

**UNITED STATES ENVIRONMENTAL PROTECTION AGENCY
ENVIRONMENTAL FINANCIAL ADVISORY BOARD**

May 27, 2005

Honorable Stephen L. Johnson
Administrator
United States Environmental Protection Agency
1200 Pennsylvania Avenue, NW
Washington, DC 20460

Dear Administrator Johnson:

The Environmental Financial Advisory Board (EFAB) is pleased to submit the enclosed report, "Combined Operations of the Clean Water and Drinking Water State Revolving Loan Funds (SRFs)," for EPA's consideration. EFAB strongly supports these important and successful infrastructure loan programs and has a well-established record of providing advice to the Agency on ways to further improve them.

This latest report examines the idea of more closely combining the financial and programmatic operations of these Wastewater and Drinking Water SRF programs. The report notes that while some states are already moving in this direction, there is significant room for further progress in this area. EFAB is convinced there are real opportunities for achieving efficiencies and economies by moving toward the combined operations of the two SRF programs at both the state and federal levels.

The Board recognizes that additional information may be needed in order to best implement combined SRF operations and recommends that EPA undertake a detailed examination of the two programs to better determine what opportunities and advantages exist and how they might best be combined. EFAB is prepared to assist in such an effort in any way consistent with its charter.

Sincerely,

_____/S/_____
Lyons Gray
Chair

_____/S/_____
A. Stanley Meiburg
Executive Director

Enclosure

cc: Charles E. Johnson, Chief Financial Officer
Benjamin H. Grumbles, Assistant Administrator for Water

COMBINED OPERATIONS OF THE CLEAN WATER AND DRINKING WATER STATE REVOLVING FUNDS

GENERAL CONTEXT

Many studies and reports indicate that the investment needs for clean water and drinking water facilities are large and growing. EPA itself estimates that capital needs for clean water will range from \$331 billion to \$450 billion during the period from 2000 to 2019. For the same timeframe, EPA estimates that capital needs for drinking water will range from \$154 billion to \$446 billion. (These figures are taken from the EPA report, *The Clean Water and Drinking Water Gap Analysis*, September 2002.) Obviously, whatever the exact figures may be, very substantial resources will be required to address the environmental investment needs of clean water and drinking water.

EFAB believes that the states, local governments, and the federal government all have roles to play in order to successfully address this significant environmental investment challenge. In particular, the Board has long supported a strong federal commitment to two important infrastructure loan programs, the Clean Water and Drinking Water State Revolving Fund (SRF) Programs. This strong commitment remains very important during this period of growing infrastructure investment needs and tight government budgets. Having noted this, the Board also believes that all federal programs should make every possible effort to realize the maximum efficiency and effectiveness in the use of whatever funds they are appropriated.

OVERVIEW

EFAB is convinced there are real opportunities for achieving efficiencies and economies by moving toward the combined operations of the two SRF loan programs at both the state and federal levels. Indeed, a number of states are already demonstrating efficiencies both in financial and programmatic management through combined operation

of some aspects of their loan programs including financial management for purposes of more efficient investment, bond issuance, and programmatic management. Some of these are described below. Many other states, however, for various reasons, maintain distinctly separate management structures. And while there are many diverse aspects of SRF management, including environmental prioritization, watershed planning, community outreach, and education which each state approaches individually, the essential common denominator of each SRF program is its financial component.

Each state fund is first and foremost a loan program where the first imperative is an understanding of the basics of loan financing. Whatever other disciplines may be involved, the SRF programs are principally banking operations and the capability to understand the fundamentals of banking and efficient money management are essential to an effective program. With the maturity of these loan programs, vast amounts of money are now circulating from loan repayments and fund investments. Annual combined loan repayments from the two funds now exceed \$3 billion dollars and annual earnings from invested funds exceed \$500 million (net of investments of leveraged bond reserves). EPA, through its own training efforts and through those financed with organizations such as the Council of Infrastructure Financing Authorities (CIFA), has encouraged states to improve their financial management capabilities in the loan programs.

This has been salutary, but in the view of this Advisory Committee, a fundamental restructuring of the program in many states as well as in EPA headquarters, has the potential to more fully achieve the advantages of efficient financial management. At a time of budget constraints, a real potential for reduced federal grant support, and increasing emphasis on achieving economies in the operation of governmental programs, EFAB believes that many states could achieve economies in SRF management by merging or more closely combining the operations of their two environmental lending programs. Moreover, in the opinion of some state program managers we have consulted, combined Clean Water and Drinking Water SRF operations could achieve economies in program administration as well, especially with respect to the integration of Intended Use Plans.

Likewise, we are of the opinion that EPA itself could achieve efficiencies in its own Clean Water and Drinking Water SRF management by combining their operations at headquarters where two separate SRF operations are maintained within the Office of Water.

EFAB urges EPA to undertake a comprehensive review of the operations of the SRF program in terms of its own management at headquarters and in the regions to determine if moving toward a combined operation of the two loan programs might achieve a more efficient and effective use of resources, and also encourage individual state programs to consider combined programs which could lead to improved financial management techniques. We appreciate that some constraints and limitations exist which may inhibit the full integration of the two programs, especially with regard to the separate state and federal enabling legislation implementing the two loan programs. Even so, the combined or close operation of the two programs in a numbers of states offers instructive prototypes of how efficiencies can be achieved through more integrated management. In recommending this action we recognize that the Congress was not prescriptive in telling the states how to administer the loan programs and that this has been one of the strong features of the program, allowing states to adapt their loan program implementation to their own constructs and particular needs. It is not our intent to suggest there is any one prototype that should be enforced upon the state programs, but rather, to suggest that there are efficiencies to be achieved by combining some operations which states, with EPA cooperation, should investigate for application to their own programs.

BACKGROUND

In June 2001, EFAB published a report titled “Environmental State Revolving Funds: Developing a Model to Expand the Scope of the SRF.” The report examined the idea of providing states the flexibility to expand their Drinking Water and Clean Water State Revolving Funds to cover projects in all environmental media. The flexibility to fund all environmental media would, in turn, allow states the flexibility to address all causes of pollution for the maximum environmental benefit. The Board believes that if such an environmental SRF is to become a reality, it should be built upon the success of

the existing Clean Water and Drinking Water programs through additional funding for a broader range of projects. As a first step towards identifying the benefits associated with an environmental SRF, EFAB undertook to identify the benefits that may result from the combined operation of the Clean Water and Drinking Water SRFs. In addition, EFAB sought to identify the regulatory, statutory, organizational and programmatic hurdles that currently prevent the Clean Water and Drinking Water SRFs from operating as a single entity.

EFAB members held informal discussions with a number of States to identify the benefits and issues inherent in the combined operation of the Clean Water and Drinking Water SRFs. Conversations were held with SRF managers from the States of New York, New Hampshire, Missouri, Maryland, Montana, North Carolina and New Mexico. The anecdotal information received from these conversations offers insights into the perceived benefits of jointly operated SRFs. This information can serve as the basis for an in-depth analysis of the benefits of combined SRF operations across states.

OPPORTUNITIES, CONSTRAINTS AND LIMITATIONS

EFAB explored a number of areas where there may be obvious advantages of combined operations. These included fund investments, leveraging, administration and staff expertise, and project funding capacity. As mentioned previously, EFAB also attempted to identify some of the possible limitations and constraints in implementing such a major shift. Both benefits and hurdles are described in further detail in the paragraphs that follow.

Administration

The majority of managers we spoke to believe they would reap significant administrative benefits if they were able to run the Clean Water and Drinking Water SRFs as one. Technical project management in most states is split by fund with coordinators and engineers working on one type of project or the other. Cost savings would result from having a single SRF with a dedicated technical staff in one, as opposed to multiple, locations. Furthermore, states mentioned they would be able to benefit from

cost savings in the time staff spend on producing separate reports for each of the funds, namely the Annual Reports and Intended Use Plans. Accounting for the funds would be greatly simplified, as SRF monies would no longer have to be tracked separately. One state mentioned that having a single SRF would assist in addressing match requirements and the accounting challenges that tracking the separate matches involves.

Moreover, moving toward consolidation of the two SRF programs would be complementary to EPA's efforts over the last several years to approach water pollution control on a more integrative, watershed basis. Recognizing the need to bring non-point source controls into the equation has caused the Agency to foster more emphasis on a watershed approach to planning and implementation of strategies for both point and non-point control and safe drinking water supply. The closer integration of the two water infrastructure financing programs at the state level would help facilitate this watershed approach, allowing states to identify the most efficient and effective use of expenditures for both control and supply. A fully integrated loan program where available money was fungible would provide the state with the flexibility to direct loan funds to the most environmentally strategic projects in a watershed. To fully achieve this objective of a common pooling arrangement and a common Intended Use Plan, would require some modest changes in federal statute in both the Clean Water and the Safe Drinking Water Acts. It would be important to maintain the current categorical appropriations so that the set-asides for state program administration as well as those for basic drinking water assessments would be sustained roughly in proportion to the administrative needs of the two programs.

Cost-of-Funding

Many states that leverage their SRFs already sell a single issue of bonds to fund both Drinking Water and Clean Water. These bonds are jointly secured or cross-collateralized by the assets of both SRFs and generally achieve AAA ratings – the highest rating assigned to municipal bonds. SRF managers are able to sell bonds jointly secured by the assets of both SRFs by complying with the proportionality or investment provisions in each Act.

Aside from advantageous borrowing levels, which the majority of SRFs enjoy by virtue of their ratings, most managers view a single pool of funds as a financial advantage for both the SRF and the projects funded. For instance, a single municipality or entity applying for both drinking water and clean water loans would be able to receive funding under a single loan application. This would simplify the legal work that must be undertaken by both borrower and lender, resulting in lower legal and trustee fees.

Fund Investments

As permitted by EPA, most investment managers treat funds under each SRF as fungible for investment purposes, although they must separately account for the assets of each SRF. The ability to account for SRF federal and state contributions in one common equity fund is an area where benefits can be significant. Several states consulted on this project jointly manage their own investments, finding it preferable to state investment pools where returns and flexibility of investment products are often limited. Since anticipated cash-flow needs for constructions draws, new lending and possible administrative costs are critical factors of short term fund investing, the capacity to shift available fund from one category to another is essential to achieving better returns. Quite simple, returns are generally directly proportionate to the amount and duration of money invested and the ability to combine available funds in one managed investment pool can significantly enhance returns.

Barriers to Implementation

The most frequently cited hurdle to combined operations is the different institutional arrangements that currently exist between the state agencies responsible for the implementation and oversight of each SRF. Characterized by one state administrator as “institutional drag” this may also be an issue for EPA, where different divisions have responsibility for the Clean Water and Drinking Water programs. Even at the Congressional level, two separate House Committees assert jurisdiction over the Drinking Water SRF, a complicating factor in achieving any statutory modification.

Furthermore, there is concern within EPA that combined operations could have a least common denominator effect, with the loss of flexibilities currently enjoyed by one or the other fund (e.g., funding for disadvantaged communities or coverage of technical assistance costs).

While there are legal constraints at the federal level for implementing a jointly operated SRF, constraints at the state level are tied to how each state is organized to manage the SRFs. Federal authorization of a common SRF would require states to review state laws as well as the powers of their current managing institutions. In this respect, some states have cautioned about the advisability of going to their legislature with requests for basic legislative change; concerned that opening up the loan program for legislative modification would unduly expose it to legislative tinkering and possible mischief and might result in some efforts to expropriate the loan funds for other state financing needs. They advised that often state legislatures have little understanding of the SRF program and any invitation for statutory changes could open the funds to politically motivated actions. However, tightly crafted federal legislation could limit attempts by state legislatures to divert SRF funds.

EFAB RECOMMENDATIONS

We recommend that EPA, perhaps in cooperation with EFAB, undertake an examination of the two programs to determine what opportunities and advantages exist for combined SRF operations. To undertake this in any comprehensive fashion is a big job and we obviously do not have the resources. But evidence from our observations and consultation with several state programs indicates wisdom in moving, however incrementally, toward a more fully integrated program. The question is not whether the programs could be combined, but rather how best can they be combined and to what advantage and perhaps at what cost.

July 21, 2005

Mr. Lyons Gray
President, Downtown Winston-Salem Partnership
500 W. 4th Street
Suite 101
Winston Salem, NC 27101-2782

Dear Mr. Gray:

Thank you for your letter to Administrator Stephen L. Johnson dated May 27, 2005, in which you transmit on behalf of the Environmental Financial Advisory Board (EFAB), the report entitled *Combined Operations of the Clean Water and Drinking Water State Revolving Loan Funds (SRFs)*. As always, I appreciate the opportunity to review and examine any input from EFAB. I found EFAB's previous report on the benefits of financing techniques such as 'backloading' to be particularly useful in a time in which we at EPA recognize that there is a substantial need for current investment in water and wastewater infrastructure around the country.

In the report, EFAB recommends that EPA undertake an examination of the Clean Water State Revolving Fund and the Drinking Water State Revolving Fund programs to determine what opportunities and advantages exist for combined SRF operations.

While I believe that examining the possibility of creating a more efficient water finance program is always a worthy endeavor, I propose to send this report, along with instructions to further study the possibilities of combined operations, to the State/EPA Workgroup. The Workgroup is comprised of representatives of 18 States and EPA. Members include representatives from State Clean Water and Drinking Water SRF programs, EPA regional coordinators for both programs, and EPA headquarters representatives. Additionally, membership is split between SRF program directors and SRF finance directors. I believe that the expertise and varying viewpoints of the members of the Workgroup would best be able to provide feedback to EFAB, and work with EFAB to further examine potential opportunities or barriers. I would also like to extend an invitation to EFAB to send a representative to the State/EPA Workgroup meeting being held in Chicago, November 2-3, 2005. This would be a great opportunity for EFAB to present its views directly to the Workgroup.

Thank you again for providing this valuable input. Combining the operations of EPA's SRF programs is an idea that may lead to a more refined and efficient water infrastructure financing program. If you have any questions or wish to speak further about this issue, please contact James A. Hanlon, Director, Office of Wastewater Management, at (202) 564-0748, or Cynthia C. Dougherty, Director, Office of Ground Water and Drinking Water, at (202) 564-3750.

Sincerely,

/s/ original signed by Benjamin H. Grumbles

Benjamin H. Grumbles
Assistant Administrator

July 21, 2005

Mr. A. Stanley Meiburg
Deputy Regional Administrator
U.S. EPA, Region IV
61 Forsythe Street, SW
Atlanta, GA 30303

Dear Mr. Meiburg:

Thank you for your letter to Administrator Stephen L. Johnson dated May 27, 2005, in which you transmit on behalf of the Environmental Financial Advisory Board (EFAB), the report entitled *Combined Operations of the Clean Water and Drinking Water State Revolving Loan Funds (SRFs)*. As always, I appreciate the opportunity to review and examine any input from EFAB. I found EFAB's previous report on the benefits of financing techniques such as 'backloading' to be particularly useful in a time in which we at EPA recognize that there is a substantial need for current investment in water and wastewater infrastructure around the country.

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Thank you again for providing this valuable input. Combining the operations of EPA's SRF programs is an idea that may lead to a more refined and efficient water infrastructure financing program. I strongly encourage you to work closely with the State/EPA Workgroup and attend, if possible, the meeting in Chicago. If you have any questions or wish to speak further about this issue, please contact James A. Hanlon, Director, Office of Wastewater Management, at (202) 564-0748, or Cynthia C. Dougherty, Director, Office of Ground Water and Drinking Water, at (202) 564-3750.

Sincerely,

/s/ original signed by Benjamin H. Grumbles

Benjamin H. Grumbles
Assistant Administrator