Submission to the Senate Finance Committee

Working Group on Community Development and Infrastructure

By American Municipal Power (AMP) and the Ohio Municipal Electric Association (OMEA)

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American Municipal Power, Inc. (AMP) and the Ohio Municipal Electric Association (OMEA) are jointly providing these comments to the Senate Finance Committee Working Group on Community Development and Infrastructure 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 132 municipal electric members in nine states (Delaware, Indiana, Kentucky, Maryland, Michigan, Ohio, Pennsylvania, Virginia, and West Virginia). The 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.

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 provide essential services and build infrastructure needed for public safety and economic growth.

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.

Congress has – until recently – refrained from pursuing attempts to alter over 100 years of tradition of reciprocal tax immunity between state and local governments and the federal government.

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:

1. **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 reflected in recent budget proposals, which – under the guise of "tax fairness" – would have reduced 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.

2. ***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.

In fact, lower-income individuals are more dependent on services and facilities financed with tax-exempt bonds than upper-income individuals. Access to public schools and hospitals, use of public transportation are essential for lower-income households. Similarly, utility services financed through municipal bonds (water, wastewater, electric, gas) represent a disproportionate share of expenditures by lower-income residents – who will feel a greater pinch if tax-exempt financing is restricted or eliminated.

3. ***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.

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 approximately $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.

Further, it is important to note 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, tax policies can and do have far-reaching consequences for the amount and type of generation

[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.").

and transmission constructed, the reliability of the electric system, and other critically important aspects that currently can benefit from the use of tax-exempt financing. Large-scale investments will be needed in the coming decades to replace aging infrastructure, comply with regulatory mandates, and ensure grid security. Tax policy should reflect these important energy, environmental and economic factors.

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 distress in the financial markets, AMP accessed the market for more than $5 billion since 2008 to support generation project development and has plans for capital bond issuances during the 2015-2016 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 a strategic 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 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 for this project, including approximately $1 billion in tax-exempt 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 development of four run-of-the-river hydroelectric projects at existing locks and dams along the Ohio River, which will generate more than 300 MW of new renewable energy. For these projects, AMP has financed approximately $2.73 billion for these projects, including approximately $400 million in tax-exempt bonds. 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. During construction, the projects directly employed more than 1,000 construction workers. With construction nearing completion, staffing and commissioning is underway at three of the four projects. .

- 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 approximately $546 million for its portion in the project, including approximately $525 million in tax-exempt bonds. The project was declared to be in commercial operation in 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 45% - and mutual funds – about 28%).[6]

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[6] Board of Governors of the Federal Reserve System, through 3rd Quarter 2013 – see Figure 1.

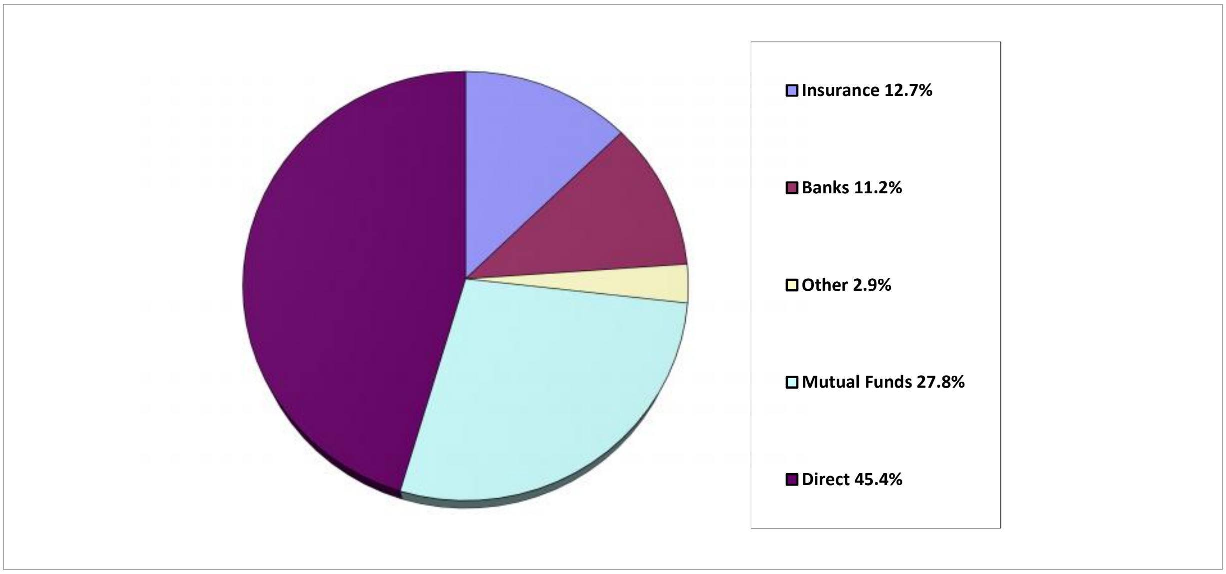

Figure 1. Municipal Bond Market by Investor Type

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 has been much higher. For example, 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.

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 are sometimes touted as options that could replace tax-exempt financing for municipalities. However, these programs have been subject to sequestration cuts, resulting in a reduction of more than $65 million in credit payments to AMP. For that and a number of other reasons, they should not be considered as a 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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