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WATER POLLUTION

Issues Concerning State Revolving Loan Fund Programs

Statement of
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Before the
Subcommittee on Water Resources
Committee on Public Works and Transportation
House of Representatives

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Dear Mr. Chairman and Members of the Subcommittee:

We appreciate the opportunity to be here today to discuss the State Revolving Loan Fund Program (SRF). SRFs are loan programs that were established by the Water Quality Act of 1987 as a primary source of financing for wastewater treatment facilities at the state level. Much of our testimony is based on our recently issued report on SRFs.[1] The report outlines (1) key characteristics of SRF Programs and (2) the major issues concerning how certain regulatory and statutory requirements affect the ability of SRFs to meet the nation's wastewater treatment needs. In addition, we will provide some further insights on these issues from our ongoing work for the Committee, primarily from the results of our recent survey of states. Finally, based on our ongoing work, we will provide some preliminary observations on the fundamental question of how well SRFs can serve as a permanent source of funding to meet these needs.

In summary, Mr. Chairman, we found the following:

-- All states have created SRF programs and have received at least one capitalization grant. However, many are still developing the details of their programs. Thus far, they are generally similar in structure but are expected to

[1]Water Pollution: States' Progress in Developing State Revolving Loan Fund Programs (GAO/RCED-91-87, March 19, 1991)

become increasingly different as states become more experienced with the programs and adopt financial strategies to meet their particular needs.

-- States and others maintain that several key statutory and regulatory changes would increase the effectiveness of the SRF Program, including allowing land not directly used in the treatment process to be eligible for SRF assistance. In this regard, while wetlands used to filter wastewater as part of the treatment process would be eligible for SRF assistance, land upon which a treatment facility is constructed would not be eligible.

-- Survey information we have gathered to date indicates that over the next ten years, SRFs will only meet about one-third of states' wastewater treatment needs and will generally not meet the needs of disadvantaged communities. We estimate that by the year 2001, states could face over $50 billion in wastewater treatment needs.

Before I discuss these issues in more depth, let me briefly provide you with some basic information on State Revolving Fund Programs.

BACKGROUND

The SRF Program represents a dramatic shift in how the nation will finance $83.5 billion in wastewater treatment needs. The Water Quality Act of 1987 replaced the title II Construction Grants Program, which provided grants directly to local governments to build wastewater treatment facilities with SRFs. SRFs are loan programs with the initial capital provided through federal seed money and state contributions. States use the fund to provide a range of loan assistance to local governments, and as loans are repaid, the fund replenishes. All 50 states and Puerto Rico have established SRF Programs and have received at least one grant.

Under the title II Construction Grants Program, the federal government provided grants to local governments averaging $4.5 billion per year in the 1970s and approximately $2.4 billion a year in the early 1980s. By the end of fiscal year 1990, $2.8 billion in grants had been awarded under the SRF Program. The federal contribution has decreased significantly in the SRF Program and will end in 1994 with the last capitalization grants authorized in the Water Quality Act. The Congress authorized a total of $8.4 billion to capitalize the state programs.

Federal grants are transferred to the states through a "letter of credit" based on the states' projections of costs associated with binding commitments in the Intended Use Plans. After 1994, when federal financial support ends, the SRFs will be sustained through repayment of loans made from the funds.

As a condition of receiving federal funds, states must provide a matching amount equal to 20 percent of the total grant and agree to use the money first to ensure that wastewater treatment facilities are in compliance with deadlines, goals, and requirements of the Clean Water Act. After meeting this "first use" requirement, the states may also use the funds to support programs to deal with nonpoint source pollution, such as pesticide runoff, and to protect their estuaries. In addition, states must agree to ensure that local governments meet a range of requirements that applied to the title II Construction Grants Program. These include, for example, compliance with Davis-Bacon Act wage requirements.[2] Furthermore, states must comply with "cross-cutting" federal requirements associated with the receipt of federal grants, such as promotion of equal employment opportunities and participation by minority-owned businesses.

The act established several reporting requirements for states. Each fiscal year, states must provide an Intended Use Plan which, among other things, describes the projects that will be funded and the financial strategy for distributing the funds. Also, states

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[2] Under Davis-Bacon, wages paid for the construction of treatment works must conform to the prevailing wage rate established for the locality by the U.S. Department of Labor.

must provide an annual report to EPA on the financial status and uses of the fund for the previous fiscal year.

KEY CHARACTERISTICS OF STATE PROGRAMS

While some notable differences in approach exist, such as whether funds are targeted to disadvantaged communities or to communities with the greatest ability to repay loans, we found that state programs, at this point, are generally similar in structure. This is due, in part, to the fact that states are still developing the details of their programs. However, EPA expects greater diversity in SRFs as states become more experienced with them, particularly with regard to financial management. Among the key program characteristics we have examined are financial strategies for capitalizing the funds (particularly the use of leveraging), how the funds are used, and how states use other programs to supplement or meet needs unmet by SRFs.

Leveraging

One of the key characteristics of SRFs is the states' plans for leveraging additional money to the funds. Leveraging involves borrowing by the state through issuance of bonds guaranteed by resources in the fund. Capital raised is then placed in the fund to increase the resources available to assist local governments.

New York has one of the most ambitious leveraging programs; it plans to use each dollar from the federal grant and the state match to back $3 in bonds. The state provided approximately $660 million in assistance, while the grant amount was approximately $212 million.

Currently, 11 states are leveraging their SRFs, while 14 others have plans to leverage. Critics of leveraging argue that it results in increased costs because of the legal and administrative costs of issuing bonds, thus reducing the amount of subsidy that states can offer local governments through the SRFs. In addition, critics maintain that leveraging does not increase total resources available to the states because the bonds must be repaid; and that leveraging, therefore, only increases resources available in the short-term.

EPA officials maintain that the determination of whether leveraging is appropriate depends on the cost and timing of a state's projects. If a state has many projects ready for construction, it may want to leverage so that the projects can be funded more quickly. However, leveraging may be less advantageous for states with fewer needs.

Use of Funds to Meet Other Authorized Needs

The Clean Water Act authorizes states to use SRF assistance for water quality needs in addition to wastewater treatment. Specifically, SRF money can be used, after specific conditions have been met, to support states' efforts to control their nonpoint source water pollution problems and to protect estuaries that are part of EPA's National Estuaries Program.

According to EPA, all states have met the "first use" requirements, thereby allowing them to use SRFs for nonpoint and estuary projects. However, only two states were funding nonpoint projects at the end of fiscal year 1990. In our recent survey of 50 states and Puerto Rico, only sixteen states indicated that there is a strong possibility they will use SRF assistance for nonpoint projects in the next 5 years. We also found that none of the states was using funds for estuary protection activities, although 4 of the 15 states with estuaries in the National Estuaries Program said that they plan to use SRF money for this purpose in the near future.

Although states that have met first use requirements are authorized to use SRFs for other purposes, most states explained that they have such large wastewater needs that they are unlikely to use SRFs for other types of projects. Rhode Island, for example, noted that $350 million in point source needs must be met to comply with statutory requirements. Nationwide, EPA's needs estimates for wastewater treatment of $83.5 billion by the year 2008 provide an indication of states' unwillingness to commit SRF resources for these other purposes.

Supplemental Programs

As of October 1990, 40 states had supplemental programs for water quality financing to meet two major needs unmet by SRFs: (1) ineligible costs, such as for land that is not directly used in the wastewater treatment process and (2) helping disadvantaged communities that cannot afford to repay loans. States finance these grant and loan programs apart from the SRF, primarily through state appropriations or by issuing bonds.

Disadvantaged communities are often the beneficiaries of supplemental programs. These communities, especially small towns that cannot benefit from economies of scale in plant construction, may not be able to repay loan assistance at any interest rate. This problem is compounded by the fact that these communities must often issue debt to purchase land that is not eligible for SRF assistance. As a result, most states said they will not meet needs of disadvantaged communities through the SRFs. For example, West Virginia has identified 2,267 miles of waterways contaminated with sewage, but state officials in charge of the SRF Program maintain that many of the communities discharging into these waters would not be able to repay SRF loans.

QUESTIONABLE SRF STATUTORY AND REGULATORY REQUIREMENTS

Several issues raised by states relate more directly to the statute that established the SRF Program and its implementing regulations. Our ongoing review addresses the following issues to determine whether statutory or regulatory changes are in fact needed:

-- Should local governments be prohibited from using SRFs to purchase land not directly used in wastewater treatment processes?

-- Are all existing EPA oversight requirements necessary after capitalization grants end in 1994?

-- Is the 20-year maximum loan term appropriate for the SRFs?

-- Should a letter of credit be used to transfer capitalization grants to states?

Acquiring Land with SRFs

Recipients of SRF assistance may use the money to acquire land that is integral to waste treatment processes. However, other land that may be necessary, such as for the treatment plant and easements and rights of way for collection systems, cannot be purchased with SRF assistance.

State officials said that this increases financing costs because local governments must often seek private financing in addition to the SRF loan. Most states we surveyed favor making all necessary land eligible for assistance through the SRF. Several states maintain that disadvantaged communities are penalized by the restriction because they often rely on land-based treatment processes, some of which is ineligible for SRF assistance. Arkansas noted that communities must pay 8 to 10 percent interest on loans for land in the market, compared with the 4 percent offered by the SRF in that state. EPA officials told us that they support making all necessary land eligible for SRF assistance and will be considering whether to recommend to the Congress that it remove the restriction.

Oversight Requirements

In accordance with the Water Quality Act, EPA has established oversight procedures to protect the integrity of SRFs and to ensure that they comply with program requirements. Among the procedures required are (1) an annual report, describing how the state carried out its SRF activities and complied with SRF program requirements and (2) an annual EPA review, assessing states' performance of their SRF activities and the financial health and management of SRFs. In addition, states must submit to an annual financial, compliance, and operational audit of their SRFs.

According to our survey, most states favor the termination of the federal oversight requirements after the awarding of capitalization grants ends in 1994. They maintain that, afterward, states should become the sole administrator of the SRF Program. EPA believes that, although not specifically required by statute, it must continue federal oversight after 1994 because the oversight requirements do not have a specific time limit. Our forthcoming report will address how EPA is using the information it collects to improve the program and monitor states' activities.

Twenty-Year Maximum Loan Term

The Congress established a 20-year maximum repayment term for loans offered through SRFs. The 20-year term significantly increases user charges to wastewater treatment plant customers over loans having terms of 28-30 years, which are offered in some state programs. States offer these longer term loans to reduce the impact on user charges in disadvantaged communities and to finance equipment with a design life exceeding 20 years, such as for sewage pipes.

Higher user charges affect primarily the ability of small or disadvantaged communities to qualify for SRF assistance. These small communities already have higher per household costs for wastewater treatment facilities because they lack the advantage of economies of scale. When this disadvantage is combined with lower per household income, user charges pose a greater burden on certain communities.

Many states that we surveyed said that requiring a 20-year loan term reduces their ability to help disadvantaged communities qualify for SRF loan assistance. West Virginia said that it would like to be able to extend the term to help communities reduce user charges to an affordable level. In addition, several states mentioned that they would like the flexibility to fit the loan term to the design life of the equipment financed. For example, while pumps may wear out in 20 years, other equipment such as pipes may have a design life of 40 years. EPA officials have responded that they would be cautious about extending the loan term beyond the 20 year statutory limit, maintaining that loans should not be made for terms longer than the design life of the equipment financed.

Letter of Credit

To capitalize each state's SRF, the federal government makes payments through a letter of credit to the states, based on the states' estimates of when costs will be incurred for projects they plan to fund. At the time the SRF or a recipient incurs a cost, the state can initiate a cash draw request against the letter of credit.

According to EPA officials, the letter of credit was one of the most contentious issues during development of the implementing regulations. Many states were initially concerned that relying on a letter of credit would delay payments to contractors. According to EPA and several states we contacted, however, reliance on the letter of credit has not resulted in such problems. Of greater consequence, however, is the question of who possesses and therefore earns interest on funds--the federal government or the states. States prefer cash payments because of the potential to earn interest and increase the money available for projects. The state of Washington asserts that it has "lost" about $1 million in interest earnings and estimates that it will lose another $12 million to $27 million through 1994.

Another problem with the restrictions on drawing cash through the letter of credit is the limitation that EPA regulations place on drawing cash for refinancing. Through refinancing, previously issued municipal bonds are retired by money borrowed from SRFs at a lower interest rate. According to the regulations, however, cash must be drawn over eight equal quarters if it exceeds 5 percent of each fiscal year's capitalization grant, or $2 million, whichever is greater. Because this amount may not be sufficient to retire the debt in one lump sum payment, states' ability to offer refinancing assistance is limited, particularly for large projects.

PRELIMINARY OBSERVATIONS ON STATES' ABILITY TO MEET NEEDS THROUGH THE SRF

Mr. Chairman, now I would like to offer some observations on the fundamental question of how well SRFs can serve as a permanent source of funding for the nation's wastewater treatment needs. Our preliminary analysis indicates that two factors limit states' ability to meet needs through their SRFs, in addition to the regulatory and statutory issues I have just discussed. These factors include the small resources committed to establish the program in comparison with needs and the limitations of the program to meet needs in disadvantaged communities.

Small Resources in Comparison With Needs

EPA's Needs Survey Report to Congress in 1988 estimated $83.5 billion in wastewater treatment needs for compliance with Clean Water Act requirements by the year 2008. States maintain that EPA vastly underestimates actual needs because of the requirement that only projects that have been designed and planned are counted. In addition, the needs survey does not include non-point and estuary needs, which were authorized by the Clean Water Act to receive SRF assistance. While nonpoint needs are difficult to estimate, we know that they are huge. For example, Pennsylvania alone estimates that it will need $3 billion to $5 billion just to correct pollution problems caused by abandoned coal mines.

In comparison, the Congress authorized $8.4 billion from 1989 to 1994 to capitalize SRFs in 50 states and Puerto Rico and each year appropriations have fallen below the amount authorized. Compounding the small federal investment is the fact that states are not allowed to receive their grants until costs are incurred and therefore do not earn interest on the grant money.

This gap between the SRF and community financial needs was highlighted in our state survey. Forty-five states responding indicated that only 22 percent of their wastewater needs will be met through the SRFs within the next 5 years and 30 percent in 10 years. Notwithstanding the unlikely possibility that states and local governments could contribute large sums in addition to what they currently plan to spend, states would still have over $50 billion of unmet needs in 2001, only for wastewater treatment, and only to meet needs currently identified. Thus, noncompliance with Clean Water Act requirements will continue to be a problem.

Limitations of the SRF to Meet the Needs of Disadvantaged Communities

SRFs are limited in their ability to meet the needs of disadvantaged communities for two reasons. First, financial goals are not consistent with the subsidy requirements of disadvantaged communities. Second, certain statutory requirements may make SRF assistance unaffordable.

As a loan program, states must make tradeoffs between helping disadvantaged communities meet wastewater treatment needs and the financial objectives of the fund. Disadvantaged communities need larger subsidies so that user charges will be affordable, and they pose a greater risk of default than financially strong communities. These concerns are particularly important in states that need attractive loan portfolios for purposes of leveraging.

Disadvantaged communities also have a difficult time qualifying for SRF assistance due to program requirements. Title II requirements demand large upfront planning and design costs which many small communities cannot afford to undertake. In addition, local governments must seek alternative sources of finance for ineligible land costs, such as land easements and rights of way for collection systems. According to the states, these costs can be substantial, particularly for small communities that must build collection systems to replace septic tanks. Costs are therefore increased and some disadvantaged communities may be unable to issue the additional debt. Another problem is the maximum loan term of 20 years which increases user charges, particularly in small communities that cannot benefit from economies of scale and have fewer people to share the debt burden.

Most states indicated in our survey that they will not meet needs of disadvantaged communities through the SRFs. States noted that the likely results of unmet needs include increased noncompliance with national environmental regulations and local public health problems.

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In summary, Mr. Chairman, our report outlines that states have implemented SRF Programs and plan to take advantage of the flexibility allowed in the statute and regulations to design programs that meet their particular needs. At the same time, our work currently underway for the Committee suggests that the SRFs will not meet needs in disadvantaged communities and that the limited resources available will make it difficult to meet needs in other communities. Finally, certain regulatory and statutory changes may increase the effectiveness of state programs. Our subsequent report on state SRFs, to be completed in the fall of

1991, will include recommendations to the Congress and EPA on a number of these issues.

This concludes my prepared statement. We would be pleased at this time to answer any questions.