

Recommendations on Clean Water State Revolving Fund Rule Amendments for Longer-Term Financing

Submitted to: Oregon Environmental Quality Commission

By: DEQ Clean Water State Revolving Fund Advisory Committee

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CWSRF Advisory Committee Report

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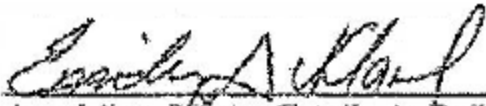
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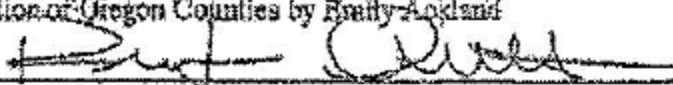
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Members are listed by their position with current employer, the organization they represent and employer location.

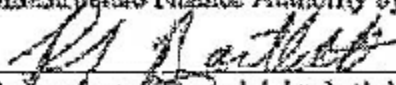
Concurrences



Association of Oregon Counties by Emily A. Clark



Infrastructure Finance Authority by Robert Ault



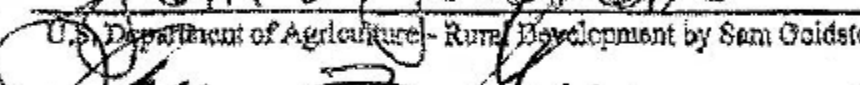
Economic and Financial Analysis by Raymond J. Bartlett



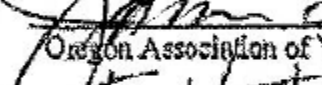
Oregon Department of Energy by Tom Elliott



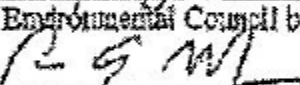
U.S. Department of Agriculture - Rural Development by Sam Goldstein



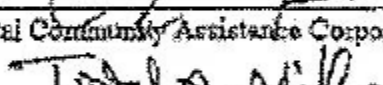
Oregon Association of Water Utilities by Jason Green



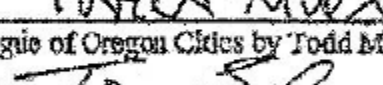
Oregon Environmental Council by Teresa Huntsinger



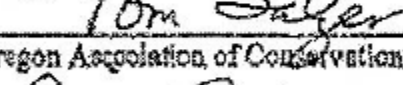
Rural Community Assistance Corporation by Chris Marko



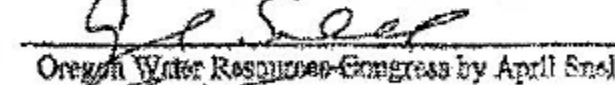
League of Oregon Cities by Todd Miller



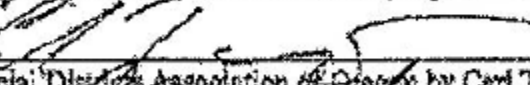
Oregon Association of Conservation Districts by Tom Salzer



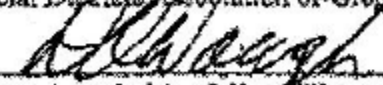
Oregon Water Resources Congress by April Snell



Special District Association of Oregon by Carl Teppert



Oregon Association of Clean Water Agencies by Doug Waugh



The Freshwater Trust by Joe Whitworth

Table of Contents

CWSRF Advisory Committee Members	iii
Concurrences.....	iv
Executive Summary	1
Background	3
Program Overview	3
CWSRF Advisory Committee	3
Longer-term Financing Rulemaking Issues	5
Recommendations	6
Eligibility	6
Interest Rates	7
Funding Allocation and Priorities.....	8
Impact of Recommendations on Program.....	9
Conclusion	10

Executive Summary

Oregon's Clean Water State Revolving Fund loan program provides low-cost loans to public agencies for funding of water quality pollution prevention and improvement projects including wastewater treatment facility construction and upgrades, stormwater controls, sewer improvements and replacement, irrigation improvements and stream restoration. Since 1990, these DEQ-administered loans have provided more than \$1 billion to 148 Oregon communities for water quality improvement projects. Low-interest rates and loan terms make this program an attractive alternative to borrowing from higher-interest bond markets.

DEQ updated the CWSRF Oregon Administrative Rules in 2012 with input from the CWSRF Advisory Committee. These rules made the CWSRF loan program more affordable to communities by reducing loan interest rates and annual fees and offering incentives for smaller- and lower-income applicants. During the 2012 rulemaking process, the committee identified a debt term up to 30 years as an option to assist future borrowers and make water quality improvements more affordable. Oregon administrative rules currently only allow use of the CWSRF for loans with terms up to 20 years. The federal Clean Water Act and state statute do, however, allow use of the fund for the purchase or refinance of debt obligations in the form of revenue bonds for terms up to 30 years. This option would especially benefit smaller and lower-income communities by spreading the debt repayment over a longer period of time, thereby decreasing the financial burden on residents if utilities are able to mitigate the need for large rate increases. The committee asked DEQ to pursue the longer-term financing option, including review of state statute and identifying how to proceed through the process for obtaining approval by the U.S. Environmental Protection Agency. EPA concurrence is necessary to allow longer-term financing in CWSRF programs.

This report to the Oregon Environmental Quality Commission reflects the CWSRF Advisory Committee's recommendations for implementation of longer-term financing. The committee recommends DEQ amend the CWSRF program rules to allow the longer-term financing option for up to 30 years. The committee did not recommend DEQ include an option of combining the traditional 20-year loan with longer-term financing. EPA has several requirements that DEQ must address to allow longer-term financing and the recommendations reflect these considerations. DEQ will consider this report's recommendations when updating the CWSRF program rules. The following summarizes the committee's recommendations for conditions associated with longer-term financing including: eligibility, interest rates and funding allocation and priorities.

Eligibility

- All new borrowers should be eligible for longer-term financing.
- Eligibility should be very limited for existing borrowers to refinance their loans. The most disadvantaged communities should be allowed to refinance as specified by economic status and loan characteristic criteria. Refinancing should be a one-time offer and available only for a finite period of time.

Interest rates

- Interest rate premiums should be added to current base rates to protect the CWSRF fund's perpetuity.
- Premiums should be added in a three-tiered structure based on borrowers' economic status, with the most disadvantaged communities paying the lowest rates and least disadvantaged paying the highest rates. These premium rates should apply to new and eligible existing borrowers, and range from 0 to 0.5 percent.

Funding allocation and priorities

- The amount of CWSRF funds allocated for longer-term financing should not be limited.
- Prioritization should not be considered in allocating the new financing option other than what is stated in current rules.
- Allocation and priority setting for incentives such as the green project and small community reserves and principal forgiveness should not change from current rules.

The committee engaged in facilitated discussions of program issues, specifically focusing on longer-term financing and financial aspects. The members represented their organizations while developing thoughtful solutions they believed were best for Oregon's CWSRF program and water quality protection.

Recommendations in this report reflect their expertise and shared vision for the program.

DEQ staff appreciates the members' time and effort in making these recommendations to the Oregon Environmental Quality Commission. Their efforts provide a reasonable, proactive approach to enhance Oregon's CWSRF program that will continue to benefit Oregon communities striving to protect water quality.

Background

Program Overview

The Oregon Department of Environmental Quality has administered Oregon's Clean Water State Revolving Fund loan program since 1989. The program is administered under Title VI, State Water Pollution Control Revolving Funds, of the Clean Water Act, and Oregon Revised Statute 468.423 to 468.440. DEQ operates the program under an agreement with the U.S. Environmental Protection Agency, Region 10. The CWSRF program provides low-interest loans to public agencies for the planning, design and construction of various projects that will prevent or mitigate water pollution. Eligible public agencies include federally recognized Indian tribal governments, cities, counties, sanitary districts, soil and water conservation districts, irrigation districts and various special districts, and certain intergovernmental entities.

The Oregon Environmental Quality Commission adopted Oregon Administrative Rules, Chapter 340, Division 54, in March 1989, that establish and prescribe how Oregon's CWSRF program is implemented, including loan and financial requirements. The program continues to evolve and address changing federal regulations, the changing economy and state water quality program priorities. Since 1990, DEQ has loaned more than \$1 billion to assist 148 Oregon communities for water quality improvement projects. This amount includes approximately \$400 million in federal capitalization grants DEQ has received from EPA. To date, 93 percent of funded projects address point source improvements such as wastewater treatment facility upgrades and 7 percent address nonpoint source projects such as stream restoration. DEQ recognizes external needs and the demand to obtain program funds and strives to maintain the program's financial integrity. DEQ administers and implements the CWSRF program to provide funding for projects that achieve water quality protection and restoration benefits while ensuring lending policy protects the program's financial integrity and perpetuity. DEQ last made extensive rule amendments to the program in 2012.

During the 2012 rulemaking process, the CWSRF advisory committee identified the option of offering longer-term financing that was more than 20 years as a way to help make water quality improvement projects more affordable for borrowers and requested DEQ to further examine this. DEQ followed up with the committee's recommendation and determined the CWSRF program administrative rules could be amended to address conditions for how the program will allow longer-term financing for up to 30 years. DEQ convened the committee and asked for their input to make recommendations for longer-term financing conditions including: the maximum allowable term, criteria defining eligibility, interest rates and funding allocation and priorities.

CWSRF Advisory Committee

The CWSRF Advisory Committee was established in 2011 to address program issues and provide input to DEQ for the 2012 rulemaking. After the committee last met in 2012, DEQ's director appointed a standing CWSRF Advisory Committee which included many of the same individuals as the previous committee and represent CWSRF interests from federal and state agencies, local governments, water and wastewater districts and utilities, watershed organizations, environmental advocacy groups, local conservation districts, and the financial sector. DEQ convened the committee for this rulemaking in early 2013 and met with the committee between June and September 2013 to obtain recommendations on how the CWSRF program should implement longer-term financing. Leah Feldon, manager for DEQ's Office of Compliance and Enforcement, facilitated the meetings.

The primary purpose of the advisory committee meetings was to make CWSRF program rule amendment recommendations for the longer-term financing option to DEQ. In developing these recommendations, the committee considered regulatory, administrative, financial, technical and policy program information.

Clean Water State Revolving Fund Advisory Committee Report

DEQ program staff presented background information to the committee on specific topics, including examples of how other state CWSRF programs have administered and implemented longer-term financing.

The committee members agreed to conduct themselves according to the CWSRF Advisory Committee Charter and Operating Principles adopted at the July 18, 2013 meeting. The Charter and Operating Principles documented the committee's purpose, structure, participation and responsibilities, as well as procedures by which the committee governed its discussions, deliberations and recommendations. The committee strived to make decisions by consensus, with the understanding that all members agree with the recommendation or decision. Committee members voted on recommendations for rule amendments that are included in this report. There were no significant minority opinions to express in this report. Committee meetings were open to the public and DEQ recorded detailed information on the committee's discussions in meeting summaries. DEQ staff kept committee and rulemaking information up to date on its CWSRF rulemaking web page.

This report to the Oregon Environmental Quality Commission is the CWSRF Advisory Committee's final product and reflects their recommendations on CWSRF program rule amendments. DEQ will consider this report's recommendations when amending the CWSRF program administrative rules.

Longer-term Financing Rulemaking Issues

DEQ updated Oregon's CWSRF administrative rules in 2012 with input from the CWSRF Advisory Committee. These rules made the CWSRF loan program more affordable to communities by reducing loan interest rates and annual fees and offering incentives for smaller- and lower-income applicants. During the 2012 rulemaking process, the committee identified a debt term up to 30 years as an option to assist future borrowers and make water quality improvements more affordable. The committee asked DEQ to pursue the longer-term financing option, including review of state statute and identifying how to proceed through the process for obtaining EPA approval. Oregon administrative rules currently limit the use of the CWSRF to loans with terms not to exceed 20 years after project completion. However, the federal Clean Water Act and state statute do allow use of the fund for the purchase or refinance of debt obligation for terms up to 30 years.

DEQ asked the committee to provide recommendations on issues associated with longer-term financing including: the maximum allowable term, criteria-defining eligibility, interest rates, and funding allocations and priorities. DEQ staff provided information to the committee about potential demand for and benefits of longer-term financing to existing and new borrowers, including:

- Characteristics of Oregon CWSRF borrowers and loans
- Oregon community demographics
- Impact of longer-term financing on community sewer rates for existing and potential new borrowers
- Other CWSRF state programs that have implemented longer-term financing

Committee members representing infrastructure funding agencies also provided information on their programs and how longer-term financing is administered. Based on the committee's discussion of different eligibility, interest rate and priority-setting criteria, DEQ presented modeling scenarios reflecting the impact of those criteria on the fund's perpetuity.

As the committee discussed these issues, several key themes emerged that informed the overall recommendations:

- Longer-term financing should focus on funding future projects rather than existing projects.
- Criteria and conditions should be simple and consistent with related current rules.
- Smaller and lower-income communities should benefit as much as possible.
- Conditions for longer-term financing should be desirable enough to communities to make it worth their potential extra effort and expense to issue a revenue bond for longer-term financing.
- Recommendations should achieve a balance between ensuring the CWSRF is used to its maximum potential without negatively affecting the fund's perpetuity.
- DEQ should evaluate how effective the amended rules are in meeting the objectives of these recommendations and adjust as needed in the future.

Recommendations

The federal Clean Water Act and state statute allow the use of the CWSRF for various purposes, including loans with terms not to exceed 20 years after project completion. Current administrative rules only allow use of the fund for loans up to 20 years. The federal Clean Water Act and state statute do allow use of the fund for the purchase or refinance of debt obligations in the form of revenue bonds for terms up to 30 years. The Advisory Committee recommended that rules should be amended to allow the CWSRF to be used for longer-term financing that cannot exceed the lesser of the useful life of the underlying asset or 30 years. Borrowers would have the option between the traditional 20 year loan and the longer-term financing without the option of a combination of the two types of financing. There were discussions about the process for selling a revenue bond and that it may require more effort and upfront costs to communities than is required for a traditional loan. The committee made recommendations on conditions for the new financing option with the intent of making the option as affordable as possible given potential extra upfront costs communities may incur. In general, the committee thought that for some communities, loan terms associated with shorter repayment periods present a hardship for ratepayers. They agreed that an option for longer-term financing would especially benefit smaller and lower-income communities by spreading the loan repayment over a longer period of time, thereby decreasing the financial burden on residents if utilities are able to mitigate the need for large rate increases.

Eligibility

The committee considered who should be eligible for longer-term financing and focused on existing borrowers and new borrowers. DEQ explained to the committee that EPA concurrence is necessary to allow longer-term financing in CWSRF programs. EPA's approval process could take longer if longer-term financing is made available to communities that are not considered “disadvantaged” by the state (“EPA Extended Term Financing Guidance, based on CWSRF Extended Financing Review Checklist, Oct. 18, 2006). The committee considered information on existing borrowers and all Oregon communities including community size, median household income, and debt burden. This information helped the committee gauge the characteristics of potential new and existing borrowers who might take advantage of the longer-term financing option. DEQ staff also presented information on eligibility criteria used by other states who have implemented longer-term financing.

Recommendation

The committee recommended the following eligibility criteria and conditions for new and existing borrowers:

- **New borrowers** - There should be no limiting criteria for new borrowers to be eligible for longer-term financing.
- **Existing borrowers** - Longer-term financing for existing borrowers should be allowed only to the most disadvantaged communities as specified by economic status and loan characteristic criteria. Refinancing should be a one-time offer with borrowers having to commit to the refinancing option within 90 days of rule adoption. Borrowers should have two years after their commitment to complete the process of selling DEQ a revenue bond. Existing borrowers that are eligible must meet all the following criteria:
 - Median household income less than 70 percent of the Oregon statewide median household income
 - Loan term remaining is 10 years or greater
 - Loan repayments are currently not in default
 - Loan does not include American Recovery and Reinvestment Act or principal forgiveness funding
 - Total term of the extended loan not to exceed the life of the asset or 30 years, whichever is less

Issues Addressed

The committee discussed the need to encourage more communities to use the Clean Water State Revolving Fund and believed that allowing another financing option for all new borrowers would encourage more use of the fund. There was concern that the amount of funds available through the CWSRF program could be jeopardized by many large communities taking advantage of longer-term financing and thus decreasing availability of program funds to smaller, lower income communities. The committee acknowledged that current rules do not allow all program funds to be committed to the larger communities, and thus leaving smaller communities at a disadvantage to pursue longer-term financing. The committee also noted that the program should encourage large communities to take advantage of the new option because one of the program goals is to make the CWSRF program more desirable as a funding option for everyone.

The committee also discussed which existing borrowers should be eligible for refinancing existing loans. In general, the committee believed that longer-term financing should only be available to future borrowers, although it thought a few existing borrowers in most need of financial assistance would benefit from this option. The committee considered the administrative burden and long-term financial impacts to DEQ's program if a large group of existing borrowers wanted to pursue this option. It believed it is important to assist communities experiencing economic hardship by offering this option to a certain number of borrowers at a level protective of the fund's long-term financial viability. Based on these considerations and the criteria established in the recommendation, potentially 14 borrowers comprising about 10.5 percent of the fund may be eligible for refinancing.

Interest Rates

CWSRF loan interest rates are calculated as a percentage of a base rate, which is based on the average national municipal bond rate as published by the Federal Reserve. Different interest rates apply to different types of loans and to loans of differing repayment periods, with smaller disadvantaged communities paying a smaller percent of the base rate. Rates are adjusted quarterly; however, once a loan is signed the interest rate is fixed for the life of the loan. Interest rates are significant in financing affordability and there are no provisions for longer-term financing interest rates in the current rules [OAR 340-054-0065(4)(e)]. EPA concurrence includes a provision that states must charge slightly higher interest rates to offset the longer repayment term in order to protect the perpetuity of the fund. DEQ asked for recommendations from the committee to determine interest premiums for new and existing debt obligations.

Recommendation

The committee wanted to ensure that disadvantaged borrowers would benefit from longer-term financing. It recommended providing lower interest rate premiums as an incentive to disadvantaged borrowers, and that new and eligible existing borrowers opting for longer-term financing pay interest rate premiums that should be added to current base rates established in the rules. These premiums should be established in a three-tiered structure based on the economic status of borrowers, with the most disadvantaged communities paying the lowest rates and least disadvantaged paying the highest rates:

- No interest premium - small communities with less than statewide median household income
- 0.25 percent premium - communities other than small communities with less than statewide median household income
- 0.5 percent premium - communities with equal to or more than statewide median household income

Issues Addressed

Key guiding principles for interest rate premium criteria were that the committee wanted to keep the rate structure and premiums simple to understand, affordable to communities, and benefitting the most disadvantaged borrower. The committee agreed that interest rate premiums should protect the fund's

perpetuity but also not deter borrowers from pursuing longer-term financing. The committee stressed that new borrowers need to understand even though interest rates will be higher, smaller incremental repayment amounts could decrease sewer bills and a borrower's financial burden. Affordability of monthly payments and less burdensome utility bills are important driving factors in community decision-making for water quality improvement projects.

Consensus was that a tiered interest rate structure should be established for new borrowers and that eligible existing borrowers should be able to refinance their loans using the same interest rate offered to new borrowers. Offering new rates to eligible existing borrowers might increase affordability of their projects, as in most cases interest rates will be less than their current loan rates. The committee discussed a two-tiered interest rate structure similar to what is currently in OAR 340-054-0065(4)(e) that provides small disadvantaged communities an interest rate less than all other borrowers. However, it decided a three-tiered rate structure that provides lower interest rate premiums to disadvantaged communities based on community size (small and large) would provide better financial assistance to disadvantaged communities. This structure assists the most disadvantaged borrowers by applying no premium to small communities with less than statewide median household income, a minimal premium amount to other communities with less than statewide median household income and a larger premium to all other communities. The committee decided a flat-rate premium (versus a percent of the base rate premium) was easy to implement and understand, and was most protective of the fund's long-term perpetuity.

Funding Allocation and Priorities

Oregon Administrative Rules 340-054-0036(1) require reserves, or set-asides, from available CWSRF funds for specific purposes including small community, planning and "green" projects. Federal regulations require states to allocate a certain amount of their annual capitalization grant to "green" projects and provide additional subsidization which is defined in OAR 340-054-0065(11). OAR 340-054-0036(2) requires funding increases to existing loans before funding new projects that are ready to proceed according to the project priority list. Currently there are no provisions allocating funds for a longer-term financing reserve or establishing priority funding for longer-term financing. DEQ asked the committee to make recommendations about the reserves and allocations, reallocation and current priorities for longer-term financing allocation.

Recommendation

The committee made the following recommendations:

- The amount of CWSRF funds allocated for longer-term financing should not be limited.
- Prioritization should not be considered in allocating the new financing option other than what is stated in current rules.
- Allocation and priority setting for incentives such as the green project and small community reserves and principal forgiveness should not change from current rules.

Issues Addressed

The committee discussed how it wanted the Clean Water State Revolving Fund to be used to its highest potential in a balanced manner. Modeling demonstrated that if all future borrowers pursued longer-term financing without limitations, the fund's perpetuity was still protected. The committee wanted to ensure longer-term financing would provide a financial benefit to smaller disadvantaged communities. There was concern that many large, higher-income communities would take advantage of longer-term financing and the fund availability would decrease to smaller, lower-income communities in the most need of financial assistance. The committee acknowledged that based on the current rules it is unlikely that funds available would all be allocated to larger, higher-income communities. The rules limit the amount of the total fund allocated to one borrower and also establish a small community reserve and project ranking criteria for small communities. DEQ awards principal forgiveness on a priority basis to small communities first.

Impact of Recommendations on Program

Offering longer-term financing to all new borrowers and a few eligible existing borrowers will make the Clean Water State Revolving Fund more attractive to borrowers thus potentially increasing the number of applications DEQ will receive for funding. DEQ may incur some additional staff time to administer the longer-term financing process, although the CWSRF program's revenue and expenses for administration should not be affected.

Reduced repayment amounts associated with longer-term financing and reduced interest rates in the case of refinancing will have an impact on the amount of program funds available in the future. To offset the impact of longer-term financing on the fund's perpetuity, premiums should be added to interest rates in effect at the time of signing a new debt agreement or refinancing an existing loan. The three-tiered interest rate structure will still make longer-term financing desirable to communities. Assuming all future borrowers opt for longer-term financing and potentially eligible existing borrowers refinance their existing loans, the projected percent difference in binding commitments over a 60-year modeled period represents only a 7 percent decrease. EPA has determined that 10 percent is the threshold to ensure perpetuity of the fund.

Conclusion

The committee thoroughly discussed the policy and financial aspects of longer-term financing and the impacts this would have on borrowers and DEQ's CWSRF program. The members reviewed and analyzed information DEQ presented to them. They respected different viewpoints and developed solutions that were best for the viability and perpetuity of the program. Members made thoughtful, meaningful and implementable recommendations to the Oregon Environmental Quality Commission. The recommendations in this report reflect their expertise and shared vision for the program.