INTRODUCTION TO POLLUTION CONTROL FINANCING IN CALIFORNIA

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[INCLUDING NEW TREASURY REGULATIONS ON

SOLID WASTE DISPOSAL FACILITIES]

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I. Introduction - What is Pollution Control Financing?

A. General Introduction

Pollution Control Financing is a technique for using tax-exempt bonds or notes[1] issued by a state or local government entity to provide the funds for various capital costs for private businesses. This technique results in passing through to the private user the lower interest costs found in the "municipal" tax-exempt financial market. Any tax benefits of the capital investment remain with the private user, and from the user's standpoint its obligations are very similar to a commercial loan or an issuance of corporate debt.

Pollution control financing is not available, however, to every business or for every project. There are three major limitations, each of which must be successfully handled:

1. State law authorization -- Since PCRBs are issued by governmental agencies, they can only be used to the extent and following the procedures allowed by the laws of the state of use. California laws are generally pretty flexible, but there are limits and procedures which must be followed.

2. Federal tax laws -- PCRB financing "works" best if the interest on the bonds (as certified by an unqualified opinion of a recognized law firm of bond counsel) is excludable from gross income of bondholders for federal income tax purposes. The Internal Revenue Code, and implementing I.R.S. regulations and rulings, are very restrictive in what facilities can qualify for PCRBs.

3. Source of financing -- Even if a project is eligible for PCRBs under state and federal laws, there may not be any investors willing to buy the bonds. The bond market looks for very safe investments, and many projects are not suitable for this market unless they have strong, third-party guarantees. This is a matter unique to each company or project, which should be explored early.

The remainder of this paper will give an introduction to items (1) and (2) listed above, which are the province of bond counsel. Item (3) is the province of bankers -- investment and commercial -- and financial advisers. To give some background to the rest of the paper, I will describe in general terms the structure of a PCRB financing. This now assumes that all the hurdles listed above have been passed.

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[1] This paper will refer to such bonds or notes by the term "pollution control revenue bonds" or "PCRBs", although the Internal Revenue Code of 1986 uses other terms such as "private activity bond" and "qualified small issue bond."

B. Structure of a PCRB Financing

Legal Structure. In the typical PCRB structure, the governmental agency (the "Issuer") acts as a conduit, or intermediary, between the company or developer seeking financing (hereafter referred to as the "User") and the bondholders (the investors, or source of capital). The transaction is structured around two major legal documents. The first is a Trust Indenture or equivalent instrument which defines the terms of the bonds, provides for their issuance, payment and redemption, and which governs all of the flows of funds to and from the bondholders. The parties to the Indenture are the Issuer and a Trustee (normally a commercial bank). The Bond proceeds will be deposited by the Issuer into a Construction Fund held by the Trustee, and the User will draw down these funds as needed to pay for its project.

The second is a financing contract. Simultaneously with the issuance of the bonds, the Issuer and the User will enter into some sort of a financing contract. Most often this will be a loan agreement, but may also be an installment sale agreement or a "full-payout" lease. (For convenience, the financing contract will be referred to as a "Loan Agreement.") The Loan Agreement will cover, among other things, the following areas:

1. the loan of bond proceeds by the Issuer to the User;

2. an unconditional promise (without allowance for any offsets or defenses) by the User to repay the loan by making payments sufficient to pay the principal of, premium, if any, and interest on the Issuer's bonds, as they become due;

3. provisions to pay fees or costs of the Trustee and the Issuer, and to maintain any required reserves;

4. the promise of the User to build the project as planned and approved, and to maintain and use it;

5. any financial covenants, security agreements or other terms desired by the lender or underwriter to secure the bonds (the security may include a deed of trust, a guaranty, or other security arrangements outside the terms of the Loan Agreement itself); and

6. remedies on default.

At the bond closing, the Issuer will assign to the Trustee all of its rights and interest in the loan agreement and in any deed of trust or other security instruments. The User will make its loan repayments directly to the Trustee, which will remit them to the bondholders. In the event of a default, the Trustee will act on behalf of the bondholders to enforce all rights available under all of the financing documents. The Issuer's role is purely to act as a conduit to provide the tax exemption on the bonds, and after bond delivery, the Issuer will have virtually no involvement with the bonds, the project, or the User. Thus the bonds are limited, special

obligations of the Issuer, payable solely from the payments made by the User under the loan agreement, and from enforcement of any security interests or credit enhancements. Neither the Issuer nor any entity of government is required to make any payment on the bonds from any taxes, other revenues or other funds. The issuance of these bonds will not affect, or be affected by, the credit rating of the Issuer.

Financing Structure. Even assuming the User has a project which fits state law and federal tax law requirements (discussed further below), there will not be a successful bond issue unless the User and its financial advisers can develop a financing structure which is sufficiently attractive to investors. There are three main models or templates for structuring a PCRB:

(i) Balance Sheet – In this model, the User's overall financial resources – its general fund and balance sheet – are promised as the source of repayment of the bonds. If the User is a strong company, particularly if it has an investment grade rating from one of the major rating agencies, this structure would likely provide the most cost-effective borrowing. Depending on the strength of the User, no collateral security may have to be pledged, or it may be necessary to pledge the assets being financed with the WFRBs. Also, if the balance sheet is strong and the amount of debt is small compared to the User's overall debt profile, up to 100% of eligible project costs can be financed.

(ii) Letter of Credit -- If the User's balance sheet is not sufficiently strong or the User is not rated, it will be very difficult to obtain investors in the bond market, as they normally seek secure investments. In order to overcome this limitation, the User can seek to obtain a third party "credit enhancement" to make the bond issue marketable. This will typically be a letter of credit from a highly-rated bank, or (very infrequently) an insurance policy. With this arrangement, the investors need not look to the credit of the User; this is usually mandatory for smaller or start-up businesses. This structure is increasingly difficult to implement as, following the financial crisis of 2008-9 and new banking reserve regulations, bank letters of credit are much harder to obtain and costs are much higher than in prior years. Letters of credit are also used by financially strong but privately held Users which do not wish to disclose their financial information to investors[2]. All financial covenants and security provisions are negotiated between the User and the letter of credit bank, not with bondholders, so matters such as the need for collateral and the amount of equity which the User must supply will depend on the User's relationship with the bank.

(iii) Project financing -- If neither of the first two structures is feasible, a third model involves placing the project and its revenue stream into a separate, bankruptcy-remote entity and pledging the project assets and revenues as the sole security for the bonds. Such

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[2] Moreover, any financial information contained in bond documents or filed with the Issuer of the bonds will be a public record, available to competitors of the User.

bonds normally cannot be rated and trade with high interest rates. They can only be sold to large institutional investors (mainly mutual funds), to bypass the need for credit enhancement. Investors will typically require stringent financial controls and substantial equity investment. Such bonds can only be sold and resold to sophisticated investors.

C. Tax-exempt and Taxable PCRBs

In some instances, all or a part of a WFRB will not meet federal tax requirements for a tax-exempt financing. In that case, WFRBs can still be issued if there is a good financial reason.

A taxable PCRB would be structured in the same way as a tax-exempt issue (see (B) above), with a governmental issuer as a conduit. Despite the loss of the federal tax-exemption, which is the greatest incentive to use conduit bonds, there are still some potential benefits to using a taxable PCRB structure:

1. Properly structured, taxable PCRBs can be exempt from registration under the Securities Act of 1933. (This is most easily done with a bank letter of credit.)

2. Certain unique markets may exist specifically for taxable municipal bonds (e.g., banks wishing to have bonds eligible to secure public deposits).

3. Governmental agencies (including enforcement agencies) may be interested in sponsoring these programs, and can provide publicity, staff support and other assistance.

4. Financial experts familiar with tax-exempt PCRBs will be adept at transferring their techniques to the taxable market to create securities which resemble taxable commercial paper, only with a longer term, to provide an attractive product to a borrower. This model will require a letter of credit.

5. Theoretically, state tax exemption could provide some marginal interest rate advantage, but no market has yet developed to exploit this factor. California (unlike a few other states) provides no other tax incentives (such as property tax abatements) for taxable PCRBs.

6. In a situation where part of the project can be financed with tax-exempt bonds, and the User does not wish to use equity for the non-qualifying costs, a taxable bond issue can be sold alongside the tax-exempt issue, using the same documents and security structure, so that both sets of bonds are secured on a parity.

Generally speaking, unless it is part of an issue with tax-exempt bonds, taxable PCRBs will be harder to structure financially because, without the lower interest rate which naturally exists in the tax-exempt market, there is less incentive to a potential borrower to participate in such a program compared to its conventional sources of funding. Nonetheless, a

carefully structured taxable PCRB program may be attractive to smaller or medium-size businesses, especially if some subsidies are available, as with the small business programs of the California Pollution Control Financing Authority.

II. California State Laws Authorizing PCRB Financing.

A. The California Pollution Control Financing Authority Act.[3]

1. The Issuing Body

The California Pollution Control Financing Authority Act (the "Act") creates within California state government a public body called the California Pollution Control Financing Authority ("Authority"). The Authority is a public instrumentality and a political subdivision of the State of California. The Authority consists of three members: the Director of Finance, the State Treasurer and the State Controller. Their offices are located in Sacramento, California, with a staff headed by an Executive Director. Information and application forms can be obtained by calling (916) 654-5610 or by visiting the website of the California State Treasurer at www.treasurer.ca.gov and clicking on the heading for the Authority on the left side of the home page.

The Authority is authorized to:

a. Determine the location of projects financed pursuant to the Act;

b. Lend financial assistance to a User to construct, renovate, replace and lease projects;

c. Enter into contracts for the sale of any pollution control facilities;

d. Issue bonds, notes and other obligations; and

e. Fix fees and charges for pollution control facilities.

2. Eligibility for Financing.

The Act authorizes issuance of bonds to finance "projects" which help abate, eliminate, prevent, control or reduce any form of pollution of the earth, air or water, solid or liquid waste disposal, thermal or noise pollution or radiation contamination. Projects for solid waste disposal or resource recovery may include elements which provide for development of landfills, new refuse removal or transfer vehicles or equipment, transfer stations, resource recovery or energy conversion plants, source separation, or any solid or liquid waste disposal

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[3] California Health and Safety Code §§ 44500-44563.

facilities involved in resource recovery systems.[4] Projects also include treatment of hazardous wastes. Amendments to the Act signed in late 2009 have expanded the Authority's scope to include facilities for supply of clean water, including desalination plants.[5]

The Act allows use of bond proceeds to pay for virtually all costs incurred by the User for the project, including: land and any interests in property; buildings; fixtures; machinery, equipment, and furnishings; landscaping; all costs for architects, engineers, surveyors, attorneys, permits, and other incidental costs; and all costs of the financing and issuance of the bonds. An eligible project can be for construction of a new facility, expansion of an existing facility, rehabilitation or replacement of part or all of an existing facility or its equipment, or acquisition and installation of new equipment.

The Act can be used to accomplish either tax-exempt or taxable financings.

3. Procedures and Terms of Financing

The Act sets forth a few very simple steps to be followed in order to issue bonds. Authority policies have evolved to mandate some additional steps. A very brief summary of these steps follows. Typically, these steps can take 3-6 months to complete, but many transactions take a longer time because of the need to arrange workable financing.

a. Filing of application.

b. Initial approval of project by the Authority (initial or inducement resolution).

c. Meeting or meetings with Authority staff to review nature of project and requested form and time schedule for financing (may occur before (b)).

d. Authority's appointment of bond counsel and underwriters. The Authority usually concurs with recommendation from the user-applicant. The State Treasurer's Office has designated investment banking firms and law firms deemed qualified to work on CPCFA issues, and the professionals are normally taken from these lists.

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[4] "Solid or liquid waste disposal facilities" means any property or portion thereof, used for the collection, storage, treatment, utilization, processing, or final disposal of solid or liquid waste in resource recovery systems.

[5] Orrick has prepared a separate paper addressing requirements for financing of privately owned or operated water furnishing facilities, which can be obtained from any of the persons listed at the end of this paper or by contacting us at www.orrick.com.

e. Final approval of terms of bond issue by the Authority (final resolution), including receipt of private activity volume cap (see Part III (F) below), and, if applicable, small business assistance grant.

f. Marketing, sale and closing of bond issue.

The actual terms of the bonds (including business covenants and security arrangements) will be negotiated between the User and the underwriter or bond purchaser, subject to a few limits set by the Act. The maximum interest rate on bonds is not limited by the Act, but normally does not exceed 12% (interest can be at a fixed rate or at variable rates). Bonds can be sold at a discount (but not to exceed 3% for tax-exempt bonds), and the maximum term on the bonds is 50 years. The Act authorizes refunding of outstanding bonds. The Act allows the bonds to be sold at private (negotiated) sale.

CPCFA charges fees for issuance of its bonds. There is a nonrefundable application fee of 1/20th of 1 percent of the requested bond financing, not to exceed $5,000. At the time of issuance of the bonds, large businesses (generally those with 500 or more employees) will pay an administrative fee of 0.2 percent of the bonds issued, plus a Small Business Fee of up to 1 percent of the par amount. Small businesses (fewer than 500 employees) do not have to pay issuance fees. The fee schedule has some variations and may change from time to time, so interested parties should inquire from CPCFA about the latest schedule.

The "standard" financing structure for CPCFA bonds requires that the Bonds be rated in the "A" category or higher from one of the major rating agencies. This may be based on the borrower's own credit or (most typically) from third party credit enhancement, such as a bank letter of credit. CPCFA has procedures in place to issue bonds for "BBB" or lower rated bonds, or for unrated bonds, but these require individual discussion with CPCFA staff and will at a minimum involve high minimum denominations and sales limited to sophisticated investors.

4. Small Business Assistance Program

In an effort to assist small businesses in the State, the CPCFA has set aside some of its fees collected from large borrowers into a Small Business Assistance Fund ("SBAF"). Moneys in the SBAF are available to provide financial assistance to make PCRB financing accessible to small businesses. Eligibility is based on the same tests as for the federal Small Business Administration, or if the applicant has fewer than 500 employees. Financial assistance from the SBAF, normally not more than $250,000 for one transaction, will assist in payment of costs of issuance of bonds or payment of costs of credit enhancement. There is a sliding scale of assistance, such that maximum aid is given for smaller projects, and the assistance drops down to zero for financings in excess of $15 million. SBAF assistance can be utilized with both tax-exempt and taxable bonds or certain other financing programs.

B. Other State Issuing Agencies.

In addition to the CPCFA, there is another State financing authority which operates very similarly, but with jurisdiction over a slightly different category of projects for financing. The California Alternative Energy and Advanced Transportation Financing Authority is authorized to finance various projects involving production of energy from non-fossil fuel or nuclear sources, or energy conservation. PCRBs for solid waste disposal projects which use waste fuels (such as agricultural waste, municipal waste, waste tires, etc.) come under the scope of CAEATFA, although such projects also are financeable by CPCFA. From time to time the State Treasurer's Office may prefer to use one agency or the other for projects which come under both. CAEATFA is chaired by the State Treasurer and shares staff with CPCFA. Further information can be obtained by phoning (916) 654-5610.

Finally, there is a State agency called the California Infrastructure and Economic Development Bank which has broad power to act as a conduit issuer of tax-exempt bonds for private users. As a policy matter, however, CIEDB will not issue bonds for projects which are under the jurisdiction of another State financing authority. With recent amendments which have expanded the Authority's scope of eligible projects, there are not likely to be many environmentally-related private projects which cannot be financed by either CPCFA or CAEATFA.

C. Local Issuers.

Under California laws, certain local government agencies could also issue PCRBs, although this has been done only infrequently in the past (largely because CPCFA provides a known method and has an effective program). First, "charter cities" would have the power to issue PCRBs for facilities within the city, or serving its residents, based on the reservation of the power of charter cities to act on matters relevant to their municipal affairs, unless State law precludes such local action. A charter city would adopt an ordinance providing basic conditions and procedures for issuance of PCRBs (and often other types of economic development bonds). Individual projects would then be approved by resolution.

In addition, "joint powers authorities" (or "JPAs"), created under Government Code Sections 6500 et. seq. can issue certain PCRBs. Many communities already have created JPAs for operational or financing purposes. If not, any two government entities (including subordinate-types entities, such as a city and its redevelopment agency) may form a JPA by an agreement between them. Under the JPA law, the JPA can issue revenue bonds to finance solid waste disposal facilities, and lease or loan the proceeds to a private user.

In the case of both charter cities and JPAs, the structure of such a financing would be the same as described in Part I above, and the same tax law considerations apply (see Part III below). No other governmental approvals are needed except for volume cap (see Part III (F)). However, as will be described below, State policy is geared to have environmental projects financed through CPCFA, and volume cap may not be available to JPAs or charter cities.

III. Synopsis of Federal Tax Law Affecting PCRB Issuance.

A. Introduction

The financial incentive for use of pollution control bonds is the exclusion from gross income for federal income tax purposes of the interest on the bonds. (However, interest on pollution control bonds generally will be included in alternative minimum taxable income.) Therefore, as a practical matter, bonds must be issued in compliance with the Internal Revenue Code of 1986 ("Code") and its implementing regulations.

It is first helpful to understand the "structure" of Section 103 of the Code. Section 103(a) provides that interest on any obligations issued by or on behalf of any state or political subdivision is excluded from gross income. Section 103(b) limits this broad exemption by providing that interest on municipal bonds is taxable if the bonds are "private activity bonds." A private activity bond (or "PAB") can be generally described as any bond whose proceeds will be used by, and the debt service of which will be paid by, a private User. (Nearly all PCRBs are private activity bonds.) Finally, several sections of the Code describe certain PABs whose interest will be exempt from taxation, despite the general prohibition, if the bonds meet prescribed tests.

Section 142 lists a variety of "exempt facilities" which can be financed with exempt PABs, without any dollar limitation, such as residential rental housing, docks, wharves, airports and certain mass transportation facilities, sewage and solid waste disposal facilities, hazardous waste facilities and water furnishing facilities. Certain PCRBs are "exempt facility bonds."

The other category of exempt PABs is described in Section 144(a), and consists of bonds issued to provide for the acquisition of any land or depreciable property associated with a manufacturing facility, but subject to strict size limits of either $1 million or $10 million. Hence, these bonds are called "small issue bonds". While not limited to pollution control purposes, the "small issue" exemption can be used for PCRBs which fit that category's many limits. The remainder of this Part will describe in a summary and simplified manner the applicable federal tax regulations for both "exempt facility" PCRBs and "small issue" PCRBs.

B. Use of Proceeds Generally; Timing Requirements

To qualify as an exempt PCRB, "substantially all" (which is defined to mean 95%) of the proceeds of the bond issue must be used to acquire, improve, construct, or reconstruct land or depreciable property. The latter generally includes buildings, fixtures, machinery, and equipment, although the Code limits the ability to use bond proceeds for some specific types of depreciable property discussed below. Under the Treasury's regulations, the remaining 5% of bond proceeds can be used to provide for some non-qualified costs for the User (this is usually called the "insubstantial portion"). The Code further provides that costs of issuance of the bonds paid from bond proceeds cannot exceed 2% of the face amount of the

issue, and this 2% is charged against the 5% "bad money," so for practical purposes only 3% is available for non-qualifying costs. (Any costs of issuance above 2% must be paid by the User from its own funds or from an issue of federally taxable bonds.)

The most important consequence of this rule is that not more than 5% of bond proceeds can be used to <u>refinance</u> the cost of acquisition or construction of any capital facilities that were originally acquired by the User (or any "related person" of the User) prior to the initial steps in the bond transaction. Any refinancing is considered by the Internal Revenue Service as the provision of working capital to the User, which is not permitted. A procedure has been developed to provide a relatively clear test for what costs can be paid from the proceeds of bonds.

The procedure requires that the issuer of bonds adopt an "inducement resolution" stating its general approval of the project to be financed and indicating its then present intent to issue bonds at some future time. Once an inducement resolution has been adopted, the User can use bond proceeds to reimburse itself for all project costs paid or incurred after a date which is 60 days prior to the date of the inducement resolution (the "inducement date") but prior to bond issuance (together, of course, with all costs to be paid after bond issuance). On the contrary, costs for acquisition or construction of capital facilities paid or incurred prior to the inducement date cannot be paid from bond proceeds except to the extent of the 5% "insubstantial portion."

There are two additional timing rules governing "inducement resolutions." First, certain "preliminary costs", such as design, engineering, permitting, soil samples, etc. can be financed or refinanced from bond proceeds regardless of when they were first paid, provided such preliminary costs cannot exceed 20% of the bond issue. Land acquisition, or any site preparation or construction cannot count as a "preliminary cost." Second, in order to qualify as good costs, reimbursements of "hard costs" made after the inducement date (i.e., other than preliminary costs) must occur not later than the earlier of (i) 18 months after the project has been placed in service or abandoned, or (ii) 3 years after the expenditure has been made. This latter rule requires diligence from project developers if they must incur some hard costs (i.e. land acquisition) from internal funds early in the process, but permitting or other delays may prevent bonds from being issued for some time.

There can be some difficult legal questions regarding whether costs have or have not been "paid or incurred" as of a particular date. It is therefore highly desirable for the User as much as possible to avoid ordering, contracting for or acquiring land, equipment or materials, or causing physical construction work to be done, more than 60 days prior to the adoption of an inducement resolution by the issuer. Failure to comply with this "timing rule" is one of the most frequent causes of disqualification of substantial project costs from being financed with tax-exempt bonds.

C. Exempt Facility PCRBs

1. Solid Waste Facilities.

A PCRB will be tax-exempt if (assuming compliance with all the other rules stated in this Part III) at least 95% of the net proceeds of the issue are used to provide "sewage or solid waste disposal facilities." Since 1986, the vast bulk of PCRBs have been for solid waste disposal facilities. Treasury Regulations defining qualified solid waste disposal facilities have been in effect for decades, but contained a number of problematic provisions, particularly a requirement that in order to qualify as "solid waste," material had to have no value. This created significant obstacles to many recycling projects. After more than six years of review, and two different draft versions, in August 2011 the Treasury Department issued new regulations for PCRBs to finance solid waste disposal facilities. While the new Regulations will become effective in October 2011, any bond issue already outstanding on that date can elect to take advantage of the new regulations retroactively. The following will be a very brief summary of the new Regulations; for more information or application to a particular project, please contact one of the Orrick attorneys listed at the end of this paper.

"Solid waste" is generally defined as garbage, refuse and other solid material derived from any agricultural, commercial, consumer, governmental or industrial operation. Solid waste must be either "used material" or "residual material." Most importantly, there is no longer a requirement for solid waste to have no value. The Regulations specify certain materials which are categorically excluded from the definition of "solid waste," including "virgin material," dissolved solids in a liquid, certain precious metals, hazardous material (which can be financed under a separate PCRB "exempt facility" rule, described further in this memorandum), and radioactive material. Material is "solid" if it is a solid at ambient temperature and pressure.

"Used material" is a product of any agricultural, commercial, consumer, governmental or industrial operation or activity, or a component of such product or activity, that has been used previously, including animal wastes. "Residual material" is any residual byproduct or excess raw material that results or remains from any agricultural, commercial, consumer, governmental or industrial production process or activity or from provision of any service. As of the issue date of bonds, the residual material must have a fair market value that is reasonably expected to be lower than the value of all the products made in the production process or lower than the value of the service that produces the residual material.

The Regulations provide that a "solid waste disposal facility" is a facility which fits in one of three categories: (i) it processes solid waste in a "qualified solid waste disposal process," (ii) it performs a "preliminary function," or (iii) it is a "functionally related and subordinate facility." A person who generates, purchases or otherwise acquires material which would fall within the definitions of "used material" or "residual material" must reasonably expect to introduce that material into a qualified solid waste process within a reasonable time after its production, acquisition or purchase. The Regulations do not specify what is a "reasonable time."

The Regulations designate three types of solid waste disposal processes: (i) a "final disposal process" (such as a landfill); (ii) an "energy conversion process," (such as a waste-to-energy plant); or (iii) a "recycling process." As with existing regulations, an energy conversion or recycling process ends when a useful, saleable product is created.

A solid waste disposal facility may also be financed if it performs a preliminary function to a solid waste disposal process, such as collection, storage or sorting of waste material prior to its placement into a material recovery facility, landfill, waste-to-energy facility, digester or other recycling facility. Components also qualify if they are functionally related or subordinate to the main solid waste disposal facility, such as pollution controls, electricity connections, offices, etc.

As with current regulations, there are rules dealing with dual use or mixed use facilities (such as a waste-to-energy plant which burns solid waste and also produces electricity) or facilities which process both solid waste and other material (such as a paper making facility which uses both waste paper and virgin fiber). The Regulations permit cost allocation in such situations between the portion which can be financed with tax-exempt PCRBs and other sources of funds. As with current regulations, for a recycling facility with mixed inputs, so long as at least 65% by weight or volume of the material going into the facility qualifies as solid waste, the whole facility can be financed with PCRBs. The new Regulations have helpful rules which clarify that the test does not have to be met until the plant "ramps up" to substantially its intended design level, and they provide a three-year averaging test to take account of unexpected circumstances out of the control of the plant operator which may temporarily prevent meeting the 65% test, such as natural disaster, strikes, etc.

In general, the new Regulations continue the ability to finance with PCRBs all of the typical solid waste projects which the CPCFA has traditionally assisted, and will expand the ability to finance various kinds of recycling facilities which were hampered in the past by the "no value" test. As is usually the case with new regulations, there will be areas of ambiguity which will have to be worked out by tax counsel and perhaps with more guidance from the I.R.S., so it will be important for project developers to consult with tax counsel early in order to ensure that the proposed project fits within the new Regulations.

2. Sewage Facilities.

Privately owned or operated "sewage facilities" can qualify if 95% of the net proceeds are used to finance facilities for the "collection, storage, treatment, utilization, processing or final disposal of sewage." At the end of 1994, final Treasury regulations were issued defining the scope of the term "sewage facilities" and having the stated purpose to distinguish between water pollution control and sewage treatment. This is achieved by generally defining "sewage facilities" to include secondary treatment facilities reasonably expected to treat wastewater that is reasonably expected to have an average daily wasteland concentration of biological oxygen demand not exceeding a certain level considered by the Treasury to be a reasonable approximation of the upper limit of concentration for most publicly owned treatment

works. The general aim of the Treasury is to permit tax-exempt financing only to the extent that the privately owned or operated treatment facilities are in essence a substitution for the treatment of sewage normally undertaken by public agencies.

"Sewage facilities" is also generally defined to include (a) preliminary and primary treatment facilities that are used in connection with and prior to secondary treatment and (b) tertiary treatment facilities that are used in connection with and after secondary treatment. Septage collection and treatment property, such as tanks, leaching fields and other facilities for the collection, treatment and disposal of human waste, also generally qualify as sewage facilities. However, pretreatment facilities (which typically treat industrial wastewater prior to discharge into a public sewer system) do not qualify, even if such pretreatment is necessary to the performance of preliminary, primary, secondary or tertiary treatment.

3. Hazardous Waste Facilities.

As part of the Tax Reform Act of 1986, a new category of exempt facility PCRBs was authorized, to finance hazardous waste disposal facilities. In order to qualify, a facility must be licensed under applicable regulations of the federal Environmental Protection Agency as a hazardous waste facility under the Resource Conservation and Recovery Act. Secondly, a facility does not qualify if the wastes being treated were generated by the company which owns or operates the project; in other words only a project which treats "third party" generated hazardous waste will qualify. Finally, a qualified hazardous waste facility must operate to either incinerate or provide burial for the hazardous wastes. Recycling facilities apparently do not qualify.

Subject to these limits, PCRBs for hazardous waste facilities will be analyzed very similarly to those for solid waste facilities. Thus, by the nature of the material, it is extremely unlikely that "value" will be an issue for these projects. As noted in #2 above, new Regulations may be adopted defining "solid waste disposal facilities." These may have some impact on financing of hazardous waste facilities.

4. Other Facilities.

Prior to the Tax Reform Act of 1986, PCRBs were also authorized for "air or water pollution control facilities," which typically consisted of devices to clean pollutants out of a stream of air or water at an industrial plant, power plant, etc. (e.g., scrubbers, baghouses, effluent treatment facilities). Although this "exempt facility" exemption no longer applies, such air or water pollution control devices located at a small manufacturing facility can still be financed using the "small issue" exemption described in Part D below.

D. Small Issue PCRBs

As noted, so long as a project meets the state law definition of a PCRB (for instance, under the Authority's Act), the issuer may use the "small-issue" tax exemption, but this

is subject to much more complicated limits than "exempt facility" PCRBs described in part C. First of all, "small issue" bonds are permitted only if directly related to a manufacturing facility; fortunately, this will normally be the type of activity which needs PCRB financing. Another concern with this form of financing is that it has been subject to a "sunset" provision in the tax law, so that periodically the authority to issue "small issue" bonds has expired, only to be extended by the Congress. In the last few years this has become almost an annual event, so interested persons should be sure to check with counsel or an issuing agency to verify the current status of "small issue" bonds.

Section 144(a)(4) of the Code limits the size of an exempt small issue to $1 million, or, upon the making of an election by the Issuer, $10 million.[6] These two size limits are discussed below.

In either case, the applicable size limit is measured only with respect to the political jurisdiction where the facility being financed is to be located, which is either an incorporated municipality, or, if the facility is not located within an incorporated municipality, the unincorporated areas of the county. If the facility will be located within one-half mile of a city or county boundary line, however, the size limits will also take into account any "integrated" facilities located on the other side of the boundary. Finally, the size limits will be measured, within the relevant political jurisdiction, with respect to both the User whose facility will be financed with bonds and any "related person" of the User. For a corporation, "related person" may include (i) corporate parents, subsidiaries or companies under common control, and (ii) individuals or companies who are "related persons" of any individual who controls the corporation (e.g., majority shareholder). With respect to individuals, "related persons" may include both blood relatives and business partners. The full definition of "related person" is quite broad, and is beyond the scope of this summary.

1. $1 million limit - For a bond issue to qualify, the "aggregate face amount" of bonds cannot exceed $1 million. To calculate this amount, it is necessary to combine (i) the face amount of the bonds to be issued and (ii) the remaining outstanding principal amount of any prior exempt small issue bonds previously issued to finance facilities within the same political jurisdiction for the User or any of its "related persons." This provision essentially makes available at least $1 million in tax-exempt bonds to finance industrial facilities for any User in each city or county where that User has ongoing or new capital requirements, subject to the $40 million limit (discussed below).

2. $10 million limit - If a proper election is made prior to the issuance of bonds, the permissible "aggregate face amount" of bonds can be increased to $10 million.

For this type of bond, however, the $10 million limit applies to the sum of:

[6] Recall that, by contrast, there is no dollar limit on either the amount of an "exempt facility" PCRB, or the total cost of the facility, if only partly financed with bonds.

a. the face amount of the bonds to be issued;

b. the remaining principal amount of all prior small issue bonds (see $1 million limit above); and

c. all capital expenditures (A) made by the User or any "related person" for any facilities located within the political jurisdiction; (B) made by any other "principal user" of the facility being financed (such as a landlord or tenant); or (C) made by any person (whether or not a "principal user") to benefit the bond-financed facility. These capital expenditures are measured over a six-year period which begins three years before the bonds to be qualified are issued and ends three years after the date of issuance. (To avoid double-counting, the capital expenditures which will be paid or reimbursed by the bonds are excluded.)

As of January 1, 2007, the $10 million capital expenditure limit was raised to $20 million, although the maximum size of a small issue bond remains at $10 million. This will very likely make more financings feasible.

The $10 million small issue is truly limited to smaller projects; bonds will not be tax-exempt if the total capital expenditures of the User at a plant site, and elsewhere throughout the relevant political jurisdiction, including the bond issue, will exceed $10 million (soon to be $20 million) over the six-year period. A $10 million bond issue is also subject to the $40 million limit discussed in Part E below.

A great deal of attention obviously must be paid to determining exactly what expenditures the User has made or plans to make, and to determining who are the "principal users" whose expenditures have to be counted. (Generally, any private user of more than 10% of a bond-financed facility is a "principal user".) It is not the purpose of this brief summary to review the mass of detailed tax law on this subject, other than to note that the questions can be rather complex, and the rules generally turn out to be more restrictive than one first thinks. *A careful review of capital expenditures by qualified bond or tax counsel at an early stage in the financing is strongly recommended to determine whether the bond issue is feasible.*

It should also be noted that, because the capital expenditure limit carries three years past the date of bond issuance, it is possible for the User to exceed the limitation after bonds are issued. In such a case, the interest on the bonds becomes taxable, but only as of the date the capital expenditure limit was breached (not retroactively to the date of issuance). The bonds normally contain provisions for mandatory redemption in such an event.

E. Other Eligibility Limits

Unless noted, these rules apply to both "exempt facilities" and "small issue" PCRBs.

1. Useful Life. The weighted average life of the bond issue cannot exceed 120% of the weighted average estimated useful life of the assets being financed.

2. Prohibited Uses. Bonds are prohibited if:

   a. for "small issue" bonds, more than 25% of the proceeds are used for automobile sales or service, retail food or beverage facilities (which does not include grocery stores), or provision of recreation or entertainment, or

   b. for any bonds, any proceeds are used for commercial golf course, country club, massage parlor, tennis club, skating facility, racquet sports facility, hot tub or suntan facility, racetrack, airplane, sky box, health club, gambling facility or retail liquor store.

3. Combination of Projects. A single User cannot be the beneficiary of a "package" of several "small issue" PCRBs issued simultaneously to finance facilities at different locations, relying on a separate $10 million cap for each issue. Furthermore, a single project exceeding $10 million in cost cannot be divided into condominium units and financed with separate "small issue" PCRBs for several unrelated Users.

4. Public Approval. Before issuance of bonds, there must be a noticed public hearing, and some elected official or elected body responsible for the bond issue, and with jurisdiction over the project site, must give its approval. This process is commonly referred to as the "TEFRA hearing" after the title of the tax legislation which enacted it. The State Treasurer gives this approval for CPCFA projects.

5. Limit on Land Cost. Not more than 25% of net bond proceeds can be used to pay for land costs. If land costs exceed 25%, the User can contribute equity toward the cost of the land without violating the rule. Valuation can be a problem, since the law does not have any good faith rule. It will usually be safest to stay well within the actual 25% limit.

6. No Acquisition of Existing Facilities. PCRBs can only be used to acquire new facilities or equipment, with one exception. A used building (and its existing equipment) can be acquired with PCRBs if the User spends an amount equal to at least 15% of the amount of bond proceeds to be used to acquire the facility on rehabilitation expenditures within two years. Again, valuation can be a problem, as may be

determining what expenditures qualify as rehabilitation. Also, an equity contribution can pay for used property without violating the rule.

7. $40 million Overall Limit. No company can use or benefit from either a $1 million or $10 million "small-issue" PCRB if upon issuance the total outstanding amount of tax-exempt bonds of all kinds issued for the benefit of the company of any "related person" will exceed $40 million nationwide. This rule does not affect issuance of "exempt facility" bonds, such as for solid waste disposal, but "exempt facility" bonds are counted in measuring the $40 million. The rule is very complex, and requires a separate $40 million inquiry to be made for every principal user of a facility over a 3-year period after bond issuance or project completion.

8. Federal Guarantees. The Code prohibits any direct or indirect "federal guarantee" of a bond issue (including PCRBs). This cuts out use of federal deposit insurance to back up bonds, and also may cause problems if there are any federal agency users of an PCRB facility. Generally, investment of normal trustee funds in government obligations is permitted.

F. State Volume Limit

Federal tax law has imposed a limit on issuance of all Private Activity Bonds within each state. This annual "volume cap" limit includes exempt facilities, small issue bonds, single family and multifamily housing bonds, mortgage credit certificates and student loan bonds. As of January 1, 2012, the statewide annual cap is $95 per capita, with the dollar figure indexed for inflation, but only in $5 increments, so the cap does not rise in every year. Excluded from the cap are bonds for certain airport, dock and wharf or publicly-owned solid waste facilities, certain veterans housing bonds, bonds for 501(c)(3) hospitals or schools, and bonds which refund an outstanding private activity bond, subject to meeting certain tests.

The cap in California for 2012 is about $3.6 billion. Pursuant to State law, the state cap is controlled and distributed by a 3-member agency called the California Debt Limit Allocation Committee (CDLAC), consisting of the State Treasurer, as chairman, the State Controller and the Director of Finance. Any issuer desiring to sell a private activity bond (including CPCFA) must apply to CDLAC.

The demand for volume cap has changed dramatically in the past three years. Whereas demand had been greater than the available amount throughout most of the past decade, with the large bulk reserved for housing projects, the recent recession, particularly with the near collapse of housing construction and much tighter credit, greatly reduced the number of bond issues which came to market. This has resulted in large amounts of unused volume cap from 2008 through 2011. Federal law allows an issuer to "carry forward" unused volume cap for three years. In each of the past three years, CDLAC has granted a large amount of unused cap at the end of the year to CPCFA, to be carried forward for use in future years for designated purposes. As of the start of 2012, CPCFA had available more than $2.6 billion of volume cap from 2009,

2010 and 2011 for solid waste disposal ($1.229 billion), water furnishing facilities ($1.192 billion) and sewage projects ($263.7 million). Signs are that statewide private activity issuance will continue to be slow in 2012.

One consequence of these actions is that CDLAC is likely to resist volume cap requests from JPAs or cities for environmental projects which could be financed through CPCFA, as that agency now has received several years' worth of volume cap for these purposes.[7] CDLAC introduced new guidelines in 2000 which place first priority for exempt facility bonds on projects for small businesses which implement AB 939 goals. Second priority is for projects for larger businesses, but which are in response to environmental mandates such as AB 939. CPCFA has agreed to use the same guidelines in using its carryforward volume cap.

For more information, including application deadlines, contact CDLAC at 916-653-3255 or CPCFA. Both agencies also have websites with extensive program information on the State Treasurer's main website (www.treasurer.ca.gov)

G. Arbitrage

Section 148 of the Code and its implementing regulations limit the practice of "arbitrage," which is the investment of proceeds of a municipal bond in taxable obligations which produce a higher rate of return.

The primary rule in this area says that, regardless of any "temporary periods" or other rules which allow investments to be made at a yield higher than the bond yield, any arbitrage profit which is actually earned has to be rebated to the Treasury. There are exceptions to this rule if all bond proceeds are spent on the project within either six or eighteen months. Generally, rebate of earnings above the bond yield can be used to comply with any "yield restriction" requirements which might apply. The rebates are due every five years, and 60 days after final maturity or payment of the bonds.

The implementation of the arbitrage rebate rules is quite complex. Orrick, Herrington has a subsidiary company, BondLogistix, with personnel nationwide, which has extensive experience in making rebate calculations and providing other financial services, such as investment management. For further information, contact Craig Underwood at 213-612-2463.

H. Factors Affecting Demand for PCRBs

The Code has a number of other provisions which affect the behavior of investors, in some cases making WFRBs harder to sell or which require higher interest rates to offset these factors:

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[7] In earlier years, when volume cap demand tended to exceed supply, environmental bonds typically received a total allocation of only about $250 million annually.

1. Interest on almost all private activity bonds (including WFRBs) is includable as an item of tax preference for both corporate and individual alternative minimum tax ("AMT") calculations. This factor adds anywhere from 25 to 100 basis points (0.25% up to 1%) to the yield on such bonds, but generally the rates are still more attractive than taxable lending rates[8].

2. Bond interest will be treated as an offset to certain deductions for property and casualty insurance companies.

3. Commercial banks -- once voracious purchasers of PCRBs and other tax-exempt bonds – lost (following the Tax Reform Act of 1986) their ability to deduct 80% of the interest cost for carrying bonds in their portfolio. This change significantly increased the cost of owning bonds to banks, and very few of them have been willing to buy PCRBs at attractive rates since the Tax Reform Act passed. This has changed somewhat in the last few years, however, giving a potential new avenue for bond sales, particularly for smaller borrowers.

4. A somewhat different "demand" issue is a change in depreciation rules allowed to a company which uses a PCRB to finance depreciable property. The new law requires the property to be depreciated on a straight-line basis, over its "class life" rather than a shorter period which would otherwise apply. A provision in recent tax legislation provides even more rapid depreciation benefits for certain equipment acquired through December 31, 2011 (unless further extended). Some Users prefer to take the more rapid depreciation over the lower interest rates provided by tax-exempt private activity bonds.

I. Caveat

Readers should be mindful that this paper has provided only a brief summary of the major issue areas under Section 103; the full scope of the rules is more complex than has been suggested in this paper and the rules are subject at all times to changes arising from new statutes or revisions in Internal Revenue Service regulations or interpretations. Early consultation with bond counsel would be a good practice -- even before the filing of an application with an issuer -- to allow a full investigation of all relevant facts, and to provide appropriate advice on steps to avoid jeopardizing the tax-exempt financing.

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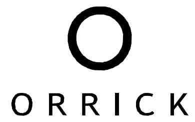
[8] Prior to 2009, it was generally thought that the impact of the "AMT surcharge" was relatively small (.25% to .50%). The federal American Recovery and Reinvestment Act of 2009 (the "stimulus bill") contained a provision suspending the inclusion of interest on private activity bonds issued between February 2009 and December 31, 2010 from the AMT, and this helped the market for private activity bonds in this period. After January 1, 2011, the AMT surcharge resumed, apparently at a higher spread than before ARRA. Interest rates generally, and the spread between tax-exempt and taxable rates at different levels of the yield curve, have been distorted in the period since the financial crisis of 2008, as compared to prior experience, so potential Users should investigate current rates with their financial advisers.



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