U.S. House of Representatives Committee on Appropriations
Subcommittee on Interior, Environment, and Related Agencies

"The Private Water Industry and Innovative Financing Approaches for Community Water Infrastructure Projects"

March 13, 2013

Testimony of Jeffry Sterba
President and Chief Executive Officer
American Water

for the

National Association of Water Companies

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Introduction

Chairman Simpson, Ranking Member Moran, and Members of the Subcommittee – good morning and thank you for the opportunity to be with you today. I am Jeff Sterba, President and CEO of American Water, the largest publicly traded U.S. water and wastewater utility company. We employ approximately 6,700 dedicated professionals who provide drinking water, wastewater and other related services to approximately 14 million people in more than 30 states, parts of Canada and 10 US military bases serving military families.

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. Our members are located throughout the nation and range in size from large companies like American Water that own, operate or partner with hundreds of systems 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.

NAWC applauds you, Mr. Chairman, and this Subcommittee, for highlighting America's water infrastructure challenges and helping identify some of the transformational solutions that will address them. I also want to relay a major "thank you" to the Congress on behalf of private water utility customers and individual investors for making permanent the capital gains and dividend tax rates. Keeping qualified dividends and capital gains taxes on par and at low rates is essential to the highly capital-intense regulated utility industry, as it relies heavily on dividend paying stocks for critical infrastructure investment for both new and old water systems to help meet the growing demands on the nation's aging infrastructure. For the private sector, access to lower cost capital leads to needed infrastructure investment, which, in turn, translates to jobs and other important economic benefits to the community, including those directly passed on to customers in the form of lower rates. Low dividend tax rates that are on par with the tax rates for capital gains benefit millions of Americans who own dividend-paying stocks, as well as businesses that pay dividends and the national economy. Investment in the water industry is good for everyone. So again, thank you.

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 – including in the popular press – is that the unseen infrastructure that truly promotes economic vitality, provides public health, and protects our environment is beginning to get the attention needed to highlight the increasingly difficult level of risk we will face if a different approach to investment is not taken.

Our Challenges Bring Opportunities

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. Last year I had the pleasure of appearing before the Subcommittee on Water Resources and Environment of the Transportation and Infrastructure Committee to testify on behalf of NAWC and I quoted a report that had just been released by the Johnson Foundation. The findings of this report, "Financing Sustainable Water Infrastructure", continue to resonate:

> "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."

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?" We are all here today to help answer these questions.

The Value of Water

Americans value clean, reliable water. For most Americans, access to clean drinking water is as effortless as turning on the tap. At a cost that is typically less than a penny per gallon, clean and safe drinking water is often taken for granted rather than being viewed as a critical resource. The network of pipes that makes it so easy for 300 million Americans to take our drinking water for granted spans 700,000 miles and is more than four times the length of the National Highway System. Some of these pipes originally intended to survive 50 to 75 years have been in service for more than 100 years – well beyond their useful life. These extensive and integrated water and wastewater systems that deliver such great value are at risk today.

What this country spends annually on bottled water really puts the value of tap water into perspective. Today, all customers in the United States pay about $29 billion annually to operate and maintain all of the tap water systems. In contrast, according to *The Big Thirst* by Charles Fishman, Americans spend about $21 billion a year on bottled water. That is, they spend almost as much on bottled water, for an amount of water that would meet less than eight hours of total water demand, as we do on operating and maintaining the systems that meet the other 8,752 hours in a

year. Think of what could be accomplished if we put that $21 billion into repairing and replacing the country's water infrastructure.

Water Infrastructure Today

Aging and deteriorating public water systems threaten economic vitality and public health, and communities nationwide are faced with massive fiscal challenges to replace critical water and wastewater infrastructure. Our aging infrastructure is a severe challenge for the water industry as evidenced by the 650 water main breaks every day and two trillion gallons of treated water lost every year at an estimated cost of $2.6 billion. And, the U.S. Environmental Protection Agency (EPA) and the Government Accountability Office (GAO) estimate the current water infrastructure funding gap to be as high as $1 trillion.

In addition to the EPA and GAO dire assessments, the American Society of Civil Engineers (ASCE) – in 2009 gave the U.S. water and wastewater infrastructure a "D minus," as part of its infrastructure report card. According to the ASCE, if left unchecked, these conditions could cost businesses $147 billion and cost households $59 billion. ASCE also notes that under a worst-case scenario, the U.S. could lose nearly 700,000 jobs by 2020.[1]

No discussion of infrastructure would be complete without mentioning Hurricane Sandy because it really speaks to the importance of building resiliency in our systems. Think about 85 mile per hour winds, 10 inches of rain, and a couple of feet of snow in some mountain areas which impacted American Water service areas in New Jersey, New York, Pennsylvania, Maryland, Virginia, and West Virginia. We serve about a total of 6 million people in those states. Through the execution of emergency planning, the use of over 200 generators due to the massive power losses, around-the-clock staffing and in-depth coordination with federal, state, and local agencies on both preparation and recovery, we had less than 2,000 customers that lost water service for any period of time. Moreover, we had only minimal damage sustained by our facilities and, most importantly, there were no employee injuries. It also demonstrated the value of new technologies we are deploying where we could locate our underground facilities even with four feet of sand, homes moved up to five or six blocks and piles of debris covering any semblance of typical landmarks. We were also able to use this technology to even help communities find roads that were not visible because of sand and debris. Sometimes such details are taken for granted, but to me it speaks volumes about our industry's focus on long-term planning and making the appropriate investment for our nation's communities. I would also like to give a special thanks to the dedicated men and women who worked tirelessly to rapidly repair critical infrastructure in order to restore services to the communities devastated by Hurricane Sandy.

Use of Private Capital

Before I talk about some specific recommendations to improve our nation's "Financial Toolbox", I want to touch on three other factors that already are helping and can continue to help the nation address our water challenges: 1) the substantial

[1] The full report is available at www.asce.org/failuretoact .

private capital already at work in water, 2) successful partnerships between the public and private sectors, and 3) the use of innovative technology.

In 2012, American Water alone invested $929 million in our community water and wastewater systems across the country and we expect to do about the same in 2013. NAWC estimates that its six largest members are collectively investing around $2 billion each year in their systems – and these six companies provide service to about six percent of the U.S. population. This is significant when one notes that the total federal appropriation for the clean water and drinking water state revolving fund (SRF) programs for last fiscal year was approximately $2.4 billion. While a number of other financing sources and programs are being used to invest in water and wastewater infrastructure, several groups estimate that there is a significant lag in total industry spending compared to what is actually needed.

Public Private Partnerships with Municipalities

We know that no sector, whether public or private, can solve the nation's water challenges on its own. I am here speaking for the private water industry which serves about 15% of the drinking and wastewater community directly and another 10% through existing partnerships with municipal and other public systems. We work closely with our partners on important legislation and regulations affecting the water and wastewater industry. We all share a strong interest in investing in our water infrastructure and serving our communities by providing reliable, clean and safe drinking water and efficient wastewater systems, and have unique dedicated professionals in our employ.

Incentivizing capital formation through public-private partnerships can be a critical tool in addressing the infrastructure challenge. Yet, due to the complicated nature of the analysis, structure, contractual negotiations, and oversight, public private partnerships (P3's) can be burdensome to municipalities. Moreover, it could be a significant diversion from their core services to the communities they serve. There are ways, however, to find efficiencies and reduce this burden. For example, I understand that Canada offers dedicated advisory assistance and professional services to municipalities at both the federal and provincial level. As a result, over the years Canada's P3 landscape has evolved considerably and is one of the more significant P3 geographies in both volume and capital size of transactions. The dedicated support of federal and provincial agencies has apparently developed a national source of expertise, producing for greater competition and lower costs for those entities in the public sector entering into forms of partnerships with private entities. It may be advantageous to consider a similar tool, whether public, private or non-profit, in the U.S.

NAWC's members interact with municipalities in three major ways: 1) we provide operating services; 2) we enter into long term lease or concession arrangements, and 3) sometimes we purchase municipal water systems. It is far more efficient to work together and we believe the financial tools that I will discuss in a moment will benefit us all.

Services Through Innovation

Leveraging technological innovation to obtain greater value for customers, cleaner water, more efficient operations and less waste is also key to the solution. Innovations in water technology are vital to the industry to meet the challenges we face today, including aging infrastructure, urbanization, resource shortages, the economic and financial crisis, emerging contaminants, the need for sustainable development, and demographic changes. Yet, according to *Global Water Intelligence*, it takes seven years for a new technology to enter the water market and there are many examples of where it took decades. We can do much better.

NAWC's members are active in the innovation space. In the case of American Water, we are working on a number of infrastructure-related money saving technologies. For example, we have just implemented a data collection system that will save money for both water service providers and our customers in two important ways. Specifically, it saves money on infrastructure investment and can save money for customers by identifying water leaks more quickly. In addition by identifying and fixing water leaks quickly we can begin to reduce the waste of this precious resource.

This first of a kind project was fully deployed in our 129 water districts in five months. This hosted solution, provided by Smart Earth Technologies (SET), collects usage readings and other data from smart water meters, as well as other devices in the system – for example, pressure gauges, acoustic leak detection monitors and water quality sensors. The platform is interoperable with all device manufacturers, thus it allows for American Water to select the best products at the lowest cost which saves significant capital through true competition and commoditization of materials. Currently the various meter vendors systems do not communicate. This is akin to an iPhone not being able to call a Blackberry.

This system will help American Water manage its assets through the analysis of real time data. For example, a continuous flow alarm at a homeowners meter can be flagged and the customer notified that they have a leak. Leaks in the distribution system can be identified and located before they surface. Water system pressure can be managed during fire flow events. The platform also uses an automatic business-to-business communication protocol that eliminates manual processing of data and saves field service representatives time.

The Financial Toolbox

Now let me turn to some of the opportunities for increasing the flow of private capital into water and wastewater infrastructure systems throughout the country, as well as some of the impediments we have the opportunity to remove.

Remove Tax Inefficiencies for Lease and Sale of Municipal Water Systems (Defeasance)

Current tax rules and regulations create significant impediments that have the practical effect of barring many municipalities from entering into cost saving and efficiency driven partnerships with private water companies for the operation of

municipal water supply and treatment facilities. Given the current state of the US economy, and that infrastructure planning is deferred to state and local governments, leaders are challenged to think in new ways to improve their financial flexibility to address other important city priorities and to ensure critical infrastructure investment in their water systems, and they look to the private sector for assistance. Municipalities sometimes make a determination that their water service can best be provided either by selling to or in a partnership with a private water company.[2] However, current IRS regulations impose a significant financial penalty on municipalities who sell or lease their water system to a private company if it was originally financed with tax-exempt debt.

Not surprisingly, most municipalities have issued bonds over the years that were used for the purchase, upgrade and/or maintenance of its water facilities. If a municipality that has these bonds outstanding chooses to engage in a public-private partnership for the provision of water services, it is subject to tax restrictions that can act as a complete barrier to entering into the partnership. The rules essentially require that the municipality either pay off the bonds or set aside funds (in a process known as defeasance) to pay off the bonds before entering into the public-private partnership. The expense associated with the current IRS defeasance requirement can be prohibitive to entering into a productive partnership. The funds required for defeasance could be 120 percent or more of the tax exempt debt being defeased, reducing the amount of funds that could otherwise be used to reduce rates for the customers or used to meet other municipal needs. This results in the IRS requiring an inefficient use of funds by the municipality, where these funds could be better used for productive purposes of improving the municipality's financial strength or the municipality's economic development initiatives.

Prior to the Tax Reform Act of 1986, the IRS tended to apply the tax exempt bond rules based on the bond issuer's expectations when it issued the bonds. After the 1986 Act, the IRS increasingly viewed compliance with all of the tax exempt bond rules as something that had to continue throughout the term of the bonds based on actual compliance/noncompliance rather than based on the issuer's expectations regarding compliance when it originally issued the bonds. It was as part of this effort that the IRS imposed the rules saying that "changes of use" of bond financed facilities, such as sales and leases, can cause the bonds to become taxable unless a remedial action is taken.

In order to allow for more efficient public-private partnerships to go forward NAWC seeks a narrowly tailored modification to IRS regulations on defeasance, which would stipulate that defeasance as it relates to the sale or lease of municipal water systems is not required where certain conditions or criteria are met that protect taxpayer interests while avoiding penalties to municipalities. We have asked the U.S. Department of Treasury to assist by revising the rules so that they would not function to deter municipalities from entering into partnerships in appropriate circumstances that provide economic and infrastructure efficiencies. We believe this can be done in a

[2] In the case where the municipality leases its system, the municipality still controls the provision of water services to its citizens through its role as the utility regulator that monitors the actions of the private water company and controls the rates the company may charge for its services. The local municipality usually also retains the ownership of the facilities while allowing the private company to use them under a long term lease arrangement.

manner that reasonably protects the tax policy concerns of the United States and with no loss of revenue to the Department of Treasury. This Subcommittee's support for these changes would be an important message to the Treasury Department that the changes needed are appropriate and should be undertaken.

Private Activity Bond Reform

One of the most effective financing tools of the federal government in helping provide financing for long-term, capital-intensive infrastructure projects is the private activity bond (PAB). PABs are a critical tool water and wastewater systems need and use for all public-purpose drinking water and wastewater projects: it makes infrastructure repair and construction more affordable for municipalities and ultimately for users or customers. The use of PABs spurs capital investment in public projects during a time when governmental budgets are tight; and investors prefer PABs because interest accrues tax-free. Greater access to PABs by removing state volume caps for PABs used for community water projects is an approach that makes much sense;

The Sustainable Water Infrastructure Investment Act (introduced in the 112th Congress as HR 1802/S 939, which received extraordinary bi-partisan Congressional support) would do just that: remove water projects from state volume caps for private activity bonds and thus spur increased private investment in systems throughout the country. This same legislation is slated to be introduced in both chambers in the 113th Congress by very strong bi-partisan sponsors who serve on the tax-writing committees. Further, dozens of business and other groups support the legislation from the Clean Water Council to the U.S. Chamber of Commerce to Operating Engineers and Laborers' Unions and the U.S. Conference of Mayors.

A number of experts have stated that this legislation 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. The Joint Tax Committee has scored this proposal to cost well under $400 million over 10 years – a small investment to make to generate the funds for much needed water infrastructure improvements.

H.R.1802 garnered 101 bipartisan co-sponsors covering the full political ideological spectrum because of the measure's undeniable merit. This legislation is bipartisan and bicameral and passed the House twice in the 111th Congress as part of larger packages sent to the Senate. In 2012 the provisions of S 939 were incorporated into the Senate Finance Committee mark-up of the surface transportation bill passing the committee by voice vote 17-6. We are eager to see this legislation reintroduced and enacted given the vitality it would bring to the economy.

State Revolving Funds and Eligibility

NAWC is a strong supporter of the State Revolving Fund (SRF) program and encourages the Subcommittee to continue its appropriations to this important tool. However, we strongly encourage this Subcommittee and Congress to fix 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. We believe that the Congress and the Environmental Protection Agency should encourage and incentivize them to do so. I hope we can agree that the existing federal financing assistance programs such as the State Revolving Funds 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 innovations in financing which improve the water infrastructure so essential to their quality of life. Thank you and I would be happy to respond to any questions you may have.