The Value of WIFIA Direct Loans vs. Guarantees for Highly Rated Water Agencies

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WIFIA's portfolio as of 9/30/21 was comprised of $11.5 billion of direct loans and loan commitments to highly rated public water agencies. The Program's guarantee capacity was not utilized. However, future development of WIFIA guarantee transactions should be considered to encourage innovation and impact for US water infrastructure, and to reduce Program portfolio interest rate exposure and capital market displacement.

The table below summarizes the difference between the two infrastructure financing products when highly rated public water agencies are the borrower.

	Direct Loans	*Guarantees*
Basic Form	**Fixed-rate private placement loan with direct recourse to borrower rate base** Rate fixed at Treasury cost at loan commitment execution with optional, penalty-less drawdowns during construction. When drawn, loan repayment terms are roughly similar to highly rated tax-exempt water revenue bonds.	**US full-faith-and-credit payment guarantee on a taxable loan or bond** Recourse to water agency borrower limited to specific funding sources and assets. This is similar to guarantees used on limited-recourse project finance transactions sponsored by highly rated entities.
Fundamental Purpose	**Interest rate risk transfer during long infrastructure construction periods** If rates rise, borrowers will draw at original commitment rate. If rates fall, borrowers will either not draw or seek a reset from WIFIA at current Treasury cost.	**Funding and asset performance risk transfer** Innovative approaches to infrastructure may be demonstrably credit-worthy but difficult or prohibitively expensive to finance. The guarantee will enable access to debt markets at near-Treasury rates.
Primary Benefit	**The avoided cost of interest rate hedging** Without the WIFIA loan commitment, a borrower would manage interest risk with a construction escrow (incurring negative arbitrage) or a swap (subject to make-whole breakage penalty if rates fall). In contrast, the WIFIA commitment acts as a costless interest rate option. Unlike other federal loan programs, there is little interest rate benefit on drawn loans. This is because highly rated public agencies can access the tax-exempt market at near or below Treasury rates.	**Enabling innovative projects that are useful to public water agencies but must be financed on a limited-recourse basis** These would include new approaches to achieve objectives like climate resilience, environmental sustainability and water equity in the design and funding of water infrastructure. This allows water agencies to consider projects that can improve local economic and social welfare by reducing downside risk exposure, a well-established project finance benefit.

Water Infrastructure Additionality	**Limited or none** Highly rated water agencies rationally use WIFIA loans to slightly reduce the cost of financing large-scale basic infrastructure projects. These projects would proceed anyway with other financing, especially tax-exempt bonds. The value of WIFIA's costless option is not in sufficient scale to enable or significantly modify projects that otherwise would not have proceeded with other financing.	**High** Highly rated water agencies would rationally seek a WIFIA guarantee on a taxable bond solely to enable a project that otherwise would not proceed. This would be the case where the limited recourse terms and the novelty of the project would make even a minimally investment-grade bond prohibitively expensive or impossible to place. The US guarantee would make cost-effective leverage possible, with significant impact on project feasibility.
Cost to Federal Taxpayers	**Low discretionary, possibly very high mandatory appropriations** The high credit quality and low project risk of WIFIA direct loans results in a low FCRA score, usually less than 1% of loan amount. This amount is sourced from on-budget annual discretionary appropriations. However, WIFIA loan commitments will create funding losses when the commitment rate is less than Treasury cost at the time of drawdown. These are nearly certain due to WIFIA commitment terms and borrowers' tax-exempt alternatives. Losses are recorded in an off-budget account that will be settled with future mandatory appropriations. WIFIA's current portfolio has unrealized funding losses of 7% of loan amount at recent Treasury rates. If rates rise further, realized funding losses may be as much as 15%-20% of loan amount.	**Medium discretionary, no mandatory appropriations** FCRA scores for WIFIA guarantees will reflect the credit and project risk of a minimally investment-grade project financing, usually about 3-5% of loan amount. This amount is sourced from on-budget annual discretionary appropriations. Since a federal lender is a patient, buy-and-hold long-term investor, FCRA cost can exclude the liquidity and novelty premia that the market will require. This is efficient in economic terms and will foster successful innovation as a public good -- a classic role for federal financing programs. Payment guarantees are not exposed to funding losses since the debt market will be the source of funding, not Treasury. Guarantees should not require any future mandatory appropriations.
Impact on Debt Capital Markets	**Negative for tax-exempt water revenue bond market segment** WIFIA direct loans essentially compete with tax-exempt water revenue bonds, primarily by offering a costless interest rate option. This appears to be inconsistent with OMB Circular A-129 guidance.	**Positive for taxable and ESG bond market segments** WIFIA guarantees will be a unique instrument that adds to taxable bond market volume and development, especially for the growing ESG segment. These investors can also assist with guarantee and project development.