Emerald People’s Utility District
POLICY

POST ISSUANCE ARBITRAGE COMPLIANCE POLICY MANUAL

COMPLIANCE OFFICER: Tiffany Collier, Chief Financial Officer 
Name/Title 
Signature 
Date

PURPOSE:

The purpose of this post-issuance compliance policy and procedure manual is to adopt policies and procedures to guide the Emerald People’s Utility District in meeting the requirements of the Internal Revenue Code of 1986, as amended, and Treasury Regulations (the “Tax Code”) concerning tax-exempt and tax-advantaged debt (“debt issuances”). Non-compliance with the Tax Code may result in fines and/or loss of the preferential status of the debt issuances.

COMPLIANCE OFFICER:

The Compliance Officer shall be the person primarily responsible for ensuring that the Emerald People’s Utility District successfully carries out its post-issuance compliance requirements under applicable provisions of the Tax Code with regard to all debt issuances of the Emerald People’s Utility District. The Compliance Officer shall be assisted by other Emerald People’s Utility District staff and officials when appropriate. The Compliance Officer will also be assisted in carrying out post-issuance compliance requirements by contracted entities including Bond Counsel, Financial Advisor, Paying Agent, Trustee, Arbitrage Consultant, and/or other consultants deemed necessary.

The Compliance Officer shall be responsible for assigning post-issuance compliance responsibilities to other Emerald People’s Utility District staff, Bond Counsel, the Financial Advisor, the Paying Agent, the Trustee and the Arbitrage Consultant. The Compliance Officer shall utilize such other professional service organizations as are necessary to ensure compliance with the post-issuance compliance requirements of the Emerald People’s Utility District.

I. GENERAL OVERVIEW OF ARBITRAGE, YIELD RESTRICTION AND REBATE REQUIREMENTS

A. Overview

The purpose of this section is to introduce the concept of arbitrage and its requirements. There are exceptions to many of the arbitrage rules. Advice from the Emerald People’s Utility District’s Arbitrage Consultant and/or Bond Counsel is strongly recommended before any action is taken.

B. Definition

Arbitrage is the price differential, or profit made, from investing inherently lower yielding debt issuance proceeds in higher yielding taxable investments. In other words, arbitrage is the difference between the yield on an issuer’s debt issuance and the investment income earned on the proceeds invested in taxable instruments. Arbitrage rebate refers to the positive or negative amount that must be paid (rebated) to the federal government.
<table>
<thead>
<tr>
<th>Debt Yield</th>
<th>Overall Investment Yield for Gross Proceeds</th>
<th>Result</th>
</tr>
</thead>
<tbody>
<tr>
<td>4.0%</td>
<td>5.0%</td>
<td>Positive Arbitrage</td>
</tr>
<tr>
<td>5.0%</td>
<td>5.0%</td>
<td>No Arbitrage</td>
</tr>
<tr>
<td>6.0%</td>
<td>5.0%</td>
<td>Negative Arbitrage</td>
</tr>
</tbody>
</table>

C. Areas of arbitrage compliance that must be addressed:

1. The arbitrage rebate requirements identify what must be done with any arbitrage (profits or earnings) above the debt issuance’s yield earned on the investment of the gross proceeds of the debt issuance. Arbitrage on gross proceeds must be rebated to the federal government every five years after the date of issuance (or earlier if elected) through and including the final maturity (“filing date”).

What is Arbitrage Rebate?

2. The yield restriction requirements set forth various investment yield limitation conditions for different categories of gross proceeds from a debt issuance (e.g. construction, refunding escrow, debt service, and reserve funds). The issuer should meet these various yield restriction conditions to avoid compromising the tax-exempt or tax-advantaged status of the debt issuance. Since the yield restriction requirements are specific to a debt issuance it is recommended that the Emerald People’s Utility District consult with the Arbitrage Consultant and/or Bond Counsel to determine the specific yield restriction requirements on a per debt issuance basis.
**Construction Fund Yield Restriction:** The most common yield restriction constraint for an issuer is related to construction funds. Generally, if there are unexpended project/construction proceeds at the end of the initial 3-year temporary period in excess of the **minor portion** (the lesser of $100,000 or 5% of the sale proceeds of the debt issuance), an issuer may no longer invest the remaining proceeds above the **materially higher yield** (debt issuance yield + .125%) without taking corrective actions to remedy interest earnings above the materially higher yield. The issuer must yield restrict the proceeds below the materially higher yield, or a yield reduction payment report will be required. Any yield reduction payment under the yield restriction requirements must be paid per the same deadlines as the arbitrage rebate requirements: every five years after the date of issuance (or earlier if elected) through and including the final maturity.

**What is Yield Restriction?**

![Diagram showing investment yield and bond yield](image)

**D. Purpose of the Tax Code regarding arbitrage:**

The Tax Code was put into place to minimize the benefits of investing tax-exempt or tax-advantaged debt proceeds, thus encouraging expenditures for the governmental purpose of the debt issuance and to remove the incentive to:

1. Issue debt earlier than needed,
2. Leave debt outstanding longer than necessary, and/or
3. Issue more debt than necessary for a governmental purpose.

**E. Type of debt issuances and funds subject to arbitrage compliance:**

1. The following types of debt issuances are subject to arbitrage compliance as of the following dates:
   
a. Single Family Debt Issuances 09/25/79  
b. Private Activity Debt Issuances 12/31/84
2. The following funds and proceeds of a debt issuance are defined as Gross Proceeds of a debt issuance:

- a. Project funds
- b. Debt service funds
- c. Costs of issuance funds
- d. Refunding escrow funds
- e. Reserve funds
- f. Disposition proceeds
- g. Replacement proceeds (other than debt service funds)
- h. Transferred proceeds (if an old debt issuance has been refunded by a new debt issuance and the old debt issuance has unspent funds, such funds may transfer to the new debt issuance)

**Note of Concern:** An often misunderstood concept is that monies received upon closing of a debt issuance are the only monies subject to arbitrage rebate. One of the most common funds found to be subject to arbitrage rebate that is not funded from debt issuance proceeds is the debt service fund. The debt service fund receives a majority of its funding from tax or use revenues. The debt service fund is required to be included in the arbitrage rebate calculation unless the fund balance is depleted at least once each bond year, except for a reasonable carryover amount not to exceed the greater of:

- a. The earnings on the fund for the immediate preceding bond year; or
- b. One-twelfth of the principal and interest payments on the Debt Issuance or the immediately preceding bond year.

**F. Exceptions to the rebate requirements:**

The Tax Code sets forth general arbitrage and rebate requirements for debt issuances. The general rule is that any arbitrage earned must be determined and reported to the federal government every fifth anniversary date after the date of issuance of the debt issuance and on the final maturity, or as elected. Arbitrage rebate is essentially 100% of investment earnings in excess of the debt issuance's yield. There are several exceptions to the arbitrage and rebate requirements, and if any one of these exceptions are met, all or a portion of the debt issuance's proceeds are not subject to the arbitrage and rebate requirements. Consult with the Emerald People's Utility District's Arbitrage Consultant and/or Bond Counsel to determine if the debt issuance is eligible for a particular exception, to establish the appropriate investment plan for the debt issuance proceeds, and to assess whether the exception requirements were met.

The purpose of this section is to introduce the concept of spending exceptions and their requirements. There may be special elections and circumstances for a debt issuance that can affect how the exceptions are tested. Advice from the Emerald People's Utility District's Arbitrage Consultant and/or Bond Counsel is strongly recommended before any action is taken. Below are descriptions of the various exceptions:

1. **6-month spending exception:** If all gross proceeds and actual interest earnings are spent within 6-months after issuance, the interest earned during that period is not subject to the
rebate requirements. Intermediate expenditure requirements are necessary (95% by 6 months and 100% within 12 months).

If there are unspent proceeds remaining at the end of the 6-month period, an issuer may still qualify for the spending exception under the following condition:

a. If the remaining amount is 5% or less and is spent within 6 months from the end of the 6-month spending date.

2. **18-month spending exception:** If a debt issuance does not qualify as a construction issuance (75% of the debt issuance actually spent on construction) then the debt issuance is eligible for the 18-month spending exception, but not the 2-year spending exception. If all gross proceeds and expected interest earnings for the 6-month and 12-month period and actual interest for the 18-month period is spent within 18-months according to a strict timetable, the interest earned during that period is not subject to the rebate requirements. Intermediate expenditure requirements are necessary (15% by 6 months, 60% by 12 months, 100% by 18 months).

If there are unspent proceeds remaining at the end of the 18-month period an issuer may still qualify for the spending exception under the following conditions:

a. A reasonable retainage amount of 5% or less is allowed for business purposes and the retainage is spent within 12 months from the end of the 18-month spending date, or;

b. If the remaining amount does not exceed the lessor of $250,000 or 3% of the issue price and due diligence is exercised to complete the project and spend the remaining project/construction proceeds.

3. **2-year spending exception:** If a debt issuance qualifies as a construction issuance (75% of the debt issuance is actually spent on construction) and all gross proceeds and expected interest earnings for the 6-month, 12-month, and 18-month period and actual interest for the 24-month period are spent within 2 years according to a strict timetable, then interest earned during that period is not subject to the rebate requirements. Intermediate expenditure requirements are necessary (10% by 6 months, 45% by 12 months, 75% by 18 months and 100% by 2-years).

If there are unspent project/construction proceeds remaining at the end of the 2-year period, an issuer may still qualify for the spending exception under the following conditions:

a. A reasonable retainage amount of 5% or less is allowed for business purposes and the retainage is spent within 12 months from the end of the 2-year spending date, or;

b. If the remaining amount does not exceed the lessor of $250,000 or 3% of the issue price and due diligence is exercised to complete the project and spend the remaining project/construction proceeds.
4. **Small issuer exception**: General taxing authorities reasonably expecting to issue $5M or less in tax-exempt or tax-advantaged debt during each calendar year (cumulative for all debt issuances) may qualify for the small issuer exception to the rebate requirements, but must still satisfy the yield restriction requirements. The small issuer exception does not apply to private activity, 501(c)(3) or student loan debt.

a. General requirements:

   i. The issuer must have general taxing powers.
   
   ii. The debt issuances must be governmental debt issuances.
   
   iii. At least 95% of the proceeds must be used for local governmental activities of the issuer or by governmental units located within the issuer's boundaries.
   
   iv. All tax-exempt or tax-advantaged debt issued in a calendar year cannot exceed $5,000,000.

b. Additional requirements for refunding debt issuances:

   i. The debt being refunded (old debt issuance) must have qualified for the small issuer exception.
   
   ii. The weighted average maturity of the refunding debt issuance (new debt issuance) must not exceed the weighted average maturity of the refunded debt (old debt issuance). Current refunding debt issuances that have a three year or less weighted average maturity are exempt from the weighted average maturity test.
   
   iii. The refunding debt (new debt issuance) must not mature more than thirty years after the issuance of the original refunded debt (old debt issuance).

   *Note* -- Historically 1/3 of refunding debt issuances (new debt issuances) will fail one of the three rules listed above and become subject to the rebate requirements.

c. Additional requirements for public school debt issuances:

   i. Public school debt issuances issued from 8/31/86 – 12/31/97
      $5 Million small issuer exception available
   
   ii. Public school debt issuances issued from 1/1/98 – 12/31/01
      $10 Million small issuer exception available: $5 Million can be used for any purpose; the amount that exceeds $5 Million must be for new public school construction.
   
   iii. Public school debt issuances issued from 1/1/02 – current
      $15 Million small issuer exception available: $5 Million can be used for any purpose; the amount that exceeds $5 Million must be for new public school construction.