REPORT ON THE APPROPRIATE ACCOUNTING TREATMENT FOR STATE REVOLVING FUND LOANS RESULTING FROM THE SAFE DRINKING WATER ACT AMENDMENTS OF 1996

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EXECUTIVE SUMMARY

The Safe Drinking Water Act Amendments of 1996 allow for states to set up State Revolving Funds. These funds are specifically available to investor owned water utilities and therefore the customers of these utilities.

It is important that state regulators be aware that the benefits of these funds will inure to the customers, not the stockholders of the privately owned utility. The accounting and regulatory treatments contained herein, show that the appropriate treatment of these funds by regulatory commissions, will provide the benefits to the customers.

Accounting changes to the NARUC Uniform System of Accounts are not necessary. Where necessary, subaccounts maybe used to identify the specific assets and long-term liabilities relating to these funds. The present USOA allows for subaccounts.

State regulatory commissions should encourage participation by investor owned utilities in the state revolving funds as these funds will benefit utility customers by lowering rate increases.

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PURPOSE

To review the Safe Drinking Water Act Amendments of 1996, determine the appropriate accounting treatment for loans to investor-owned water utilities, determine whether changes need to be made to the NARUC Uniform System of Accounts, prepare a report and provide any recommended changes.

INTRODUCTION

The relevancy of the Safe Drinking Water Act Amendments (SDWA) is very important to the state revolving fund (SRF). The current SDWA amendments are very important because they will look at water sources in particular and attack contamination before it occurs. The outgrowth of a SRF is extremely important to maintain and increase safe and high quality sources of drinking water. The fund allows the local water systems to upgrade infrastructure and put in place new water systems.

Funding is always a priority for successful implementation of any law. The authorization of $9.6 billion needs to be examined. How these monies are distributed will be critical to overall effectiveness. A major question is how much should go to public utilities versus investor owned utilities.

The establishment of a SRF will allow each state to administer its federal monies and monitor state water utilities. The 20% match from the states appears to be under attack. Many states feel that the federal moneys should be the only funds that go to investor owned utilities and that matching state funds should only go to publicly owned utilities.

Though there is no prohibition for investor owned utilities receiving the funds, many states have laws against public monies going to investor owned utilities. These can be located in state constitutions or legislation. The main question is whether public monies should go to a privately owned utility. The National Association of Water Companies has recently completed a survey on this issue in the 41 states with member companies. Of the 41 states surveyed 15 have a restriction on access to these loans by investor owned utilities.

As taxpayers, an investor owned utility's customers have contributed to the fund, both on the federal and state sides and should not be excluded from the benefit of those funds. Assurances should be given to state legislatures that these funds will not benefit the stockholders of the utility, but rather that they will directly benefit the customers of the utility through the appropriate regulatory treatment by the state regulatory commission.

It was the intent of the United States Congress to allow the state revolving fund to be available to all drinking water systems, including investor owned water utilities. If not available to private

systems, customers of needy investor owned utilities will continue to be provided with less than adequate service.

SAFE DRINKING WATER ACT AMENDMENTS OF 1996

As stated in the General Guide to Provisions, published by the Environmental Protection, Office of Ground Water and Drinking Water in August 1996:

The Safe Drinking Water Act Amendments of 1996 (PL 104-182) establish a new charter for the nation's public water systems, states and the Environmental Protection Agency in protecting the safety of drinking water. The amendments include, among other things, new prevention approaches, improved consumer information, changes to improve the regulatory program, and funding for States and local water systems.

The last phrase is the subject of this paper. The Act provides money to the states to set up state revolving funds to aid the country's water systems through low interest loans and through principal forgiveness.

Highlights of the state revolving fund portion of the Act are as follows:

- A total of $9.6 billion in capitalization grants are authorized to establish state revolving funds.

- The EPA is required to enter into agreements with eligible states to make capitalization grants to further the health protection objectives of the SDWA.

- EPA is required to withhold funds from states that do not set up capacity development programs.

- EPA is required to withhold funds if a state does not meet the requirement for operator certification programs.

- The funds can be used for loans, loan guarantees and source of reserve and security for leveraged loans.

- Small systems, defined by the Act as those serving fewer than 10,000 persons, are to receive 15% of annual assistance from a state's SRF. Disadvantaged systems may receive loan subsidies, including forgiveness of principal, up to 30% of a state's annual assistance.

- States must annually prepare an Intended Use Plan that identifies how the SRF funds will be used. States must give highest priority to projects that address the most serious risks to public health, are necessary to achieve compliance, and assist systems most in need on a per household basis.

- States must contribute an amount equal to 20% of the total contribution.

- $10 million per year is reserved for health effects research and $2 million per year is reserved for unregulated contaminant monitoring. In addition, 2% of the funds appropriated maybe reserved by EPA for technical assistance.

- Up to 4% of the state allotment may be used by the state for administration of the fund. An additional 2% may be used for small system technical assistance. Up to 10% may be used for a combination of the following: PWSS (Public Water System Supervision) activities, state capacity development strategies, operator certification programs, and source water protection programs. Up to 15% may be used for a combination of the following: loans for the acquisition of land or conservation easements, loans to implement voluntary source water protection measures, technical and financial assistance to water systems as part of a state capacity development strategy, delineations/assessments of source water protection areas, and establishment and implementation of well head protection programs. No single item can receive greater than 10%.

- The governor of a state is allowed to transfer 33% of the funds from the drinking water SRF to the Clean Water Act SRF.

- The EPA is required to publish regulation and guidance as necessary. Interim guidelines were published in October 1996 and final guidelines were published in February 1997.

- States are required to publish and submit to EPA a report every two years that describes program activities and expenditures and includes the most recent audit of the state's program.

- The EPA is required to perform an assessment of the capital improvement need of all eligible public water systems and submit a report within 180 days of the passage of the Act. Additional surveys will be conducted every four years thereafter.

- Within two years of enactment, the EPA must publish guidelines for water conservation plans. Within a year of publication of the guidelines, a state may, as a condition of receiving a loan, require a water system to submit a water conservation plan.

DRINKING WATER STATE REVOLVING FUND PROGRAM GUIDELINES

The EPA published final guidelines in February 1997. As stated in the final guidelines:

This document provides a comprehensive description of the guidelines that will apply in the operation of the DWSRF program. In basic terms, the guidelines explain:

- what states must do to receive a DWSRF capitalization grant,
- what states may do with Federal capitalization grant funds,
- what states may do with funds the law intends for activities other than project construction (set-asides) and
- the roles of both states and EPA in managing and administering the program.

The most important portions of the final guidelines with respect to investor owned water utilities are in Sections II C and III. Privately owned water utilities are specifically included as eligible for funding.

Section II C lists the types of financial assistance that the fund may provide. It states that a fund may make loans for project construction, purchase or refinance of local debt obligations, guarantee or purchase insurance for local debt issues, provide revenue for or secure state bonds if the proceeds of the bonds are deposited in the fund, and earn interest on fund accounts. NOTE: Private systems are ineligible for refinancing.

The provisions of Section II C allow for loans with interest rates that are less than or equal to market interest rate, including zero percent loans. It also requires that borrowers must begin repayment not later than one year after completion of the project. Recipients must complete loan repayment not later than 20 years after completion of the project. States which establish a disadvantaged community loan program may provide loans to qualified recipients for up to 30 years, as long as the period of the loan does not exceed the expected design life of the project. In addition, each recipient, except for a disadvantaged subsidy portion, must establish a dedicated source of revenue or, in the case of a privately owned system, demonstrate that there is adequate security for repayment of the principal and interest due on the loan.

Section II C also provides for additional loan subsidies such as principal forgiveness and negative interest rate loans to benefit communities meeting the definition of disadvantaged.

Section III A provides the following definition:

Drinking water systems that are eligible for fund assistance are community water systems, both <u>privately</u> and publicly owned, and nonprofit noncommunity water systems.

Section III B defines the eligible projects that the fund may be spent on, while Section III C defines the projects not eligible for funding.

ACCOUNTING TREATMENT

NARUC UNIFORM SYSTEM OF ACCOUNTS

The NARUC Class A Water Uniform System of Accounts (USOA) does not need to be amended to account for the SRF. All necessary accounts are contained in the USOA

The USOA presently contains accounts for the recording of this type of funding for the eligible projects. The assets should be recorded in water utility plant assets (Account Nos. 301 - 348). The eligible projects would be recorded in these accounts as soon as they are completed and in service. The control account for these plant accounts is Account No. 101 - Utility Plant in Service. The description of that account states:

A. This account is the control account for plant accounts 301 through 348.

B. This account shall include the original cost of utility plant, included in the plant accounts prescribed herein and in similar accounts for other utility operations, owned and used by the utility in its utility operations, and having an expected life in service of more than one year from date of installation, including such property owned by the utility but held by nominees. Separate subaccounts shall be maintained hereunder for each utility department and/or division.

The USOA would require that accumulated depreciation on these projects be recorded in Account No. 108 - Accumulated Depreciation. The corresponding depreciation expense would be recorded in Account No. 403 - Depreciation Expense.

The loans from the SRF should be recorded in Account No. 224 - Other Long-Term Debt which states:

A. This account shall include, until maturity, all long-term debt not otherwise provided for. This covers such items as receiver's certificates, real estate mortgages executed or assumed, assessments for public improvements, notes and unsecured certificates of indebtedness not owned by associated companies, receipts outstanding for long-term debt, and other obligations maturing more than one year from date of issuance and assumption.
B. Separate subaccounts shall be maintained for each class of obligation, and records shall be maintained to show separately for each class all details as to date of obligation, date of maturity, interest dates and rates, security for the obligation, etc.

Interest on the loan from the SRF should be recorded in Account No. 427 - Interest Expense and its corresponding subaccount No. 427.3 - Interest on Long-Term Debt.

The USOA also provides accounts and subaccounts to record any premium or debt discount and corresponding amortization accounts. It also provides for deferred income tax accounts for this type of asset where the depreciable life for tax purposes may be different from the life for book purposes.

If a surcharge is allowed for the collection of revenues associated with the repayment of the loan, those revenues would be properly recorded in Account No. 400 - Operating Revenues. In the case of a surcharge, the only change from normal accounting would be the depreciable life of the asset. The life of the asset may match the life of the debt repayment. This would require that the accumulated depreciation account have a subaccount that would track the accelerated depreciation on the asset. Subaccounts are allowed by the USOA in Accounting Instruction 2.D.

If there is a forgiveness of the principal or a negative interest rate allowed, the forgiveness of the principal and the portion of the negative interest rate which actually forgives the principal should be properly recorded in Account No. 271 - Contributions in Aid of Construction. The appropriate portions of the description of this account state:

A. This account shall include any amount or item of money, service or property received by a utility, from any person or governmental agency, any portion of which is provided at no cost to the utility, which represents an addition or transfer to the capital of the utility, and which is utilized to offset the acquisition, improvement or construction costs of the utility's property, facilities, or equipment used to provide utility services to the public.

B. The records supporting the entries to this account shall be so kept that the utility can furnish information as to the purpose of each donation, the conditions, if any, upon which it was made, the amount of donations from (a) states, (b) municipalities, (c) customers, and (d) others, and the amount applicable to each utility department.

Amortization of the contribution, if recognized by the regulatory commission should be recorded in Account No. 272 - Accumulated Amortization of Contributions in Aid of construction and in Account No. 403 - Depreciation Expense.

REGULATORY TREATMENT

There are two areas where the appropriate regulatory treatment of SRF loans should help alleviate the fears that public monies will result in profit for stockholders of investor owned utilities. These areas are the appropriate treatment of the low interest loans and the principal forgiveness.

In normal rate base, rate of return regulation, a below market rate loan from the SRF will reduce the overall cost of capital for a utility. This is recognized for ratemaking purposes by reducing the interest rate on debt, thereby reducing the overall rate of return that will be allowed to be earned on the stockholders' investment (rate base) which will result in a lower revenue requirement and lower rates for water service. This assumes that there will be a regulatory action reducing cost of service or a rate case proceeding. There will be an ongoing reduction in the cost of water service over the life of the asset.

A loan where the repayment of the principal is forgiven would be considered a contribution in aid of construction. A negative interest rate loan would have the same effect, except that a negative interest rate would be over the life of the asset as opposed to a one time forgiveness of some portion of the debt. The same CIAC treatment should apply. For ratemaking purposes, this is considered a cost free asset, and the stockholders would not receive any return on the asset, and therefore, the cost of service to the customers will be reduced over the life of the asset.

POSSIBLE PROBLEMS

There are several problems that may arise with respect to the SRF. The first is where the life of the assets constructed is longer than the repayment period of the loan. Typical regulation would record the asset and allow depreciation and a return on the asset. The loan would be recorded as a long term debt item to be included in a utility's cost of capital. The return on the asset should theoretically cover the interest expense on the debt, with the depreciation returning the principal over the life of the asset. A problem arises when the repayment period of the loan is materially shorter than the depreciable life of the asset. Utilities, especially small ones, may not have the cash flow to cover the debt expense. A surcharge on the customer bill, along with a shorter depreciable life for the asset, may be an answer for this problem.

The second possible problem will arise in the event of a default on a SRF loan by an investor owned utility. If any investor owned utility defaults on the loan, it may jeopardize the availability of funding for other investor owned utilities. This is especially true in states where there is a great negative reaction to providing SRF funds to private utilities.

As stated earlier, some states are prohibited by laws and by their constitutions from using public funds for privately owned entities. We believe that state regulatory commissions should urge their legislatures to change these prohibitions for SRF funds. Investor owned utility customers are taxpayers and contribute to the availability of these funds. They should also benefit from these funds. The above regulatory and accounting treatments should show that the funds will benefit the customers of investor owned utilities as well as public utility customers.

PENNVEST

The Commonwealth of Pennsylvania has had an established SRF since it was enacted by the Pennsylvania legislature in 1988. The Pennsylvania Infrastructure Investment Authority (PENNVEST) has lent monies to both public and private utilities. A recent (May 1997) NRRI publication entitled "Lessons From PENNVEST Applicable to the Design of a State Safe Drinking Water Revolving Loan Fund" by Raymond W. Lawton, Ph.D., contains the following key lessons learned from a review of PENNVEST:

1. The importance of an expedited rate review by the state commission focused on loan repayment.

2. Having both public and investor-owned community water systems be eligible loan recipients.

3. As revolving loans have to be repaid, up-front financial analysis is required that may benefit from the established expertise of the state commission.

4. State matching funds should be larger than the federal mandated minimum match requirement in order to allow for necessary state flexibility.

5. Advance loans are important policy tools for the weakest systems.

6. An effective loan program should be combined with a multi-agency "tool bag" approach.

7. Continued training and certification of system operators are necessary.

8. It is important to coordinate loans with other funding sources.

9. While a regulatory commission is not the primacy agency, it does have technical resources and rate approval authority that can directly assist the state loan administrator.

10. A revolving fund may be established or enlarged through statewide referendums: PENNVEST's experience indicates by its success that broad public support exists for a revolving loan approach.

11. The lending authority's operating funds can come from repayment, state general revenue funds, or the original loan funds.

12. New regulatory procedures may not be necessary, as commissions may already have sufficient tools and procedures in place.

13. Customer notification about loan repayment surcharges is necessary.

14. Having a commission explicitly retain its auditing and refunding authority regarding the use of and repayment of low-interest revolving fund loans.

Task Force Comment on Customer Notification: Where appropriate, the surcharge can be shown as a separate line item on ratepayers' bills. This will alert customers to the portion of their bill that is being used for significant system improvements to comply with Safe Drinking Water Act mandates.

CONCLUSION

The mission of the task force was to review the SDWA amendments, determine the appropriate accounting treatment for loans made to investor owned utilities and determine whether changes were needed for the USOA.

This report provides an overview of the SDWA amendments and the appropriate accounting treatment for SRF loans. It was determined that no changes to the USOA were necessary.

The task force also believes that SRF loans are beneficial to the customers of investor owned utilities and should be encouraged wherever possible.

ATTACHMENTS

Joint Resolution on Establishing Accounting Procedures for Drinking Water State Revolving Fund Loans to Water Utilities

General Guide To Provisions of the Safe Drinking Water Act Amendments of 1996

Environmental Protection Agency Drinking Water State Revolving Fund Program Guide

Overview of National Association of Water Companies Survey of State DW-SRF Programs Regarding Investor-Owned Utility Access to DW-SRF Loans

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