

**STATE WATER RESOURCES CONTROL BOARD
BOARD MEETING SESSION - DIVISION OF FINANCIAL ASSISTANCE
NOVEMBER 18, 2008**

ITEM 7

SUBJECT

CONSIDERATION OF A RESOLUTION ADDRESSING THE SECURITY OF CLEAN WATER STATE REVOLVING FUND (CWSRF) FINANCING AGREEMENTS

DISCUSSION

Background

Recent events have raised questions about the security of payments to the CWSRF program from financial assistance recipients. Current law gives wastewater service ratepayers not only the power to disapprove proposed rate increases, but also appears to allow them to reset their rates at any time after receiving assistance from the CWSRF. Since most CWSRF recipients rely on wastewater service revenue, they may have difficulty making payments to the State Water Resources Control Board (State Water Board) to repay the CWSRF. This could undermine the operations and effectiveness of the CWSRF.

The security of CWSRF payments is related to Proposition 218 (Prop. 218). Prop. 218 was a constitutional amendment passed in 1996 as a follow-up to Proposition 13 of the 1970s. Proposition 13 limited local governments' ability to tax property, and Prop. 218 limited their power to assess property related fees, including those for water, wastewater, and garbage collection. Prop. 218 required that local governments give property owners an opportunity to protest before imposing any new or increased assessment.

In July 2006, the state Supreme Court decided the case of Bighorn-Desert View Water Agency v. Verjil (Bighorn). Bighorn interpreted provisions of the California Constitution created by Prop. 218. Among other things, Bighorn made clear that property owners can reduce their water rates by initiative. This authority likely extends to wastewater rates because sewer, water, and garbage services are treated identically under Prop 218's rate-setting procedures.

Follow-up legislation to Prop. 218 limits voter ability to impair contracts protected under the federal constitution. It is unclear at this point whether, and to what extent CWSRF contracts are protected.

There are currently several municipalities that are experiencing or recently experienced rate challenges due to Prop. 218 and Bighorn. The Cities of Colfax and Petaluma are current CWSRF borrowers. In July 2008, ratepayers protested Colfax's attempt to raise rates. Currently, Colfax does not have sufficient revenue to pay its CWSRF agreement. Colfax plans to seek approval of a new assessment on November 19, 2008, that will give it enough revenue to pay its loan. "Petalumans for Fair Utility Rates" qualified a measure for the November 4, 2008, ballot that will reduce Petaluma's wastewater rates to 2006 levels and provide for future rate increases based on the Consumer Price Index for the San Francisco metropolitan area.

Petaluma stated in Resolution No. 2008-100 that a rate rollback to 2006 levels will give it insufficient funds to operate and maintain its facility and repay CWSRF and other debt financing.

Colfax and Petaluma potentially represent over \$130 million in assets at risk should the citizens not approve or overturn the rates necessary to pay their CWSRF agreements. There is additional risk to the CWSRF's assets if other agencies follow suit. A disaffected ratepayer group can qualify a rollback for the ballot with signatures from five percent of the number of voters on the most recent ballot.

The State Water Board took steps on September 16, 2008, to address the risk from situations like Colfax. The State Water Board amended its *Policy for Implementing the CWSRF for Construction of Wastewater Treatment Facilities* (Policy) to require that, with limited exceptions, all applicants adopt any necessary rate increases consistent with Prop. 218 requirements before the financing agreements can be executed. All applicants are also required to undergo a formal credit review before receiving approval for their projects and show that they meet minimum debt coverage ratios and ability to repay the financial assistance.

Consequences for the CWSRF Program

There are several consequences for the CWSRF program if financing recipients fail to make their payments.

- It could affect the program's ability to fulfill disbursement requests on executed financing agreements.
- It will reduce funds for new financing agreements.
- It will increase collection costs.
- It could affect the program's ability to make debt service on its Bonds.
- It could make it more difficult or costly to borrow funds in the future.
- It will reduce the growth of the CWSRF.
- It will ultimately reduce the effectiveness of the CWSRF.
- It could result in lost grants or revocation of the program by the United States Environmental Protection Agency (U.S. EPA).

CWSRF Finances

The CWSRF has about \$2.8 billion in net assets. There are about \$2.6 billion in loan receivables (principal due on CWSRF agreements). The program's approximate annual revenues and expenses are summarized in Table 1.

Table 1
**Approximate Annual Clean Water State
 Revolving Fund Revenues and Expenses**

REVENUES	AMOUNT
Capitalization Grant	\$ 45,000,000
Payments	\$ 201,000,000
Investment Earnings	\$ 10,000,000
Total Revenues	\$ 256,000,000

EXPENSES	AMOUNT
Administration	\$ 5,600,000
Debt Service	\$ 32,000,000
Total Expenses	\$ 37,600,000

The program has executed over 380 financing agreements with about 180 different recipients (mostly local governments). Over 60 percent of the payments come from about 20 recipients. The remainder comes from the other 160 recipients. A portion of the “Payments” is restricted; it must first be used for debt service. About \$70 million in payments is currently pledged toward debt service.

The program has approximately \$387 million in cash. The outstanding obligations, cash restricted for debt service, administration costs, and executed financing agreements (about \$350 million in disbursements scheduled over the next one to three years), are about \$400 million. Therefore, CWSRF currently has sufficient cash to meet all its current obligations (the funds restricted for debt service are greater than the necessary payment; excess funds will become available for other uses after debt service is paid).

The State Water Board’s policy is to maintain a minimum balance in the CWSRF of \$25 million. Therefore, the State Water Board has about \$193 million it can disburse to applicants yearly. This number is increasing for two reasons: (1) additional capital from U.S. EPA and past payments are generating new payments and (2) debt service is decreasing.

The program’s cash flow is dynamic. The current balance between cash and obligations may shift depending on how aggressive or conservative the State Water Board is at approving new financing agreements or taking on additional debt. Reductions in future revenue likewise can affect the balance of cash and obligations and, therefore, the program’s ability to make and meet future commitments.

Other factors also affect future cash flow. The Governor approved Assembly Bill 2356 on September 30, 2008. It may decrease CWSRF revenue by up to \$50 million through 2014 to provide grants to small, disadvantaged communities. Although federal grants have been declining for the last four years, there are efforts in Congress to significantly increase funding for the CWSRF. House Resolution 720 contains \$14 billion for CWSRF nationwide from 2008 – 2011.

A similar measure, S. 3500, in the Senate contains \$20 billion for the CWSRF through 2012. California's potential share based on the current distribution formula is between \$1 billion and \$1.4 billion.

With one exception – the Los Osos Community Services District – payments have been remarkably predictable since the beginning of the program. Over 3,100 payments have been made to the program for a total of about \$1.5 billion. To date only nine payments have been received late. The latest payment received was 17 days late. Recipients have paid a total of \$21,459.40 in late penalties. About 95 percent of payments are for wastewater infrastructure related projects.

The sewer sector is mature and relies on proven technology. Wastewater utilities are a natural monopoly, operated by local governments. The systems are essential to public health and the environment, and regulatory compliance is compulsory. As of 1999, only one-half of one percent of Moody's public ratings on water and sewer systems was below investment grade.¹

Fitch also reports that the wastewater sector has extremely strong credit characteristics with minimal history of default over the past quarter century. This strong performance is reflected by the fact that the majority of ratings by Fitch is between "A-" and "AAA," and should remain within this range for the foreseeable future.²

The State Water Board staff is working to develop additional security measures on individual finance agreements or additional policy changes in cooperation with the CWSRF Stakeholders Advisory Group (SAG). SAG was formed in February 2008 to provide an opportunity to the stakeholders to advise the CWSRF Program in the following areas; setting funding priorities, operational improvements and development of regulations, marketing, business development, and financial forecasting. In addition, the State Water Board staff started working to develop a systematic approach for evaluating the risk of default by each applicant. This approach will ensure that new agreements are backed by adequate rates for repayment, and will highlight any local controversy that may indicate a future rate rollback. Any change to the CWSRF risk evaluation process will be done in cooperation with the CWSRF SAG in future meetings.

Possible Measures

There are a wide range of measures available to the State Water Board to address the ramifications of Prop. 218 and the Bighorn decision. The State Water Board implemented Policy changes on September 16, 2008, to reduce the risk of ratepayers disapproving rate increases through the Prop. 218 process. Additional options to address the risk of rollbacks are discussed below. These can broadly be classified as internal changes (procedure or policy) the State Water Board can make to the program or external changes it can take to counteract the effects of Bighorn.

¹ RATING METHODOLOGY: Analytical Framework For Water And Sewer System Ratings, Moody's Investors Service, August 1999

² Water and Sewer Revenue Bond Rating Guidelines, Fitch Ratings, August 6, 2008

1) Internal Measures:

- a) Delay implementing reduced interest rates and limit extended term financing.

The CWSRF program recently received U.S. EPA approval to offer extended term financing (for up to 30 years rather than 20 years). The program is also extending its ability to offer further reduced interest rates. These two activities will both reduce the earnings of the CWSRF program. Implementing these measures at a time when earnings may suffer from late payments or defaults could exacerbate the problem of rate rollbacks. Delaying reduced interest rates and/or extended term financing may be prudent until the effect of rate rollbacks is clearer.

Delay in these efforts limits the State Water Board's ability to use these program changes as leverage to achieve its water quality goals. Reduced interest rates and extended term financing also reduce the need for or size of lower rate increases. Lower rates are less likely to trigger rollbacks due to "sticker shock."

- b) Limit encumbrances to cash on hand or limit future encumbrances to some percentage of future cash flows.

The potential magnitude and pace of lost or delayed revenue due to rate rollbacks is difficult to predict. An overnight, catastrophic drop in revenue is unlikely. Community groups need time and political support to qualify a rollback measure for a ballot. It may be necessary for the community to wait for a regularly scheduled election. Voters may or may not approve a rate rollback. If a community with a CWSRF agreement rolls back its rates, it may or may not be able to make its payments with remaining revenues. The courts in time may determine that the rate rollback is invalid and the community must pay the CWSRF what it owes.

One way to counterbalance deterioration of CWSRF revenues over the next several years is to limit the encumbrance of future funds so that even if revenue declines, the CWSRF can still meet its commitments. The State Water Board may direct staff to commit no more than cash on hand or a certain percentage of future years' receipts.

- c) The CWSRF program can suspend execution of new agreements for some period of time or until some condition is met.

Suspending the program is a strong statement about the State Water Board's interest in protecting the program, and may encourage local agencies with a vested interest to assist the State Water Board in solutions. It carries a mixed message, however. Some may feel the State Water Board is favoring financial security at the expense of water quality protection. It also reduces help to communities most in need of financial assistance.

There are practical consequences if the program is suspended for a significant length of time. U.S. EPA may withhold grants or revoke California's program delegation depending on the length of the suspension.

CWSRF cash is invested in the Surplus Money Investment Fund (SMIF). Interest rates over the last five years have ranged from about 1.6 percent to about 5.1 percent; the average was about 3.6 percent.

Although it is possible that the program will earn more interest invested in SMIF than it will lending the funds to applicants, there will be no environmental benefit from the program during this time. Approximately 30 Personnel Years (PY) are allocated to the program. The majority of CWSRF program effort is associated with reviewing and processing new applications. The Division of Financial Assistance (Division) estimates that about 16.5 PYs will need to be redirected to other programs if the CWSRF is suspended for a significant period of time.

A suspension could take a number of forms:

- i) Suspend all new assistance for a brief period of time.

This will allow the State Water Board to consider the situation and further develop specific ideas in cooperation with stakeholders. However, it doesn't solve the problem.

- ii) Suspend all new assistance until the California Constitution is amended to protect state agency financial assistance contracts from impairment by voter initiative.

A constitutional amendment would provide solid protection from additional exposure due to rollbacks. Constitutional amendment is difficult, however. During the past four years, the Legislature considered 131 constitutional amendments, and passed only two of them were passed.

- iii) Suspend all new assistance relying on property related user charges for payment unless other security is provided.

Other states use a variety of security mechanisms for their CWSRF agreements. These include:

- Minimum debt coverage ratios
- A "full faith and credit" pledge
- Escrowed reserve funds
- Financing insurance
- Letter of credit from a bank or trust company
- Personal or corporate guarantees
- State funds intercept
- Trustee lockbox
- Purchase of local debt
- Other collateral

Some of these measures may be applicable in California. Others may not, or may be difficult to apply given market conditions. Some may be overly expensive for small, disadvantaged communities.

- d) Establish a policy to aggressively seek redress in court as soon as an applicant fails to make a payment, or fails to properly maintain facilities funded by CWSRF. This action will send a strong message to borrowers and potential borrowers that the State Water Board takes its fiduciary responsibility seriously. It also increases the potential for recovery of CWSRF funds.

It does not prevent a community, however, from rolling back rates. Any court action is likely to take significant time, and will have limited application. In addition, the cost of legal action may be high, and potentially could exceed the funds recovered.

2) External Measures:

- a) The State Water Board could seek legislation specifying consequences if rate rollbacks cause municipalities or districts to breach a CWSRF agreement.

This approach sends a strong message about the State Water Board's stance on the CWSRF. It may deter communities from rolling back rates needed to make CWSRF payments, and, therefore, help the State Water Board avoid lengthy and costly court battles to recover funds.

A legislative solution, however, is inferior to a Constitutional amendment or decision by the court. Additionally, such a solution will only result in action after the fact.

- b) The State Water Board can focus Regional Water Board and State Water Board enforcement against CWSRF borrowers that roll back rates and jeopardize payment of a CWSRF agreement.

This sends a strong message about the importance of communities providing adequate funds to finance and maintain their facilities. The effect on the CWSRF is indirect, however, and does not provide affirmative protection.

POLICY ISSUE

Should the State Water Board:

Implement staff recommendations approving changes and modifications to the CWSRF policies and procedures of current financial processes affected by the Bighorn Decision and Prop 218?

FISCAL IMPACT

The potential loss of revenue due to rate rollbacks is unpredictable at this point.

The potential increase in collection cost is unpredictable at this point. These costs, however, will increase in proportion to the number of recipients paying late or defaulting on their financing agreements.

The potential costs of fines or damages related to the program's failure to make debt service on its Bonds is unpredictable at this point.

The potential increase in future borrowing costs is unpredictable at this point.

The cost of the additional measures recommended by staff will be absorbed within current resources allocated to the program.

REGIONAL WATER BOARD IMPACT

Suspending new loans will eliminate a vital source of funding for projects that support the Regional Water Boards' Basin Plans. Over the last five years, the CWSRF program has issued an average of approximately \$320 million per year in financing for eligible water quality projects.

STAFF RECOMMENDATION

The State Water Board should:

1. Adopt a multi-faceted approach to deal with rate rollbacks.
2. Direct staff to closely monitor local rate setting and make the State Water Board aware of significant trends.
3. Direct staff to include "bad debt outlook" as a standing topic for the CWSRF's Quarterly Finance/Audit Committee meetings.
4. Direct staff to continue to develop security measures on individual finance agreements or additional policy changes in cooperation with the CWSRF Stakeholder Advisory Group. Division staff should also develop a systematic approach for evaluating the risk of default by each applicant.
5. Authorize the Division to contract with a professional financial advisor to provide additional financial expertise to the program.
6. Direct staff to aggressively pursue, in conjunction with the Attorney General's Office, redress in the courts for any breach of contract.
7. Direct staff to explore potential legislative solutions with stakeholder groups, both statutory and constitutional, to provide better protection for CWSRF agreements

D R A F T

STATE WATER RESOURCES CONTROL BOARD RESOLUTION NO. 2008-

ADDRESSING THE SECURITY OF CLEAN WATER STATE REVOLVING FUND (CWSRF) FINANCING AGREEMENTS

WHEREAS:

1. Californians have the authority to disapprove or reset wastewater service rates based on Proposition 218 and the Bighorn decision;
2. The majority of CWSRF financing agreements rely on wastewater service revenues for payment; and
3. The timely and full payment of financial assistance agreements greatly affects the operation and effectiveness of the CWSRF program.

THEREFORE BE IT RESOLVED THAT:

The State Water Resources Control Board (State Water Board):

1. Accepts the staff recommendations to continue offering financial assistance to eligible applicants while simultaneously implementing additional measures to ensure the security of CWSRF payments; and
2. Directs staff to make the State Water Board aware of developments that signal a deterioration of CWSRF finances.

CERTIFICATION

The undersigned, Clerk to the Board, does hereby certify that the foregoing is a full, true, and correct copy of a resolution duly and regularly adopted at a meeting of the State Water Board held on November 18, 2008.

Jeanine Townsend
Clerk to the Board