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General Obligation Bonding Authority and Present Value Subsidy Limit (Environmental Improvement Fund)

[LFB 2005-07 Budget Summary: Page 162, #2 and #3]

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 pollution abatement or urban stormwater 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. The state match is provided with general obligation bond proceeds. 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 with the general obligation bonds paying the costs of the state subsidy to municipalities that results because loans to municipalities are made at an interest rate below the market interest rate the state pays for its revenue bonds. 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 program and safe drinking water loan program projects. The present value subsidy limit acts as a cap on the sum of all assistance provided through the clean water fund program and safe drinking water loan 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 currently $90 million authorized in present value subsidy for the clean water fund for the 2003-05 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 15% of the total present value subsidy authorized during a biennium.

The safe drinking water loan program within the environmental improvement fund 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 program provides loans using proceeds of federal capitalization grants and a 20% state match provided with general obligation bond proceeds. The program does not have a state revenue obligation bond component like the clean water fund program has. There is $12.8 million in present value subsidy for the safe drinking water loan program for the 2003-05 biennium and $1,000 authorized for subsequent biennia.

Safe drinking water loan projects are scored according to a priority ranking system that is used to establish a list of projects to be funded. Top priority is provided for projects that address an acute public health risk, especially risk related to a confirmed waterborne disease outbreak or confirmed microbial contamination. Second priority is provided for projects that address chronic and longer-term health risks to people who drink the water.

The land recycling loan program within the clean water fund provides financial assistance to local governments for the investigation and remediation of contaminated (brownfields) properties. Eligible projects include investigation and remediation of contamination at sites or facilities owned by the local government if the contamination has affected, or threatens to affect, groundwater or surface water. The land recycling loan program is funded with up to $20 million, which comes from reallocation of repayments of clean water fund program loans made with the proceeds of federal grants to the clean water fund. There is $4.0 million in present value subsidy for the land recycling loan program for the 2003-05 biennium, and $1,000 for subsequent biennia.

GOVERNOR

Provide an increase in general obligation bonding authority of $15,700,000 for the environmental improvement fund, including: (a) $9,600,000 for the clean water fund program; and (b) $6,100,000 for the safe drinking water loan program.

Provide a "present value subsidy limit" totaling $153.4 million for the environmental improvement fund for the 2005-07 biennium, including: (a) $136.6 million for the clean water fund program; (b) $13.5 million for the safe drinking water loan program; and (c) $3.3 million for the land recycling loan program. Provide a present value subsidy limit of $1,000 for any biennium after the 2005-07 biennium.

DISCUSSION POINTS

1. The environmental improvement fund biennial finance plan submitted by DNR and DOA to the Building Commission and Legislature in September, 2004, requested sufficient general obligation bonding authority and present value subsidy limit under the clean water fund program to fund all expected wastewater needs during the biennium. DNR identified wastewater project needs of $685.9 million for the 2005-07 biennium, including: (a) $168.0 million of the $336.0 million in estimated 2004-05 project costs for which applications had not been submitted as of August, 2004, and were reestimated to be submitted in 2005-06 instead of 2004-05 (inclusion of this component meant that it was estimated that 2003-05 present value subsidy limit would not be needed for the projects, but that instead 2005-07 present value subsidy limit would be needed. The estimate also assumed that the other $168.0 million in 2004-05 project costs would be submitted in 2004-05.); (b) $489.6 million in estimated need for new clean water fund program applications in the 2005-07 biennium; (c) $8.3 million in land recycling loan program costs in the 2005-07 biennium; and (d) $20.0 million as a 3% construction contingency for the $665.9 million in applications described above. DNR's projections represented the best estimates of need as of September 1, 2004, based on both file materials and a comprehensive survey of municipalities. In comparison, the estimated project costs in the 2003-05 biennium were almost $300 million lower at $387.7 million.

2. The bill is based on an assumption of a 6% market interest rate for revenue obligations issued during the biennium. Under this assumption, $685.9 million in estimated wastewater project costs would require a present value subsidy limit of $136.6 million, general obligation bonding authority of $166.5 million, and revenue obligation bonding authority of $534.7 million. However, the bill requests $9.6 million instead of $166.5 million in general obligation bonding, and no revenue obligation bonding authority, because of the high levels of available carryover bonding authority from 2003-05 and previous biennia. The reasons for the high level of carryover general obligation bonding authority include a restructuring of subsidy and credit reserve funds to reflect actual need and interest rates, lower than estimated loan activity levels, higher than

estimated loan repayments and federal capitalization grants, unused financial hardship assistance funds, and actual market interest rates of 4.3% instead of the estimated 6.0%.

3. The biennial finance plan and the bill are based on an estimated revenue obligation market interest rate of 6% for long-range planning purposes, based on historical trends. This is the same assumption that was included in the 2001-03 biennial budget. The revenue obligation market interest rate for most of the 1999-01 biennium was 5.4%, decreased to 5% in April, 2001, and decreased to 4.3% in March, 2004. DOA officials anticipate that the revenue obligations issued in 2004 will be sufficient to fund anticipated clean water fund project costs through the fall of 2005, and the market interest rate of awards under the program would continue at 4.3% during that time.

4. The 2003-05 biennial budget adopted by the Legislature included a present value subsidy limit for the clean water fund program of $55.1 million instead of the $92.4 million requested by the Governor, and a decrease in general obligation bonding authority of $21.5 million, assuming a 5.0% market interest rate and deletion of 10% contingency allowances. The Governor's partial veto allowed the program to retain the $90.0 million in present value subsidy limit provided in the 2001-03 biennium, and the current $637.7 million in general obligation bonding authority.

5. If market interest rates continue at the current 4.3% rate or remain at an interest rate lower than the 6% "planning interest rate" used in the biennial finance plan during the 2005-07 biennium, the Governor's recommended levels of bonding authority could 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 6% 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 6%).

6. The Milwaukee Metropolitan Sewerage District (MMSD) borrows the largest percentage of project costs of any municipality in the program. The biennial finance plan estimated MMSD low-interest loan project costs of approximately $249.4 million during 2005-07, (excluding construction contingencies) and present value subsidy of $47.9 million, equaling 35.0% of the total present value subsidy limit under the bill. This is within the statutory requirement that an individual municipality may receive no more than 35.2% of the total present value subsidy limit. The percentage of the total present value subsidy limit allocated to MMSD would be approximately the same if the actual interest rates would be lower than the estimated rate under the bill because the estimated project costs for MMSD and the statewide total would remain the same as under the bill.

7. MMSD used almost the statutory maximum 35.2% of present value subsidy available to it under the program in the 1999-01 and 2001-03 biennia. However, MMSD project costs in 1999-01 were approximately 58.3% of actual statewide project costs ($198.9 million of $340.9 million in statewide project costs). In 2001-03, MMSD project costs were approximately 39.2% of the statewide total ($165.9 million of $422.9 million statewide). MMSD represented a higher proportion of total costs, than of present value subsidy, primarily because actual projects funded for other communities were significantly lower than had been projected. In the 2003-05 biennium, MMSD project costs as of mid-March, 2005, totaled $63.6 million, out of $184.4 million in statewide project costs to date (35%). DOA and DNR officials anticipate that MMSD will enter

into financial assistance agreements during the remainder of the 2003-05 biennium under which the program will allocate present value subsidy to MMSD up to the 35.2% maximum.

8. Because actual market interest rates were lower than estimated during the 1999-01 and 2001-03 biennia, the program could finance more projects through the clean water fund program than it would have been able to do if the present value subsidy limit had been established at a lower level that more closely reflected actual market interest rates.

9. When a municipality submits a clean water fund application, DOA allocates present value subsidy limit to the project based on the 6% planning market interest rate. When the program and the municipality enter into a financial assistance agreement, projects are assigned a loan interest rate based up on the actual market interest rate, and present value subsidy is allocated as funds are disbursed under the loan. As long as actual interest rates remain below 6%, the actual present value subsidy remains less than the statutory figure.

10. If estimates of need are made using a market interest rate lower than the 6% used in the bill, the level of general obligation bonding authority and present value subsidy limit could be decreased to more accurately reflect expected interest rates. If the interest rate would be estimated as 5.5% during the 2005-07 biennium, cumulative clean water fund program general obligation (GO) bonding authority of $634.5 million would be sufficient to fund all need projected through June, 2007. This would represent a $3.2 million reduction to the currently authorized cumulative amount of $637.7 million (a $12.8 million reduction to the bill, see Alternative #2). In addition, a present value subsidy limit of $123.1 million would be sufficient for the clean water fund program instead of the $136.6 million provided under the bill.

11. If the interest rate would be estimated to continue at 5.0% during the biennium, cumulative GO bond authority of $622.0 million would be sufficient for the clean water fund program, representing a $15.7 million reduction to the currently authorized $637.7 million (a $25.3 million reduction to the bill, see Alternative #3). In addition, a present value subsidy limit of $109.6 million would be sufficient for the clean water fund program instead of $136.6 million.

12. Any reduction in GO bond authority from current levels would not be expected to result in significant GPR savings in debt service costs until after 2006-07. This is because bonds allocated for projects that are approved for funding in the 2005-07 biennium would likely be issued late in the biennium or in future biennia as facility construction is completed, and debt service would typically begin to be paid after 2006-07. Further, it is probable that any general obligation bonding authority not needed during 2006-07 would be needed for allocation to project costs in the 2007-09 biennium.

13. Although interest rates for awards under the program are currently at 4.3%, and are expected to remain at that rate through the fall of 2005, it is likely that the next revenue bond issue would have an interest rate higher than 4.3%. An estimated market interest rate of 5.0% or 5.5% would allow for some increase in market rates over the biennium without limiting anticipated projects. If average interest rates rise beyond 5.0%, and if a 5.0% interest rate would be used for provision of funding, the higher than expected interest rates could limit funding for some projects.

14. If interest rates rise beyond expectations, municipalities encounter project cost increases, or need is greater than identified in the September, 2004, biennial finance plan, Alternative #2 or #3 could result in some projects being deferred from the spring of 2007 to after June 30, 2007, when 2007-09 financing would be made available. On the other hand, it is possible that some demand currently expected for the 2005-07 biennium will not materialize until 2007-09. It is estimated that $168 million in 2003-05 projects will not be realized until 2005-07. Similarly, some of the $489.6 million in expected new 2005-07 project costs may not be realized until 2007-09.

15. The safe drinking water loan program uses all of the authorized general obligation bonds to provide the 20% state match to the federal capitalization grant under the Safe Drinking Water Act. This differs from the clean water fund program, which uses part of the general obligation bonds for the 20% state match to the federal capitalization grant under the Clean Water Act, and the remainder of general obligation bonds are used to pay the costs of the state subsidy to municipalities under the revenue obligation bond component of the program. The biennial finance plan prepared in September, 2004, requested $6.1 million in general obligation bonds which, in combination with $0.7 million in previously authorized but uncommitted bonding authority, would be sufficient to provide the 20% state match to approximately $34,000,000 in federal capitalization grants during the biennium. This would provide a state match approximately $0.2 million higher than needed if the federal fiscal year 2005 and 2006 grants (for 2005-06 and 2006-07 project costs) continue at the $16,442,800 level provided in federal fiscal year 2004 for 2004-05 project costs. The state is required to have the entire 20% state match in place before it can accept the federal capitalization safe drinking water grant.

16. If an estimate of a 5.5% market interest rate is made, a present value subsidy limit of $12.1 million could be provided for the safe drinking water loan program instead of the $13.5 million under the bill. Under an estimated 5.0% market interest rate, a present value subsidy limit of $10.8 million could be provided.

17. If an estimate of a 5.5% market interest rate is made, a present value subsidy limit of $3.0 million could be provided for the land recycling loan program. Under an estimated 5.0% market interest rate, a present value subsidy limit of $2.7 million could be provided.

ALTERNATIVES

1. Approve the Governor's recommendation to provide: (a) an increase in general obligation bonding authority of $9,600,000 for the clean water fund program; (b) a "present value subsidy limit" totaling $136.6 million for the clean water fund program; (c) an increase in general obligation bonding authority of $6,100,000 for the safe drinking water loan program; (d) a "present value subsidy limit" totaling $13.5 million for the safe drinking water loan program; and (e) a "present value subsidy limit" of $3.3 million for the land recycling loan program.

2. Estimate a 5.5% revenue market interest rate, and approve the following: (a) a decrease in general obligation bonding authority of $12,800,000 from the amount in the bill for the clean water fund program (a decrease of $3.2 million from current law amounts); (b) a "present value subsidy limit" totaling $123.1 million for the clean water fund program; (c) an increase in general obligation bonding authority of $6,100,000 for the safe drinking water loan program; (d) a "present value subsidy limit" totaling $12.1 million for the safe drinking water loan program; and (e) a "present value subsidy limit" of $3.0 million for the land recycling loan program.

Alternative 2	BR
2005-07 REVENUE (Change to Bill)	**-** $12,800,000

3. Estimate a 5.0% revenue market interest rate, and approve the following: (a) a decrease in general obligation bonding authority of $25,300,000 from the amount in the bill for the clean water fund program (a decrease of $15.7 million from current law amounts); (b) a "present value subsidy limit" totaling $109.6 million for the clean water fund program; (c) an increase in general obligation bonding authority of $6,100,000 for the safe drinking water loan program; (d) a "present value subsidy limit" totaling $10.8 million for the safe drinking water loan program; and (e) a "present value subsidy limit" of $2.7 million for the land recycling loan program.

Alternative 3	BR
2005-07 REVENUE (Change to Bill)	**-** $25,300,000

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