U.S. House of Representatives Committee on Transportation and Infrastructure
Subcommittee on Water Resources and Environment

"A Review of Innovative Financing Approaches for Community Water Infrastructure Projects"

February 28, 2012

Testimony of Jeffry Sterba
President and Chief Executive Officer
American Water

for the National Association of Water Companies

NAWC
National Association of Water Companies

AMERICAN WATER

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Chairman Gibbs, Ranking Member Bishop, and Members of the Subcommittee – good morning and thank you for the opportunity to be with you this morning. I am Jeff Sterba, President and CEO of American Water, the largest publicly-traded U.S. water and wastewater utility company. We employ approximately 7,000 dedicated professionals who provide drinking water, wastewater and other related services to approximately 15 million people in more than 30 states, as well as parts of Canada and including 10 US military bases. I am pleased to be with you today representing the National Association of Water Companies. NAWC is the voice of the private water service industry and has members located throughout the nation and ranging in size from large companies like American Water owning, operating or partnering with hundreds of utilities in multiple states to individual utilities serving a few hundred customers. Through our various business models private water and wastewater professionals serve more than 73 million Americans, nearly a quarter of our country's population.

I am pleased to join you today to present actions we can take together as a Nation to unleash *"More Tools for the 'Financing Toolbox'"* through innovation and by embracing the powerful combination of public service and private enterprise to build the water infrastructure our communities need to thrive and to be healthy. The good news about the increasing attention water and wastewater is getting – even in the popular press – these days is just that: that the infrastructure that truly promotes economic vitality, provides public health, and protects our environment is getting the attention it deserves and needs. The bad news about too much of this coverage is that it primarily tells a story of doom and gloom.

Our Challenges Bring Opportunities

When it comes to providing safe water in this country, we have been doing the same thing for so long that we are comfortable. And in many ways the status quo has worked – the United States generally has built systems that reliably bring safe drinking water to homes and business and efficiently takes away waste and treats it to be returned to the environment or to be reused. And while our efforts have been successful, many signs are emerging that continuing as we always have is no longer sustainable. Former EPA Assistant Administrator for Water Ben Grumbles, who now is President of the Clean Water America Alliance, recently identified this trend as "the Public Rust Doctrine" – the "principles and teachings that water and wastewater infrastructure systems should only be owned, operated and maintained by public entities supplied with public funds as long as possible and that efforts to change this dynamic should be resisted, at least until systems rust, decay, or approach catastrophic collapse."

The challenges we face to protect and maintain our water and wastewater systems and make the investments needed for continuing growth and new public health and environmental standards seem vast, but they need not paralyze us. As the Johnson Foundation, in collaboration with American Rivers and Ceres, says in a report, *"Financing Sustainable Water Infrastructure"*, released just a month ago on January 26, 2012, as part of its Charting New Water initiative:

> While these challenges are significant, they are not insurmountable. In fact, they can be viewed as drivers of much-needed change in how we finance and develop our water systems to meet future demands. New financing models and pricing flexibility, which are necessary to pay for new infrastructure and to support legacy systems, provide enormous opportunity for positive transformation necessary to keep pace with the rapid changes being experienced by counties, municipalities and investor owned utilities.[1]

The guiding questions the Johnson Foundation asked of the diverse group of experts it convened for the report were 1) "What new financing techniques can communities use to pay for integrated and sustainable infrastructure approaches?" and 2) "How can we direct private capital toward more sustainable water management projects?"

The NAWC applauds you, Mr. Chairman, and this Subcommittee, for leadership in bringing these same questions to the halls of Congress and providing this forum for presenting some of the transformational solutions that will answer them.

Americans Value Water

Americans value clean, reliable water. A survey by ITT Corporation in 2010 shows that 95 percent of voters value water over any other service their households receive, including heat and electricity. And more than three out of four of these voters say that disruptions in their water system would create direct and personal consequences. What Americans may not understand as clearly, unfortunately, is what it takes to ensure they do not suffer those disruptions and consequences. American Water recently conducted a series of focus groups throughout our service area that reinforced the ITT survey, finding our customers believe having safe and reliable running water in their homes and businesses is invaluable and essential to their lifestyles. However, many of our customers do not know the extent of the infrastructure network that delivers water to their homes – they know there are pipes under the streets in their neighborhood, but they don't think about the reservoir, the treatment plant, the thousands of miles of pipe that underlay every other neighborhood in their town or city, and the pumps and energy that move a ton or more of water into every household every day.

These extensive and integrated water and wastewater systems that deliver such great value are at risk today. Take for example, the overall state of water mains in the U.S. There are approximately 240,000 main breaks annually – about 650 every day – that lose roughly 7 billion gallons of water treated to drinking water standards daily. This should be no surprise since many community water systems are on schedule to replace their pipes on a 250 year cycle. Which means the water pipes that Thomas Jefferson laid for Monticello are just about ready for an upgrade. This is not acceptable, nor is it sustainable, if we are to maintain the great progress we have made protecting public and environmental

[1] The Johnson Foundation, *Charting new Water Convening Report: Financing Sustainable Water Infrastructure*, January 2012, http://www.johnsonfdn.org/sites/default/files/reports_publications/WaterInfrastructure.pdf.

health and to build the economic foundation for future prosperity. The American Society of Civil Engineers in its recent study on the economic impact of underinvesting in our water and wastewater infrastructure estimates that on the track we currently are on, between now and 2020 American businesses will lose $734 billion in sales and the cumulative loss to our GDP will be $416 billion directly due to deteriorating infrastructure.

The upkeep and replacement of these systems drives the need to invest substantial amounts of capital, and once Americans are educated about their water systems and investment needs, they understand their role in ensuring long-term access to clean water. The ITT survey found that two-thirds of American voters are willing to pay an average of 11 percent more per month than their current water bills. Such increases are necessary, but we still need to attract the capital to be invested that full-cost recovery customer rates will support. We believe one major answer lies in removing roadblocks that deter increased private investment in water infrastructure.

Use of Private Capital

Before I talk about some specific recommendations to improve our nation's "Financial Toolbox", I think it is important to understand that substantial private capital already is at work in water. In 2011, American Water alone invested $925 million in our community water and wastewater systems across the country and we expect to do about the same in 2012. NAWC estimates that its 6 largest members are investing around $2 billion each year in their systems, which is significant when one notes that the total federal appropriation for the clean water and drinking water state revolving fund (SRF) programs for the current fiscal year is approximately $2.4 billion. While those numbers are big and a number of other financing sources and programs are being used to invest in water and wastewater infrastructure, several groups estimate that the total industry spend is significantly lagging what is needed.

In any situation, and particularly when discussing the needs of the water and wastewater systems, we need to agree that any distinction between public and private operations, any argument over the inherent virtue of public or private capital, any such demagoguery is not only meaningless – it is harmful. Our sole driving objective should be to provide the maximum amount of flexibility to deliver the most cost-effective and sustainable solutions for our nation's water and wastewater infrastructure systems. And right now our nation needs as many tools in its financing toolbox as we can develop.

The tools I am proposing will help attract additional private capital – including funds from companies such as American Water and additional private capital that is already in infrastructure funds and pension funds and other sources eager for the long-term, reliable investments that well-run water utilities provide. These tools will also provide municipalities with additional flexibility in addressing their water and wastewater system and for improving their overall fiscal health.

Impediments Keep the Financing Toolbox Closed

I would like to share with you today some of the opportunities for increasing the flow of this money into water and wastewater infrastructure investments, as well as some of the impediments in place.

Requiring Defeasance of Debt

No one likes to be told they cannot do something. This is particularly true when governmental entities are reviewing all of their strategic and fiscal options including their options related to how their water and wastewater systems are financed and operated. Unfortunately, the presence of existing IRS rules and the interpretations of those rules are effectively telling governmental entities they cannot pursue the use of private capital and operational expertise unless they pay a significant penalty to remove existing debt. The penalty I am talking about is not a specific fine. Rather it is the difference between the costs, on one hand, of the face value of the debt the IRS requires governmental entities to retire because of the use of private capital and, on the other hand, of the securities municipalities are required to buy to prefund the debt service on the portion of the debt that cannot be repaid immediately. The specific process I am referring to is called "defeasance", a term rarely used in general conversation.

So what drives the need to "defease" the debt and incur what is effectively a penalty? For the most part, local governments finance their water and wastewater facilities, and other infrastructure, through the issuance of tax-exempt bonds. The tax-exempt status of interest on these bonds enables municipalities and public utilities to borrow on a low-cost basis to fund their infrastructure needs by allowing the buyers of their debt to not pay federal income taxes on the interest those buyers will receive. In order to issue their bonds on a tax-exempt basis, however, local governments must comply with a number of tax law restrictions. For example, tax-exempt bonds ordinarily cannot be issued if the proceeds are loaned to a nongovernmental person or are used to construct property that is then leased on a long-term basis to a nongovernmental person. It is important to note that the proceeds from tax-exempt bonds can be loaned to a nongovernmental person if those funds are used to construct certain types of assets, included water and wastewater infrastructure. Under this scenario, American Water has issued hundreds of millions of dollars' worth of tax-exempt private activity bonds through state conduits.

Public-private partnerships related to municipal water and wastewater facilities often arise in a very different context than this, however. A common situation where public-private partnerships might arise is when a municipal water or wastewater utility constructs its system through the issuance of tax-exempt bonds with no intent to involve a private entity in the operation of that system. Then many years later that utility finds it needs to bring in a private partner in order to more efficiently run the system or to provide a new source of capital to make improvements to the system. In these situations, often the preferable path forward for the governmental entity and the private partner is to have the private partner lease the system on a long-term basis, agreeing both to operate the system and make necessary improvements while keeping the rates to customers reasonable and subject to governmental control. In these circumstances, the parties would enter into arm's length negotiations to determine the consideration to be paid and the fact that the governmental entity's borrowing cost was based on tax-exempt rates would not ordinarily be part of the negotiations. As a result, *in these transactions, the nongovernmental entity leasing the system would not be benefitting from the fact that the system was financed on a tax-exempt basis and the IRS ought to be indifferent to the transaction.*

What I am proposing is not a new concept. In fact, until at least the late 1980s, the IRS permitted this type of public-private transaction if it happened well after the tax-exempt bonds were issued. In other words, for many years the IRS had permitted issuers of tax-exempt bonds to lease tax-exempt bond financed property if the lease had not been reasonably expected at the time that the bonds were issued, evidently taking into account that a later, unexpected public-private partnership for the facilities had little or nothing to do with the original bond issuance. If the circumstances of the later public-private partnership transaction did not indicate that the transaction was a mechanism to pass on the benefits of tax-exempt financing to a nongovernmental person, the transaction was permitted by the IRS.

Beginning in the mid-1990s, however, the IRS began issuing rules that required continuing compliance with the limitations on the use of the facilities throughout the term of an issuer's tax-exempt bonds. Given that tax-exempt bonds often have final maturity dates of 30 years or more, this created a very significant restriction on the ability of local governments that ran into unexpected financial or other difficulties or sought to realize other benefits from bringing in private partners to operate the systems on a long-term basis. As the new IRS restrictions evolved, the rules effectively required that in the event of any non-compliance with the use restrictions while the related tax-exempt bonds are outstanding those bond must be "remediated." In the context of a governmental entity that wants to lease its water or wastewater system to a nongovernmental person, remediation as imposed by the IRS involves the onerous requirement that the governmental person "defease" the related tax-exempt bonds with the effective penalty I noted earlier. In the present environment of very low interest rates, this means that an issuer will have to buy securities with a significantly larger value than the remaining amounts due on outstanding tax-exempt bonds in order to meet the escrow requirements. Thus, for example, to remediate a private activity bond "violations" by defeasing $10 million of tax-exempt bonds to satisfy the IRS rules could necessitate that the issuer use $11 - $12 million or more to fund an escrow that, when invested, is sufficient to provide for all of the payment of the principal and interest on lower cost, tax-exempt bonds.

We believe that the IRS rules and interpretations of those rules in the context of utilizing solutions for water or wastewater systems that use private capital or operational expertise are punitive and should be eliminated. Moreover, much of the work to correct the problems entails simple IRS interpretation changes that are not mandated by the Internal Revenue Code provisions. These IRS rules create a significant economic barrier for local governments that seek to bring in a private partner to operate and/or finance their water and wastewater systems. Whether the public-private partnership is motivated by a governmental utility's economic situation or recognition of the benefits that an experienced private operator can bring, IRS rules should not hinder these transactions by imposing a significant monetary penalty on the governmental entity. In addition, we believe that these changes would have no effect on federal income tax proceeds. We urge that the rules and interpretations that penalize governmental entities for accessing private capital or expertise be repealed or altered.

Private Activity Bond Reform

The next tool water and wastewater systems need is greater access to private activity bonds (PABs) for all public-purpose drinking water and wastewater projects. H.R. 1802, the Sustainable Water Infrastructure Investment Act, would do just that by removing water projects from state volume caps for private activity bonds, spurring increased private investment in systems throughout the country. Some experts state that H.R. 1802 would generate at least $2 billion – translating into 60,000 jobs – in new investment each of the first few years and grow to several times that as the market opens up. And this is federal support for water infrastructure and jobs that is highly leveraged. That new investment of

billions of dollars per year costs, the last time this PAB proposal was scored by the Joint Tax Committee, well under $400 million over ten years.

H.R.1802 has nearly 60 cosponsors and I am delighted and grateful that 15 of those 60 serve on the Transportation and Infrastructure Committee. This legislation is bipartisan and bicameral and in fact passed the House twice in the last Congress as part of larger packages sent to the Senate. Most recently, the provisions of H.R. 1802 were incorporated into the Senate Finance Committee mark-up of the surface transportation bill. We are eager to see this legislation enacted this year, given the private investment it will spur and the jobs it will create. We very much appreciate the support it has received from members of this Committee and hope that you will continue your work to ensure it becomes law.

The Water Infrastructure Finance and Innovation Authority (WIFIA)

Finally, we commend the American Water Works Association (AWWA), along with the Water Environment Federation (WEF) and the Association of Metropolitan Water Agencies (AMSA), for their focus on lowering the cost of infrastructure investments and increasing the availability of lower-cost capital to utilities. These organizations' proposal to create a Water Infrastructure Finance and Innovation Authority – "WIFIA" – is a significant topic of today's hearing. NAWC generally supports their objectives and the principles of WIFIA, which would 1) offer loans, loan guarantees, and other credit support for large water infrastructure projects and those with national or regional importance; and 2) reduce the cost of leveraging for State Revolving Fund (SRF) programs by lending to them directly at Treasury bond rates. However, we believe the legislation should not set a minimum project size so large that only the biggest and most complex projects would qualify. Many smaller and medium-sized water utilities, especially in suburban and rural areas, could benefit from WIFIA-like loan programs outside of the SRF if they are eligible.

The WIFIA proposal itself has merit as far as it goes, but we believe it will do little to bring significantly *increased investment* into America's water infrastructure. By lowering the cost of capital to some large projects and SRFs it certainly will allow the amount of investment supported by utility revenues to increase, but to a large degree, we fear that WIFIA funding will substitute for municipal debt or SRF leveraging that would otherwise occur anyway. NAWC believes that WIFIA, or similar financing proposals such as an infrastructure bank, should explicitly encourage and facilitate investment by the private sector rather than passively allowing it. The Federal Highway Administration's "TIFIA" program after which WIFIA takes its name, for example, states on its website that *"[t]he program's fundamental goal is to leverage Federal funds by attracting substantial private and other non-Federal co-investment* in critical improvements to the nation's surface transportation system" (emphasis added) and that the "TIFIA credit program is designed to fill market gaps and leverage substantial private co-investment by providing supplemental and subordinate capital." We strongly encourage that the Subcommittee consider strengthening the WIFIA proposal by establishing similar program priorities.

State Revolving Fund Eligibility and WIFIA

This Subcommittee's consideration of the WIFIA proposal provides an opportunity to redress an unfortunate oversight in the Clean Water Act. Currently, private water utilities are not eligible to participate in the Clean Water SRF. Moreover, while the Safe Drinking Water Act gives states the option to make private water utilities eligible for the Drinking Water SRF, nearly half the states have not done so. The part of WIFIA that helps leverage SRF funds would provide little benefit to the millions of American taxpayers who are customers of NAWC member companies. NAWC and our member

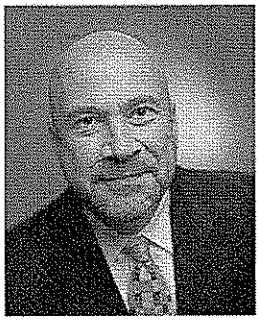
companies are proud to stand alongside our colleagues in the water industry promoting WIFIA as we strive to bring more capital investment into America's water infrastructure. I hope we can agree that the existing federal financing assistance programs, such as the State Revolving Funds, and any new federal programs such as WIFIA, should benefit all taxpayers, including those who are customers of private water companies.

Conclusion

I sincerely appreciate your invitation to appear before the Subcommittee today and, along with my many colleagues in the National Association of Water Companies, look forward to continuing our work with you to ensure that all Americans benefit from innovation in financing and delivering the water infrastructure that every day delivers to them their quality of life. Thank you and I would be happy to respond to any questions you may have.

BIOGRAPHY

AMERICAN WATER



Jeffry Sterba

President and Chief Executive Officer

Jeffry Sterba is president and chief executive officer (CEO) of American Water, the largest investor-owned U.S. water and wastewater utility company. Mr. Sterba brings more than 30 years of exceptional operational experience and a wealth of industry knowledge to American Water.

Mr. Sterba leads a team of more than 7,000 dedicated professionals who provide drinking water, wastewater and other related services to approximately 16 million people in 35 states and Ontario and Manitoba, Canada. He is responsible for developing the overall strategy and vision of American Water and directing its key business development initiatives.

Prior to joining American Water on August 16, 2010, Mr. Sterba served as Chairman and CEO of PNM Resources, Inc., the parent company of PNM, Texas-New Mexico Power Company (TNMP) and First Choice Power, from 2000 until March 2010, and was Non-Executive Chairman of PNM Resources from March 2010 until December 2011. After joining PNM in 1977, he held a succession of positions including Executive Vice President & Chief Operating Officer, Senior Vice President Bulk Power Services, Senior Vice President Asset Restructuring, Senior Vice President Retail Electric & Water Services and Vice President Revenue Management. From 1998 to 2000, Mr. Sterba was Executive Vice President of United States Enrichment Corporation (USEC), a global energy company headquartered in Maryland.

Mr. Sterba is a nationally recognized thought leader in the areas of energy policy, climate change legislation, renewable energy, and sustainability. He has served as chair of Edison Electric Institute, the national association of shareholder owned utilities, and chair of the Electric Power Research Institute, a non-profit center for energy and environment research. He serves on the board of directors of the Meridian Institute and is a member of the Business Environmental Leadership Council for the Pew Center on Global Climate Change. Mr. Sterba also previously served on the board of directors of the U.S. Chamber of Commerce, and is a recipient of the Keystone Leadership in Industry Award and numerous other national and local honors.

Mr. Sterba has been actively involved in community and economic development efforts. He served as a community board member for Wells Fargo of New Mexico, on the board of directors of the Albuquerque Community Foundation, and as a member of the Kirtland Partnership Committee. He has also chaired the Albuquerque Economic Forum, United Way of Central New Mexico, Greater Albuquerque Chamber of Commerce and the Middle Rio Grande Business Education Compact.

Mr. Sterba attended Washington University in St. Louis, earning a bachelor's degree and completing post-graduate work in economics, and was accepted as a PhD candidate at the University of Chicago. He resides in Philadelphia, and is married with two grown children.

More information can be found by visiting www.amwater.com.

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COMMITTEE ON TRANSPORTATION AND INFRASTRUCTURE

Truth in Testimony Disclosure

Pursuant to clause 2(g)(5) of House Rule XI, in the case of a witness appearing in a nongovernmental capacity, a written statement of proposed testimony shall include: (1) a curriculum vitae; and (2) a disclosure of the amount and source (by agency and program) of each Federal grant (or subgrant thereof) or contract (or subcontract thereof) received during the current fiscal year or either of the two previous fiscal years by the witness or by an entity represented by the witness. Such statements, with appropriate redaction to protect the privacy of the witness, shall be made publicly available in electronic form not later than one day after the witness appears.

(1) Name: Jeff Sterba

(2) Other than yourself, name of entity you are representing:
National Association of Water Companies

(3) Are you testifying on behalf of an entity other than a Government (federal, state, local) entity?

X **YES** **If yes, please provide the information requested below and attach your curriculum vitae.**

NO

(4) Please list the amount and source (by agency and program) of each Federal grant (or subgrant thereof) or contract (or subcontract thereof) received during the current fiscal year or either of the two previous fiscal years by you or by the entity you are representing:

See attached Exhibit A

Signature

2/22/12
Date

			EXHIBIT A
Prime Contracts of American Water			
AW Legal Entity	**Contract**	**Government Agency**	**Contract Value**
AWE	Utility Privatization Contract at Fort Sill, OK	Department of Army	$86,673,276.16
AWE	Utility Privatization Contract at Fort Rucker, AL	Department of Defense, Defense Logistics Agency	$45,837,234.08
AWE	Utility Privatization Contract at Fort Leavenworth, KS	Department of Defense, Defense Logistics Agency	$157,607,444.00
AWO&M	Utility Privatization Contract at Scott Air Force Base, IL	Department of Defense, Defense Logistics Agency	$68,808,911.43
AWO&M	Utility Privatization Contract at Fort A.P. Hill, VA	Department of Defense, Defense Logistics Agency	$138,275,932.46
AWO&M	Utility Privatization Contract at Fort Polk, LA	Department of Defense, Defense Logistics Agency	$359,808,788.94
AWO&M	Utility Privatization Contract at Fort Hood, TX	Department of Defense, Defense Logistics Agency	$353,848,700.55
AWO&M	Utility Privatization Contract at Fort Meade, MD	Department of Defense, Defense Logistics Agency	$655,988,093.00
AWO&M	Utility Privatization Contract at Fort Belvoir, VA	Department of Defense, Defense Logistics Agency	$289,884,743.75
AWO&M	Services Contract for Operations & Maintenance for Fort Hood Family Housing	Department of Defense, Defense Logistics Agency	$64,678.98
Subcontracts of American Water			
AW Legal Entity	**Contractor**	**Government Agency**	**Contract Value**
AWE	Carothers Construction, Inc.	US Army Corps of Engineers (USACE)	$283,487.00
AWE	Williams Electric Co., Inc.	US Army Corps of Engineers (USACE)	$2,265.00
AWE	Southeast Cherokee Construction, Inc.	US Army Corps of Engineers (USACE)	$49,121.00
AWE	Carters Contracting Services, Inc.	US Army Corps of Engineers (USACE)	$76,800.97
AWE	J&J Worldwide Services	US Army Engineering & Support Center	$26,328.00
AWE	Atlantic Marine Construction Company, Inc.	US Army Corps of Engineers (USACE)	$28,240.00
AWE	The Clement Group, LLC	US Army Corps of Engineers (USACE)	$41,878.21
AWE	J&J Maintenance Services	US Army Corps of Engineers (USACE)	$26,597.33
AWE	Hughes Construction, LLC	US Department of Defense	$12,479.37
AWE	Hughes Construction, LLC	US Department of Defense	$9,139.10
AWO&M	N/A	Army and Air Force Exchange Service	$200,805.37
AWO&M	QSS International, Inc.	Mission & Installation Contracting	$33,908.00
AWO&M	Kiewit Federal Group Inc.	US Army Corps of Engineers (USACE)	$190,146.00
AWO&M	Autumn Contracting, Inc.	US Army Command	$28,393.00
AWO&M	Divco, Inc.	Fort Belvoir Directorate of Public Works	$109,433.00
AWO&M	Divco, Inc.	Fort Belvoir Directorate of Public Works	$88,309.00
AWO&M	Divco, Inc.	Fort Belvoir Directorate of Public Works	$32,743.00
AWO&M	Biscayne Contractors, Inc.	US Army Corps of Engineers (USACE)	$23,664.00
AWO&M	N/A	United Service Organizations, Inc.(USO)	$281,016.88
AWO&M	Biscayne Contractors, Inc.	US Army Corps of Engineers (USACE)	$22,245.12
AWO&M	Biscayne Contractors, Inc.	US Army Corps of Engineers (USACE)	$20,134.00
AWO&M	Harnett County - Fort Bragg	Department of Defense, Defense Logistics Agency	$2,277,182.00