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May 18, 2023 Joint Committee on Finance Paper #345

Revenue Obligation Bonding Authority (Environmental Improvement Fund)

[LFB 2023-25 Budget Summary: Page 179, #2]

CURRENT LAW

The environmental improvement fund consists of two state revolving loan funds, the clean water fund and the safe drinking water loan program. The clean water fund program provides financial assistance to municipalities for the planning, design, and construction of wastewater treatment facilities. The safe drinking water loan program provides low-interest loans to municipalities for planning, designing, constructing, or modifying public drinking water systems, if the projects will facilitate compliance with national primary drinking water regulations under the federal Safe Drinking Water Act.

The U.S. Environmental Protection Agency (EPA) provides capitalization grants to provide capital to each loan fund to make financial assistance. In order to receive the capitalization grants, the state must match a portion of federal funds with state monies. Wisconsin's match is provided through environmental improvement fund revenue bonds, with debt service paid from loan repayments. Under current law, EIF is provided with up to $2,551,400,000 in revenue obligation bonding authority. The state match was previously provided through general obligation bonds, with most debt service paid through GPR. The clean water fund is authorized up to $659,783,200 in general obligation bonds and the safe drinking water loan program is authorized up to $74,950,000 in general obligation bonds.

DISCUSSION POINTS

1. The environmental improvement fund is funded through federal capitalization grants and a required state match. Prior to 2022-23, the state match for all capitalization grants was 20%, but recent federal legislation has reduced or eliminated the match for certain capitalization grants. The biennial budget act has historically authorized the amount of bonds anticipated to be needed to provide

the state match needed to maximize receipt of federal grants during that biennium. Any previously authorized but unused bonding authority is carried forward to the subsequent biennium. In addition to the required state match, the EIF uses the proceeds of revenue bonds to fund any financial assistance agreements that cannot be funded through loan repayments and interest earnings or other fund incomes.

2. Federal rules generally require states to have match funding secured before they may receive capitalization grants. AB 43/SB 70 would increase EIF revenue bonding authority by $372,000,000, from $2,551,400,000 to $2,923,400,000. This funding would be sufficient to provide the state's match for four years, rather than two, so that any potential delay in adoption of a state budget, or any increases in federal capitalization grants above estimated amounts, would not limit the state from accepting federal grants and closing on financial assistance agreements in future biennia.

3. Under the Infrastructure Investment and Jobs Act (IIJA) of 2021, the state match requirement varies for different capitalization grant purposes. The IIJA and the Consolidated Appropriations Act of 2022 provide states with up to three different capitalization grants for the clean water fund: (1) the base clean water fund capitalization grant; (2) a supplemental capitalization grant; and (3) an emerging contaminants capitalization grant. Additionally, the Acts provide states with up to four safe drinking water loan program capitalization grants: (1) the base drinking water grant; (2) a supplemental drinking water grant; (3) a lead service line replacement capitalization grant; and (4) an emerging contaminants grant. The estimated value, purpose, and required state match for each grant are summarized in the attachment. Table 1 summarizes the value of each grant and required state match for the 2023-35 and 2025-27 biennia.

TABLE 1

EIF Capitalization Grants by Biennium (Millions)

	2023-25		2025-27	
Grant Type	Grant	State Match	Grant	State Match
Clean Water Fund				
Base	$51.6	$12.5	$62.6	$12.5
Supplemental	117.6	17.9	132.8	26.6
Emerging Contaminants	11.5	-	11.5	-
Subtotal	$180.7	$30.4	$206.8	$39.1
Safe Drinking Water Loan Program				
Base	$23.1	$5.3	$29.2	$5.8
Supplemental	74.7	10.3	83.8	16.8
Lead Service Line Replacement	162.4	-	162.4	-
Emerging Contaminants	26.2	-	26.2	-
Subtotal	$286.3	$15.6	$301.5	$22.6
EIF Total	$467.0	$46.0	$508.4	$61.7

A. State Match

4. As shown in the table, between 2023-24 and 2026-27, the state is estimated to receive $975.4 million in federal capitalization grants, including $387.5 million for the clean water fund and $587.9 million for the safe drinking water loan program. To receive these grants, the state would be required to provide a match of $107.7 million. The Committee could consider increasing EIF revenue obligation bonding authority by $107.7 million to fund projected state match requirements between 2023-24 and 2026-27 [Alternative A1].

5. Alternatively, the Committee could consider providing sufficient revenue bonding authority to provide the state's required match through only the 2023-25 biennium. The state is estimated to receive $467.0 million in clean water and safe drinking water capitalization grants over the next two fiscal years. To receive these grants, the state would be required to provide $46.0 million in match funding [Alternative A2]. This would increase environmental improvement fund revenue bonding authority from $2,551,400,000 to $2,597,400,000.

6. It should be noted that, in response to current levels of inflation, the Federal Reserve has been raising the federal funds rates, which in turn increases other interest rates, in order to make borrowing more costly. Rising interest rates affect the cost of issuance of new bonds. Any debt authorized in the current budget would likely be issued in this higher-interest environment. When the state issues fixed-rate bonds to fund projects, the proceeds from the bond issue are generally a combination of the principal amount of the bond issue and a premium. Bond premiums lower the effective interest rate on a bond as the interest rate shown on the bond (the "coupon rate") applies only to the principal of the bond. The amount of premiums received typically decreases as interest rates increase, which raises the true interest cost of state debt. Between August, 2021, and October, 2022, the true-interest cost of new-issue EIF revenue bonds increased from 1.83% to 4.00%.

7. The March, 2023, biennial finance plan reports that the current period of higher interest rates could put financial stresses on the EIF. While investment and interest income and proceeds from currently authorized bonds are expected to be able to fund current EIF commitments, "there is no guarantee that funding at [projected] levels can be maintained for future years." The plan notes that interest costs on EIF revenue bonds could exceed interest earnings on fund loans, the largest source of funding to the EIF.

8. As of June 30, 2022, approximately $2.2 billion is outstanding on EIF loans. The weighted interest rate on outstanding loans is 2.08%. While some low-interest loans will be retired and replaced with higher-interest loans in coming years, sustained periods of higher interest rates could see more fund income paying off high fixed interest rates on state bonds. Under this scenario, the EIF would be required to reduce the amount of financial assistance agreements from the fund.

9. Given high interest rates on new-issue revenue obligations, the Committee could consider providing cash funding, in lieu of state debt. This would have two benefits. First, providing cash would incur no debt service costs. Therefore, fund interest earnings and investment incomes could be used to award financial assistance, rather than to pay debt service.

10. A second benefit concerns the use of bond arbitrage. Federal law restricts the timing

between the issuance of tax-exempt bonds, such as EIF revenue bonds, and when the proceeds are actually used. If bond proceeds are used to purchase a security with a higher yield than the bond, the securities may only be held for a temporary period, before bond interest is taxable. This does not apply if investments are purchased with cash. Therefore, a one-time transfer of cash into the EIF could accrue interest indefinitely, until the cash is used to pay fund expenses and make loan disbursements. In April, 2023, the annualized rate of return on the state investment fund, which holds EIF cash balances, was 4.8%.

11. The Committee could consider providing a one-time transfer of either $107.7 million GPR to provide the state's required EIF match between 2023-34 and 2026-27 [Alternative A3], or $46.0 million GPR to provide the state's required match for the 2023-25 biennium [Alternative A4].

B. Additional Funding

12. In addition to the required state match, the EIF uses the proceeds of revenue bonds to fund any financial assistance agreements that cannot be funded through loan repayments and interest earnings or other fund incomes. The March, 2023, biennial finance plan estimated program demand for the clean water fund at $917.5 million in the 2023-25 biennium and $1,110.8 million in the 2025-27 biennium. Demand for the safe drinking water loan program is estimated at $222.5 million in the 2023-25 and at $254.6 million in the 2023-25 biennium. Total demand for EIF financial assistance is estimated to be $1,140.0 million in the 2023-25 biennium and $1,365.4 million in the 2025-27 biennium, as shown in Table 2.

TABLE 2

Environmental Improvement Fund Projected Demand (Millions of Dollars)

	Percent of Market Interest Rate	2023-24	2024-25	2025-26	2026-27
Clean Water Fund					
	Pilot Projects (0%)	$11.1	$12.3	$13.7	$15.2
	0	20.7	22.7	25.0	27.5
	33	111.0	122.1	134.3	147.8
	55	272.8	300.1	330.1	363.1
	100	21.3	23.4	25.8	28.3
Total		$436.9	$480.6	$528.9	$581.9
Safe Drinking Water Loan Program					
	33%	$43.3	$46.3	$49.5	$53.0
	55	64.2	68.7	73.5	78.6
Total		$107.5	$115.0	$123.0	$131.6
EIF Total		$544.4	$595.6	$651.9	$713.5

13. In addition to the $2,505.4 million in expected financial assistance agreements, the biennial finance plan anticipates that the EIF will need $179 million for program administration, $26

million for general obligation debt service (for bonds issued to fund the program prior to 2019), and $261 million for revenue obligation debt service. An additional $475 million will be used for principal forgiveness, as provided by federal law, as well as disbursements on existing loans that have not yet closed. In total, DOA and DNR expect to use $3,561 million between 2023-24 and 2026-27.

14. Under current projections, the EIF is expected to have $2,747 million in funding sources, including investment income, capitalization grants, loan repayments, and interest, available to be used for financial assistance and program administration. Therefore, the fund would need an additional $814 million in fund sources to meet all projected needs in the 2023-25 and 2025-27 biennia.

15. According to the EIF biennial finance plan issued by DNR and DOR in March of 2023, the EIF has $485.2 million in unissued bonding authority. In its May 3, 2023, meeting, the Building Commission voted to approve the issuance of $150 million in EIF revenue obligation bonds. Once DOA issues these bonds, the EIF would need an additional $664 million to meet all projected needs between 2023-24 and 2026-27. Of this, $335.2 million could be met with existing bonding authority, leaving $328.8 million in unfunded projected financial need. This amount includes the funding needed to provide the required state match. In addition to funding the state's required match ($107.7 million for four years), the Committee could provide $221.1 million in revenue obligation bonding authority to fund all projected financial assistance requests through 2026-27 [Alternative B1].

16. The biennial finance plan is required to consider future needs for the EIF for a four-year period. The requirement to plan for an extended period is intended to provide the fund with financial stability over an extended period and to reduce funding uncertainty in case the 2025-27 biennial budget is passed late. However, the Committee could consider providing sufficient funding for financial assistance only in the 2023-25 biennium. Under this perspective, the Committee could consider increasing EIF revenue obligation bonding authority by $118 million [Alternative B2]. This would, paired with the state match funding, would fund all financial assistance needs projected through 2024-25.

17. Providing additional state funding through GPR would reduce expenses from the EIF. Currently, state funding for the EIF is provided through revenue obligation bonds. The debt service costs on these revenue obligation bonds are paid through loan repayments and interest. The EIF would not incur debt service costs from GPR and could receive interest income from the state investment fund. Given the reduced costs of using GPR, the Committee could fund additional financial assistance agreements with GPR. The Committee could provide $221.1 million GPR to fund all projected needs through 2026-27 [Alternative B3]. Alternatively, the Committee could provide $118 million GPR to fund all projected needs through 2024-25 [Alternative B4].

18. As described above, the current period of high interest rates makes public debt more expensive. While the EIF is able to provide some reduced-rate financing and principal forgiveness, many financial assistance agreements provide at least a portion of a loan at the market rate. DNR has indicated that some municipalities have reduced the scope of projects due to high costs of capital. Current law authorizes DNR and DOA to request the Committee to modify loan interest rates for financial assistance awarded through the CWF and SDWLP. To date, the agencies have not requested any Committee approval. If the Committee provides a GPR transfer to the fund, in lieu of revenue obligation funding, DNR and DOA could pass a portion of the interest rate reduction to municipal

borrowers. The Committee could consider requiring DNR and DOA to provide an additional interest rate subsidy on certain loans [Alternative B5]. DNR and DOA could outline interest rate reductions and eligibility through the annual intended use plan.

19. If the Committee takes no action [Alternative B5], DNR may be required to pause processing financial assistance applications until additional funding is authorized by the Legislature.

ALTERNATIVES

A. State Match Funding

1. Increase the revenue bonding authorization for the EIF by $107.7 million, from $2,551,400,000 to $2,659,100,000, to provide the required state match for a four-year period.

ALT A1	**Change to Base**
BR	$107,700,000

2. Increase the revenue bonding authorization for the EIF by $46 million, from $2,551,400,000 to $2,597,400,000, to provide the required state match for a two-year period

ALT A2	**Change to Base**
BR	$46,000,000

3. Transfer $107.7 million from the general fund to the EIF to provide the required state match for a four-year period.

ALT A3	**Change to Base**
GPR-Transfer	$107,700,000

4. Transfer $46 million from the general fund to the EIF to provide the required state match for a two-year period.

ALT A4	**Change to Base**
GPR-Transfer	$46,000,000

5. Take no action to provide additional funding for the state match.

B. Additional State Funding

1. Increase the revenue bonding authorization for the EIF by $221.1 million to fund all projected financial assistance needs between 2023-24 and 2026-27.

ALT B1	Change to Base
BR	$221,100,000

2. Increase the revenue bonding authorization for the EIF by $118 million to fund all projected financial assistance needs in 2023-24 and 2024-25.

ALT B2	Change to Base
BR	$118,000,000

3. Transfer $221.1 million from the general fund to the EIF to fund projected financial assistance needs for a four-year period.

ALT B3	Change to Base
GPR-Transfer	$221,100,000

4. Transfer $118 million from the general fund to the EIF to fund projected financial assistance needs for a two-year period.

ALT A4	Change to Base
GPR-Transfer	$118,000,000

5. In addition to providing additional funding through GPR, require DNR and DOA to provide additional interest rate subsidy on certain loans. Require the agencies to publish interest rate reductions and eligibility in the annual intended use plan.

6. Take no action to provide additional funding for projected financial assistance needs.

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Attachment

ATTACHMENT

Estimated Federal Capitalization Grants under IIJA and Federal Appropriations Acts

		2023-24*			2024-25			2025-26			2026-27		
Grant Type	Purpose	Grant Value	Match Percent	Match Value	Grant Value	Match Percent	Match Value	Grant Value	Match Percent	Match Value	Grant Value	Match Percent	Match Value
Clean Water Fund													
Base	Wastewater and storm water treatment	$20,279,000	20%	$6,256,200	$31,300,000	20%	$6,256,200	$31,300,000	20%	$6,256,200	$31,300,000	20%	$6,256,200
Supplemental	infrastructure upgrades and developments.	56,351,000	10	5,635,100	61,291,661	20	12,258,332	66,392,923	20	13,278,585	66,392,923	20	13,278,585
Emerging Contaminants	Principal forgiveness for PFAS wastewater treatment.	5,749,000	0	-	5,728,500	0	-	5,728,500	0	-	5,728,500	0	-
Subtotal		$82,379,000		$11,891,300	$98,320,161		$18,514,532	$103,421,423		$19,534,785	$103,421,423		$19,534,785
Safe Drinking Water Loan Program													
Base	Drinking water and source water	$8,455,000	20%	$2,388,600	$14,600,000	20%	$2,920,000	$14,600,000	20%	$2,920,000	$14,600,000	20%	$2,920,000
Supplemental	treatment and protection.	36,053,000	10	3,066,600	38,662,779	20	7,210,600	41,880,655	20	8,376,131	41,880,655	20	8,376,131
Lead Service Line Replacement	Loans and principal forgiveness for lead service line replacement projects; lead service line inventories.	81,203,000	0	-	81,203,000	0	-	81,203,000	0	-	81,203,000	0	-
Emerging Contaminants	Principal forgiveness for PFAS drinking water treatment projects.	13,082,000	0	-	13,082,000	0	-	13,082,000	0	-	13,082,000	0	-
Subtotal		$138,793,000		$5,455,200	$147,547,779		$10,130,600	$150,765,655		$11,296,131	$150,765,655		$11,296,131
Total		$221,172,000		$17,346,500	$245,867,940		$28,645,132	$254,187,078		$30,830,916	$254,187,078		$30,830,916

*Actual