

Increasing State Revolving Fund Capacity through Leveraging

By Katy Hansen, Sridhar Vedachalam & John Ryan



Editor's Note: This article is a follow-up to a piece in the April issue discussing how innovative features of the WIFIA program can help expand SRF loan capacity.

In 2008, Iowa state lawmakers were determined to finance infrastructure upgrades in 600 small communities without sewer systems after record floods carried untreated wastewater into local rivers and lakes.

But, according to the Associated Press, the projects proceeded very slowly. Each year, the state committed to upgrades in about a dozen communities. Local ratepayers funded most of the project costs by paying increased

monthly fees, though the state provided some grants. Several lawmakers worried that small communities would not receive enough assistance if the state also funded much larger projects in Des Moines.

The tale of financing capital projects in Iowa is common across the country. Local ratepayers fund nearly all water and wastewater infrastructure in the United States. Systems serving smaller populations or low-income residents have weaker revenue bases and typically invest less in infrastructure, leading to disparities in service. Investment has not kept pace with increasing need due to backlogged maintenance, population shifts, and climate change. State and federal assistance — primarily through the Clean Water and Drinking Water State Revolving Fund (SRF) programs — plays an important role in financing water infrastructure but is limited in scale. In 2020, states committed \$9.4 billion through SRFs, a mere fraction of the \$129 billion that the American Society of Civil Engineers estimates is needed nationwide.

Limited capacity prevents states from providing more assistance to local water and wastewater systems. Capacity refers to the resources that organizations have to fulfill their goals. Larger appropriations from the federal and state governments will increase the size of SRFs, but states could further enhance capacity by leveraging federal funds with other debt. The failure to leverage leaves money on the proverbial table and has real-world impacts on communities. Without more financing, the gap between need and investment in water infrastructure will continue to widen.

Increasing the size and administrative capacity of SRF programs will improve their accessibility.

Increasing SRF Capacity through Appropriations

The main sources of capital for SRFs are federal appropriations, state matching funds, and leveraging. Congress appropriates funds to capitalize revolving loan funds in each state. All states add at least a 20 percent match and some leverage. Congress and the White House are working on legislation and plans to increase the SRF appropriation. For example, the Drinking Water and Wastewater Infrastructure Act (S.914), overwhelmingly approved in the Senate on April 29, 2021, aims to increase the

annual SRF appropriation from slightly less than \$3 billion in FY2021 to nearly \$6.5 billion in FY2022. The American Jobs Plan proposed by the Biden-Harris administration includes nearly \$56 billion for water, wastewater, and stormwater infrastructure over eight years, much of which could be allocated through SRF programs. Appropriations of these magnitudes could increase the capitalization grants to states by two to fivefold.

A main barrier to increasing the capacity of SRFs through increased federal appropriations is the state match requirement. The SRF authorizing legislation requires states to match at least 20 percent of the capitalization grant. States use revenues from state taxes, fees, and retired bonds to make their match. Their ability to contribute to SRFs is constrained by tight budgets and commitments to other programs. Some practitioners are concerned that states may turn down federal funding to avoid the matching requirement.

Congress will need to modify the state match requirement if it significantly increases the SRF appropriation. Potential workarounds include waiving the requirement, capping the total amount of the match, or allowing states to use a different source of federal funds, such as the state aid under the American Rescue Plan Act of 2021 (P.L. 117-2). Congress waived the match requirement when it nearly doubled SRF appropriations in the 2009 American Recovery and Reinvestment Act (P.L. 111-5), which Jonathan Ramseur and Elena Humphreys at the Congressional Research Service found contributed to the successful allocation of funds.

Leveraging SRFs with Municipal Bonds

States can also increase the size of the SRF programs by “leveraging” or using capital to borrow from other institutional debt sources. Traditionally, state agencies turn to the municipal bond market to leverage their revolving funds. SRFs have credit and tax characteristics that allow them to borrow very cost-effectively in the tax-exempt municipal bond market.

The extent to which states increase their SRF capacity by leveraging federal funds in the municipal bond market varies. The cases of Ohio and Pennsylvania are illustrative of this variation, as shown in Table 1. Despite similar populations and SRF allotments, these neighboring states have drastically different leveraging practices. Accord-

			Ohio	Pennsylvania
Demographics	Population		11.7 million	12.8 million
	Urbanization		78%	79%
Clean Water State Revolving Fund	Federal capitalization grant		89.4 million	62.9 million
	Leveraged bonds issued		690 million	0
	Binding commitments	\$	517.4 million	175.7 million
		#	201	111
Drinking Water State Revolving Fund	Federal capitalization grant		\$27.7 million	\$33.9 million
	Leveraged bonds issued		254.9 million	0
	Binding commitments	\$	226 million	141.9 million
		#	69	13

Table 1 – Capitalization grants, leveraging and disbursements in Ohio and Pennsylvania based on data from the National Information Management System, FY 2020.

ing to a categorization by the Council of Infrastructure Finance Authorities (CIFA), Ohio “frequently” leverages (i.e. issues bonds every or every other year) but Pennsylvania only “occasionally” leverages (i.e. issues bonds once in five years).

Leveraging facilitates different levels and types of infrastructure investments. Whereas Ohio financed 270 projects worth \$743 million in FY 2020, Pennsylvania financed only 124 projects worth \$317.6 million the same year. A larger fund allows a state to provide more assistance and differentiate the terms of assistance. Ohio offers loans with lower interest rates (0.5 percent) to small communities, about half of the interest rate (1 percent) offered to larger communities. Pennsylvania does not provide any preferential rates for small communities. Ohio also provides loans with zero percent interest for projects addressing priority issues, such as combined sewer overflows, regionalization, lead service line replacement, and PFAS. Finally, the amount of assistance that Ohio provides with additional subsidization — in the form of grants, principal forgiveness, and negative interest loans — is 40 percent of the annual federal capitalization grant, as opposed to Pennsylvania’s 28 percent.

Leveraging SRFs with WIFIA Loans

The U.S. EPA’s Water Infrastructure Finance and Innovation Act (WIFIA) Loan Program is possibly a more effective source of debt financing for SRFs. WIFIA has special features for SRF lending (known as ‘SWIFIA’) through the America’s Water Infrastructure Act of 2018 that allows 100 percent financing and expedites loan processing. So far, five larger SRFs that already use bond financing have successfully applied to WIFIA. Encouraging smaller SRFs to use loans to expand their capacity is a top program priority.

Like municipal bond financing, a WIFIA loan offers a very attractive interest rate. But the loan’s structure and form are much easier to manage than a public bond issue. In addition, a WIFIA loan has unique interest rate and cash flow management features that may be especially useful to SRFs for building and managing their own loans to smaller borrowers. The scope to utilize these features in innovative ways that address specific SRF needs is significant. The program has been very responsive

to innovative proposals from its water system applicants, and it is likely that innovative proposals from smaller SRFs will likewise be welcomed.

Constraints to Leveraging SRFs

Despite staggering need for investment, available capital, and low interest rates, only 28 states have leveraged their SRF programs. Of these, only a handful have leveraged to any significant degree. According to CIFA, just 12 states are responsible for 75 percent of the bond issuances. New York, Massachusetts, and Ohio are the most active in leveraging their federal allocations. Administrative constraints, concerns about changing the terms of assistance, and limited demand from borrowers may constrain leveraging.

Administrative Constraints

A main constraint to increasing the size of SRFs is administration capacity. The state agencies that administer SRFs engage in various outreach efforts; establish eligibility, application, and implementation criteria; provide technical assistance to applicants; determine which projects to finance; and set the terms of the assistance. Administering the program requires significant technical, managerial, and financial expertise and time. According to the National Information Management System (NIMS), state administrators are already not providing SRF awards up to the available funds. Increasing the size of the program — through additional appropriations or leveraging — will likely exacerbate this difference. Congress needs to provide additional administrative resources for state agencies to run the programs well. Contracting with third parties to assist with low-capacity systems with planning, project design, applications, paperwork, and implementation could also reduce the administrative burden and increase access to the program.

Concerns Over Interest Rates

Many water systems choose to finance projects with SRF loans because the interest rates are lower than the market rate. Leveraging may marginally increase interest rates for all applicants because part of the portfolio must provide market returns. State SRF administrators may fear that higher interest rates will discourage systems from applying or accepting loans. Lower demand would leave the program under-subscribed.

Low Demand

Increasing the capacity of SRFs to finance more projects assumes that systems can and will apply. Communities serving large or high-income populations may turn elsewhere for loans, especially if they are able to borrow at low interest rates, and with less red tape, on the municipal bond market. Communities serving small or low-income communities may not be able to apply for SRF assistance. Applications to finance infrastructure usually require designs and analyses that are expensive to conduct. Communities with limited technical staff turn to private consultants for help. The Roundtable of Regions estimates that the average cost to apply for state aid to finance water infrastructure in California was \$17,000. Providing technical assistance and project planning assistance as part of the funding can help ameliorate this barrier.

Impact on Real-World Outcomes

Increasing the size and administrative capacity of SRF programs will improve their accessibility. Currently, most water and wastewater systems do not apply or receive SRFs. For example, less than 5 percent of the more than 5,300 eligible water systems in Texas received a DWSRF award from 2011-2020. Texas is representative of a broader sample of states. By increasing the size of SRF programs, states can make the funds more accessible. In addition to ensuring more financial assistance reaches more systems, states must be mindful of equity in allocation. Systems serving low-income or high-poverty communities will struggle to take on loans. Expanding the SRF through leveraging will allow states to offer preferential rates, including zero interest loans and principal forgiveness, to disadvantaged communities. Leveraging SRF funds with WIFIA loans will not only scale up water financing across the country, it also has the potential to enhance the equity and efficiency of water infrastructure investments. 🌟



Katy Hansen is a senior advisor at the Environmental Policy Innovation Center (EPIC) in Washington, D.C.



Sridhar Vedachalam is the director of water at the Environmental Policy Innovation Center.



John Ryan is principal of InRecap LLC.