuers from using tax-exempt bonds to build facilities large enough to meet not just current needs, but future needs. These rules treat near-term excess generation sold outside a public-power utility’s customer base as “private use” even if that excess generation capacity will be needed to meet increased customer demand in the future. Additionally, private use rules severely limit the ability of municipal utilities to acquire existing privately-owned, power-related assets with tax-exempt municipal bonds.⁹

Private Activity Bonds

As discussed above, a municipal bond that exceeds private use limits is considered a private activity bond and, generally, is subject to federal tax. However, a private activity bond can be exempt (in whole or in part) from federal tax if it is used to finance certain specific types of qualified facilities or activities. A qualified facility can include an airport, dock, wharf, mass-transit facility, multi-family housing, or solid waste disposal facility.

A qualified facility (or activity) can also be a facility furnishing local electric energy¹⁰ or an environmental enhancement of a hydro-electric facility.¹¹ The definition of “local electric energy” is very narrow—applying only to facilities furnishing electric energy to either: a) a city and one contiguous county or b) two contiguous counties.¹² Likewise, environmental enhancements to hydroelectric facilities financed by qualified facility bonds are an extremely small portion of the investments made by public power utilities. Given these narrow constraints, power-related qualified facility private activity bonds are relatively rare. For example, in 2015, of 183 power-related municipal bonds totaling \$17.5 billion, just two totaling \$49 million were private activity bonds.¹³

⁶ See, e.g., Pub. L. No. 97-258 § 3124, 96 Stat. 945 (Sept. 13, 1982); Pub. L. No. 86-346 § 105, 73 Stat. 622 (Sept. 22, 1959); Public Debt Acts of 1941, Pub. L. No. 77-7 § 3, 55 Stat. 8 (Feb. 19, 1941).

⁷ I.R.C. § 141(b)(2).

⁸ I.R.C. § 141(b)(4).

⁹ I.R.C. § 141(d).

¹⁰ I.R.C. § 142(a)(8).

¹¹ I.R.C. § 142(a)(12).

¹² I.R.C. § 142(f).

¹³ Bond Buyer, “The Bond Buyer/Thomson Reuters 2016 Yearbook” (2016).

Energy-Related Tax Provisions

By Joint Committee on Taxation (JCT) estimate, the bulk of the tax value of energy tax expenditures come in the form of tax credits for renewable power investments and production (worth \$4.5 billion annually), accelerated cost recovery for oil and gas operations (worth \$3.1 billion annually), and an exemption from corporate taxation for publicly-traded partnerships owning certain energy facilities, generally oil and gas pipelines (worth \$1.2 billion annually).¹⁴

As not-for-profit entities, public power utilities cannot directly benefit from these provisions. This includes:

- Credits for investing in clean coal technologies;
- Credits for electricity production from renewable resources;
- Credits for investments in certain renewable and other energy producing facilities; and
- Section 1603 grants in lieu of tax credits.

In fact, in so far as public power utilities partner in ownership with entities that do qualify for such credits, the amount of credit available is reduced if tax-exempt municipal bonds are used to finance the public power portion of the project. Likewise, inapplicable to public power utilities are tax code provisions allowing five-year cost recovery for certain energy property, amortization of air and pollution control facilities, and normalization rules preventing accelerated depreciation and the like from reducing the rate base for investor-owned utilities.

To begin to provide comparable incentives to invest in renewable power, in 1992 Congress authorized Renewable Energy Production Incentives (REPI) for public power and cooperative utilities. Congress, however, provided little funding for the program – just \$54 million to pay \$329 million in REPI credits earned by public power and cooperative utilities -- and stopped funding REPI entirely after 2009.

Congress took a different tack in the Energy Policy Act of 2005 (EPA05)¹⁵ with the creation of Clean Renewable Energy Bonds (CREBS), which have since been replaced by New CREBs. Under current rules, qualified issuers of New CREBs included public power utilities, states and towns, and cooperative electric utilities. Interest paid on a New CREB is taxable, but the bondholder receives a tax credit. The tax credit is calculated by Treasury at the date of bond issuance and set at 70 percent of the level necessary to allow the bond to be issued at the same interest rate as if the bond had been issued as a tax-exempt bond. Alternatively, the issuer may elect to receive the tax credit as a direct payment from the federal government (with the credit calculated the same as if the bond were issued as a tax credit bond). A total of \$2.4 billion in New CREBs may be issued, split evenly between public power utilities, rural electric cooperatives, and state and local governmental entities that are not public power utilities.

As of March 2015, public power utilities have issued a total of roughly \$283 million in New CREBs. By way of comparison, public power utilities typically finance \$9 billion in new projects every year with traditional municipal bonds.¹⁶ And according to JCT tax expenditure estimates, CREB and New CREB tax credits and direct payments are worth roughly \$100 million annually.¹⁷

¹⁴ Jt. Comm. on Taxation, “Estimates of Federal Tax Expenditures for Fiscal Years 2015-2019,” JCX-141R-15 (Dec. 7, 2015).

¹⁵ Energy Policy Act of 2005, Pub. L. No. 109-58 § 1303, 119 Stat. 991 (codified as I.R.C. § 54)(Aug. 8, 2005).

¹⁶ Bond Buyer, “The Bond Buyer/Thomson Reuters 2016 Yearbook” (20116); Bond Buyer, “The Bond Buyer/Thomson Reuters 2011 Yearbook” (2011).

¹⁷ Jt. Comm. on Taxation, *supra* note 13.

As discussed above, CREBs and New CREBs were an attempt to provide direct benefits to not-for-profit utilities making targeted energy investments. However, as a tax credit bonds, CREBs were exceedingly unpopular and New CREBs have been hamstrung by: a burdensome application process; a low cap on bond volume; and a process that provided bond volume allocations of a fraction of the amounts being sought. Additionally, public power utilities that issued New CREBs as direct payment bonds continue to face penalties, with federal budget sequestration cutting otherwise authorized payments since 2013 – sequestration cuts that are now scheduled to continue through 2025.

The IRS announced in February 2015 new procedures for receiving an allocation of New CREB bond volume – i.e., to secure the right to issue a New CREB – including \$527 million in New CREB bond volume available to public power utilities.¹⁸ Data is not publicly available, but many of the same issues hamstringing New CREBs in the past will continue to hamstring them in the future.

APPA has long said that if Congress wants to incentivize energy investments, it should provide comparable incentives to all utility sectors – including not-for-profit entities, which collectively provide power to roughly 27 percent of the nation’s electric power customers.

For example, EPAct05 created the IRC § 45J advanced nuclear production tax credit to offset the first-of-a-kind risk of the first 6,000 megawatts of new nuclear generating capacity built after 2005, but placed in service prior to 2021. Since then, construction has begun on four nuclear reactors in Georgia and South Carolina – the first new reactors built in the United States since the 1970s. Additional projects, including the first of a new generation of small modular reactors, are moving through the licensing process at the Nuclear Regulatory Commission, and will be ready for commercial deployment in the first half of the next decade. Nonetheless, the pace of new nuclear plant construction has not been as rapid as Congress had hoped in 2005, meaning credits for 1,600 megawatts of new nuclear power will be stranded by the 2020 placed-in-service deadline. Additionally, those plants which are under construction have required involvement of investor-owned utilities, electric cooperatives, *and* public power utilities. These new nuclear plants now being developed will provide needed baseload electricity; create tens of thousands of new jobs during construction and operation of the plants and through the entire nuclear supply chain; and reduce the electric power industry’s carbon dioxide emissions. However, public power utilities investing in these new plants will not receive the production tax credit. Allowing the credit to be transferred from public-power utilities and extending the placed-in-service date beyond 2020 – as proposed in H.R. 1551 and S. 666 – would directly benefit utilities that are making the investments Congress sought to encourage in EPAct05 and encourage further such investments.

Defense of Municipal Bonds from Repeal or “Cap”

Modifying the advanced nuclear PTC is a small step Congress could take to accomplish the goals set in EPAct05. Likewise, allowing public power issuance of New CREBs is of benefit to the utilities that can receive an allocation. However, for public power utilities, the single most important step Congress could take to encourage energy-related investments would be to stop talking about taxing municipal bonds and start talking about ways to improve the rules surrounding municipal bonds. Every municipal bond issued includes an official statement warning that the tax treatment of municipal bonds could be changed by Congress at any time. The premium that investors demand as a result of this risk is not insignificant. Conversely, this risk premium could be reduced to nearly nothing if policymakers would clearly state their intention not to tax municipal bonds. Savings on new projects would be immediate, reducing electric power rates for customers, or allowing larger investments in needed new infrastructure.

¹⁸ I.R.S. Notice 2015-12 (Feb. 3, 2015).

This threat applies to both an outright repeal of the tax exclusion for municipal bonds and to proposals to “limit” or “cap” the tax value of the exclusion for municipal bond interest. The real-world example of private activity bonds subject to the alternative minimum tax shows that such a “cap” would increase the interest rate demanded by purchasers of municipal bonds.¹⁹ For example, a \$250 million generation project would cost \$40 million more in total debt service were the tax value of bond interest “capped” at 28 percent.²⁰ The impact on a smaller project would be greater still: a \$25 million grid upgrade would cost an additional \$5 million if the tax value of bond interest was capped.²¹

Improvements to Municipal Bonds

Congress could undertake to improve the current-law tax treatment of municipal bonds. APPA supports a recent proposal to repeal the five percent unrelated or disproportionate private business use test (Section 141(b)(3) of the Code) to simplify the private business use test applicable to governmental bonds. This test involves vague factual determinations that can lead to a reduction in the otherwise permitted 10 percent private business use participation to five percent. Treasury has said in the past that the five-percent test creates undue complexity and should be repealed²² and we agree. We also agree that the “10 percent private business limit generally represents a sufficient and workable threshold for governmental bond status”²³ and would, as a result, recommend that other unnecessary addenda to the 10 percent limit also be reconsidered.

Likewise, Code Section 141(b)(4) provides for a \$15 million private business use/payments limitation on certain output facilities which are part of the same project. The per-project limitation is a punitive rule that singles out governmentally-owned electric output facilities from other bond financed governmental owned assets and systems. Accordingly, we support the repeal of this provision. At a time in which additional electric output and smart-grid transmission and distribution facilities are needed to meet a rising energy needs, the repeal of this per-project limitation would provide needed operational flexibility.

Similarly, Code Section 141(b)(5) provides for a maximum \$15 million private business use/payments limitation on all tax-exempt governmental bonds unless volume cap is allocated to such excess under Section 146 of the Code. This \$15 million limitation, like the \$15 million per-project limitation of Section 141(b)(4), creates undue complexity for municipal issuers and interferes with a policy goal of creating a bright line 10 percent private business use test. We support its repeal.

APPA would also support a revision in the tax treatment of capital contributions by public power utilities to investor-owned utilities (IOUs) to build facilities (e.g., interconnections and associated facilities, transformers, circuits, etc.) to serve the public power utility’s retail demand (“load”). Under current law, these payments are treated as taxable “contributions-in-aid of construction” to the IOU.²⁴ Because the

¹⁹ Municipal Bonds for America, “Experience with the AMT and Private Activity Bonds Shows ‘Capping’ the Tax Value of Municipal Bond Interest Would Increase State and Local Borrowing Cost,” (Feb. 22, 2017).

²⁰ BLX Group LLC, “Tax Reform Proposal Analysis: Impact on Tax-Exempt Bond Financing,” prepared for American Public Power Association 6 (Jan. 28, 2013).

²¹ *Id.*

²² U.S. Dep’t of the Treas., “General Explanations of the Administration’s Fiscal Year 2016 Revenue Proposals” at 273 (Feb. 2, 2015).

²³ *Id.*

²⁴ I.R.C. § 118(b).

IOU traditionally requires the public power utility to “gross up” its contribution, the cost of the investment is effectively increased by as much as 35 percent.

Finally, we support the recent proposal to simplify the arbitrage investment restrictions applicable to tax-exempt bonds under Code Section 148. We fully agree that the investment yield and arbitrage rebate restrictions are duplicative and that these dual restrictions create an unnecessary compliance burden for state and local governments.²⁵

Conclusion

The federal income tax includes a variety of provisions intended to encourage energy-related investments. Almost none are of direct benefit to public power utilities, although public power utilities have made limited use of New Clean Renewable Energy Bonds. Conversely, there remain substantial impediments to energy-related investments in rules governing tax-exempt municipal bonds. If Congress is seeking to encourage needed investment in energy infrastructure – of all sorts – it should update the treatment of such investments when financed by municipal bonds and, at the very least, remove the threat of a tax on municipal bonds.

We thank you for your time.

For more information, please contact:

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²⁵ U.S. Dep’t of the Treas., *supra* note 17, at 270.