



Legislative Fiscal Bureau

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Joint Committee on Finance

Paper #291

Variable Interest Rate Revenue Obligations (Environmental Improvement Fund)

[LFB 2005-07 Budget Summary: Page 162, #4]

CURRENT LAW

The market interest rate under the clean water fund program is the effective rate of a revenue obligation issued by the state to fund a project loan or a portion of a project loan under the clean water fund program. The rate changes with each state clean water fund revenue bond issue, and is currently 4.3%. The market interest rate under the safe drinking water loan program is set as the rate determined under the clean water fund program.

The interest rate on a municipality's wastewater loan under the clean water fund program is established based on the type of project and financial capability of the municipality. The interest rate is set as a percent of the market interest rate. Compliance maintenance projects (projects to prevent a significant violation of an effluent limitation by a municipal sewage treatment facility) and new or changed limit projects (projects to achieve compliance with an effluent limitation if the project is for a municipality that is not a violator of the specific limit that is changing) receive an interest rate of 55% (currently 2.365%) of the market interest rate. Projects to abate nonpoint source pollution and to control urban stormwater runoff receive an interest rate of 65% (currently 2.795%) of the market interest rate. Projects to provide treatment facilities and sewers for unsewered areas receive an interest rate of 70% (currently 3.01%) of the market interest rate if two-thirds of the initial flow originates from wastewater from residences that were in existence prior to October 17, 1972. Market interest rate loans are provided to the portions of a project that are designed to address a wastewater discharge permit violation, serve industrial flow or are unsewered areas that do not meet the two-thirds criteria above. Projects may receive financial hardship assistance of a combination of grant and loan if the municipality has median household income of 80% or less of the median household income of the state and annual wastewater treatment charges that would exceed 2% of the median household income in

the municipality without hardship assistance. The maximum amount of financial hardship assistance is a 70% grant with the remaining 30% of costs provided through a 0% interest rate loan.

Loan interest rates under the safe drinking water loan program are 55% (currently 2.365%) of the market interest rate determined under the clean water fund program. However, a borrowing municipality receives a loan with an interest rate of 33% (currently 1.419%) of the market interest rate if the municipality meets financial eligibility criteria established by DNR under administrative rule, including: (a) the population of the local government is less than 10,000; and (b) the median household income of the local government is 80% or less of the statewide median.

The loan repayment period for a municipality's loan under the clean water fund program or the safe drinking water loan program may be for no longer than 20 years after the date of the financial assistance agreement.

GOVERNOR

Change the way in which the market interest rate is calculated under the clean water fund program to specify that if the state issues variable interest rate revenue obligations under the clean water fund program, the market interest rate would be determined by the Department of Administration as the interest rate that would have been paid if the state had sold the variable rate obligations at a fixed interest rate. The market interest rate under the safe drinking water loan program would continue to be calculated as the same rate as under the clean water fund program.

DISCUSSION POINTS

1. Over the past several years, the state has issued millions of dollars of variable interest rate obligations to take advantage of low, short-term interest rates. In March, 1997, the Building Commission authorized a general obligation commercial paper financing program with issuance of short-term variable rate commercial paper with maturities of 270 days or less. The program tries to take advantage of short-term borrowing rates when those rates are substantially lower than long-term rates and reduce the state's overall debt service costs. As of December, 2004, the state had approximately \$388.5 million outstanding from its general obligation commercial paper programs. In February, 2003, the DOA Capital Finance Office reported to the Building Commission that, between 1997 and December 31, 2002, the state realized approximately \$25.4 million in debt service savings by paying variable interest rates as compared with the interest the state would have paid if it had issued long-term bonds instead of variable rate obligations. (DOA has not issued a more recent comparable report.)

2. The state also has short-term variable rate revenue obligation programs. The state had \$142.3 million in short-term commercial paper petroleum inspection fee revenue obligations

outstanding as of December 1, 2004, for which the proceeds are used to pay claims under the PECFA (petroleum environmental cleanup fund award) program. The revenue obligations are repaid with a portion of the three cent per gallon petroleum inspection fee. The state also had \$120.0 million in variable rate transportation revenue obligations outstanding as of December 1, 2004, which are primarily repaid with revenue from the state's motor vehicle registration fees.

3. DOA Office of Capital Finance officials indicate that the authority provided in the bill could allow the environmental improvement fund to take advantage of potentially lower short-term interest rates by reducing the amount of interest paid on outstanding debt. DOA officials anticipate that the variable rate program might be structured similar to the short-term commercial paper obligations for existing programs described above, with maturity dates of less than 270 days.

4. The proposal would allow the program to blend short-term and long-term borrowing obligation proceeds held in the local government investment pool until funds are disbursed through clean water fund loans. Blending these funds would allow the program to have lower cost funds in the local investment pool which would reduce the interest expense losses eventually incurred by the program when the cost of long-term funds held in the pool exceed the rate of investment earnings on those funds. For example, the most recent fixed rate clean water fund revenue obligations were issued in March, 2004, in the amount of \$100 million at an interest rate of 4.3%. Portions of the proceeds from these obligations are being held at interest rates as low as 1.5% until they are disbursed in loans, which means the program is paying roughly 2.8% more in debt service interest costs on the obligations than it is earning on the funds in the investment pool. Interest cost savings would be realized if this differential could be reduced.

5. Allowing a variable rate component for the program would also provide program officials the flexibility to hold the lowest cost funds in the investment pool and lend the higher cost fixed rate funds to municipal borrowers. This could also reduce the difference between the rates paid on bond proceeds and the earnings on those proceeds.

6. The proposal might lead to a scenario where the state would issue variable interest rate short-term obligations and establish a market interest rate that would provide loans to municipal borrowers at a higher interest rate than the state pays on the variable interest rate obligations. For example, suppose that the state issued fixed rate revenue obligations at an interest rate of 4.3% and also issued variable rate short-term obligations at an interest rate of 1.5%. Under the example, DOA determines that 4.3% is the interest rate the variable rate obligations would have been issued at if issued at a fixed rate. Therefore, 4.3% would also be the market rate for the proceeds used to lend to clean water fund program borrowers. Municipal borrowers who are eligible for a loan at 55% of the market interest rate (the majority of loans under the program) would pay an interest rate of 2.365%, which is almost 1% higher than the variable rate paid by the state. Under this scenario, the savings that occur from borrowing at the lower, variable interest rate, would accrue to the state.

7. Under current law, DOA could establish a variable rate borrowing program for clean water fund obligations. However, if DOA is not provided the authority to set the cost of their funds at the market rate for long-term fixed bonds, DOA would have to set the market rate as the interest

rate on the variable rate bonds and would have to change the market rate every time the variable rate would change. This might happen as frequently as every week because of the short term of the bonds, and would be administratively difficult. Further, while the state would incur higher administrative costs, any savings associated with borrowing under this scenario at a lower, variable rate, would accrue to the local government in the lower cost of funds. Under the bill a municipality would be expected to pay the same interest rate as under current law.

8. DOA officials do not estimate the amount of program savings that might be incurred through a potential variable interest rate component of the clean water fund program because they indicate there are many different ways to structure a program, and it takes considerable effort and consultation with investment bankers to develop a program. In addition, it is unknown what amount of variable rate obligations might be issued over given time periods, at what short-term variable interest rates, and in comparison with what long-term fixed interest rates.

9. DOA officials indicate that if variable interest rate obligations would be issued under the clean water fund program, the Department would probably hire an independent firm to conduct a financial analysis and to determine what the equivalent interest rate would have been if fixed rate obligations had been issued. The equivalent interest rate would be used as the rate against which the lower than market interest rates would be calculated for loans made under the clean water fund program and safe drinking water loan program. While the interest rate paid by municipal borrowers under the program would be fixed for the 20-year term of the loan, the interest rate of variable rate obligations could increase or decrease with changes in the bond market.

10. Under a variable interest rate program, there would be a risk that variable interest rates would increase to levels higher than the calculated fixed interest rate before the variable rate obligations could be refinanced to long-term fixed rates. If this scenario would occur, it is possible that the amount of general obligation bonds issued to pay for the state subsidy for a municipality's loan would need to be increased above the amount calculated when the equivalent fixed interest rate was established for the 20-year term of the loan.

11. This risk is similar to the risk currently incurred on the state's other variable interest rate programs. In addition, proponents argue the program is currently incurring unnecessary costs by not having the ability to hold short-term variable rate investments when interest rates make it advantageous to do so.

12. Also, DOA officials indicate that the risk of rising variable interest rates could be managed in several ways. For example, variable rate obligations might be structured with an interest rate slightly above the short-term interest rate and with a ceiling above which the variable rate would not increase. For example, if a variable rate obligation is available at a 1.5% interest rate and a ceiling rate of 10%, the program might be able to purchase the obligation at 1.7%, but with a lower ceiling rate of 5%. Small amounts of variable rate obligations might be combined with larger amounts of long-term fixed obligations. For example, DOA could issue \$10 million of short-term variable rate obligations and blend them with \$70 million of fixed rate obligations. DOA anticipates that it would manage variable rate obligations in a way that the obligations could be

refinanced with long-term fixed obligations before the variable rate would increase to a level higher than the calculated equivalent fixed rate. Further, the Building Commission would approve any variable rate bond issue before the obligations would be issued, since the Commission is responsible for approving all state bond issues.

13. The success of the state in achieving cost savings under a variable rate program, or in preventing future increases in state subsidy costs for clean water fund program and safe drinking water loan program loans, would depend on the state's ability to accurately establish the equivalent market interest rate upon which interest rates for loans under the program would be established. If the rate is established too low, or if variable rates rise above anticipated levels, state subsidy costs could increase above anticipated levels. On the other hand, if the program is managed effectively, future state general obligation bond subsidies (and associated GPR debt service payments) would be expected to decline.

ALTERNATIVES

1. Approve the Governor's recommendation to specify that if the state issues variable interest rate revenue obligations under the clean water fund program, the market interest rate used to calculate clean water fund loan interest rates would be determined by the Department of Administration as the interest rate that would have been paid if the state had sold the variable rate obligations at a fixed interest rate.

2. Maintain current law.

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