Policy on Subordination of Tennessee Local Development Authority (TLDA) and State Revolving Fund (SRF) Program Debt

Background

The State Revolving Fund (SRF) loan program was created to provide financial assistance to local governments to address the health, safety and environmental requirements for clean water and safe drinking water. The program makes loans to qualified local governments (the "borrowers") at or below market rates loans to finance the infrastructure to address the above mentioned issues and to comply with federal EPA and state requirements. Although the SRF programs have successfully contributed to meeting the needs of over 150 communities since 1989, the program cannot meet all of the needs of the larger and faster-growing communities. As a result, some local governments must also issue its long-term debt in the capital markets to provide for funding needs. The blending of the rate of a SRF loan and the rate of debt sold in the capital markets has historically created average user fees that were lower than if the local government issued only its long-term debt.

The Tennessee Local Development Authority is delegated the responsibility for issuing bonds and notes to provide funds to make loans to (1) local governments for water, sewer and solid waste resource recovery facilities, (2) certain small business concerns for pollution control facilities, (3) local government units for capital projects, (4) farmers for certain capital improvements, (5) counties for the acquisition of equipment for use by county or volunteer fire departments serving unincorporated areas, (6) airport authorities and municipal airports, (7) mental health/mental retardation and drug facilities, and (8) reimburse reasonable and safe cleanup of petroleum sites.

T.C.A. §68-221-1003(7) et seq. defines a Local government as a county, incorporated town or city, metropolitan government, state agency, water/wastewater authority, energy authority or any instrumentality of government created by any one (1) or more of these or by an act of the general assembly. A Local government is also defined as any utility district created pursuant to title 7, chapter 82, existing on July 1, 1984, and which operates a wastewater facility; and also includes such utility district created after July 1, 1984, if such utility district operates a wastewater facility comprised of at least five hundred (500) customer connections.

Purpose

The purpose of this policy is to specify the lien position of the TLDA with respect to TLDA program borrowers' debt and establish guidelines and procedures for a local government that requests subordination of its existing TLDA or SRF indebtedness to its own outstanding debt that has been issued in the capital markets. Due to the nature of the SRF as a revolving loan fund, and the TLDA's responsiblity to ensure repayments of those funds, the TLDA does not make it a practice to grant permission to subordinate SRF debt. The following points will be considered in this process:

- The amount of debt that the Authority is willing to subordinate to the borrower while considering the following: State-shared taxes, other revenues, General Obligation (GO) pledge (other than the utility districts), increase in deposit amount required for the Utility District (UD)
- A requirement for a yearly report from the borrower, demonstrating they are meeting all loan covenants, for the life of the loan
- The debt rating of the borrower
- The amount of the borrower's revenue (as obtained from an independent source that is acceptable to the TLDA)
- The borrower's payment status (is current on all SRF debt, has not had a late payment in the past five years)
- The borrower's revenues from 10 number of largest users of the system do not constitute more than 10 percent of total system revenues

The policy applies to (a) local governments that have issued debt and have secured it with either a general obligation or revenue pledge, and (b) utility districts and authorities that either (i) sold debt directly in the capital markets and subsequently borrowed from the State Revolving Fund ("SRF") loan program, or (ii) borrowed from the SRF loan program and subsequently sold debt directly in the capital markets.

Effective Date

Immediately.

Policy

It is the Tennessee Local Development Authority's policy that it may consider the subordination of its debt to the debt of a local government upon the request of a borrower.

Analysis

TLDA program borrowers have inquired about the lien status of their SRF loans as compared to the lien status of the borrower's debt issued in the capital markets. They have also sought advice on the position of the debt service reserve fund and the perfection of the reserve for the payment of debt service in the event there is a default by the borrower. These questions provided the opportunity to document the analysis of the security opposition for the borrowers.

Office of State and Local Finance (SLF) staff with the assistance of the Office of the Attorney General, the Assistant to the Comptroller for Public Finance and staff from the Department of Environment and Conservation have examined this issue and have made the following conclusions:

For Municipalities

The concerns relating to parity are not significant for SRF loans approved for municipalities. Municipalities pledge user fees and charges and/or ad valorem taxes. They covenant to increase fees or the ad valorem tax levy to cover their expenses including depreciation. As further security, Local Governments pledge and assign their Unobligated State-Shared Taxes in an amount equal to the maximum annual debt service requirements under the Agreement. The ratio of debt service to State Shared Taxes is also considered. Loans are occasionally recommended even when debt service exceeds State-Shared Taxes and the financial analysis demonstrates the borrower's strong ability to pay. These borrowers have been determined to have strong management that has demonstrated a willingness to raise user fees if necessary. In the event a borrower fails to pay a delinquency within sixty days of receipt of a delinquency notice, the TLDA notifies the Commissioner of Finance and Administration who is obligated to withhold the delinquent amount from any State-Shared Taxes that were not previously obligated. Pursuant to Loan Agreement, a borrower acknowledges that it has no claim on State-Shared Taxes withheld under the Loan Agreement. (If multiple claims, first in time, first in line)

Pursuant to T.C.A. §68-221-1010, Local Governments may be referred to the Water and Wastewater Financing Board (the "WWFB") for failure to comply with the statute if there is an earnings deficit in any one year, has a negative change in net assets for any consecutive two-year period or is in default on any debt obligation. The WWFB can require the municipality to raise user fees and charges or to merge with other utilities to maintain financial stability.

For Utility Districts and Authorities

These same parity concerns are important to utility districts and authorities because the debt service payments of these entities are based on user fees and other revenues collected by the entity. By statute, the borrower pledges and assigns any funds due

to the borrower from the State. In most cases, there are none. Similar to municipalities, any identified funds may be intercepted in the event of a delinquency.

Included in the Representations and Covenants of the Utility District or Authority Loan Agreement are the following:

- To advise the Department before applying for federal or other State assistance for the Project;

- To abide by and honor any further guarantees or securities as may be required by the State which are not in conflict with State or federal law;

- To do, file or cause to be done or filed any action or statement required to perfect or continue the lien(s) or Pledge(s) granted or created hereunder;

- To establish and collect, and to increase, user fees and charges as needed to pay the monthly installments due under this Agreement as well as the other cost of operation and maintenance including depreciation and debt service of the system of which the Project is a part;

- To establish and collect, and to increase user fees and charges sufficient to meet a 1.20X debt service coverage to net revenues. Net revenues are gross earnings, fees and charges, less current expenses. Current expenses are those incurred in the operation of the system, determined in accordance with generally accepted accounting principles (GAAP), including the reasonable and necessary costs of operating, maintaining, repairing and insuring the system, salaries, wages, cost of material and supplies, and insurance premiums, but shall specifically exclude depreciation and debt service payments. (Paragraph 7 (l))

- No additional debt payable from the revenues of the system will be issued or entered into unless

  (1) Prior approval is received from the Authority

  (2) The annual audit required by the terms of this Agreement for the most recent fiscal year has been delivered within six(6) months after the end of such fiscal year,

  (3) The covenant in Paragraph 7(l) was met for the most recent fiscal year,

  (4) The net revenues of the system for the next three fiscal years ending after the issuance of the additional debt shall be sufficient to comply with the covenant in Paragraph 7(l)

(5) The Local Government shall have adopted a revised schedule of rates and fees and taken action to put such revisions in effect at or prior to the issuance of the additional debt.

As additional security for the loan, prior to the first disbursement of funds under the loan agreement, the utility district or authority must deposit with the TLDA an amount of cash equal to the maximum annual debt service on the loan. This reserve must be funded from cash available to the utility district or authority exclusive of the amount of the loan.

These loans may take one of two positions:

(a) the SRF loan is issued first and subsequently the borrower needs to access the public market; or
(b) the borrower has outstanding debt, subsequently borrows from the SRF program and then once again may need to access to the public markets.

These positions raise the issue: What is the lien position of the SRF loan with respect to loan repayment and the debt service reserve fund?

To make this determination, staff examined the relevant statutes, loan agreements and other available information published by the federal government. We found and confirmed that:

(1) Neither the SRF statutes nor the loan agreements mandate a prior or parity lien status for the SRF loan.
(2) T.C.A. §9-22-101 et seq., "Perfection, Priority and Enforcement of Public Pledges and Liens Act" states that public obligations of the same issue shall be ratably secured . . .without priority unless otherwise authorized. It further states that any pledge is junior in priority to obligations created prior to the date of such pledge.
(3) The Utility Management Review Board ("UMRB") monitors all utility districts for timely and sufficient revenues. Should the revenues be insufficient, the UMRB requires the district to raise its rates to provide the necessary coverage. Prior to entering into the Loan Agreement, authorities must elect to place themselves under the jurisdiction of the UMRB or the WWFB for monitoring and compliance purposes.
(4) A goal of the TLDA is to provide financial assistance to local governments at the lowest possible cost to the users for safe drinking water and for clean water in Tennessee streams, rivers and other natural water ways.
(5) Additional educational materials provided by the Council for Infrastructure Authorities states that debt of the SRF program may be subordinated.

Conclusion

For Municipalities

(1) Parity is not an problem for municipalities that enter into SRF loans. In addition to the pledge of user fees, the municipality provides an ad valorem pledge and commits to the intercept of State-Shared Taxes. No debt service reserve fund is required. Municipalities should consult their bond or disclosure counsels to obtain advice on the appropriate loan disclosure in official statements for general obligation bonds or notes.

For Utility Districts and Regional Authorities

(1) If the SRF debt is issued prior to any public debt, the TLDA has the senior lien position, but the TLDA may, at the request of the borrower, subordinate its debt to any public debt thereafter issued by the borrower.

(2) If the public debt was issued prior to the SRF loan, the SRF loan is subordinate to the public debt previously issued by the borrower. If additional public debt is issued pursuant to that prior resolution, that debt also maintains a superior lien position to the SRF loan. However the borrower must seek approval from the Authority for the issuance of additional debt, must maintain all rate covenants and continue to meet all other requirements of the loan agreement.

Currently, under the loan agreement the debt service reserve fund should be held in the Local Government Investment Pool (LGIP) separate from the debt service reserve fund of any publicly issued debt.

Furthermore:

- At any time that a borrower wants to issue debt in the public market, it must seek approval from the TLDA
- It must meet the revenue covenants required in the loan agreement
- It must make a deposit to the debt service reserve fund from its own cash. This deposit is not a portion of the loan
- It must subject itself to the rules and regulations of the UMRB or the WWFB as the case may be.
- It must continuously meet all other requirements and covenants of the loan agreement

Given these requirements and the provisions of the law, staff continues to be comfortable recommending these borrowers for loans through the SRF program.

Dated 1/13/12

By: Joe Vaught