

ENVIRONMENTAL PROTECTION AGENCY ENVIRONMENTAL FINANCIAL ADVISORY BOARD

APR 30 2002

Honorable Christine Todd Whitman
Administrator
U.S. Environmental Protection Agency
1200 Pennsylvania Avenue, NW
Washington, D.C. 20460

Dear Administrator Whitman:

The Environmental Financial Advisory Board (EFAB) is pleased to provide you with its report on a proposal to expand lending of the Clean Water State Revolving Fund (SRF) program for projects designed to prevent or reduce pollution from non-point sources. The Board wishes to clearly recognize the highly effective efforts of the Office of Water in opening up and realizing the potential of the SRF program in the support of non-point source control. Great progress has been made in this regard underscoring the flexibility of the revolving fund concept to the efficient financing of many environmental and public health projects.

The proposal outlined in the attached report builds on that broad foundation of progress already in place. The proposal envisions a cooperative arrangement between a Clean Water State Revolving Fund and a municipality where the latter borrows from the SRF and in turn passes the loan funds on, in a subsidiary lending arrangement, to a non-point source discharger to finance implementation of best management practices (BMP). Essentially, this is a conduit lending structure which could be adaptable to many communities, but would seem to have most application to municipalities faced with the prospects of stricter permit limitations, making the determination that it would be more cost-effective to use SRF loan funds to finance BMPs. The conduit lending arrangement would provide a means to fund these important non-point source control measures where financing is frequently a critical problem. This type of cooperative arrangement, imbedded in an implementation plan, could be directly targeted toward achieving total maximum daily load goals for a watershed. The report recommends that the Office of Water support and help facilitate a demonstration project with a SRF and municipality to implement this strategy. To our knowledge, conduit lending through a municipal government has not been undertaken with SRF loan funding; although it has worked using other governmental or quasi-governmental entities and that model could be expanded.

When the Board discussed this report, it generated considerable comment and suggestions from the members and expert witnesses. Other possibilities were suggested to


improve the original concept. Areas of interest included expanded use of nonprofits, credit enhancements, and the use of best management credits. Additionally, in a future report we would like to profile innovative state programs, such as Ohio's Water Resource Restoration Sponsor Program, as prototypes for reaching nontraditional SRF borrowers.

This report, then, is intended as the first product of an ongoing project. We earnestly hope you will find it informative and helpful and will pursue the Board's recommended action.


The Board wishes to express its appreciation to Jim Smith who is the principal author of the report. Jim is a nationally recognized authority on SRF lending and the development of new ways of using the programs to more efficiently and effectively finance water quality improvement projects. We also want to sincerely thank Rich Kuhlman, Kit Farber, and Jordon Dorfman who provided valuable advice and insight to this project.

We would like to suggest meeting with you to review this and other EFAB projects to discuss additional ways that we may be of assistance. In that regard, our goal is to increase the impact of EFAB as a resource to EPA.

Sincerely,



Robert O. Lenna
Chair, EFAB



A. Stanley Meiburg
Executive Director, EFAB

Attachment

cc: Tracy Mehan, III, Assistant Administrator, OW
Ben Grumbles, Deputy Assistant Administrator, OW
Diane Regas, Deputy Assistant Administrator, OW
Thomas Gibson, Associate Administrator, OPEI
Linda Combs, Chief Financial Officer
Mike Ryan, Deputy Chief Financial Officer
Joe Dillon, Comptroller

Environmental Financial Advisory Board

EFAB

Robert Lenna
Chair

A. Stanley Meiburg
Executive Director

Members

Hon. Pete Domenici
Terry Agriss
George Brewster
George Butcher
Michael Curley
Michael Deane
Michael Finnegan
Mary Francoeur
Hon. Vincent Girardy
Steve Grossman
Evan Henry
Anne Pendergrass Hill
Mary Kelly
Stephen Mahfood
Langdon Marsh
John McCarthy
George Raftelis
Arthur Ray
Andrew Sawyers
James Smith
Sonia Toledo
Jim Tozzi
Billy Turner
Mary Ellen Whitworth
John Wise

Expanding Lending for Non-Point Source Projects

FINAL

This report has not been reviewed for approval by the U.S. Environmental Protection Agency; and hence, the views and opinions expressed in the report do not necessarily represent those of the Agency or any other agencies in the Federal Government.

April 2002

Printed on Recycled Paper

EXPANDING LENDING FOR NON-POINT SOURCE PROJECTS

INTRODUCTION

Potential exists to greatly expand the application of the State Revolving Loan Fund (SRF) to non-point source water quality problems using municipal treatment systems as the borrowing conduit to reach the mainly private community of farmers, growers, developers and home owners. In a cooperative arrangement between an SRF and a municipality, the latter would borrow from the SRF and in turn pass the loan funds on, in a subsidiary lending arrangement, to the non-point source discharger to finance implementation of best management practices. Presumably, the state would lend to the municipality at a very favorable rate which in turn could be passed on to the non-point source borrower possibly even more heavily subsidized by the municipality.

While this conduit arrangement could be used in many circumstances, it will have more application for communities situated on so called "quality limited" waters where trade offs between point and non-point sources of discharge have the potential of alleviating regulatory pressure on the community to further limit its treated sewage discharge, saving the municipality millions of dollars in more advanced treatment facilities and operational costs. Cost savings are the main incentive enticing a municipality into becoming a conduit lender. As for the state, the incentives are several fold. First, it holds out the prospect of water quality benefits through controlled non-point source discharges. Second, lending through the municipality effectively insulates the SRF from credit exposure to the uncertain finances of many non-point source borrowers. And, just as important in many states, it provides a means of surmounting state constitutional and statutory limitations on lending state funds to private parties in as much as the SRF loan is to the municipality, not the private non-point source discharger.

BACKGROUND

In the area of water pollution control two phenomena are increasingly in evidence. One is the progressive implementation of the point source regulatory control strategy embodied in the Clean Water Act of 1972 which mandates increasingly rigorous control of permitted point source discharges in order to achieve or maintain ambient levels of quality in a specific water body. Under this strategy, waters determined to be in violation of designated quality standards must be subjected to pollution loading allocations that calculate the amount of pollution discharged from permitted sources and develop reallocations of discharge limitations which, mathematically at least, allow the specific water body to achieve the ambient standard. These calculations are referred to as maximum daily loadings and in the last few years have become the focus of multiple legal and administrative actions aimed either at enforcing the incremental regulatory strategy of the Clean Water Act, or disputing the efficacy of its application to certain waters.

Juxtaposed against this strategy of increased control of permitted point source discharges is growing evidence that rapid urbanization and changes in land use practices throughout the country are accelerating the level of pollution flowing into our streams, rivers and oceans from

unregulated and mainly uncontrolled non-point sources, contributing, in many cases, levels of pollution to certain waters that obviate the entire point source control strategy.

In other words, even in the presence of rigid control of point sources, the goal of achieving and maintaining water quality standards may not be attainable as a result of uncontrolled non-point discharges into the same waters. In such circumstances, under the present federal regulatory regime, the only alternative is to clamp-down even more rigorously on the permitted point source discharges which, because of the sheer quantity of discharge from municipal treatment plants, especially those located in urban areas, means the application of costly advanced treatment technologies to the municipal waste stream. Anticipation of the expected cost of this threat to the municipal treatment works is one of the factors contributing to recent efforts by the Association of Municipal Sewage Authorities, the National League of Cities, and other municipal based interests to focus attention on the growing cost of municipal compliance.

NON-POINT SOURCE LENDING

While the Clean Water Act is a point source control statute, the amendments in 1987, creating the SRF loan program, provide that water pollution control problems attributable to non-point sources can qualify for SRF assistance so long as they are identified and included in the state's non-point source management plan authorized under Section 319 of the Act or the National Estuary Program's Comprehensive Conservation and Management Plan referenced under Section 320 of the statute. The Environmental Protection Agency (EPA) has been quite latitudinal in its application of these provisions, providing eligibility to most projects that can be associated with abatement of either ground or surface water pollution or those designed to protect the water resource from deterioration. Examples include such things as manure storage and composting facilities, no-till farm equipment and water conserving irrigation machinery, wetlands restoration and protection, land mitigation banking, stream bank restoration, estuary protections, restoration of submerged aquatic vegetation, control of storm water run-off in unsewered areas, underground storage tank removal, failed septic systems and landfill improvements or closures.

Notwithstanding the above, many state SRFs are restrained from lending directly to non-point source borrowers. Mainly these are private, non governmental borrowers in states where constitutional or statutory provisions prohibit the state from providing direct financial assistance to private parties such as farmers, growers, businesses and homeowners. Still other states have self imposed limitations on the SRF from lending to other than point source discharges. Federal regulations, OMB policy and constraints imposed by Federal tax law on the use of funds from tax-exempt bond proceeds can also make it difficult for a state to lend directly to a private party. Although, it should be noted that SRFs can issue taxable debt not subject to most of these same constraints.

Perhaps more daunting for SRF managers are the different credit considerations that enter into the area of private lending. Basically, it is an area of commercial lending without the assurances of either a revenue stream from user fees or a source of taxes to pledge for

repayment. Many state loan programs have been reluctant to take on the potential credit exposure inherent in commercial banking. Those SRFs that finance non-point control measures often structure conduit lending arrangements through state or local governmental entities or commercial banking establishments which serve to insulate them from direct credit exposure. (see Council of Infrastructure Financing Authorities' Monograph No. 10 on "Credit Considerations for Reaching Nonpoint Source SRF Borrowers")

The SRFs, with EPA support and encouragement, have structured an impressive array of intermediary options designed to provide subsidized loans to private parties for non-point source projects. For example, SRFs in some states loan to other state agencies or authorities which in turn relend to individual property owners; to nongovernmental organizations (NGOs) that relend to individuals; directly to individuals; and to commercial banks that make loans to private parties, including individuals.

This latter approach, termed "linked deposit" involving a commercial banking entity, is probably the most comparable to the proposed municipal conduit lending arrangement. An SRF deposits funds in a commercial bank in exchange for a certificate of deposit at a significantly reduced rate which it would otherwise pay. The bank makes loans from the deposited funds to private parties for non-point source projects. The loans are at below market rates with the spread going to the bank. The bank performs the credit analysis, services the loan, and assumes the credit risk.

THE MUNICIPAL CONDUIT

What the Environmental Financial Advisory Board (EFAB) suggests here is not a strategy to further subsidize municipal treatment costs, but rather a means by which municipalities can access low cost financing of non-point source controls through the State Revolving Loan Fund, thus deferring, in certain areas, the time when advanced treatment technologies need to be employed. Comparable with linked deposit programs where commercial banks are making loans from deposited SRF proceeds, the municipality would serve as a conduit, borrowing from the SRF, and, in turn, lending the proceeds of the loan to a non-point source project. The attraction for the municipality in facilitating this arrangement is two-fold.

First, and most obviously, it allows the city, with the application of certain well selected non-point source controls, to claim an off-set to pollution loadings, relieving it at least in the immediate future, from needing to implement more stringent controls on its own discharges. It may be appropriate that non-point source control projects selected by the municipality for loan assistance receive advance approval by the state permit issuing authority.

Secondly, this could be accomplished with minimal cost to the municipal treatment authority. Assuming the SRF cooperates in making the funds available at an attractive rate (including zero interest) they would be working with essentially free money. In contrast to a linked deposit program where the spread between the cost of the SRF deposit and the interest charged on the loan goes to the commercial bank, no spread is necessary with municipal conduit lending, although the municipality may wish to generate sufficient funds to pay their

administrative costs. The same subsidy from the SRF loan to the municipality can be passed along to the borrower at more favorable terms than those provided by a linked deposit program.

A small loan origination fee or nominal interest might be charged to the borrower to cover the cost of administering and servicing the loan and developing the loan package. The largest consideration from the city would be exposure to uncertain credits from the non-point source borrowers and possible manpower resource costs in putting the loans together. Because non-point source projects can be difficult to implement, especially where multiple parties are involved, the physical design of the project and development of the loan package could be manpower intensive. On the other hand, the overall cost savings to the municipality of identifying and implementing environmentally strategic non-point source projects with potential to defer or eliminate the need to install additional major advanced treatment, could be tremendous.

In the lending arrangement, the municipality would, in effect, serve as the conduit to the private sector (non-point source) borrower. Borrowing directly from the SRF, the municipality would secure the loan with either a pledge of tax or user fee based revenues, thus insulating the SRF from serious credit exposure. As the direct borrower, the municipality would be responsible for loan repayment to the SRF and any associated reporting requirements including those of disclosure in the event that bond proceeds are involved in the loan. Consequently, the state lender would not be especially concerned with the financials of the ultimate borrower but would in all likelihood want to be assured that the project or projects selected for funding met certain environmental criteria determined capable of accomplishing quantifiable water quality results.

To our knowledge, this particular arrangement for reaching the non-point source through a municipal conduit loan has not yet been employed, but would seem to have attractive potential for some communities faced with prospects of increasing costs for control of non-point source discharges. Indeed, there is nothing we are aware of in the Title VI provisions of the Clean Water Act that would effectively prohibit a state loan fund from designating funds, probably through an advance lending pledge device, that could be drawn on by a municipality to incrementally loan to non-profit sources, thus alleviating some of the administrative work associated with approval of each individual loan by the SRF.

ISSUES

Several issues were raised in the development of this report.

- Can municipalities lend to private parties, particularly in States where SRFs are prohibited from doing the same thing? The extent of this as an issue will need further investigation, but in those states where such lending is not prohibited, EFAB believes that municipal conduit lending for non-point source projects holds considerable promise as a significant cost-cutting option to achieve water quality goals within a watershed.

- Can municipalities lend to private parties outside of their immediate political jurisdiction? Again, this is a state by state consideration and legal authorities vary. EFAB is aware of the use of the SRFs as a source of capital to state governments, quasi-governmental organizations, NGOs, and commercial banks for relending to private parties for non-point source projects. It is not aware of any SRF lending to municipalities for the purpose of relending to private parties outside of their political jurisdictions. The municipality might enlist the participation of the county or even a multi-county jurisdiction, if so limited. On this issue, the absence of comprehensive state by state survey information should not deter further evaluation of the merits of municipal conduit lending as an option.

- Would municipal employees have the requisite skills to perform credit analyses of prospective borrowers? While the answer to this involves a case-by-case determination, it seems likely that a municipality interested enough to serve as conduit and assume the risk of loan repayments to the SRF would ensure that it had available to it the necessary skills for the evaluation of loan applications. Technical assistance from outside sources, including SRF assistance and mentoring, provide other resources to the municipality. Other agencies with experience in credit analysis might prove helpful such as the Department of Agriculture's Rural Utility Service.

RECOMMENDATION

The Environmental Financial Advisory Board recommends that the Office of Water support the demonstration of municipal conduit lending for non-point source projects with one or more SRFs and selected municipalities. At the same time, these demonstrations will shed more light on the above issues and provide the empirical information to properly evaluate the concept and possibly other variations.



UNITED STATES ENVIRONMENTAL PROTECTION AGENCY
WASHINGTON, D.C. 20460

MAY 31 2002

OFFICE OF
WATER

Mr. A. Stanley Meiburg
Executive Director, EFAB
Environmental Protection Agency - Region IV
61 Forsyth Street, S.W.
Atlanta, GA 30303-8960

Dear Mr. Meiburg:

STAN

Thank you for your letter of April 30, 2002, to Administrator Christine Todd Whitman, transmitting the Environmental Financial Advisory Board's (EFAB) recent proposal to expand lending of the Clean Water State Revolving Fund (CWSRF) program.

As you know, we are greatly interested in seeing that States utilize the unique flexibility of CWSRF funding as allowed by Congress in its 1987 amendments to the Clean Water Act. We have issued policy memoranda which clarify that nonpoint source (NPS) and estuary projects may be funded with CWSRF even if the facilities are privately owned. We are always interested in expanding the range of borrowers who may be eligible to receive CWSRF funds; so it is with great interest that we read of EFAB's proposal for conduit lending to municipalities.

As you note in your report, *Expanding Lending for Non-point Source Projects*, the CWSRF program already supports the intermediary option called "linked deposit" whereby a commercial bank uses CWSRF funds to relend to private parties. The Ohio Environmental Protection Agency has been a prominent leader in this regard. Other States already have programs in which local governments borrow funds from the CWSRF and then loan to individuals.

Minnesota's Agricultural Best Management Practices loan program was recently profiled in the enclosed fact sheet. Minnesota's Agricultural Best Management Practices loan program is unique among CWSRF programs because of the many partners involved in its operation. The Minnesota Department of Agriculture manages the program. Counties receive loans from the CWSRF and use these funds for agricultural loan programs at a local level. Soil and water conservation districts assist farmers with needs assessment and with project planning and design. In return for a percentage of the loan interest payments, local lending institutions (banks and farm credit institutions) review loan applications and

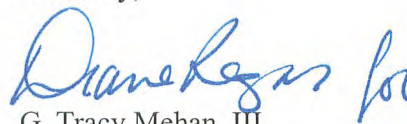
guarantee repayment of each loan. Counties repay the CWSRF using repayments from their local-level agricultural loans. Minnesota's CWSRF program has funded more than 1,961 agricultural projects for more than \$32.2 million.

Since 1995, Massachusetts has used pass-through loans with local municipalities to fund the repair of septic systems. This CWSRF program provides communities with zero percent loans; homeowners then receive two to five percent loans. In a forthcoming *CWSRF Activity Update*, we are featuring the "pass through" loans of the Massachusetts Department of Environmental Protection.

We agree with EFAB that conduit lending arrangements could significantly expand the ways in which we provide financing for water quality improvements. Of particular interest is increased CWSRF lending for the implementation of integrated priority systems and total maximum daily loads for water bodies. To advance this idea further, we will share your paper with our regional CWSRF coordinators who serve as our link to States. In addition, George Ames, Chief, State Revolving Fund Branch, Holly Stallworth, an economist in the SRF Branch, and Dov Weitman, Chief, Nonpoint Source Control Branch would like to meet with EFAB and the Environmental Finance Team to discuss ways of advancing conduit lending arrangements in State programs. This meeting could also be used to address the three questions at the end of your paper.

We appreciate your work on expanding financing for nonpoint source borrowers. If you have any further questions, please feel free to contact George Ames (202-564-0661) or Richard Kuhlman, Director, Municipal Support Division (202-564-0696).

Sincerely,

A handwritten signature in blue ink that reads "Diane Regan for".

G. Tracy Mehan, III
Assistant Administrator

Enclosure



Funding Agricultural Best Management Practices with the Clean Water State Revolving Fund

Nonpoint Source Pollution from Agriculture

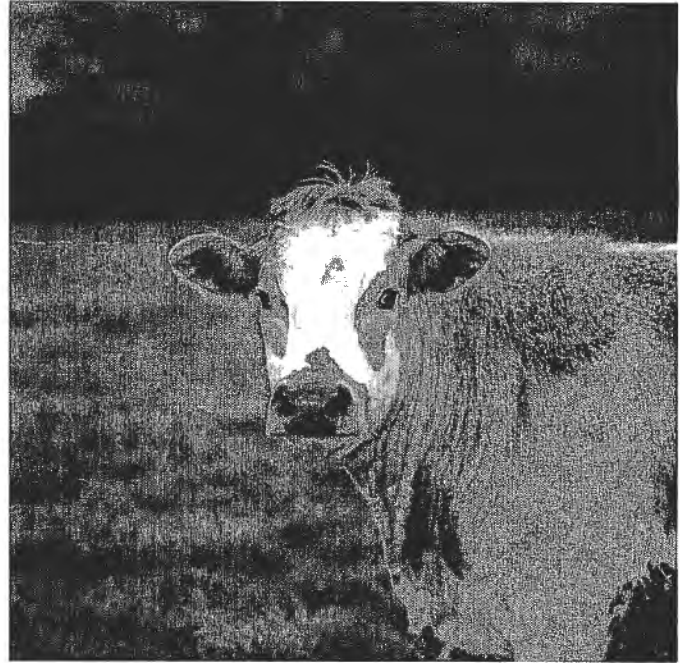
The United States has more than 330 million acres of agricultural land that produce an abundant supply of low-cost, nutritious food and other products. American agriculture is noted worldwide for its high productivity, quality, and efficiency in delivering goods to the consumer. However, when improperly managed, agricultural activities can affect water quality.

The most recent National Water Quality Inventory reports that agricultural nonpoint source pollution is the leading source of water quality impacts to surveyed rivers and lakes, the fifth largest source of impairments to surveyed estuaries, and also a major contributor to ground water contamination and wetlands degradation.

Agricultural activities that cause nonpoint source pollution include confined animal facilities, grazing, plowing, pesticide spraying, irrigation, fertilizing, planting, and harvesting. The major pollutants that result from these activities are sediment, nutrients, pathogens, pesticides, and salts. Agricultural activities also can damage habitat and stream channels. Agricultural impacts on surface water and ground water can be minimized by properly managing activities that cause nonpoint source pollution.

Clean Water State Revolving Fund Programs Can Address Agricultural Nonpoint Source Pollution

Congress created the Clean Water State Revolving Fund (CWSRF) program to provide reduced-rate loan funding for water quality projects of all kinds, including agricultural best management practices. All fifty states and Puerto Rico manage CWSRF programs that are similar to banks. Federal and State contributions have established CWSRF programs, and states use these assets to provide low or no-interest loans to important water quality projects. As borrowers repay CWSRF loans, states use the loan repayments to fund other important water quality projects. CWSRF programs nationwide



have more than \$34 billion in assets and fund \$3-4 billion in water quality projects each year.

Many states have used their CWSRF programs to fund agricultural best management practices. States have provided funding for a wide variety of projects, including waste management systems, manure spreaders, conservation tillage equipment, irrigation equipment, filter strips and streambank stabilization. Delaware, Minnesota, and West Virginia provide excellent examples of how states have used their CWSRF programs to address agricultural nonpoint source pollution.

State Examples: Delaware, Minnesota, West Virginia

Delaware's CWSRF program targets poultry and dairy producers. Natural Resources Conservation Service staff (Department of Agriculture) and local conservation district planners assist agricultural producers with needs assessments and with project planning and design. After individual producers have designed best management practices for their animal feeding operations, they can receive low-interest loans from the CWSRF for project

implementation. Borrowers guarantee repayment of the loans with revenue streams from poultry integrators and dairy cooperatives. Delaware has funded more than 341 agricultural projects for more than \$2.89 million.

Minnesota's Agricultural Best Management Practices loan program is unique among CWSRF programs because of the many partners involved in its operation. The Minnesota Department of Agriculture manages the program. Counties receive loans from the CWSRF, and the counties manage agricultural loan programs at a local level. Soil and water conservation districts assist farmers with needs assessment and with project planning and design. In return for a percentage of the loan interest payments, local lending institutions (banks and farm credit institutions) review loan applications and guarantee repayment of each loan. Counties repay the CWSRF using repayments from their local-level agricultural loans. Minnesota's CWSRF program has funded more than 1,961 agricultural projects for more than \$32.2 million.

West Virginia's CWSRF program provides low-interest loans that farmers use as the cost-share match for Department of Agriculture grant programs such as the Environmental Quality Incentives Program. Many partners have contributed to the success of this program. The West Virginia Department of Agriculture manages the program. Soil and water conservation districts assist farmers with needs assessment and with project planning and design. In return for a percentage of the loan interest payments, local banks review loan applications and

guarantee repayment of each loan. This program has funded more than 174 agricultural best management practices for more than \$3.9 million.

Restriction: Concentrated Animal Feeding Operations

Concentrated Animal Feeding Operations (CAFOs) are large animal feeding operations that are defined by federal statute as point sources of pollution. Because CAFOs are privately owned point sources of pollution, they are ineligible for financial assistance targeted to nonpoint sources of pollution. National Estuary Programs, however, have wide leeway to fund priority water quality projects with the CWSRF program. For this reason, CAFO water quality projects that are located within a National Estuary Program study area and are included in a National Estuary Program management plan are eligible for CWSRF assistance.

Challenges Ahead

EPA has been encouraging states to use their CWSRF resources to finance the widest variety of water quality projects while addressing high priority projects in targeted watersheds. Those interested in cleaning up polluted runoff resulting from agricultural nonpoint sources should seek out their CWSRF programs, gain an understanding of how their State program works, and participate in the annual process that determines which projects are funded.

For more information about the Clean Water State Revolving Fund, or for a program representative in your State, please contact:

Clean Water State Revolving Fund Branch
U.S. Environmental Protection Agency
1201 Constitution Avenue, NW (Mailcode 4204M)
Washington, DC 20004
Phone: (202) 564-0752 **Fax:** (202) 501-2403
Internet: <http://www.epa.gov/owm>

