Reclamation Manual

Directives and Standards

Subject: Title XVI Financial Capability Determination Process

Purpose: Establish requirements and a review process to determine whether a Title XVI project sponsor is financially capable of funding the non-Federal portion of project construction costs and all necessary project operation, maintenance, and replacement costs. The benefits of the requirements and review process will ensure consistent review of analyses and facilitate decision making criteria.

Authority: Reclamation Projects Authorization and Adjustment Act of 1992 – Title XVI, Reclamation Wastewater and Groundwater Study and Facilities Act, Section 1631(b) (Pub. L. 102-575; 43 USC 390h *et seq*.), as amended (the Act)

Approving Official: Director, Policy and Administration

Contact: Reclamation Law Administration Division, 84-55000

1. **Introduction.** The Act provides the Secretary of the Department of the Interior both general planning authority and specific guidance for administering the Bureau of Reclamation's Title XVI Program. Section 1631(b) states that "Funds may not be appropriated for the construction of any project…until after…(B) the Secretary has determined that the non-Federal project sponsor is financially capable of funding the non-Federal share of Project's cost." Reclamation Manual (RM) Directive and Standard (D&S), *Title XVI Water Reclamation and Reuse Program Feasibility Study Review Process* (WTR 11-01) states minimum requirements that indicate the project sponsor is likely to demonstrate financial capability to fund the non-Federal share of the project's cost if the project moves to construction. Paragraph 4.B.(9) of WTR 11-01 also notes that Reclamation will request more detailed information to make a determination that the project sponsor has the financial capability to pay the non-Federal share of the project's costs before a construction funding agreement can be executed. The purpose of this D&S is to specify the type of information that Reclamation requires and the process undertaken by Reclamation to make financial capability determinations related to a project sponsor's ability to fund the non-Federal share of Title XVI project costs.

2. **Applicability.** This D&S applies to all activities that are conducted for Title XVI projects by Reclamation employees, managers, decision makers, projects sponsors, and individuals working under contract for Reclamation or the project sponsor that are related to the preparation, review, and approval of financial capability analyses. As defined in this D&S, a financial capability analysis must be completed to include the project sponsor's share of construction costs and all necessary project operation, maintenance and replacement (OM&R) costs.

3. **Definitions.** The following definitions apply to this D&S:

   A. **Bond Rating or Issuer Credit Rating.** A bond or issue rating relates to a specific financial obligation (by a corporation or government entity) while an issuer credit rating relates to an issuer's overall capability to meet its financial obligations and are used to assess credit quality and vulnerability to risk. A bond or issuer credit rating is an evaluation of the possibility of default on a bond issue. Ratings are based on an analysis of the issuer's financial condition and profit potential. Any Nationally Recognized Statistical Rating Organization (NRSRO) maintained by the Securities and Exchange Commission are acceptable; this D&S uses Standard and Poor's, Moody's, and Fitch Ratings to demonstrate rating equivalents. Bond ratings generally start at AAA (being the highest investment quality) and usually end in D (in payment default).

   B. **Debt Service Coverage Ratio.** The debt service coverage ratio, also known as "debt coverage ratio," is the ratio of cash available to the sponsor's total debt obligation including but not limited to interest, principal, lease payments, and sinking fund payments. The ratio is used as a measure of creditworthiness; the higher the ratio the more likely the prospective borrower will produce sufficient cash to cover their debt obligations.

   C. **Financial Capability.** Financial capability is the likelihood of a project sponsor being able to provide its share of the non-Federal portion of project construction costs and all necessary project OM&R costs. Financial capability is often used interchangeably with the terms capability to pay and ability to pay.

   D. **Non-Federal Project Sponsor (Project Sponsor).** Non-Federal project sponsors may include a state, regional, local authority; Indian tribe or tribal organization; or other entities such as a water conservation or conservancy district, wastewater district, rural water district, or water association within the 17 Western States or Hawaii as defined in Paragraph 2.B. of WTR 11-01.

   E. **Primary Analysis.** The primary analysis is the first step in determining financial capability through analysis of a project sponsor's bond rating or issuer credit rating and the debt service coverage ratio, and will include reviewing audited financial statements for consistency with the bond rating or issuer credit rating and debt service coverage ratio. This will help establish what type of secondary analysis must be performed.

   F. **Secondary Analysis.** The secondary analysis is the second and final step in determining financial capability through analysis of a project sponsor's socio-economic indicators, water service affordability, rate comparison, and rate shock. The secondary analysis is more in-depth than the primary analysis and is undertaken when the primary analysis results are acceptable.

4. **Responsibilities.**

   A. **Director of Policy and Administration.** The Director of Policy and Administration is responsible for evaluating the findings and recommendations of the regional director and determining whether or not the project sponsor demonstrates financial capability to fund the non-Federal share of the project's costs and OM&R costs.

   B. **Regional Directors.** Regional directors are responsible for reviewing and forwarding findings and recommendations of financial capability to the Director of Policy and Administration. The regional director will designate an appropriate reviewing office.

   C. **Reviewing Analyst.** The reviewing analyst is responsible for following the requirements outlined in Paragraph 6 to determine financial capability of a project sponsor by using all necessary information outlined in Paragraph 5.

   D. **Reviewing Office.** The reviewing office will facilitate the review of financial capability documentation by establishing a schedule, coordinating meetings, providing documents to Reclamation staff involved in the review of documentation, and communicating with the project sponsor. The reviewing office will determine who will be the reviewing analyst and will provide the funding necessary to perform the review.

   E. **Title XVI Program Manager.** The Title XVI Program Manager is responsible for monitoring ongoing reviews and providing periodic status updates on the reviews to the Director of Policy and Administration.

5. **Information Necessary to Analyze Financial Capability.** Reclamation will work with the project sponsors to ensure that it has the information necessary to make a determination of financial capability. The following information is required:

   A. estimated non-Federal portion of the costs of the project associated with construction and annual OM&R activities;

   B. a calculated debt service coverage ratio;

   C. bond rating and issuer credit rating;

   D. financial statement analysis (to include previous 3 years of financial statements);

   E. information on socio-economic indicators of the project region, including:

      (1) unemployment;

      (2) median household income; and

      (3) property values;

F. estimated average monthly cost of water for the project sponsor with and without the project in place;

G. estimated average monthly cost of water for other water entities within the region; and

H. primary source of revenue to fund the Title XVI project construction.

6. **Requirements Necessary to Make a Determination of Financial Capability.** A two-step approach to financial capability analysis will be followed in determining whether or not a sponsor is financially capable of funding the non-Federal share of a project's construction and OM&R costs. See Appendix A for the Title XVI Financial Capability Decision Tree illustrating this two-step approach.

A. **Primary Analysis – Bond Rating or Issuer Credit Rating and Debt Service Coverage Ratio.** A primary analysis will be conducted looking at the project sponsor's bond rating or issuer credit rating and its debt service coverage ratio. The bond rating or issuer credit rating comparison shown in Table A includes the credit rating agencies from which Reclamation will accept ratings from and the corresponding acceptable versus unacceptable ratings. The debt service coverage ratio ratings shown in Table B include an acceptable and unacceptable range of ratios. Financial statements of the project sponsor(s) will be analyzed to verify that the bond rating or issuer credit rating and the debt service coverage ratio are in the acceptable range.

(1) **Bond Rating or Issuer Credit Rating.** Any Title XVI sponsor utilizing either bonds or debt to fund its portion of the project must submit its bond rating or issuer credit rating. Reclamation will only accept a bond rating or issuer credit rating for financial capability that is investment grade (see Table A below). The parameters for bond rating and issuer credit ratings are as follows:

(a) A high bond rating or issuer credit rating means that even under adverse economic conditions, such as a recession, the overall capability of the sponsor to meet its financial obligation is strong.

(b) A medium bond rating or issuer credit rating means that an obligation has adequate protection, but that adverse economic conditions could weaken commitment to meet an obligation.

(c) An unacceptable bond rating or issuer credit rating indicates potential vulnerability to adverse economic conditions and possible inability to meet the financial commitment on an obligation. A speculative bond rating or issuer credit rating is considered unacceptable.

(d) The bond rating or issuer credit rating must be no more than 3 years old to be considered current.

(e) If a current bond rating or issuer credit rating is not available from a NRSRO agency, a current credit rating with supporting documentation from a lender coupled with the analyst's verification of the credit rating must be combined with a rigorous secondary analysis.

(f) Projects that are funded entirely by capital improvement funds (funds currently on the sponsor's balance sheet approved for capital improvement projects consistent with the proposed project) will be exempt from the requirement for a bond rating or issuer credit rating analysis and will be accorded an acceptable high rating.

Table A – Sample Bond Rating or Issuer Credit Rating Comparison by Rating Agency

Rating Agency	**Acceptable (Investment Grade)**		**Unacceptable (Speculative)**
	High	Medium	
Standard and Poor's	AAA, AA, A	BBB-	BB+, B, CCC, CC, C, D
Moody's	Aaa, Aa, A	Baa3	Ba1, B, Caa, Ca, C
Fitch Ratings	AAA, AA, A	BBB-	BB+, B, CCC, DDD, DD, D

(2) **Debt Service Coverage Ratio.** The formula and description to calculate the debt service coverage ratio is:

(a) Debt Service Coverage Ratio = $\frac{\text{Net Cash Operating Income}}{\text{Annual Debt Service}}$[1]

(b) A debt service coverage ratio for the project sponsor must be at least 1.0 for 5 years beginning when the project is placed in service or repayment begins, to meet the minimum requirements for financial capability. If a ratio is currently or projected to be less than 1.0 within the initial 5-year period, a plan to meet the shortfall during this initial period and additional analysis must be provided to document that the ratio will increase to 1.0 or greater and remain above 1.0 for an additional 5-year period. The debt service coverage ratio ratings are shown in Table B.

Table B – Debt Service Coverage Ratio Ratings

Debt Service	**Acceptable**		**Unacceptable**
	High	Medium	
Ratio	> 2.0	1.0 to 2.0	< 1.0

[1]In addition to the project sponsor's Net Cash Operating Income, all income and revenues that could be used toward repayment of a water supply project will be included in the debt service coverage ratio analysis.

(3) **Title XVI Projects with Multiple Non-Federal Sponsors.** For Title XVI projects with more than one non-Federal project sponsor, each sponsor must provide documentation of an acceptable bond rating or issuer credit rating and/or debt service coverage ratio as described above. However, if a project sponsor or a portion of the project sponsors submit documentation that they have acceptable ratings and ratios to meet the financial capability criteria for the entire project, the sponsor(s) must submit documentation and proof that they are willing to accept financial responsibility for the entire project. If the sponsors with acceptable ratings and ratios cannot (or will not) meet the financial capability criteria for the entire project, then the overall bond rating or issuer credit rating and debt service coverage ratio will be considered unacceptable.

(4) **Financial Statement Analysis.** Audited financial statements from the sponsor will be reviewed for the most recent 3-year period. A comparison of the data from the financial statements and accompanying notes will be made to determine consistency with the information presented in the bond rating or issuer credit rating and the debt service coverage ratio analyses. Any qualified opinions[2], inconsistencies, or issues that raise concerns identified in the analysis of the financial statements must be addressed before proceeding with further analysis of the sponsor's financial capability. Qualified opinions and inconsistencies require a rigorous secondary analysis be performed.

(5) **Outcome of Primary Analysis.** A matrix of the possible outcomes of the primary analysis is shown in Table C. The possible outcomes include:

(a) If the bond rating or issuer credit rating for the project sponsor is in the acceptable high range, the debt service coverage ratio is in the acceptable high range, and the financial statement analysis shows consistency with these results without a qualified opinion, then a cursory secondary analysis will be performed to confirm that the project area is not experiencing severe adverse conditions that could negatively affect financial capability.

(b) If the bond rating or issuer credit rating is in the acceptable medium range, the debt service coverage ratio is in the acceptable medium range, or the financial statement shows inconsistency with these results with a qualified opinion, then a rigorous secondary analysis will be performed to evaluate financial capability.

(c) If the bond rating or issuer credit rating is unacceptable, the project sponsor will be found not financially capable of funding the non-Federal share of the Title XVI project.

[2]A qualified opinion is a statement issued by a professional auditor. A qualified opinion suggests that the information provided was limited in scope and/or the entity being audited has not maintained generally accepted accounting principles.

(d) If the debt service coverage ratio is unacceptable (below 1.0), an additional analysis must be completed (see Paragraph 6.A.(2)(b) above). If, during this additional analysis, the debt service coverage ratio stays below 1.0 for the entire 5-year period beginning when the project would be placed in service or repayment begins, then a determination will be made that the project sponsor is not financially capable. However, if the analysis shows the debt service coverage ratio rising above 1.0 within the initial 5-year period and remaining there for an additional 5 consecutive years, then a rigorous secondary analysis must be performed to determine financial capability.

Table C – Primary Analysis Matrix

Primary Analysis Matrix		**Bond Rating or Issuer Credit Rating – Acceptable**		**Bond Rating or Issuer Credit Rating – Unacceptable**
		High	Medium	
Debt Service Coverage Ratio (Ratio) – Acceptable	High	Cursory Secondary Analysis	Rigorous Secondary Analysis	Unacceptable
	Medium	Rigorous Secondary Analysis	Rigorous Secondary Analysis	Unacceptable
Ratio Unacceptable	Low	Unacceptable	Unacceptable	Unacceptable

B. **Secondary Analysis – Additional Economic and Financial Indicators.** The secondary analysis will be cursory or rigorous depending on the outcome of the primary analysis. In a cursory secondary analysis, an analysis of the socio-economic indicators in the project region will be conducted. In addition to analyzing the socio-economic indicators of the project region, a rigorous secondary analysis includes water service affordability, rate comparison, and rate shock analyses. The results of the secondary analysis on the overall determination will depend on the outcome of the following Paragraphs (see Table D below).

(1) **Socio-economic Indicators of the Project Region.** The relative importance of general economic conditions depends, to some degree, on the source of funds for the proposed project and the professional judgment of the reviewing analyst. If the primary source of revenue for the project sponsor is from fees and water charges, then income and unemployment data and trends are most relevant. If property-based assessments are the primary sources of revenue, then property values and trends in property values are most relevant. Ratings by economic indicator are shown below in Table D.

(2) **Water Service Affordability.** The U.S. Environmental Protection Agency (EPA) has indicated in previous studies that a combined water and sewer bill in excess of 4.5 percent of annual median household income is considered the benchmark for affordability, with 2.5 percent of annual median household income allowed for water supply costs. An estimated percentage of 2.5 percent of annual median household income does not necessarily indicate the maximum amount households could pay for water supplies, but is an indicator of the threshold above which the potential for economic hardship increases. The criterion for water service affordability is shown in Table D. The following criteria apply to water service affordability:

(a) Water supply costs below 2.5 percent of annual median household income have a water service affordability rating of good.

(b) Reclamation considers an amount between 2.5 and 6.5 percent[3] of annual median household income to have a water service affordability rating of medium and could be affordable, but payment of these costs could reduce other types of household spending.

(c) An affordability rating above 6.5 percent is considered poor, and a determination will be made that the sponsor is not financially capable.

(3) **Rate Comparison.** In a rate comparison analysis, rates of feasible alternative sources for water are examined; where they are less than the proposed project rates, a medium or poor rating is given and further justification for the project will be required. Where proposed project rates are competitive or below rates of alternative sources of water, a good rating is given. The criterion for the rate comparison analysis is shown in Table D.

(4) **Rate Shock.** In a rate shock analysis, potential negative public reactions to potential rate shocks are assessed by evaluating estimated percentage changes in rates, not necessarily rate levels.[4] Reclamation's criteria on rate shock analysis are shown in Table D below, which classifies water rate increases of more than 200 percent as medium or poor indicators, regardless of the percentage of annual

[3]Data from the Bureau of Economic Analysis, U.S. Department of Commerce, for the period of 1990 through 2009 indicates that personal savings as a percentage of personal income has averaged about 5.62 percent. Data from the American Housing Survey from 1995 through 2009 indicates that an average water bill for all U.S. households was approximately 0.914 percent of median household income. Therefore, assuming that savings represents maximum available household income for additional water service charges, 6.5 percent of household income is considered the maximum affordable water service.

[4]Studies conducted by the EPA on water supply affordability suggest that water rate increases, or shocks, of 100 to 200 percent may be a sign of questionable affordability and that increases of 200 percent or more may be unaffordable.

median household income necessary to pay water bills. This indicator must be considered in combination with socio-economic indicators, water service affordability, and rate comparison.

(5) **Outcome of Secondary Analysis[5].** The possible ratings for socio-economic indicators, water service affordability, rate comparison, and rate shock are shown in Table D below. The possible outcomes for the secondary analysis include the following:

(a) Poor socio-economic indicator ratings combined with minimally acceptable findings of the primary analysis and marginal affordability will result in unacceptable overall financial capability.

(b) If the results of the cursory secondary analysis for all three socio-economic indicators (unemployment, median household income, and property values) are good, then a determination will be made that the project sponsor is financially capable. Otherwise, a rigorous secondary analysis must be performed.

(c) If the results of the cursory secondary analysis reveal that any of the socio-economic indicators are not good (medium or poor), a rigorous secondary analysis must be performed for water service affordability, rate comparison, and rate shock. If these three indicators are good, then a determination will be made that the project sponsor is financially capable. Alternatively, if these three indicators are medium or poor, then additional analysis or documentation that the project sponsor's financial condition is strong must be provided to justify the analyst's recommendation regarding a project sponsor's financial capability to the regional director. Lastly, if these three indicators are poor, then the determination will be made that the project sponsor is not financially capable to pay the Title XVI project costs.

(d) In the rigorous secondary analysis, if all regional socio-economic indicators, water service affordability, rate comparison, and rate shock analyses are good (see Table D), then a determination will be made that the project sponsor is financially capable.

(e) If the outcome of any or all of the four analyses described in Table D is either medium or poor, then additional analyses or documentation that the

[5]If the primary requirements for bond rating or issuer credit rating and debt service coverage ratio are only minimally acceptable (for example a BBB- Standard and Poor's rating and 1.05 debt service coverage ratio) and water service affordability is questionable (for example water service will be 5.5 percent of median household income and water rates will increase 200 percent), then the general socio-economic indicators can be used to determine if only marginal acceptance will likely decline into an unacceptable range. That is, if all three socio-economic indicators are poor, then the ability to cover debt will likely decline and the cost of water service as a percentage of median household income will increase.

project sponsor's financial condition is strong must be provided to justify the analyst's recommendation regarding a project sponsor's financial capability to the regional director.

(f) If the water service affordability analysis results in an affordability threshold of greater than 6.5 percent (poor), then the determination will be made that the project sponsor is not financially capable to pay the Title XVI project costs.

Table D – Secondary Analysis

Secondary Analysis		**Good**	**Medium**	**Poor**
Socio-economic Indicators of the Project Region – Current and Trend Over Last 10 Years	**Unemployment**	Below the state average and declining or stable trend	At or within 1 percent above state average but declining trend or below state average but increasing trend	More than 1 percent above state average or at state average but increasing trend
	Median Household Income	Above state average and stable or increasing trend	Within 25 percent of state average and stable or increasing trend	25 percent or more below state average or 10 percent below state average and a decreasing trend
	Property Values	Above state average and stable or increasing trend	At or above state average and decreasing trend or below state average but increasing trend	Below state average and decreasing Trend
Water Service Affordability		Less than 2.5 percent median household income	Between 2.5 and 6.5 percent median household income	Greater than 6.5 percent median household income **(NOT FINANCIALLY CAPABLE)**
Rate Comparison		Alternative sources of water rates > proposed water rates	Alternative sources of water rates < proposed rates	
Rate Shock		Water rate increase < 200 percent	Water rate increase > 200 percent	

7. **Process for the Review of Financial Capability Documentation.**

A. **Review Initiation.** Within 15 days from when the project sponsor submits the documentation described in Paragraph 5 of this D&S to the appropriate Reclamation regional or area office, the reviewing office will examine the documentation provided in order to identify any missing significant items. This review is intended to be a quick-check to determine whether each item required by Paragraph 5 has been included for Reclamation review.

(1) If the financial capability documentation is incomplete, the reviewing office will notify the project sponsor, in writing, of the items that need to be included for review.

(2) If the financial capability documentation includes all of the items listed in Paragraph 5, the reviewing office will notify the project sponsor, in writing, that review of the documentation will be initiated and will identify Reclamation staff to conduct the financial capability analysis.

B. **Review of the Financial Capability Documentation.**

(1) The reviewing analyst will examine the documentation provided by the project sponsor as required in Paragraph 5 to determine whether it meets all of the requirements of Paragraph 6 of this D&S.

(2) If the documentation is found to be inadequate, the reviewing analyst will inform the reviewing office what additional information is required. The reviewing office will request any necessary additional information from the project sponsor in writing.

(3) Prior to making a final determination, the reviewing analyst will provide draft findings for peer review in accordance with Temporary RM Release (TRMR) Policy, *Peer Review of Scientific Information and Assessments* (CMP TRMR-30) and RM Policy, *Scientific Integrity* (CMP P13).

(4) Any written request for additional information from the project sponsor shall occur within 45 calendar days of completion of the preliminary review.

(5) If additional information is required, review of the new information shall occur within 45 calendar days of receipt of the information.

C. **Findings and Notification of the Non-Federal Project Sponsor.** The reviewing analyst will prepare a memorandum to the reviewing office to document the findings. The reviewing office will then prepare a memorandum to document the process and findings, and to document concurrence of the regional director and the Director of

Policy and Administration. The memorandum shall be addressed to the Director of Policy and Administration from the regional director, with a concurrence line for the Director of Policy and Administration.

(1) **Finding – Meets Requirements.** If the reviewing analyst finds that the applicant meets the established financial capability requirements and the regional director concurs, the regional director will document and recommend that the Director of Policy and Administration find the applicant to be financially capable of meeting its responsibilities pursuant to the requirements of section 1631(b)(1)(B) of the Act, as amended (43 USC 390h-13(b)(1)(B)). Upon receipt of the signed memorandum from Policy and Administration, the reviewing office will notify the project sponsor, in writing, of Reclamation's findings.

(2) **Finding – Does Not Meet Requirements.** If the reviewing analyst finds that the applicant does not meet the financial capability requirements and the regional director concurs, the regional director will document and recommend that the Director of Policy and Administration find that the applicant does not meet the requirements of section 1631(b)(1)(B) of the Act, as amended (43 USC 390h-13(b)(1)(B)). Upon receipt of the signed memorandum from Policy and Administration, the responsible reviewing office will notify the project sponsor, in writing, explaining why the applicant did not meet the financial capability requirements.

D. **Determination of Findings and Notification of the Regional Office.** If the Director of Policy and Administration concurs with the findings of the financial capability analysis, the signed concurrence memorandum will be sent to the regional office from Policy and Administration. If the Director of Policy and Administration does not concur with the findings of the financial capability analysis, a separate memorandum will be sent by Policy and Administration documenting the reasons for not concurring with the financial capability analysis.

E. **Timeframe.** Within 60 days of the reviewing office's receipt of a memorandum documenting the findings of the financial capability analysis, the following will occur:

(1) Receipt of the regional director's recommendation to the Director of Policy and Administration (either the applicant meets the requirements or does not meet the requirements) will occur within 30 calendar days of completion of the final financial capability analysis.

(2) If the Director of Policy and Administration concurs with the regional director's recommendation, the concurrence line will be signed by the Director of Policy and Administration. In the case of non-concurrence, the Director of Policy and Administration will prepare and send the memorandum described in

Paragraph 7.D. to document the findings. The Director of Policy and Administration will notify the regional director of Reclamation's determination within 15 calendar days of receipt of the recommendation.

(3) The reviewing office will provide written notification to the project sponsor within 15 calendar days of receiving Reclamation's determination.

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RECLAMATION MANUAL TRANSMITTAL SHEET

Effective Date: **08/31/2015** Release No. **473**

Ensure all employees needing this information are provided a copy of this release.

Reclamation Manual Release Number and Subject

WTR 11-02 Title XVI Financial Capability Determination Process

Summary of Changes

Minor revisions approved to reflect organizational changes, references, and to comply with the formatting requirements of RCD 03-01.

NOTE: This Reclamation Manual release applies to all Reclamation employees. When an exclusive bargaining unit exists, changes to this release may be subject to the provisions of collective bargaining agreements.

Filing instructions

Remove Sheets	Insert Sheets
WTR 11-02 pp 1-13	**WTR 11-02 pp 1-13**
Appendix A p 1	**Appendix A p 1**

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Filed by: _____ Date: _____