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April 25, 2013 Joint Committee on Finance Paper #270

General Obligation Bonding Authority and Present Value Subsidy Limit - Clean Water Fund Program (Environmental Improvement Fund)

[LFB 2013-15 Budget Summary: Pages 153 to 154, #1 (part) and #2 (part)]

CURRENT LAW

The clean water fund program within the environmental improvement fund provides low-interest loans to municipalities for planning, designing, constructing or replacing a wastewater treatment facility, or for nonpoint source water pollution abatement or urban storm water runoff control projects. The program provides loans using proceeds of federal capitalization grants, general obligation bonds, and revenue obligation bonds. The federal grants are used for a state revolving loan fund, and must be matched by state funds equaling at least 20% of the federal grant amount. Wisconsin provides the state match with general obligation bond proceeds. Most of the general obligation bond debt service costs are paid by general purpose revenues (GPR), and a portion is paid from segregated loan repayments from municipalities. The program also uses general obligation bonding authority to leverage a larger amount of capital through the sale of state revenue obligation bonds for loans to municipalities. State revenue obligation bonds are retired primarily through repayments of program loans made to municipalities at below market interest rates. General obligation bonds pay the remainder of revenue obligation debt service costs related to the costs of providing the state subsidy because loans to municipalities are made at an interest rate below the market interest rate the state pays for its revenue bonds.

The clean water fund program is currently authorized a cumulative total of $3,500,043,200 in bonding authority as follows: (a) $783,743,200 for general obligations; and (b) $2,716,300,000 for revenue obligations.

DOA administers most aspects of the financial management of the environmental improvement fund. DNR primarily administers the loan and grant provisions.

To provide a financial control mechanism, the statutes provide a concept unique to the environmental improvement fund, termed a "present value subsidy" limit. This limit is a means for the Legislature to control the commitment of state financial assistance to municipalities in a biennium. Because it incorporates the debt service that will be paid on bond issuances, the present value subsidy limit reflects the total estimated cost to the state, in current dollars, of subsidizing clean water fund loan projects. The present value subsidy limit acts as a cap on the sum of all assistance provided through the clean water fund program in a biennium. To the extent that actual bond interest rates are greater or less than assumed rates, the number of projects that may be funded would decrease or increase. The amount of present value subsidy is intended to be the equivalent of the amount the state would expend, but not be repaid, for a given project if that entire subsidy were provided in the year the loan was made, rather than over twenty years. Conceptually, the present value subsidy is the amount the state would need to invest today at a 7% annual rate of return to receive interest payments equal to the annual subsidy provided to municipalities. There is $69.2 million authorized in present value subsidy for the clean water fund for the 2011-13 biennium and $1,000 authorized for subsequent biennia.

Clean water fund projects, other than financial hardship assistance projects, are funded on a continuous funding cycle. If DNR and DOA determine that the amount of present value subsidy, general obligation bonding authority, or revenue bonding authority approved for a biennium is insufficient to provide funding for all projects for which applications will be approved during the biennium, the program would revert to an annual funding cycle, DNR would establish a funding list for each year of the biennium that ranks projects of municipalities that submit financial assistance applications by June 30 of the preceding fiscal year, and DOA would allocate funding to projects in the order they appear on the funding list. Financial hardship assistance projects are scored according to a priority ranking system that is used to establish a list of hardship projects to be funded. Funding for financial hardship assistance is statutorily limited to 5% of the total present value subsidy authorized during a biennium.

Clean water fund program projects receive subsidized interest rates as a percent of the market rate. The market interest rate is the interest rate at which the state issues revenue obligation bonds for the program, and is currently 3.5%. The 2009-11 and 2011-13 biennial budget acts decreased state subsidy by increasing the interest rate for projects. Currently, most projects receive a loan with an interest rate of 75% of the market rate.

Federal capitalization grants for federal fiscal years 2010 through 2012, and federal funds provided under the American Recovery and Reinvestment Act of 2009 (ARRA) have authorized use of a portion of federal funds for "principal forgiveness" loans (grants). In Wisconsin, 2009 Act 384 and 2013 Act 7 were enacted to authorize the program to utilize the principal forgiveness provisions.

GOVERNOR

Provide a "present value subsidy limit" of $76,700,000 for the clean water fund program for the 2013-15 biennium. Provide a present value subsidy limit of $1,000 for any biennium after 2013-15. No new bonding authority would be provided for the program.

DISCUSSION POINTS

1. Current law authorizes a present value subsidy limit for the clean water fund totaling $1,000 for any biennia after 2011-13. This would be insufficient to fund any expected projects during the 2013-15 biennium. In every biennial budget enacted since the clean water fund was created in 1987 Act 399, the Legislature has approved a present value subsidy limit for the programs as a method of establishing a maximum amount of state financial assistance provided to municipalities in a biennium.

2. The environmental improvement fund biennial finance plan submitted by DNR and DOA to the Building Commission and Legislature in September, 2012, requested sufficient present value subsidy limit under the clean water fund program to fund all expected wastewater needs during the biennium under the current law interest rates. DNR and DOA identified wastewater project needs of $707.7 million for the 2013-15 biennium, including: (a) $319.1 million of $638.2 million in estimated 2012-13 project costs for which applications had not been submitted as of August, 2012, and are now expected to be submitted in 2013-14 instead of 2012-13 (inclusion of this component meant that it was estimated that 2011-13 present value subsidy limit would no longer be needed for the projects, but that 2013-15 present value subsidy limit would be needed); (b) $368.0 million in estimated need for new clean water fund program applications in the 2013-15 biennium; and (c) $20.6 million as a 3% construction contingency for the $687.1 million in applications described above. The DNR and DOA projections represented the best estimates of need as of September, 2012, based on both file materials and a comprehensive survey of municipalities.

3. The DNR and DOA September, 2012, biennial finance plan identified a need for $54.9 million in general obligation bonding authority to provide the state match for anticipated federal capitalization grants and state subsidy for funded projects during the 2013-15 biennium. The plan identified an available balance of $95.8 million in general obligation bonding authority carried forward from the 2011-13 biennium. The biennial finance plan also identified a need for $534.7 million in revenue obligation bonding authority to fund anticipated projects during the biennium, and an available balance of $595.7 million in revenue obligation bonding authority carried forward from the 2011-13 biennium. Based on the identification of these available balances, the biennial finance plan and Governor's budget did not include recommendations for additional bonding authority for the clean water fund program.

4. DOA and DNR indicate that the reasons for the large amount of available balance of previously-authorized bonding include: (a) the availability of ARRA funding in 2009-10 and associated principal forgiveness provided a one-time upsurge in funding for projects ready to proceed at that time; (b) the decreases in the market interest rate to 3.5% during the 2011-13 biennium resulted in increases in municipalities prepaying old loans made with older, higher interest rates at over 5%; (c) the program has a long-enough history that the need for general obligation bonds to be used for credit reserves has been minimized (general obligation bonds continue to be used for the 20% state match to the federal grant and for the costs of state subsidy of loans made with revenue obligation proceeds); and (d) demand was less than anticipated because of recessionary delays in project starts and reduced state subsidy levels.

5. During 2007-09 biennial budget deliberations, estimated project costs were $709.8 million. Subsequently, the actual project costs in financial assistance agreements entered into with 2007-09 funding were $583.1 million. During 2009-11 biennial budget deliberations, estimated project costs were $804.3 million. Actual project costs in financial assistance agreements with 2009-11 funding were $396.9 million. During 2011-13 biennial budget deliberations, estimated project costs were $684.1 million. Actual project costs in financial assistance agreements with 2011-13 funding were $194.0 million as of April 8, 2013. It is anticipated that additional financial assistance agreements will be entered into with 2011-13 funding. The actual project costs for both the 2009-11 and 2011-13 biennia include regular and ARRA funding, and agreements that include loans and principal forgiveness.

6. The biennial finance plan and the bill are based on an estimated revenue obligation market interest rate of 5.5% for long-range planning purposes. The administration used this estimated or "planning interest rate" to calculate the amount of state subsidy needed to fund anticipated projects.

7. The market interest rate has averaged 5.1% for the 21 years that the program has issued bonds. The program issues bonds during construction of the project, often over a four- to five-year period after the project financial assistance agreements are entered into. Thus, bonds issued over a six- to seven-year period after budget enactment may have varying interest rates for determining actual state subsidy costs.

8. The revenue obligation market interest rate has been at or below 5% since April, 2001, is currently 3.5%, and may change when revenue obligations are next sold for the program in approximately the first half of calendar year 2014. If market interest rates remain at an interest rate lower than the 5.5% planning interest rate used in the biennial finance plan during the 2013-15 biennium, the Governor's recommended levels of present value subsidy limit would be sufficient to fund a greater amount of projects than were estimated under the biennial finance plan. If actual market interest rates would rise to a rate higher than the 5.5% planning rate during the biennium, the amounts provided under the bill might fund a smaller amount of projects than estimated (depending on when during the biennium the interest rate would rise above 5.5%).

9. The Legislature approved levels of general obligation bonding authority and present value subsidy limit based on an estimated 5.0% market interest rate in 2003-05, 2005-07, 2007-09, and 2011-13, and based on an estimated 5.5% market interest rate in 2009-11.

10. When a municipality submits a clean water fund application, DOA currently allocates an initial present value subsidy to the project based on the planning market interest rate of 5.0%, and would allocate it in 2013-15 based on the planning market interest rate of 5.5%. When the program and the municipality enter into a financial assistance agreement, projects are assigned a loan interest rate based upon the actual market interest rate (currently 3.5%), and present value subsidy is allocated as funds are disbursed under the loan during construction of the project. As long as actual interest rates remain below the planning rate (currently 5.0% and proposed 5.5%) during disbursal of funds under the loan, the actual present value subsidy decreases to less than the amount allocated at the time of the application, and less general obligation bonds are issued. This allows the state to spend less money to subsidize individual projects, and allows the state to finance

a greater number of projects than estimated. Interest rates for loans under the program are currently calculated as a percentage of the 3.5% market interest rate from the mid-2012 issuance of revenue obligations. However, it is possible that the next revenue obligations issued by early- to mid-2014 would have a higher market interest rate than 3.5%.

11. If interest rates rise beyond estimated rates (for example, if the Governor's proposed planning interest rate of 5.5% would be used for provision of funding and the average interest rates rise above 5.5%), municipalities encounter project cost increases, or need is greater than identified in the September, 2012, biennial finance plan, some projects might be deferred from the spring of 2015 to after June 30, 2015, when 2015-17 financing would be made available, or projects might have to obtain interim financing (with a higher interest rate) and refinance with clean water fund program loans at a later date.

12. It is also possible that some demand currently expected for the 2013-15 biennium will not materialize until 2015-17, similar to what has happened in recent biennia. This means that bonding authority approved prior to 2013-15 will be used in 2013-15 to finance projects that were previously anticipated to be financed in 2011-13. Similarly, some of the $368.0 million in expected new 2013-15 project costs may not be realized until 2015-17, and bonding authority anticipated to be needed for that demand may not be needed until 2015-17. Any general obligation or revenue obligation bonding authority authorized, but unused during a biennium, remains available for program use in subsequent biennia.

13. Providing funding for 2013-15 based on an estimated market interest rate of less than 5.5% would allow a lower present value subsidy limit to be provided than under the bill. It would still allow for some increase in market rates over the biennium without limiting anticipated projects. For example, if funding decisions were based on an estimate of a market interest rate of 5.0% instead of 5.5%, a present value subsidy limit of $69.7 million would be sufficient for the clean water fund program instead of the $76.7 million provided under the bill (Alternative 2). If the Committee would base funding decisions on an estimate of a market interest rate of 4.5% instead of 5.5%, a present value subsidy limit of $61.9 million would be sufficient for the clean water fund program instead of the $76.7 million provided under the bill (Alternative 3).

14. The clean water fund program does not need any new authorization of general obligation or revenue obligation bonding authority because the authorized, but unused authority remaining at the end of the 2011-13 biennium, remains available for program use in the 2013-15 and subsequent biennia.

15. The portion of the authorized but unused general obligation (GO) and revenue obligation bonding authority that is carried forward from 2011-13 to 2013-15, but is not anticipated to be needed during the 2013-15 biennium, would remain available for future use by the program. The Committee could consider deleting the authority not anticipated to be needed during the 2013-15 biennium. For example, if funding levels are approved based on a 5.0% planning interest rate (rather than 5.5% under the bill), approximately $51.7 million in GO bonding authority would fund anticipated projects (instead of $55.0 million under the bill's 5.5% planning interest rate). If a contingency of 10% would be included to allow for potential increases in the planning interest rate or federal funding, $56.9 million in GO bonding authority would be expected to be sufficient, and

the remaining $38.9 million of the $95.8 million in available GO bonding authority could be deleted (Alternative 2a). Similarly, if a contingency of 10% would be added to the $534.8 million of anticipated need for revenue obligation authority, $588.3 million in revenue obligation authority would be expected to be sufficient, and the remaining $7.4 million in available revenue obligation authority could be deleted (Alternative 2a). The Committee could also retain the currently authorized but unused bonding authority for use in the 2015-17 biennium (Alternative 2b). This would moderate the need for additional bonding authority in future biennia.

16. If funding levels are approved based on a 4.5% planning interest rate (rather than 5.5% under the bill), approximately $52.9 million in GO bonding authority, including a 10% contingency, would be expected to be sufficient, and the remaining $42.9 million of the $95.8 million in available GO bonding authority and the $7.4 million in remaining available revenue obligation authority could be deleted (Alternative 3a) or retained for use in the 2015-17 biennium (Alternative 3b).

17. It should be noted that GO bonding authorized for the clean water fund program can only be used for that program, and it is probable that general obligation bonding authority not used during the 2013-15 biennium will be needed for allocation to project costs in the 2015-17 biennium. Thus, if available bonding authority carried forward from 2011-13 is deleted, it is probable the Legislature will need to reauthorize it in the 2015-17 biennial budget. Further, approval of GO bond authority at a level less than provided in the bill would not be expected to result in GPR savings in debt service costs during the 2013-15 biennium because GO bonds are issued only as financial assistance is disbursed during the four to five years of construction of a project.

18. In 2011-13, when the Governor proposed reducing the state subsidy to municipalities, the Governor's Executive Budget Book indicated the state could no longer afford the subsidy level provided in 2009-11. Some may argue that state subsidy levels could be increased in 2013-15 to the subsidy levels provided in 2009-11 because the availability of lower-interest rate financing offers the state an opportunity to provide additional assistance to municipalities for financing of wastewater treatment projects.

19. The following table shows the loan interest rate municipalities would pay under the current subsidy level, and under the subsidy levels provided in 2009-11, based on the current 3.5% market rate. For example, most municipalities currently receive a loan of 75% of the market rate. Based on the current 3.5% market rate, the interest rate of the loan would be 2.625%. Under the 2009-11 subsidy level of 60% of market rate, the current 3.5% market rate would result in a loan with a 2.1% interest rate. It should be noted that interest rates paid by a municipality would be based on the market rate prevailing at the time of their loan agreement closing.

Clean Water Fund Program Loan Interest Rates by Project Type

	Percent of Market Rate			Current Interest Rate for Various Subsidy Levels		
Project Category	Prior to 2009-11	2009-11	As of 2011-13	Prior to 2009-11	2009-11	2011-13
Compliance maintenance/ New and changed limits	55%	60%	75%	1.925%	2.100%	2.625%
Storm water/nonpoint	65	65	75	2.275	2.275	2.625
Unsewered	70	70	75	2.450	2.450	2.625
Violator, reserve capacity, Industrial flow or unsewered not meeting two-thirds rule	100	100	100	3.5	3.5	3.5
Transition	N.A.	N.A.	N.A.	N.A.	2.5	2.5
Hardship	Variable	Variable	Variable	0.0 to 3.5	0.0 to 3.5	0.0 to 3.5
Hardship grants and principal forgiveness	Grant	Grant	Grant	Grant	Grant	Grant
Septage treatment and capacity	0	0	0	0.0	0.0	0.0

20. If the state subsidy would be increased to the levels provided in the 2009-11 biennium, based on a 5.0% planning interest rate, a present value subsidy limit of $104.8 million would be needed (an increase of $28.1 million from the $76.7 million provided under the bill). In addition, $86.4 million in GO bonding authority (including a 10% contingency) would be sufficient for projects anticipated to be financed during 2013-15 (Alternative 4). The remaining $9.4 million in available GO bonding authority could be deleted in 2013-15 (Alternative 4a), or could be retained to meet future demand (Alternative 4b).

21. If funding would be provided for the subsidy levels provided in the 2009-11 biennium, based on a 4.5% planning interest rate, a present value subsidy limit of $93.5 million would be needed (an increase of $16.8 million from the $76.7 million provided under the bill), and $80.5 million in GO bonding authority (including a 10% contingency) would be sufficient for projects anticipated to be financed during 2013-15 (Alternative 5). The remaining $15.3 million in available GO bonding authority could be deleted (Alternative 5a) or retained (Alternative 5b).

22. If the state subsidy would be increased to the levels provided prior to the 2009-11 biennium, based on a 5.0% planning interest rate, a present value subsidy limit of $116.0 million would be needed (an increase of $39.3 million from the $76.7 million provided under the bill), and the currently available $95.8 million in GO bonding authority (including a 10% contingency) would be sufficient for projects anticipated to be financed during 2013-15 (Alternative 6).

23. If funding would be provided for the subsidy levels provided prior to the 2009-11 biennium, based on a 4.5% planning interest rate, a present value subsidy limit of $103.3 million would be needed (an increase of $26.6 million from the $76.7 million provided under the bill), and $89.4 million in GO bonding authority (including a 10% contingency) would be sufficient for projects anticipated to be financed during 2013-15 (Alternative 7). The remaining $6.4 million in available GO bonding authority could be deleted (Alternative 7a) or retained (Alternative 7b).

24. The effect of increasing the state subsidy level on 2013-15 GPR debt service payments would be minimal, because projects approved in the 2013-15 biennium generally would not begin construction until late in the biennium or in the 2015-17 biennium. However, state costs would rise and increased state general obligation bond issues would be required to support the increased subsidy levels. To return to the 2009-11 level of state subsidy would require $27.6 million BR more than current law to accommodate estimated 2013-15 program demand (at a 4.5% planning rate). To the extent this full amount was needed for 2013-15 projects, and while interest rates established at the time of bond issuance may vary, it could be expected that debt service payments (principal and interest) on that amount of bonds would total approximately $40 million over the 20 year life of the bonds. To return to the state subsidy level in effect prior to 2009-11 would require $36.5 million BR more than current law to accommodate estimated 2013-15 program demand (at a 4.5% planning rate). Debt service payments on that level of bonds could be expected to total approximately $53 million over the 20 year life of the bonds.

25. The Milwaukee Metropolitan Sewerage District (MMSD) borrows the largest percentage of project costs of any municipality in the program. The statutes require that an individual municipality may receive no more than 35.2% of the total available present value subsidy limit. In 2007-09, MMSD was allocated 20.2% ($20.5 million) of the $101.6 million in available (budgeted) present value subsidy limit. MMSD project costs were approximately 30.4% of the statewide total ($177.1 million of $583.1 million in financial assistance agreements statewide). In the 2009-11 biennium, MMSD project costs totaled $132.5 million, out of $396.9 million in statewide project costs (33.4%). In the 2009-11 biennium, MMSD was allocated $22.3 million (16.6%) of the $134.9 million in available present value subsidy limit. In the 2011-13 biennium, as of April 8, 2013, MMSD project costs totaled $40.2 million, out of $194.0 million in statewide project costs (20.7%). It is anticipated that DOA and DNR will allocate additional 2011-13 present value subsidy to MMSD and other municipalities.

ALTERNATIVES

1. Approve the Governor's recommendation to provide a "present value subsidy limit" of $76.7 million for the clean water fund program based on an average 5.5% market interest rate, and to maintain current levels of bonding authority for the program.

2. Estimate a 5.0% market interest rate, and provide a "present value subsidy limit" of $69.7 million for the clean water fund program (a decrease of $7.0 million from the bill). In addition, approve one of the following levels of bonding authority:

a. Reduce clean water fund program bonding authority by $46.3 million, including $38.9 million for general obligations and $7.4 million for revenue obligations.

ALT 2a	**Change to Bill** Revenue
BR-GO	- $38,900,000
BR-REV	- 7,400,000
Total BR	- $46,300,000

b. Maintain current levels of general and revenue obligation bonding authority.

3. Estimate a 4.5% revenue market interest rate, and provide a "present value subsidy limit" of $61.9 million for the clean water fund program (a decrease of $14.8 million from the bill). In addition, approve one of the following levels of bonding authority:

a. Reduce clean water fund program bonding authority by $50.3 million, including $42.9 million for general obligations and $7.4 million for revenue obligations.

ALT 3a	**Change to Bill** Revenue
BR-GO	- $42,900,000
BR-REV	- 7,400,000
Total BR	- $50,300,000

b. Maintain current levels of general and revenue obligation bonding authority.

4. Approve the following: (a) estimate a 5.0% market rate; (b) increase the state subsidy for clean water fund program projects to provide an interest rate of 60% of the market rate for compliance maintenance and new and changed limits projects (instead of the current 75% of market rate); (c) increase subsidy for nonpoint source and urban storm water projects to provide an interest rate of 65% of the market rate (instead of the current 75%); (d) increase subsidy for projects for eligible unsewered areas to provide an interest rate of 70% of the market rate (instead of the current 75%); (e) provide a "present value subsidy limit" totaling $104.8 million (an increase of $28.1 million from the bill). In addition, approve one of the following levels of bonding authority:

a. Reduce clean water fund program bonding authority by $16.8 million, including $9.4 million for general obligations and $7.4 million for revenue obligations.

ALT 4a	**Change to Bill** Revenue
BR-GO	- $9,400,000
BR-REV	- 7,400,000
Total BR	- $16,800,000

b. Maintain current levels of general and revenue obligation bonding authority.

5. Approve the following: (a) estimate a 4.5% market rate; (b) increase the state subsidy for clean water fund program projects to provide an interest rate of 60% of the market rate for compliance maintenance and new and changed limits projects (instead of the current 75% of market rate); (c) increase subsidy for nonpoint source and urban storm water projects to provide an interest rate of 65% of the market rate (instead of the current 75%); (d) increase subsidy for projects for eligible unsewered areas to provide an interest rate of 70% of the market rate (instead of the current 75%); (e) provide a "present value subsidy limit" totaling $93.5 million (an increase of $16.8 million from the bill). In addition, approve one of the following levels of bonding authority:

a. Reduce clean water fund program bonding authority by $22.7 million, including $15.3 million for general obligations and $7.4 million for revenue obligations.

ALT 5a	**Change to Bill** Revenue
BR-GO	- $15,300,000
BR-REV	- 7,400,000
Total BR	- $22,700,000

b. Maintain current levels of general and revenue obligation bonding authority.

6. Approve the following: (a) estimate a 5.0% market rate; (b) increase the state subsidy for clean water fund program projects to provide an interest rate of 55% of the market rate for compliance maintenance and new and changed limits projects (instead of the current 75% of market rate); (c) increase subsidy for nonpoint source and urban storm water projects to provide an interest rate of 65% of the market rate (instead of the current 75%); (d) increase subsidy for projects for eligible unsewered areas to provide an interest rate of 70% of the market rate (instead of the current 75%); (e) provide a "present value subsidy limit" totaling $116.0 million (an increase of $39.3 million from the bill). In addition, maintain current levels of general and revenue obligation bonding authority.

7. Approve the following: (a) estimate a 4.5% market rate; (b) increase the state subsidy for clean water fund program projects to provide an interest rate of 55% of the market rate for compliance maintenance and new and changed limits projects (instead of the current 75% of market rate); (c) increase subsidy for nonpoint source and urban storm water projects to provide an interest rate of 65% of the market rate (instead of the current 75%); (d) increase subsidy for projects for eligible unsewered areas to provide an interest rate of 70% of the market rate (instead of the current 75%); (e) provide a "present value subsidy limit" totaling $103.3 million (an increase of $26.6 million from the bill). In addition, approve one of the following levels of bonding authority:

a. Reduce clean water fund program bonding authority by $13.8 million, including $6.4 million for general obligations and $7.4 million for revenue obligations.

ALT 7a	**Change to Bill** Revenue
BR-GO	- $6,400,000
BR-REV	- 7,400,000
Total BR	- $13,800,000

b. Maintain current levels of general and revenue obligation bonding authority.

8. Delete provision. There would be no new present value subsidy limit for the clean water fund program. The current law present value subsidy limit for any biennium after 2011-13 is $1,000, which would not be sufficient to fund any expected projects during the 2013-15 biennium.

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