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Funding Privately Owned Water Providers through the Safe Drinking Water Act State Revolving Fund

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Introduction

The Safe Drinking Water Act Amendments of 1996 amend the Safe Drinking Water Act (SDWA) to provide for the establishment by each State of a drinking water treatment revolving loan fund (a "State loan fund"). In contrast to the revolving loan funds ("SRF's") established pursuant to the Clean Water Act, the SDWA authorizes the provision of financial assistance to privately owned community water systems and nonprofit noncommunity water systems, as well as publicly owned water systems. The introduction of this new category of assistance recipients raises a number of legal, financial, and practical issues for State loan fund administrators that do not exist in the Clean Water SRF.

The objectives of this report are (1) to identify the unique issues that arise as a result of providing financial assistance to privately owned and nonprofit water systems and (2) to discuss the range of alternatives available and the approaches being taken by State loan funds to address these issues. The issues and alternatives described below have been identified through discussions with various State loan fund administrators. Issues unique to providing assistance to privately owned and nonprofit water systems can be categorized as follows:

- State constitutional prohibitions on private donations and gifts or on lending of the State's credit to a private entity.
- Tax issues related to funding of projects for non-municipal water systems/Bond structuring options.
- Credit and structuring issues related to the size, nature and financial status of the private and nonprofit water systems.
- Issues relating to compliance with specific provisions of the SDWA and the Drinking Water State Revolving Fund Program Guidelines (the "Final Guidelines").
    - Dedicated source of revenues
    - Prohibition on refinancing
    - Technical, managerial and financial capability
    - Cross-cutting requirements
- Targeting benefit of SRF loan to water system users.

State Prohibitions on Private Donations

A number of States have constitutional provisions that prohibit the State from make private donations or private gifts and/or prohibit the State from lending its credit for the benefit of a private person or entity. Two alternatives are being utilized or considered by various States to facilitate incorporation of the private water providers into State loan fund programs. First, several States indicated that these restrictions have been overcome by administering the drinking water SRF through a separately created authority or agency rather than directly by the state. Alternatively, this prohibition may be avoided by funding the loans to private water systems as direct loans made from the Federal capitalization grant. In one State the prohibition on lending the State's credit to private entities does not apply to extensions of credit for a public purpose. It is believed that a loan to a public water system that is privately owned would be such a permitted "public purpose."

Tax Issues

Including loans to private water providers in a leveraged SRF program can affect the tax exemption of the SRF bonds unless the issuer complies with the provisions of the Internal Revenue Code relating to so-called "private activity bonds." If a SRF bond issue is deemed to be a private activity bond, in order for the bonds to be tax-exempt (a) a portion of the State's volume cap must be allocated to the issue and (b) even if tax-exempt, the bonds will be subject to the alternative minimum tax ("AMT"). The effect of being subject to the AMT is to increase an issuer's cost of funds by 15 to 25 basis points.

It is worthwhile mentioning that the January 1997 Private Activity Regulations significantly liberalized the treatment of bonds issued to finance municipally owned facilities under private management contracts -- an often used form of privatization. Prior to these rules, municipal facilities under private management contracts longer than the five-year safe harbor were considered to be private activity bonds subject to tax-exempt bond cap. Management contracts with private companies can now be extended up to 20 years for publicly owned facilities without triggering private use and requiring allocation of tax-exempt bond cap.

A private activity bond includes any bond in which (i) an amount exceeding the lesser of 5% or $5 million of the proceeds is to be used for loans to any person other than a governmental unit or (ii) 10% or more of the proceeds of the bonds are used in a trade or business of a person other than a governmental unit. In addition, if the portion of the issue used for a nongovernmental purpose exceeds $15 million, the State must obtain volume cap for the excess.

Accordingly, a State loan fund has the following alternatives for leveraging its loans to private and nonprofit water systems:

- Issue taxable bonds

- Issue tax-exempt private activity bonds:
  - The bonds would be subject to the AMT;
  - State volume cap must be allocated to the issue;
  - Advance refunding would be prohibited;
  - For any facilities for the furnishing of water, the water must be made available to the public and water rates must be regulated by a state agency or locality; and,
  - At least 95% of the net bond proceeds must be used for costs that are treated as capital costs under the tax code.

- Issue pooled loan bonds which are not private activity bonds:
  - No more than the lesser of 5% or $5 million of the bond proceeds may be "lent" to private and nonprofit entities;
  - Total private use (counting both loans and any nonqualified use by a governmental unit) cannot exceed 1 0% of the bond proceeds; and,
  - Any private use in excess of $15 million must obtain State volume cap.

In their Clean Water pooled loan programs, some States have required that the loans from their borrowers be tax-exempt in order to preserve the option to securitize or sell the loan portfolio. However, in order to make the loans to privately owned systems tax-exempt, it would be necessary to obtain volume cap on each loan. At least one State loan fund administrator has been advised by bond counsel that the amount of volume cap required for each borrower would exceed the amount of the borrower's tax-exempt loan. If correct, this would make it impractical for the loans to privately owned borrowers to be structured on a tax-exempt basis.

Other non-leveraged structuring options which may avoid any tax concerns include using the federal capitalization grant or (if not funded on a tax-exempt basis) state match to make direct loans, or to secure a guarantee of loans by banks or other third parties, to private or nonprofit water providers.

Credit Issues

Nature of Privately Owned Water Systems

In every state surveyed, there are some large privately owned water systems that are regulated as to rates by the state, and, in some states such as Connecticut and Missouri, a majority of the population is served by privately owned systems. However, in each case, the number of large privately owned systems is small (typically, less than ten) and there are also a large number (in some cases, several hundred) of privately owned systems that serve as few as 25 families, including small developments, homeowners associations, resorts, summer camps, and trailer parks. These small systems are not subject to rate regulation, and in many cases, are weak credits with a limited amount of financial sophistication.

Funding of these small water systems poses issues for State loan funds in determining whether these systems meet the financial capability requirements of the SDWA, in ensuring that the loans are adequately secured, and in considering their inclusion in a pool of loans securing publicly offered bonds. Concerns relating to financial capability are discussed below. Although the dollar volume is sufficiently small that including them in a. loan pool would have no significant impact on the pool credit, the surveyed State loan fund administrators uniformly indicated that loans to these small systems would not be leveraged. The decisions not to leverage these loans result either from a general policy of funding small loans directly or from a desire not to be required to discuss, even in general, the nature of these credits and the risk of nonpayment of these loans. The non-leveraged loans will be funded either as direct loans or by providing loan guarantees to banks. One political benefit noted by several fund administrators of providing loan guarantees, rather than direct or leveraged loans, is that it removes the State loan fund from involvement in any enforcement or foreclosure proceedings.

Adequacy of Security

Some of the larger privately owned water systems are rated or ratable at least investment grade and do not pose a unique credit challenge. Such systems can provide a dedicated source of revenue and could be included in a leveraged pool without raising significant credit or disclosure issues. Other privately owned systems, while not ratable at an investment grade level, are subject to rate regulation and may be able to provide a pledge of revenues that adequately secures their loans. Standard & Poor's Corporation has published a matrix of criteria for water utilities that could be useful in assessing the creditworthiness of both of these categories of privately owned water systems. A third group of privately owned systems consists of small water systems that are not subject to rate regulation and that might be characterized as either speculative or highly speculative credits. As is the case with all privately owned systems, these speculative or highly speculative credits could file for bankruptcy in the event that they encounter financial difficulty.

To ensure their loans are adequately secured as required by the SDWA, many small systems will need to make additional security arrangements. Additional security arrangements being considered by State loan funds to achieve an adequate level of security include: lockbox or other process controls, pledge of physical assets, pledge of securities, personal guarantees, recourse debt, or letters of credit.

Examples of approaches being considered by various State loan funds to ensure the adequacy of security include (1) requiring that each private borrower provide a bank letter of credit or other equivalent of an investment grade rating, (2) requiring that each borrower receiving a loan have the equivalent of a "B" rating as determined by the State loan fund, (3) evaluating each loan on a case-by-case basis, and (4) providing loan guarantees to banks under a risk-sharing arrangement that motivates the banks to closely scrutinize the credit.

Issues Relating to Compliance with the SDWA and the Final Guidelines

Dedicated source of revenues

The SDWA makes it a condition for a State loan fund to make a loan that the recipient "will establish a dedicated source of revenue (or, in the case of a privately owned system, demonstrate that there is adequate security) for repayment of the loan..." This requirement is echoed in the provisions of the Final Guidelines relating to loans. The guidelines give several examples of possible sources of security, including: a pledge of accounts receivable, provision of credit enhancement, a pledge of collateral, and/or other types of security, such as corporate or personal guarantees. The exemption from the requirement of having a dedicated source of revenue is important for certain privately owned systems that do not have a separate charge for water services.

The Final Guidelines require that the State provide an assurance (No. 11) relating to this requirement. However, the textual explanation of this assurance does not reflect the alternative requirement of demonstrating the adequacy of the security for borrowers that are privately owned systems. Rather, it states that "[t]he State must adopt policies and procedures to assure that borrowers have a dedicated source of revenue," and that in addition, "States must develop criteria to evaluate an applicant's financial ability to repay the loan." Given the straightforward language of the statute, it seems likely that the omission of the alternative for private systems to demonstrate the adequacy of security is an oversight.

Prohibition on Refinancing

The Final Guidelines state that "[p]rivate systems are not eligible for refinancing" from the State loan fund, This provision is likely to discourage privately owned systems from proceeding with needed improvements until funds are actually available from the State loan fund. In order to reduce the adverse impact of this provision, certain State loan funds are proposing to allow privately owned systems to remain eligible for SRF funding for a project if no project costs are financed from borrowed funds until the State has a binding commitment relating to the project.

Technical, managerial and financial capability

The SDWA and Final Guidelines provide that, except as described below, no assistance shall be provided to a water system that does not have the "technical managerial and financial capabilities" to ensure compliance" with the provisions of the SDWA. A water system that does not have adequate technical, managerial or financial capabilities may receive assistance if the owner or operator of the system agrees to undertake feasible and appropriate changes in operations (including ownership, management, accounting, rates, or other procedures). In addition, the State is required to develop a program to evaluate each system to be funded to ensure that it has adequate capacity to receive funding.

Various State loan fund administrators indicated that determining the adequacy of technical, managerial and financial capabilities of privately owned water systems, particularly small systems, will require a different approach from that used in the Clean Water SRF or with publicly owned systems. To make the required evaluations, State loan fund administrators are taking advantage of the experience and capabilities of (a) their own and sister agencies in evaluating privately owned credits and (b) the department of health (or other agency responsible for determining SDWA compliance) in assessing the technical and managerial capabilities of small water systems.

An issue that will arise for many State loan funds in determining the financial capabilities and creditworthiness of small privately owned systems, is what type of financial records are sufficient to

consider making a loan. Three categories of record keeping are reported: (a) no records kept, (b) records maintained, but with gaps that would prevent an audit; and (c) records sufficiently maintained to allow an audit. Some State loan fund administrators indicated that they will require an audit in order to consider a loan application. Other administrators, particularly those whose agencies have prior experience with loans to small privately owned systems, indicated a willingness to evaluate the borrowers on a case-by-case basis if the borrower maintained records, even if there are gaps that would prevent an audit. In all cases, the administrators indicated that there would be a prospective requirement for systems receiving a loan to obtain an annual audit.

The issue of financial capability is further complicated for those State loan funds that have elected to provide assistance to disadvantaged communities. The assistance authorized by the SDWA to be provided to disadvantaged communities includes principal forgiveness. The Final Guidelines indicate that "the State should take its affordability criteria into account when deciding the level of subsidy a disadvantaged community will receive, in order to make the loan affordable."

Cross-cutting requirements

The "Cross-cutting Authorities" are Federal laws and authorities that apply by their own terms to projects and activities receiving Federal assistance, regardless of whether the statute authorizing the assistance makes them applicable. Cross-cutting Authorities include various environmental laws such as the National Historic Preservation Act, social and economic policy authorities such as the Age Discrimination Act of 1975 and Title VI of the Civil Rights Act of 1964, and government-wide debarment and suspension rules.

In general the requirement that State loan funds comply with the Cross-cutting Authorities applies only to an amount of assistance equal to the Federal capitalization grant ("equivalency projects""). Projects funded with monies in an amount greater than the capitalization grant ("non-equivalency projects") are not generally subject to the Cross-cutting Authorities. However, all programs, projects and activities undertaken by a State loan fund, including non-equivalency projects are subject to Federal anti-discrimination laws, including the Civil Rights Act of 1964, section 504 of the Rehabilitation Act of 1973, and the Age Discrimination Act of 1975. The State loan fund has the day-to-day responsibility for overseeing implementation of Cross-cutting Authorities by funding recipients.

To avoid application of the Cross-cutting Authorities to smaller private water systems, State loan funds are likely to fund their projects as non-equivalency projects. To address those provisions of federal anti-discrimination laws that apply to non-equivalency projects, use of covenants to comply together with annual compliance certifications should be sufficient.

In addition to the applicable Cross-cutting Authorities, non-equivalency projects must undergo a state environmental review. However, the State may elect to apply an alternative environmental review process in lieu of applying a review that is functionally equivalent to the review followed by the EPA under the National Environmental Policy Act.

Targeting Benefit of SRF Loan to Water System Users

Some State loan fund administrators have expressed an interest in ensuring that the benefit of the SRF loans inures to the benefit of the water system's customers. For regulated water systems, the rate approval process should ensure this outcome. Similarly, for nonprofit systems and systems controlled by homeowners associations, the benefit should be passed to the customer. However, for certain small systems, including trailer parks and camps, there may be no ready mechanism to enforce a requirement that the benefit be passed on to the customer. Also, some State loan fund administrators expressed concern whether, given the rigidity of the criteria for determining project priority, the SDWA and final guidelines contain sufficient authority for a State loan fund to require that a private owner pass the benefit of obtaining a SRF loan to its customers.