Environmental Financial Advisory Board
Environmental Protection Agency

JAN 30 1998

Mr. Robert Perciasepe
Assistant Administrator for Water (4101)
Environmental Protection Agency
401 M Street S.W.
Washington, D.C. 20460

Dear Mr. Perciasepe:

We are pleased to provide you with a technical report of the Environmental Financial Advisory Board (EFAB) entitled: "Why Longer Loan Terms Are Prudent for SRFs." The report presents the argument for permitting longer loan terms for loans made by the State Revolving Funds, as encouraged in the Conference Report for the Agency's fiscal year 1998 appropriations bill.

If you wish to discuss this report or if we can be of any other assistance, please let us know.

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Why Longer Loan Terms are Prudent for SRFs

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The recently-enacted HUD appropriation bill incorporated by reference Committee language which underscores the importance of loan structuring flexibility for State Revolving Funds (SRFs). Specifically, the Committee submitted that it:

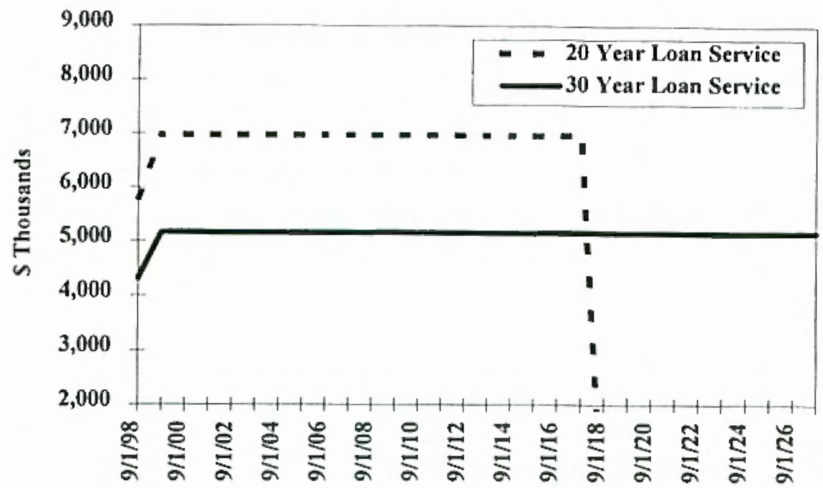
> "is aware of the financial difficulties many municipalities and regional water authorities face as they undertake projects to modernize their sewer and water systems in order to comply with the Federal Water Pollution Control Act. . . . absent the enactment of long-term legislative reforms . . . it is appropriate to seek other, non-legislative forms of relief for communities struggling to meet the financial requirements of compliance with the Act, and that in fact, such non-legislative relief could also reduce the need to continue providing direct assistance.
>
> The Committee notes in this connection that, . . . reimbursements to SRFs . . . stretched out over a longer period of time will result in lower annual debt service, thereby making it easier for municipal water authorities (and their ratepayers) to afford the costs of projects mandated by the Act."

Through this language, EPA is being encouraged by Congress to permit longer terms for loans funded with leveraged SRF bond proceeds, which have traditionally been limited to 20 years. Programmatically, longer loan terms provide a number of benefits to leveraged SRFs: (i) a better alternative to grants; (ii) a better fit with the life of assets financed; and (iii) a strong incentive for environmental projects to get under way.

Longer Term Loans as an Alternative to Grants

Longer loan terms provide SRF administrators with additional flexibility in managing loan service burdens for borrowers saddled with financing large environmental programs. As illustrated by the chart below, a 30 year loan reduces annual costs to a borrower by 34% in comparison to a 20 year subsidized loan. The chart illustrates the impact on annual loan service requirements from a $100 million 20 year loan subsidized at 50% of market versus a 30 year loan with the same subsidy level. Total payments on the 20 year loan total $138 million while payments on the longer 30 year loan total $154 million, an increase of approximately 12%. However, the lower annual payments associated with the 30 year loan can make a large project affordable. A 34% reduction in annual loan costs is significant by any measure, particularly when considering that no additional SRF subsidy dollars are required and that 100% of the loan principal returns to the SRF.

Comparison of 20 and 30 Year Loan Service



The Safe Drinking Water Act explicitly provides for 30 year loan terms for disadvantaged communities. From a programmatic perspective, longer loan terms are preferable to direct loan subsidies (i.e. grants), which are also allowed for disadvantaged communities under the Safe Drinking Water Act. Loan subsidies have a permanent impact on the lending capacity of the SRF and run counter to the philosophy that was used to establish SRFs in the late 1980s. Longer loan terms are consistent with the philosophy that established SRFs initially and do not run the risk of reversing the good work done by states in accustoming localities to a loan, rather than a grant program.

<u>Longer Term Loans Provide a Better Match to the Useful Life of Assets Financed</u>
SRFs finance capital intensive projects with long useful average lives. Projects financed by the Clean Water and Drinking Water SRFs include treatment plants, distribution systems, and storage facilities, among others. These assets, some of which may last as long as 100 years, are traditionally financed by water and sewer authorities through 30 or even 40 year debt. The limitation on SRF loans fails to recognize the fact that many of these large, capital intensive projects will pay for themselves over a time horizon well in excess of 20 years.

<u>Environmental Projects are Likely to Be Accelerated with Longer Loan Terms</u>
Municipalities and water and sewer systems -- the principal borrowers of SRF moneys -- operate in an environment where rate increases are highly publicized and the financing of expensive environmental projects is debated because of the burden imposed on to ratepayers. The availability of longer loans for SRF-eligible projects will make them more affordable and will provide a strong incentive for a larger amount of projects to be financed at an earlier point in time given a budget of palatable rate increases.

<u>Longer Loan Terms are a Better Option than Other Allowable Loan Structures</u>
EPA's Clean Water Act SRF Guidance allows for the structuring of "balloon" loans which come due in a large payment, rather than in serial maturities over the life of the loan. The Guidance

states that balloon loans may be offered provided that the structure is included in the Intended Use Plan and the state in question can prove there is no adverse impact on the SRF. A balloon loan, depending on its final maturity, will have an average life in excess of the average life on a thirty-year loan structured to provide for annual payments and level debt service. Thirty-year loans are likely to have no impact on the lending capacity for leveraged SRFs.

Longer Loan Terms are Most Suitable for Credit-Worthy Borrowers

Loans longer than twenty years expose SRFs to the credit of the underlying borrower for a more extended period of time. As a result, SRFs may want to limit structuring longer loan terms for borrowers with stable credits and investment grade ratings. Longer loans to borrowers which do not meet this criteria may require additional security from the borrowers or incremental monitoring by SRF administrators.

The Impact of Longer Loan Terms on Leveraged Programs is Minimal

The 20-year limitation on loan terms may make sense for SRFs which do not leverage and whose only resources for continuing loan activity are federal grants, state matching funds and loan repayments. However, SRFs which actively use leveraging frameworks are already making more funding available than is possible from the direct lending of federal grants and state matching funds. In other words, leveraged programs provide greater near-term funding, counteracting the slower pace of "recycling" resulting from longer loan terms.

Conclusion and Recommendations

SRFs, borrowers and the environment can all benefit from greater flexibility in the structure of SRF loan terms. SRF loans that more closely match the life of the assets financed is financially prudent. Longer term loans also meet important environmental objectives -- lower annual debt burdens for municipalities will provide incentives for more environmental projects to be built upfront.

We encourage the Agency to move as far forward as permitted by the directive of the Appropriations Committee in implementing longer loan terms as an alternative for SRFs which leverage their capitalization grants. Longer loan terms are appropriate for projects with useful lives exceeding 20 years. In addition, longer loan terms should be made available to credit-worthy borrowers facing large mandates.

We also recommend that, given the significant benefits that would result from longer loan terms, EPA work jointly with the States whose leveraged programs cannot implement longer loan terms under existing law to secure amendments that will permit the universal application of this technique.