


DATE: December 22, 2020

TO: Commissioner Sophie Maxwell, President
Commissioner Anson Moran, Vice President
Commissioner Tim Paulson
Commissioner Ed Harrington

THROUGH: Michael Carlin, Acting General Manager 

FROM: Eric Sandler, Assistant General Manager, Business Services & CFO 

SUBJECT: Tax-Exempt Bond Financing of Distributed Infrastructure

BACKGROUND

This Memorandum addresses a question posed by Commissioner Harrington at the October 13, 2020 meeting regarding the financing of distributed infrastructure. Specifically, Commissioner Harrington asked about the effort that the San Francisco Public Utilities Commission (SFPUC) has undertaken with respect to financing “distributed infrastructure” programs with tax-exempt debt. As with many agencies, distributed infrastructure programs and projects have been historically funded out of current year rate revenues. This financing approach can result in relatively small and more variable allocations of resources to such programs.

By way of context, “distributed infrastructure” refers to “technologies and practices that are decentralized and distributed over many locations.” For water and power utilities, these may include programs that encourage water or electricity conservation, such as rebate programs for low flow plumbing fixtures and energy efficient appliances or “cash for grass” programs that promote the use of indigenous, drought resistant plants for landscaping. For wastewater utilities, these may include stormwater abatement infrastructure such as rain gardens, permeable pavement and cisterns. Distributed infrastructure may reduce demand on existing infrastructure, potentially delaying or eliminating the need for more costly infrastructure expansion or upgrade projects.

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Though they provide a clear public benefit, distributed infrastructure is often owned by either other public agencies or private citizens. As a result, proper program design, financing and implementation requires addressing questions regarding legal authority, accounting and tax-law that are more easily addressed in the case of public ownership. The discussion below provides a description of these considerations.

KEY CONSIDERATIONS

Legal authority – Proposition A, passed by San Francisco voters in June 2018 provided clarity regarding the permitted use of the proceeds of bonded indebtedness. The prior charter language was unclear regarding distributed infrastructure, with a reference to facilities “...under the supervision of the Public Utilities Commission.” Prop A appended the phrase “...or for any other lawful purpose” which created clear authority under the City Charter for distributed infrastructure facilities.

Accounting – A key test that must be met for an asset to qualify for tax-exempt bond financing is the ability to capitalize the asset for accounting purposes. The Government Accounting Standards Board (GASB) provides guidance to state and local governments on the topic of asset capitalization. One of its first pronouncements, GASB Concepts Statement No. 4, establishes two conditions that must be met for capitalization to occur - present service capacity and control. For municipalities considering utility investments in distributed green infrastructure programs, applying these conditions has been a matter of ongoing public discussion.

For discussion purposes, the SFPUC’s Green Infrastructure Grant Program (GIGP) is intended to mitigate stormwater runoff so that localized flooding and untreated effluent discharges do not occur. This is consistent with the present service capacity condition for capitalization, as these installations enable the Wastewater Enterprise to carry out its core objectives. In addition, the grant application and deed restriction places strict requirements upon program participants as to the manner that assets can be constructed and their purpose. While these contract obligations serve as a basis for control, other water/wastewater agencies have employed limited easements to further their demonstration of control. In order to more aptly address ongoing questions of asset ownership and control, GASB published Statement No. 62. Most notably, it establishes standards for regulated operations whereby regulatory assets could be capitalized if certain criteria are met. Specifically, “Rate actions of a regulator can provide a business-type activity with reasonable assurance of the existence of an asset. A regulated business-type activity should capitalize all or part of an incurred cost that otherwise would be charged to expenses if both of the following criteria are met: a) GIGP costs are allowable for rate-making purposes, and b) future revenue garnered from these rate increases in fact cover these costs “rather than provide for expected levels of similar future costs.” Given

that the SFPUC is regulated by both its Commission and the San Francisco Board of Supervisors for ratemaking and debt authorization/issuance purposes, the SFPUC could conclude that rate increases pursuant to GASB Statement No. 62 would justify the capitalization of GIGP assets.

Municipal bond tax law – Generally, distributed infrastructure projects that benefit state and local governmental entities, including other City departments, and private homeowners can be financed with tax-exempt bonds subject to certain federal tax law limitations. Projects that benefit private businesses, including landlords of residential rental projects, would likely be considered a private use of bond proceeds. Such uses would require the SFPUC to ensure that no more than 10% of tax-exempt bond proceeds (also limited to \$15 million per bond issuance) benefits private businesses. This concern may be partially mitigated based on the design of the distributed infrastructure program (e.g., grant programs targeted to residential homeowners). Additionally, distributed infrastructure improvements by nature may have shorter useful lives than traditional infrastructure improvements. This concern, though, could be mitigated by issuing bonds for both traditional and distributed infrastructure projects in a single issue, which would increase the overall weighted average life of the bond-financed property. It should be noted that these issuance limitations for tax-exempt bond financings do not apply to bonds issued on a federally taxable basis.

CONCLUSION

Based on our research and conversations with bond counsel, the City Attorney's Office and municipal advisors, as well as discussions with the SFPUC's Accounting Group, the SFPUC would be able to fund certain decentralized infrastructure projects or programs using tax-exempt bond proceeds under its existing revenue bond structure. Staff anticipate including this funding strategy as part of the upcoming budget reopening relating to the Wastewater capital plan.