FISCAL NOTE

The North Carolina Federal Tax Reform Allocation Committee (the "TRAC") is proposing a permanent rule change with a non-substantial economic impact and an impact on local government funds as follows:

General Information

1) The title of the rule is "Procedures and Criteria for Allocation of Qualified Energy Conservation Bonds" and the citation is 04 NCAC 01H.0501. Note that there is currently a temporary rule in effect with this same title, which is nearly identical to the proposed permanent rule attached hereto. The temporary rule was preceded by an identical emergency rule, which took effect on July 15, 2011. In any event, the existing temporary rule expires on June 30, 2012, necessitating the need for the enactment of the attached permanent rule as soon as possible.

2) The rule-making agency is the TRAC, which is a three-person committee comprised by statute of (i) the Secretary of Commerce, (ii) the State Treasurer, and (iii) the State Budget Director. *See* N.C.G.S. § 143-433.7. However, the N.C. Department of Commerce provides staffing support for the TRAC, and communications to the TRAC can be addressed to:

   Mark Poole,
   Commerce Finance Center
   4301 Mail Service Center
   Raleigh, NC 27699-4301
   Phone: (919) 733-4151

   with a copy to:

   Tina Krasner,
   Special Deputy Attorney General
   North Carolina Department of Justice
   PO Box 629
   Raleigh, NC 27602
   Phone (919) 716-0141

3) Authority for the rule is G.S. 143-433.6(d); 143-433.8; 143-433.9(a); 150B-21.2.

4) Impact Summary:

State government:	Yes
Local government:	Yes
Substantial economic impact:	No

5) The rule does not directly govern or allow the dispersal or allocation of any State or Federal funds. Rather, the rule relates to allocation of bond capacity under which (i) the local government may itself issue the specific types of bonds for

public projects or (ii) other entities may issue bonds for certain types of non-governmental private activity.

6) See proposed rule text in Appendix.

7) This rule is not required by federal rules and North Carolina's receipt of this QECB allocation is not expressly contingent on these rules being adopted. However, federal rules do not prohibit North Carolina from re-allocating its QECB capacity to local government issuers within North Carolina. *See* 26 U.S.C.S. § 54D; IRS Notice 2009-29. North Carolina General Statutes provide that the TRAC is the appropriate entity to allocate QECB capacity and direct the TRAC to create procedures regarding such allocation. *See, e.g.,* N.C.G.S. § 143-433.8, § 143-433.9(a).

Summary of the Proposed Regulation

In 2008, the United States Congress authorized Qualified Energy Conservation Bonds (QECBs) to finance a wide range of energy conservation measures, including construction, and allowed a maximum nationwide volume cap of $800 million. In February of 2009, through the American Recovery and Reinvestment Act (the "ARRA"), Congress increased the cap to $3.2 billion, which was then to be allocated to each state based on population. The total allocation for North Carolina is $95,677,000 in QECB issuing authority. The TRAC has temporary rules in place that allow the TRAC to allocate QECB capacity to eligible issuers within the State so that North Carolina's QECB capacity can be fully utilized (*see* 4 NCAC 1H.0501); however, these rules are due to expire on June 30, 2012. Therefore, it is essential that the TRAC have permanent rules in place as soon as possible so that the TRAC can continue to allocate the QECB capacity without interruption.

Economic Analysis

The rule affects local governments by setting forth the criteria the TRAC will consider in awarding QECB capacity to eligible local government entities. The rule does not directly govern or allow the dispersal or allocation of any State or Federal funds. Rather, the rule relates to allocation of bond capacity under which (i) the local government may itself issue the specific types of bonds for public projects relating to energy conservation measures or (ii) other entities may issue bonds for certain types of non-governmental private activity relating to energy conservation measures.

The following analysis describes both the benefits and the costs of the QECB program.

Benefits:

QECBs are qualified tax credit bonds and they can be issued either as a true tax credit bond, in which the holder of the bond receives a tax credit rather than tax exempt interest, or as a direct credit bond, where the issuer of the bond pays the holder a higher interest rate that is not tax exempt and in return receives a payment from the federal government. Given current market conditions where holders may be carrying losses on their tax forms, a QECB issued as a direct credit bond is more likely to be sold. The reimbursement rate on QECBs is equal to the lesser of: (1) 70% of the qualified tax credit rate published by the U.S. Treasury (the "Tax Credit Rate")[1] on the date the unit receives a binding commitment to purchase the bonds or (2) the non-tax-exempt interest to be paid on the bond. According to our discussions with bond counsel who has worked at length with QECB issuances, the tax credit number used for QECBs in North Carolina almost always ends up being the Tax Credit Rate applicable to the bond (since the actual interest paid is almost always higher than the Tax Credit Rate shown on the U.S. Treasury's qualified tax credit rate page). Thus, this fiscal note assumes that tax credit for a QECB is equal to 70% of the Tax Credit Rate.

To clearly identify what the impact of this rule is, it is important to understand how a QECB works. Suppose the TRAC allocates $1,000,000 in QECB capacity to a local government to be used in the issuance of bonds to finance the modification of a public building to make it more energy-efficient. In this case, the local government would have to pay the bond holder a non-tax-exempt interest rate on the bond, and receive a tax credit from the federal government in the amount of 70% of the applicable Tax Credit Rate for the $1,000,000 bond. Depending on the credit rating of the issuer, and assuming a 20 year maturity on the bond, the non-tax-exempt interest rate could be about 4.75% (generally it varies depending on credit rating between 4.28% and 5.17%[2]). So the issuer would pay $47,500 in interest to the bondholder. If the Tax Credit Rate were 5%, and the tax credit for 70% of that interest was obtained, then the reimbursement the issuer would receive from the federal government on that $1,000,000 bond would be $35,000 ($1,000,000*5%*70%) in the first year of the life of the bond. (Note: the Tax Credit Rate changes each day, and over the past 12 months, the applicable Tax Credit Rate has reached a high of 5.59% and a low of 4.24%.[3]) Based on this hypothetical example, the issuer would have essentially paid only $12,500 in interest in the first year.

The impact of the proposed rule is not, however, the difference between what the local governments would pay the bondholders and what they receive as credit from the federal government. It is important to note that these bonds would likely be issued as simple tax-exempt bonds if the QECB tax credit allocation were unavailable. In other words, in the absence of the QECB, the local governments would have to pay the bondholders interest on the bond, which would be tax-exempt. When interest on bonds is

---

[1] The tax credit rate is published on the U.S. Treasury's qualified tax credit rate page: https://www.treasurydirect.gov/

[2] Based on general interest rate on a 20-year bond information received from the Department of State Treasurer, Local Government Commission staff.

[3] Source: U.S. Treasury Department, https://www.treasurydirect.gov/GA-SL/SLGS/selectQTCDate.htm.

tax-exempt, an issuer can obtain a lower interest rate on those bonds. Based on our conversations with staff at the State Treasurer's Local Government Commission, the tax-exempt interest rate that local governments pay on a 20-year bond can vary between 2.78% and 3.67% depending on the local government's credit rating. In the example above regarding a $1,000,000 bond, if the ordinary tax-exempt rate is assumed to be about 3.25%, the local government would pay $32,500 in interest in the first year of the bond. Using the hypothetical $1,000,000 bond example from above, the savings local governments would incur from the proposed rule would be equal to $20,000, or the amount of interest local governments would have generally paid on the tax-exempt bond, $32,500, less the net interest paid on a QECB, $12,500.

To project the volume of QECBs that may be issued in the future, it is instructive to examine the TRAC's historical data. The emergency/temporary rules governing QECB allocation have been in place since July 15, 2011, but only $5,600,000 has been allocated as a result of applications to the TRAC from eligible issuers. (Note that under the existing emergency/temporary rules, the TRAC has additionally allocated $62,643,170 in non-discretionary allocations to Large Local Governments as expressly required by federal regulations. This allocation to Large Local Governments is a one-time allocation that will not happen in the future.) At this time, only $27,433,830 in QECB capacity remains available for allocation under the proposed rule (out of the original $95,677,000), but no additional requests for QECB capacity are pending.

In the six months that these rules have been in place, only three applications for QECB capacity have been brought before the TRAC. As referenced above, those applications and subsequent awards totaled $5,600,000 in capacity. The following assumptions are made in computing an estimates impact:

- the trend QECB capacity applications would continue over the next 12 months, so the TRAC would expect to receive approximately $11,200,000 in applications for bond capacity per fiscal year,
- local governments would receive a Tax Credit Rate ranging between 4.24% and 5.59% (as discussed above) on QECBs issued after receiving an award of capacity under the proposed permanent rules,
- the QECBs issued would have a 20-year maturity,
- the non-exempt interest rate local governments would pay on QECBs to bondholders would range between 4.28% and 5.17%, and
- the interest rate range on tax-exempt bonds that local governments would have issued in the absence of QECBs would have been 2.78% to 3.67%.

Based on these assumptions, the estimated savings to local governments from the proposed rule in the year following the bond's issuance would be approximately **$164,400** [= 11,200,000*(4.28% - 70%*4.24%) - 11,200,000*2.78%] to **$270,300** [= 11,200,000*(5.17% - 70%*5.59%) - 11,200,000*3.67%].

Costs:

Given the relatively small level of bond allocation issued for QECBs, bond counsel has informed us that QECBs are almost always issued through private placement with a financial institution (e.g., a bank), rather than as a full-blown public offering. According to bond counsel, costs for private placement are generally between $10,000 and $15,000. As stated above, however, if these bonds were not issued as QECBs, they would likely be issued as more traditional tax exempt bonds, which would entail nearly identical costs. Given that the cost to a QECB issuer does not exceed the cost to a tax exempt bond issuer, this cost can be largely ignored.

Staff time needed to set up the program under the existing emergency and temporary rules was initially significant. However, it is anticipated that continued administration of the existing program under the proposed permanent rule will be much less demanding. As stated above, the North Carolina Department of Commerce provides staffing support to the TRAC, primarily consisting of part-time work by three employees. From time-to-time, the TRAC may also request limited input from employees of the State Energy Office regarding an analysis of data relating to the environmental impact of a proposed project. The TRAC may also seek legal advice from other state employees. Additionally, most QECB issuers must obtain prior approval from the North Carolina Local Government Commission, a division of the North Carolina State Treasurer's office. This QECB program will account for some minor portion of those employees' time as well in reviewing requests for approval to issue bond capacity. Based on our estimates and information provided by various state employees who would be spending time on the QECB program, it is assumed that approximately 6 total hours of state employees' time is spent per each application/award of QECB capacity. Assuming six awards of QECB capacity per year (as stated earlier in this document), total estimated time spent by state employees on this matter would be approximately 30 hours, which at an average hourly rate of about $27/hr, represents a negligible opportunity cost to the state of about $800 (one-time cost).

At this point, we do not have any information suggesting that any federal or state requirements for the QECB program will change in any way moving forward and this fiscal note assumes the program will remain the same.

Summary Table of Projected Costs and Benefits Due to Rule Change:

Impact	**Low Estimate**	**High Estimate**
Benefit to local governments in the first year after the bond is issued*	$164,400	$270,300
Cost to state government agencies	$800	$800

* Note: as the principal of the bond would decrease each year, so would the interest payments, so the impact in the following years is assumed to be declining.

APPENDIX

CHAPTER 01 - DEPARTMENTAL RULES

SUBCHAPTER 01H - PRIVATE ACTIVITY BOND VOLUME CAPACITY PROGRAM

SECTION .0500 - QUALIFIED ENERGY CONSERVATION BONDS

04 NCAC 01H .0501 PROCEDURES AND CRITERIA FOR ALLOCATION OF QUALIFIED ENERGY CONSERVATION BONDS

(a) The North Carolina Tax Reform Allocation Committee (the "Committee") shall allocate Qualified Energy Conservation Bond ("QECB") capacity to entities eligible to issue the bonds under 26 U.S.C.S. 54D as follows:

(1) To "large local governments," as the term is used in 26 U.S.C.S. 54D(e)(2) in the amounts and manner as directed by the United States Internal Revenue Service ("IRS") in 26 U.S.C.S. 54D and all relevant implementing notices provided by the IRS (including IRS Notice 2009-29), as modified, amended or supplemented. For purposes of calculating the populations of local governments to determine which constitutes a "large local government," the Committee shall use population estimates as of July 1, 2007, as directed by the IRS.

(2) To "Indian tribal governments," as the term is used in 26 U.S.C.S. 54D(h) in the amounts as directed by the IRS in 26 U.S.C.S. 54D and relevant implementing notices provided by the IRS (including IRS Notice 2009-29), as modified, amended or supplemented.

(b) Following the allocations described in Item(a) of this Rule, the Committee shall allocate the remaining QECB capacity to other issuers. The allocation shall be made by the Committee upon completed application by an issuer, and after consideration of the following factors:

(1) The ability of the State to ensure that at least 70 percent of the State's allocation is used for government projects, and no more than 30 percent for projects considered QECB private activity bonds under IRS rules, regulations and guidelines;

(2) The extent to which the project constitutes an eligible conservation purpose under 26 U.S.C.S. 54D and all relevant implementing notices provided by the IRS (including IRS Notice 2009-29), as may be modified, amended or supplemented;

(3) The extent to which the project demonstrates the potential to directly conserve energy;

(4) The extent to which the project supports the development or implementation of innovative energy conservation technology;

(5) The extent to which the project uses renewable resources to produce energy;

(6) The number of citizens benefiting from the project;

(7) The estimated number of jobs to be produced by the projects (for private activity allocations) and the amount of QECB authority per job produced;

(8) The readiness of the project to proceed;

(9) The certainty of the issuer using the allocation within the estimated timelines;

(10) The amount of other public and private funding leveraged by the QECB allocation;

(11) The amount of local community support for the project;

(12) The best interests of the State of North Carolina with regard to economic development, energy conservation, green initiatives and the general prosperity of the State;

(13) Whether the unit of local government is in competition with another state for project benefits such as jobs and tax base;

(14) Whether the availability of the allocation is a crucial part of attracting a new company or keeping an existing company in place;

(15) Whether the requested allocation will benefit a project for which an eligible issuer is already issuing QECBs;

(16) The ability of the unit of local government or company benefiting from the QECB to obtain financing and close the issue in a timely manner, including demonstration of a

commitment from a bank or other financial institution to purchase or underwrite the QECBs;

(17) The total amount of capacity available to the Committee for allocation in relation to the total number of pending requests for allocation;

(18) The tier status of the county in which the project is to be located, as defined in N.C.G.S. § 143B-437.08; and

(19) The geographic location of the project in light of the location of other projects benefitting from QECB capacity.

(c) If required by G.S. 159 or G.S. 160A-20, local governments shall coordinate issuance of QECBs with and through the North Carolina Local Government Commission (the "LGC") in the Office of the North Carolina State Treasurer and shall obtain approval from the LGC for QECB issuance.

(d) Entities allocated QECB capacity by the Committee and entities who issue QECBs shall ensure compliance with all federal and state laws, rules, regulations and requirements applicable to the allocation or issue.

(e) Entities receiving an allocation under Item (a) of this Rule ("large local governments" and "Indian tribal governments") may waive or reallocate to the State of North Carolina all or a portion of their allocation. Upon the State's receipt of any additional QECB capacity through any waiver or reallocation, the Committee shall allocate the capacity to eligible issuers in the manner described in Item (b) of this Rule.

(f) To ensure timely use of any QECB allocation, the Committee shall attach to an allocation of capacity made under subsection (b) of this Rule contingencies relating to a time deadline for issuance of the QECBs pursuant to the allocated capacity and contingencies limiting the use of the allocated QECB capacity for public or private activity bonds.

History Note: *Authority G.S. 143-433.6(d); 143-433.8; 143-433.9(a); 150B-21.1B; S.L. 2009-140; S.L. 2009-475;*
Emergency Adoption Eff. July 15, 2011.