Loans To Recycling Manufacturers –
The Role of Cap & Trade Funds and Potential Changes to the RMDZ Loan Program
Zone Works - June 5, 2013

INTRODUCTION

CalRecycle continues to consider how to further support the development of recycling manufacturing and composting/anaerobic digestion infrastructure to help meet the goals of Assembly Bill (AB) 341. With respect to loan mechanisms, CalRecycle is preparing for the use of Cap & Trade funds (should any become available), examining related potential changes in the RMDZ Loan Program, and examining how to streamline the RMDZ Loan application review, approval and funding process. A workshop was held April 16th to solicit initial input from Zone Administrators and, as a result, substantial revisions have been made to this background document and staff's initial recommendations. The intent of this Zone Works session is to obtain additional comments about these potential changes. Subsequently, a Request for Approval will be presented at a future CalRecycle monthly public meeting.

In particular, CalRecycle is seeking feedback on the following topics:

1. Options for using Cap & Trade funds
2. Options to maximize RMDZ Subaccount funds
3. Other potential changes to the RMDZ Loan Program

CalRecycle is examining these topics because of: 1) AB 341's new statewide policy goal that not less than 75% of solid waste generated be source reduced, recycled, or composted by the year 2020; and 2) AB 32 and the recognition in the 2008 Scoping Plan that recycling manufacturing can play an important role in achieving greenhouse gas (GHG) emission reductions. In order to reach the 75% and GHG goals, CalRecycle needs additional funding to assist new and established recycling-based manufacturing (including composting and anaerobic digestion) in the state. CalRecycle currently has only a few direct financial incentive tools to use in this effort, the primary one being the Recycling Market Development Zone (RMDZ) Program and its Loan component. The RMDZ partnership between CalRecycle and the Zone Administrators has been a key part of recycling market development efforts over the last 20 years and is critical to achieving the 75% statewide goal. The RMDZ program began in 1993 and currently consists of 35 zones that cover 54% of the state. To date, the program has funded 175 loans totaling $126,000,000 and provided assistance to hundreds of other businesses. CalRecycle Zone Liaisons and Loan staff remain committed to working with Zone Administrators to ensure the RMDZ program's success.

The RMDZ Subaccount has limited funds available and these funds are critical for maintaining the integrity and functions of the Zones. Currently the RMDZ Subaccount is funded based on payments of principal and interest. As the California economy slowly improves, some non-performing borrowers are starting to increase payments, but this will not result in a significant increase in available funding. CalRecycle will continue to seek direct means of recapitalizing the RMDZ Subaccount, for example by supporting legislation to provide for an increase in tipping fees, some portion of which potentially could be used for the RMDZ Subaccount. CalRecycle also will continue to evaluate the opportunities for a third sale of its loan portfolio, which has been done in the past as a means of augmenting the Subaccount albeit at some discount.

At the same time, there may be projects outside of the RMDZs that CalRecycle considers worthy of loan support. Furthermore, if Cap and Trade funds are made available in the future for recycling manufacturing, they will have to be tied to GHG emission reductions. Consequently, CalRecycle wants to be poised to use Cap & Trade funds to provide loans for recycling manufacturing projects throughout the state that will have the greatest impact on increasing recycling, provide more jobs in California, and reduce GHGs.

Based on these considerations and the input received from stakeholders at the April 16 workshop, staff is proposing the following for discussion:

1) Use Cap and Trade funds (if available) anywhere in the state
2) Restrict use of RMDZ Loan funds to Zones
3) Change eligibility criteria
    a. For Cap and Trade funds – finance equipment only
    b. For RMDZ Subaccount funds – limit non-equipment funding to a maximum of 25%, and discontinue financing of onerous debt
4) Other administrative changes

I. OPTIONS FOR USING CAP & TRADE FUNDS

a <u>Use for Statewide Loans</u>

If Cap & Trade funds are received for use in FY 13/14, CalRecycle is proposing that these funds should be made available for loans statewide to develop the infrastructure needed to support AB 341 and reduce GHGs. Restricting Cap & Trade funds to the 54% of the state inside zones would not allow projects with the greatest potential for diversion and GHG reductions to be funded regardless of business location. A solid loan portfolio with successful projects throughout the state also may help CalRecycle obtain future Cap & Trade allocations.

b <u>Authority to Use Cap & Trade Funds Outside Zones</u>

CalRecycle continues to diligently pursue legislative authority for statewide loans. If this does not come to fruition, CalRecycle currently has authority under PRC § 42023.1(f) to provide loans outside of zones where partnerships exist with public entities: "The department may expend the money in the subaccount to make loans to local governing bodies, private businesses, and nonprofit entities within recycling market development zones, or in areas outside zones where partnerships exist with other public entities to assist local jurisdictions to comply with PRC § 40051."

To date, CalRecycle has not defined partnerships for the purposes of PRC § 42023.1(f). Because of its interest in being able to provide Cap & Trade-funded loans to businesses outside of existing Zones, CalRecycle will develop a definition of "Partnership" to ensure consistency in determining whether a business is eligible for a loan. CalRecycle is seeking input to develop a definition of "partnership."

One proposal for defining "partnership" is: *"A formal relationship between CalRecycle and a local governing body that is documented with a partnership certification and a Resolution for a local project that results in greenhouse gas emission reductions. A local governing body may be a public entity such as a city, county or other government entity where the project is located."*

c <u>Target Projects</u>

Depending on how Cap & Trade funds might be allocated, loans could finance compost and anaerobic digestion, recycled container glass manufacturing, food processing, recycled paper and paperboard manufacturing, and recycled plastic manufacturing facilities. If allocations are based on the April 2013 Draft Investment Plan and on needs related to AB 341's 75% goal, CalRecycle would initially target projects related to composting and anaerobic digestion. CalRecycle is aware of 183 compost and anaerobic digestion projects, most of which are permitted and operating. Approximately 40% are located outside the boundaries of an existing RMDZ. Most are located in disadvantaged communities.

Disadvantaged communities are a priority pursuant to 2012 legislation to receive funding from the Cap & Trade's Greenhouse Gas Reduction Fund, regardless of when such funds are received and used. CalRecycle's understanding is that the Department of Finance will develop guidelines for how administering agencies should maximize benefits for disadvantaged communities. The Draft Investment Plan proposed allocating 25% of the available monies in the Greenhouse Gas Reduction Fund to projects that provide benefits to disadvantaged communities, and allocating a minimum of 10% of available monies to projects located within disadvantaged communities.

d <u>Allowed Use of Cap & Trade Funds</u>
Staff proposes to limit the use of Cap & Trade fund loans to the purchase of equipment. This will shorten the loan approval process for those loans funded with Cap & Trade monies. If funds are limited to the purchase of equipment, it could potentially reduce the number of non-performing loans and risk because applicants are more likely to be better capitalized with owner and investor funds. Below are some of the pros and cons related to this concept.

Limit the use of Cap & Trade fund loans to equipment only.

Pros:

- Machinery and equipment directly lead to increased diversion and recycling of waste materials. These are tangible and thereby can be liquidated to recover some of the loan proceeds in case of default.
- More funds will be available to many borrowers, instead of large loans to a few borrowers.

Cons:

- Some borrowers need the funds for non-equipment purchases.
- It does not allow borrowers to use the equity in real estate for all business expenses.

e. <u>Size of Loans</u>
Staff recommends that the maximum loan amount be the same for Cap & Trade funds as for RMDZ Subaccount funds (i.e., the maximum amount would $2,000,000 or 75% of eligible project costs, whichever is less). As recently demonstrated on several loans, borrowers are readily able to obtain matching funds from traditional lenders, including for anaerobic digestion projects. To reduce the repayment exposure, it is common for multiple lenders to jointly fund a single project.

f. <u>Interest Rate</u>
Staff proposes an interest rate of 3.25%, equal to the national Prime Rate of Interest. This will provide a greater incentive for businesses to apply for loans and lower their cost to increase the diversion of waste materials. The Prime Rate is the interest rate that banks offer to their best credit worthy borrowers. Recent RMDZ borrowers have obtained matching fund loans at interest rates between 5% and 8%.

II. OPTIONS TO MAXIMIZE RMDZ SUBACCOUNT FUNDS

a. <u>Use of Subaccount Funds Within Zones</u>
Staff does not recommend any change in the locations for which RMDZ Subaccount funds may be used; i.e., they will continue to be used for loans inside RMDZs, whether for new or existing projects. With respect to existing composting and anaerobic digestion projects, there are approximately 111 in zones, of which less than ten have obtained a loan. A Notice of Funds Available and new marketing campaign could revitalize lending to zone businesses.

b. Allowed Use of Funds

For many years, RMDZ funds have been used for purchase of equipment, working capital, refinancing of onerous debt, purchase of real estate, and leasehold improvements. In some cases, the funding of costs other than equipment has led to considerable problems when companies are unable to adhere to the terms of their loans (e.g., for loan defaults, there is no collateral or recovery from working capital, leasehold improvements, and onerous debt). Additionally, such a broad use of funds also means that fewer dollars are available for other projects. Borrower matching funds generally can cover working capital, and real estate is generally easier to finance via bank loans. Focusing the RMDZ funds on equipment would allow businesses to process more material, increase the recycling of materials and potentially allow for more loans.

Staff recommends that at least 75% of a loan award be used to purchase machinery and equipment and not more than 25% be used towards working capital (accounts receivable and inventory), real estate improvements (when secured by a deed of trust), the purchase of real estate (maximum of $500,000), and loan closing points. Staff also proposes to discontinue lending for onerous debt. Below are pros and cons to these proposed changes.

a) *Limit non-equipment funding to a maximum of 25%.*

Pros:

- Machinery and equipment directly lead to increased diversion and recycling of waste materials. These are tangible and thereby can be liquidated to recover some of the loan proceeds in case of default.
- More funds will be available to many borrowers, instead of large loans to a few borrowers.

Cons:

- Some borrowers need the funds for non-equipment purchases.
- It does not allow borrowers to use the equity in real estate for all business expenses.

b) *Discontinue the finance of onerous debt.*

Pros:

- The finance of onerous debt does not result in additional diversion. Loan staff always attempt to assist borrowers faced with onerous debt to obtain financing from other federal, state, local, and private lending institutions.
- This would eliminate applicants looking at CalRecycle as a "bailout" program and not as an equipment lender.
- It will decrease the number of loan recipients requiring a restructure and save staff time.

Cons:

- Businesses will have to rely on traditional financing to fund onerous debt.
- CalRecycle will have to share the collateral with another lender.

c. Size of Loans

Staff recommends no change to the maximum loan amount. The maximum amount is $2,000,000 or 75% of eligible project costs, whichever is less. As recently demonstrated on several loans, borrowers are readily able to obtain matching funds from traditional lenders, including for anaerobic digestion projects. To reduce the repayment exposure, it is common for multiple lenders to jointly fund a single project.

d. Interest Rate

Staff proposes to decrease the interest rate for loans funded from the RMDZ Subaccount, from 4.00% to 3.25%, equal to the national Prime Rate of Interest. This will provide a greater incentive for businesses to apply for loans and lower their cost to increase the diversion of waste materials. The Prime Rate is the interest rate that banks offer to their best credit worthy borrowers. Recent RMDZ borrowers have obtained matching fund loans at interest rates between 5% and 8%.

III. OTHER POTENTIAL CHANGES TO THE RMDZ LOAN PROGRAM:

CalRecycle also is considering other changes to streamline the loan program to significantly shorten the application review, approval, and funding process, and administer the loan program using generally accepted commercial loan practices. Although not the focus of today's session because they do not impact loan eligibility or funds for businesses in RMDZs, CalRecycle also welcomes comments about these potential changes.

a. Simplify the Loan Application

Initial Application for early eligibility determination:

- Create Application Guidelines and Instructions
- Create a simple application cover page
- Utilize the Small Business Development Center (SBDC) business plan template
- Require historical financial statements with the initial application.

Post-Application for full eligibility determination:

- Provide financial projections
- Provide business documents
- Provide permits

b. Conform Regulations to Statute

Update the regulatory definition of "applicant" to conform to text in statute. This may be accomplished via a Section 100 Regulation change, a simple non-public process for very minor edits that do not change the intent or purpose of the regulation.

c. Interest Rate, Application of Payments, Late Charges and Refinance Option

Allow Loan program to reduce the interest rate on an outstanding loan; apply loan payments to principal, interest and fees; reverse late charges; and refinance and consolidate outstanding RMDZ loans. On non-performing loans, apply payments first to principal to provide a greater incentive to pay.

d. Loan Committee

Change the structure of the Loan committee to facilitate loan staff interaction with the loan committee members as applications are being evaluated. The Loan Committee will no longer be subject to the requirements of the Bagley-Keene Act.