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DRINKING WATER STATE REVOLVING FUND

INTERIM GUIDANCE



**INTERIM GUIDANCE - -
DRINKING WATER
STATE REVOLVING FUND**

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INTRODUCTION

The Safe Drinking Water Act (SDWA) Amendments of 1996 (Pub. L. 104-182) authorize a Drinking Water State Revolving Fund (DWSRF) program to assist public water systems to finance the costs of infrastructure needed to achieve or maintain compliance with SDWA requirements and to protect public health. Section 1452 authorizes the Administrator of the U.S. Environmental Protection Agency (EPA) to award capitalization grants to States, which in turn can provide low cost loans and other types of assistance to eligible systems.

The SDWA Amendments also establish a strong new emphasis on preventing contamination problems through source water protection and enhanced water systems management. That emphasis transforms the previous law from a largely after-the-fact regulatory oriented program into a statute that can provide for the sustainable use of water. Central to this emphasis is the development of State prevention programs, including source water protection, capacity development and operator certification. States have the option to use a portion of their capitalization grant to fund these eligible activities as allowed in the statute. The success of these activities will act to safeguard the DWSRF funds that are loaned for improving system compliance and public health protection, and help determine whether the new law's potential as a preventive environmental statute is realized.

The DWSRF program will help ensure that the nation's drinking water supplies remain safe and affordable, that drinking water systems that receive funding will be properly operated and maintained, and that permanent institutions will exist in each State to provide financial support for drinking water needs for many years to come. Congress has placed particular emphasis on assisting smaller drinking water systems, and those serving less affluent populations, by providing greater funding flexibility for these systems under the DWSRF to ensure that systems have adequate technical, managerial, and financial resources to maintain compliance and provide safe water.

Under the SDWA, a State may administer its DWSRF in combination with other State loan funds, including the wastewater SRF, hereafter known as the Clean Water State Revolving Fund (CWSRF). Beginning one year after a DWSRF program receives its first capitalization grant, a State may also transfer up to a third of the amount of its DWSRF capitalization grant to its CWSRF or an equivalent amount from its CWSRF capitalization grant to its DWSRF.

These two provisions linking the DWSRF and the CWSRF signal Congressional intent to implement and manage the two programs in a similar manner. EPA also intends to administer the two programs in a consistent manner, and to apply the principles developed for the existing CWSRF to the DWSRF program to the fullest extent possible. Like the CWSRF, the DWSRF is fundamentally a State program. Each State will have considerable flexibility to determine the design of its program and to direct funding toward its most pressing compliance and public health protection needs. Only minimal Federal requirements will be imposed.

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 (non-project funds); and
- the role of both the States and EPA in managing and administering the program.

The sources of these guidelines are the statute itself, existing regulations and policies that apply in EPA grant programs, particularly those that apply in EPA general grant regulations and the CWSRF program, and the Administrator's authority to regulate under SDWA. Where a specific statutory or regulatory provision is the basis for a requirement, that provision is cited. Questions of a more detailed nature are bound to arise during the implementation of the DWSRF program, as they continue to arise in the CWSRF program. The Agency will address these questions in subsequent policy memoranda.

I. DEVELOPMENT OF A CAPITALIZATION GRANT APPLICATION/AGREEMENT

The capitalization grant agreement process begins when the State is ready to receive a capitalization grant. A capitalization grant cannot be awarded until after federal funds have been appropriated for the DWSRF under section 1452 and then allocated to the States. A State submits an application to the Regional Administrator (RA) requesting a capitalization grant. With its application, the State must also submit an Intended Use Plan (IUP), documentation on the institutional framework of its DWSRF program, and a proposed schedule for capitalization grant payments by the EPA.

The Act allows States the option to use part of the capitalization grant for uses other than project construction to encourage the development of source water protection and State prevention programs and to enhance water systems management. All DWSRF funds, including those that States will direct toward set-asides, will be awarded through the capitalization grant process. Before applying for a capitalization grant, States must prepare an IUP that identifies how it intends to distribute the grant among the set-asides and the DWSRF fund, and includes the list of projects that will be funded.

The State must seek public review and comment on these funding decisions. A State may, however, prepare this IUP in two parts. The first part would present the overall framework of how the State intends to allocate the grant among the set-asides and the DWSRF Fund, but would not include the project priority list. The second part would be the IUP for the project fund only. States would still be required to provide public review and comment on both parts. The two part process has the advantage of allowing States to proceed with a partial capitalization grant application (e.g., a set-aside) before it completes all of the activities required to obtain a full capitalization grant.

In addition to identifying the distribution of funds, the IUP outlines the State's planned DWSRF activities, provides assurances and specific proposals for meeting requirements of the SDWA and Federal general grant regulations, and serves as the basis for negotiations between the RA and the State on the proposed payment schedule. The IUP and the payment schedule are then incorporated into the capitalization grant agreement, which also defines the State program and operating methods and the Regional oversight role. Material in these documents that does not change from year-to-year may be incorporated by reference in subsequent grant agreements or

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in an operating agreement, which remains in effect unless the Regional Administrator and the State agree to amend it. An operating agreement contains those portions of the capitalization grant agreement which do not change annually.

For DWSRF grant applications, States must submit EPA's standard application for non-construction grant assistance (EPA Form SF-424). States should submit grant applications no later than ninety days prior to the end of the period of funds availability. By so doing, EPA has adequate time to properly review the application and, as necessary, request additional information from the State. States that submit applications after this date run the risk of losing funds due to the provisions governing reallocation.

Headquarters will concur on one State capitalization grant application in each Region.

A. Items Necessary to Establish a Loan Fund that Complies with Federal Requirements

The State must provide assurances in the capitalization grant agreement on how it will comply with the fourteen specifications discussed below for all DWSRF funding. In some cases, the State must simply agree or certify in the grant application that it will comply with the specifications. In other cases, documentation on the procedures by which the State plans to ensure compliance with the specifications must be furnished. The State should include this documentation with its capitalization grant application (see Table 1).

1. Assurance that the State has the authority to establish a Fund and to operate the DWSRF program in accordance with the SDWA

The State must establish a Fund and comply with section 1452 before it can receive a capitalization grant award (section 1452(a)(1)(B)).

With each capitalization grant application, the State's Attorney General (AG), or someone designated by the AG, must sign or concur in a certification that the authority establishing the DWSRF program and the powers it confers are consistent with State law and that the State may legally bind itself to the terms of the capitalization grant agreement. The AG must also provide written assurance that the DWSRF program will be administered by an instrumentality of the State that is authorized to (1) enter into capitalization grant agreements with the EPA, (2) accept capitalization grant awards made under section 1452(a)(1)(A) of the SDWA and (3) otherwise manage the Fund in accordance with the requirements and the objectives of the SDWA. Documentation supporting the AG's certification, such as copies of statutes, executive orders, or administrative orders, must be furnished with the application.

If more than one State Agency is involved in the DWSRF program, the roles and responsibilities of each agency must be described in the application, and a copy of any Memoranda of Understanding or interagency agreement(s) that describes the roles and responsibilities between agencies, must be included with the application. However, the agency that is awarded the capitalization grant must retain ultimate responsibility for properly executing the grant agreement under federal general grant regulations (40 CFR 31.3).

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A State may (as a convenience and to avoid unnecessary administrative costs) combine, in accordance with State law, the financial administration of the Fund with the financial administration of any other revolving fund established by the State if otherwise not prohibited by the law under which the Fund was established and if the State certifies that:

(A) all monies in the Fund, including grants, state match, bond proceeds, loan repayments and interest, will be separately accounted for and used solely for the purposes specified in section 1452(a); and

(B) the authority to establish assistance priorities and carry out oversight and related activities (other than financial administration) with respect to assistance remains with the State agency having primary responsibility for administration of the State's public water supply supervision program (primacy agency), after consultation with other appropriate State agencies (section 1452(g)(1)).

In those States that are eligible to receive a capitalization grant but do not have primacy, the Governor shall determine which State agency will have the authority to establish priorities for financial assistance from the State loan fund (section 1452(g)(1)(B)). Evidence of the Governor's determination must be furnished with the application.

2. Assurance that the State will comply with State statutes and regulations

The State must agree to comply with all State statutes and regulations that are applicable to DWSRF funds, including federal capitalization grant funds, State match, interest earnings, bond proceeds and repayments, and funds used for non-project activities.

3. Assurance that the State has the technical capability to operate the program

The State must provide documentation demonstrating that it has adequate personnel and resources to establish and manage the DWSRF (e.g., current and future staffing plan, background/qualifications statements).

4. Assurance that the State will accept capitalization grant funds in accordance with a payment schedule

The State must agree to accept federal grant payments in accordance with the negotiated payment schedule and use those payments for the activities of its Fund and other programs under section 1452. As part of its capitalization grant application, the State must submit a proposed schedule of grant payments that is consistent with its proposed binding commitments outlined in its IUP (see section I.A.11 below), and its plan for expending non-project funds. The payment schedule will become part of the capitalization grant agreement. The State will receive Federal funds in accordance with the provisions of the EPA-Automated Clearing House (formerly known as Letter-of-Credit). (See section V.B. below.)

5. Assurance that the State will deposit all capitalization grant funds in the DWSRF

The State must agree to deposit the capitalization grant in the Fund except for those portions of the grant that the State intends to use for non-project purposes authorized under the SDWA (section 1452(a)(1)(B)). The State must maintain an identifiable and separate account(s) for the portion, or portions, of the capitalization grant to be used for non-project activities (see section II.B. below).

Once capitalization grant funds are deposited into the Fund, such monies may only be expended for activities authorized under section 1452(f), which describes the types of infrastructure assistance eligible from the Fund. At its option, a State may submit a grant amendment to transfer unused capitalization grant funds that were made available for non-project activities into the DWSRF Fund. States must document any transfer of funds from the non-project account to the Fund and include this information in the biennial report.

6. Assurance that the State will deposit an amount at least equal to 20 percent of the capitalization grant (State match) in the Fund and deposit any required match for 1452(g)(2) activities in a non-project account

The State must agree to deposit into the Fund an amount equaling at least 20 percent of the amount of each capitalization grant. Except for payments made from FY 1997 appropriations, the State match must be deposited into the fund on or before the date that each federal capitalization grant payment is made to the State (section 1452(e)). States have until September 30, 1999 to provide the State match for FY1997 appropriations. (See Section V.A for additional details.)

A State may use up to 10% of its capitalization grant for 1452(g)(2) activities. The State must match these funds, dollar for dollar, and deposit these funds into a non-project account. A State cannot use any of the 20% fund match to match this 10% match requirement.

7. Assurance that the State will deposit all proceeds into the Fund

The State must agree to credit all funds, except as otherwise allowed, including repayment of principal and interest, and any other funds, into the DWSRF Fund. Fund assets may be used as a source of revenue or security for general obligation or revenue bonds, as long as the net proceeds of the sale of bonds will be deposited into the Fund (section 1452(f)(4)).

Loans for land acquisition and source water protection, made pursuant to section 1452(k)(1)(A) must be repaid. A State may deposit these repayments, including principal and interest, in the DWSRF Fund or the State may choose to deposit the repayments into a subaccount revolving fund dedicated to 1452(k)(1)(A) activities.

A State may undertake pooled bond arrangements, as long as the revenues from the bonds are deposited in the Fund in the same proportion as the Fund's assets are used for security on the bonds.

8. Assurance that the State will use generally accepted accounting principles

The State must agree to establish fiscal controls and accounting principles, as promulgated by the Governmental Accounting Standards Board, that are sufficient to account for and report DWSRF activities. The accounting system used for the DWSRF should allow for proper measurement of (1) revenues earned by the DWSRF and other receipts, including, but not limited to, loan repayments, capitalization grants, State match deposits and bond proceeds; (2) expenses incurred by the DWSRF and other disbursements, including but not limited to, loan disbursements, repayment of DWSRF bonds, asset purchases and other expenditures allowed under section 1452; (3) the assets, liabilities and capital contributions in the DWSRF; (4) the DWSRF's maintenance of the corpus of the federal and State capital contributions made to the DWSRF; and (5) the DWSRF's performance in relation to its short and long-term financial goals as identified in the previous IUP.

9. Assurance that State will have DWSRF funds audited annually in accordance with Generally Accepted Government Auditing Standards.

The State DWSRF funds shall be audited on an annual basis. Such audits shall be conducted in accordance with generally accepted government auditing standards (GAGAS) issued by the Comptroller General of the United States.

The Administrator is relying on the annual audit of the DWSRF funds to minimize the risk of waste, fraud and abuse and increase the chance that such occurrences will be detected and reported. As called for under GAGAS, audits should be designed to provide reasonable assurance of detecting material misstatements resulting from non compliance with applicable laws, regulations, contracts and grant agreements, and which have a direct and material effect on the determination of financial statement amounts. If specific information comes to the auditor's attention that provides evidence concerning the existence of possible noncompliance, auditors should apply procedures specifically directed to ascertaining whether noncompliance has occurred.

10. Assurance that the State will adopt policies and procedures to assure that borrowers have a dedicated source of repayment of the unsubsidized portion of loans.

The State must agree to determine that an applicant has the ability to repay a loan according to its terms and conditions, prior to making that loan. States must develop criteria to evaluate an applicant's financial ability to repay the loan, in addition to paying for operation and maintenance costs, and other necessary expenses.

11. Assurance that the State will disburse loans as efficiently as possible, and in an expeditious and timely manner

The State must agree to commit and expend all DWSRF Fund monies "as efficiently as possible" (section 1452(g)(3)) and to enter into binding commitments with recipients of Fund assistance equal to the combined amount of each quarterly grant payment and match within one year of the grant payment. The State must agree to disburse the funds in a timely and expeditious manner (See section V.B.3. for additional details.)

12. Assurance that funds will be used in accordance with the Intended Use Plan

The State must agree to expend DWSRF funds in accordance with an Intended Use Plan (section 1452(b)) that has undergone public review and comment. (See section I.B. for additional details)

13. Assurance that the State will provide EPA with a biennial report and annual audit

The State must agree to complete and submit a biennial report and annual audit (with separate opinion) on the uses of the capitalization grant. The scope of the report and audit covers the Fund and all other non-Fund activities funded by the state from funds in the DWSRF program. The contents of the annual audit and the biennial report are discussed in more detail under part VI of this guidance.

States which jointly administer DWSRF and CWSRF programs, in accordance with section 1452(g)(1), may submit a report and/or audit which covers both programs. However, even though the report/audit covers both programs, financial information must be reported separately for each program. If the State elects to prepare a joint report, it has the option of either (1) submitting a joint report in alternate years, and an annual CWSRF report in the other years; or (2) submitting a joint report annually.

The Administrator will periodically audit State Funds and all other amounts allotted to the States pursuant to section 1452(m).

14. Assurance that the State will comply with all Federal cross-cutting authorities

The State must agree to comply with all applicable federal cross-cutting authorities in existence at the time that a loan recipient receives a binding commitment from the DWSRF. (See section IV.A for additional details.)

B. Intended Use Plan

The central component of the capitalization grant application is an Intended Use Plan (IUP) (section 1452(b)), which describes how the State intends to use available DWSRF funds for the year to meet the objectives of the SDWA and further the goal of protecting public health.

The state must prepare the IUP, after providing for public review and comment, and submit it to the Regional Administrator as part of its capitalization grant application. In the IUP, the State must include specific details on how it will use all funds available to the capitalization grant, including funds that will be allocated to the set-asides. States may, as an alternative, develop the IUP in a two part process, one part that identifies the distribution and uses of the funds among the various set-asides and the DWSRF Fund and the other part dealing only with project funding in the DWSRF Fund. The two part process would allow States to submit a capitalization grant application for a portion of the funds before it completed all of its specific funding decisions. In this situation, a State would have to conduct two rounds of public review and comment -- one for the overall distribution of funds and the other for the project priority list(s).

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For example, assume that a State has decided to allocate 75% of its funds to the DWSRF Fund, 10% of its funds to the source water delineation set-aside, 4% for DWSRF administration, and 10% for the PWSS program set-aside, but the State has not yet developed its project priority list(s). This State could seek public review and comment on the allocation of funds and submit a capitalization grant application for the 24% of funds that will be used for set-aside purposes. As with all grant applications, the State would have to include a detailed description of what the set-aside funds would be used for. The State would then, at a later date, develop the DWSRF Fund component, including the project priority list, seek public review and comment on this list and then submit an amendment to the capitalization grant application for the additional funds.

To the maximum extent possible, the part of the IUP for the DWSRF Fund must give priority for the use of funds to: (1) projects that address the most serious risk to human health; (2) projects that are necessary to ensure compliance with the Safe Drinking Water Act; and (3) systems most in need, on a per household basis, according to State affordability criteria (section 1542(b)(3)).

Because the Fund account can only provide those types of assistance described in section 1452(f), funds that the State will use for non-project activities must be placed in an account that is separate (outside) from the Fund account.

The IUP must describe how all funds, including capitalization grants, state match, loan repayments, interest earnings, bond proceeds, and other monies deposited into the Fund account are intended to be expended. The State must prepare an IUP as long as the DWSRF Fund account remains in operation, not just in those years in which the State submits an application for a Federal capitalization grant.

States must provide IUP information in a format and a manner that is consistent with the needs of the Regional Administrator.

1. List of projects, including description and size of community

The IUP must contain a list of the projects (eligible projects list) expected to receive assistance from the DWSRF Fund account for the year (section 1452(b)(2)). This list must include the name of the public water system and a description of the project, the expected terms of financial assistance, and the size of the community served.

In addition to the list of eligible projects to be funded in the current fiscal year, a State must develop a "comprehensive priority list" of projects that are eligible for assistance from the DWSRF. States may elect to combine these lists into one and indicate, each year, where the bottom of the priority funding line for the current year is drawn. After notice and opportunity for public comment, each State must publish and periodically update this comprehensive priority list of projects that are eligible for assistance under section 1452. The comprehensive priority list must include the priority assigned to each project and, to the extent known, the expected funding schedule for each project (section 1452(b)(3)(B)).

A State may by-pass a project on the priority list if the State's by-pass procedures have undergone public review and comment. These by-pass procedures should clearly identify the

conditions which would allow a project to be by-passed and the way the State will identify which projects would receive the by-passed funds.

A State must annually use at least 15% of all funds credited to the DWSRF Fund account to provide loan assistance to systems serving fewer than 10,000 persons (section 1452(a)(2)), to the extent that there are a sufficient number of eligible projects to fund. States must determine the amount to be used for this provision based on the level of available funds on the first day of the planning year of the IUP. A State that does not use at least 15% of the available funds for small systems must describe in the next IUP the steps it is taking to ensure a sufficient number of projects for future years. States that exceed the prescribed percentage of assistance may bank the excess toward future years.

2. Description of criteria and method used for distribution of funds

The IUP must describe the criteria and method that the State will use to distribute DWSRF funds (section 1452(b)(2)(B)). This description will include: (1) the process for selection of systems to receive assistance, (2) the rationale for providing different types of assistance and terms (e.g., length of repayment, interest rate), including a description of the financial planning process undertaken by the Fund, (3) the priority and allocation of assistance the State gives to different eligible categories of projects, and (4) the impact of funding decisions on the long-term financial health of the DWSRF Fund.

A State may also place into a separate, non-project administration sub-account, loan application fees or other program fees or assessments that a DWSRF program collects from loan recipients to help offset the cost of running the DWSRF program. Because these fees and assessments would be considered program income under the Agency's general grant regulations (40 C.F.R. 31.3125), the grant agreement must specify that they will be used for purposes directly related to the DWSRF program and not be made available for other purposes. The IUP should also identify the amount of any fees that are placed in the non-project administration account, and describe how they are used.

3. Description of the financial status of the DWSRF

The IUP must include a description of the financial status of the DWSRF account (section 1452(b)(2)(C)). This description should detail: the total amount of funds in the DWSRF Fund; the types of projects to be funded; the loan terms and conditions for each project; and the amount of the capitalization grants that will be used for disadvantaged community assistance.

4. Description of the short and long-term goals of the DWSRF

The IUP must describe the short and long-term goals of the DWSRF program (section 1452(b)(2)(C)), including how the capitalization grant funds will be utilized to ensure compliance and protect public health. The IUP should include factors such as expected loan demand, the need to leverage, and other factors that determine the short-term and long-term focus of the program.

The IUP must also describe the objectives of the DWSRF program over the long-term (section 1452(b)(2)(C)), and how these objectives can be realized. The IUP should include a

description of how the capitalization grant funds will be used to support other components of the State drinking water and ground water programs, including restructuring, capacity building, operator certification, source water protection, and wellhead protection.

5. Description of amounts transferred between the DWSRF and the CWSRF

The Governor of a State may transfer up to 33% of the DWSRF capitalization grant to the CWSRF or an equivalent amount from the CWSRF to the DWSRF, starting a year after the State has set up its DWSRF program, but no later than the beginning of FY2002 (section 302 of Pub. L. 104-182). EPA will provide additional guidance concerning these fund transfers at a later date.

6. Description of the non-DWSRF project activities, and percentage of funds, that will be funded from the DWSRF capitalization grant, including DWSRF administrative expenses allowance, PWSS program support, technical assistance, etc.

The IUP must identify what portion of the capitalization grant a State is electing to use for non-DWSRF project activities (e.g., section 1452(g)(2), section 1452(k)), and place those funds in a non-project account(s). The non-DWSRF project account must be dedicated to supporting the other activities authorized in section 1452. The IUP must describe how the funds placed in this separate account will be used. States must provide the same level of detail for projects funded from the non-DWSRF project Fund as is required from the Fund. Unused funds in the non-DWSRF project account may be transferred to the DWSRF Fund account if the IUP authorizes a transfer and the state and Regional Administrator amend the capitalization grant.

Recipients of 1452(k) loans are required to repay the loans in a manner similar to loans from the DWSRF Fund. The State has the option to place the repayments in the DWSRF Fund or it can set up a sub-account to continue funding eligible 1452(k) loan activities. Subsequent loans from this sub-account must meet the same requirements as loans from the Fund.

7. Description of how a State will define a disadvantaged system and the amount of DWSRF funds that will be used for this type of loan assistance

A State may provide additional subsidies to disadvantaged communities receiving DWSRF Fund loans (section 1452(d)). If the State establishes a disadvantaged community program it must describe in the IUP how the program will operate. This description must include: (1) a definition of disadvantaged community, (2) the total amount of the capitalization grant that will be used for providing additional subsidies, (3) an identification of the systems that will receive additional subsidies and their amount, (4) a description of affordability criteria that the State will use to determine how much loan forgiveness to allow, and (5) an evaluation of the effect that providing disadvantaged community assistance will have on the DWSRF Fund over the long-term.

The value of subsidies a DWSRF Fund provides in any year under this provision cannot exceed 30 percent of the amount of the capitalization grant for that year. Subsidies under this provision cannot be banked for future use.

C. Capitalization Grant Agreement

The Capitalization Grant Agreement (CGA) is the principal instrument by which the State commits to manage its revolving fund program, and to ensure that it conforms with the requirements of the SDWA Amendments of 1996. The CGA contains, or incorporates by reference, the following parts of the agreement: the application; the IUP, set-asides funding, the agreed upon payment schedule; certifications or other agreement requirements discussed in the first section, and the operating agreement, if used, and other documentation required by the Regional Administrator. In addition to these requirements, the CGA should also define the types of oversight responsibilities that will be required to determine compliance with section 1452. Agreement also is needed on the contents of the biennial report, annual audit, and the EPA review. Table 1 describes how each of the following assurances and CGA requirements should be addressed:

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TABLE 1

State Requirements for the Capitalization Grant Agreement

REQUIREMENT	HOW ADDRESSED
<u>CG APPLICATION</u>	
Part 31 Assurances	Agree to
Established SRF	Document
Instrumentality	Document
Technical Capability to	Document
Manage Program	
Review Technical, Financial &	Propose
Managerial Capability of	
Assistance Recipients	
IUP	
(1) List of Projects	Propose
(2) SRF Goals	Describe
(3) Activities to be Supported	Describe
(4) Disadvantaged Communities	Propose
(5) Assurances and Proposals	
- Environmental Review	Document/certify
- Federal cross-cutters	Document/certify
- 120% binding Commitments	Agree to
- Timely Expenditure	Agree to
(6) Criteria & Method for	Describe
distributing funds	
Payment Schedule/Schedule of	Propose
Estimated SRF Disbursements	
Other Activities to be Supported	Identify Amount and Propose
By Set-Asides	Work plan
Transfer of Funds to/from CWSRF	Identify
<u>GRANT AGREEMENT</u>	
Accept Grant payments	Certify
Deposit Funds in DWSRF Account	Certify
Deposit State Match	
o Source of the Match	Identify
o Deposit of match	Certify *
120% Binding Commitments	Agree to
Information Management System	Agree to
Use State Laws & Procedures	Agree to
Use GAAP	Agree to
Use GAGAS (Generally Accepted	
Government Auditing Standards	
Design a system to minimize risk of Waste, Fraud & Abuse	Agree to
Recipient Accounting	Agree to
Biennial Report	Agree to
Annual Audit	Agree to
Environmental Review	Agree to
Program Oversight	Agree to

All changes to the agreement require a formal grant amendment.

* For payments from FY 1997 appropriations, the State must agree to provide the certification no later than September 30, 1999, of the availability of its match. A State that fails to certify by that date may not receive further grant payments until the match is deposited.

D. Operating Agreement

The framework and procedures of the DWSRF program that are not expected to change annually may be described in an Operating Agreement (OA) that can be included as part of the Capitalization Grant Agreement. The grant application and subsequent grant agreement may incorporate by reference relevant portions of the previous year's application. If there are proposed changes to the OA, the State should outline them in the capitalization grant application.

The decision to prepare an OA does not entail additional program requirements, demonstrations or documentation. The OA simply describes the structure of the state's program, explains its goals and objectives, and includes review, overview, accounting, auditing and sanction provisions. Upon the successful completion of negotiations, the OA must be signed by the State signatories to the CGA and the Regional Administrator. On an annual basis, the OA should be supplemented with an Intended Use Plan that identifies the projects and activities that the State plans to support with financial assistance from the fund. Based on the OA and the Intended Use Plan, the Region would award a capitalization grant to the State. Regions and States that choose this alternative method of program implementation may find that it facilitates their program management capability.

II. ALLOTMENT/USE OF FUNDS

Section 1452(m) authorizes a total of \$9.6 billion for the DWSRF from FY1994 through FY 2003. This section describes how these funds will be allotted and reallocated, national and State set-asides, and types of financial assistance available from the capitalization grant.

A. Allotment/Reallotment/Withholding of Funds

1. Allotment formula

Funds available to States from FY 1997 appropriations will be allotted according to the formula used for distributing Public Water System Supervision (PWSS) grants under section 1443 in FY 1995. Funds available to States from FY 1998 appropriations and beyond will be allotted according to a formula that reflects the proportional share of each state's needs identified in the most recent Needs Survey conducted pursuant to section 1452(h). In each case, the minimum proportionate share established in the formula will be one percent of the funds available for allotment to the States. Wyoming and the District of Columbia will also receive a one percent share of available funds. The Virgin Islands and the Pacific Island territories will together receive an allotment of 0.33 percent (Section 1452(a)(1)(D)).

2. Period of availability and reallotment

Funds are available for the Agency to obligate to the States during the fiscal year in which they are authorized and during the following fiscal year (section 1452(a)(1)(C)). The amount of any allotment not obligated to the State at the end of this period of availability will be reallocated among other States according to the original formula used to allot these funds (FY 1997 funds: PWSS formula; FY 1998 funds and beyond: Needs Survey). Any state that does not obligate all of the funds allotted to it in the period of availability shall not be eligible to participate in the reallotment of funds for that particular fiscal year. The Administrator may reserve up to 10 percent of the funds available for reallotment to provide additional assistance to Indian tribes (section 1452(a)(1)(E)).

3. Withholding of Funds

a. The Administrator will withhold funds under the following provisions:

1. Capacity Development Authority --The Administrator will withhold 20% of a State's allotment unless the State has obtained the legal authority or other means to ensure that all new community water systems and new nontransient, noncommunity water systems commencing operation after October 1, 1999, demonstrate technical, managerial, and financial capacity with respect to each drinking water regulation in effect. This withholding provision becomes effective with FY 2000 funds and will cease when the State obtains the required statutory authority.
2. Capacity Development Strategy -- The Administrator will withhold funds from any States that are not developing and implementing a strategy to assist public water

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systems in acquiring and maintaining technical, managerial, and financial capacity. The amount of a State's allotment that will be withheld is 10 percent of FY 2001 funds, 15 percent of FY 2002 funds, and 20 percent of each subsequent year funds. Funds will cease to be withheld once a State develops and implements its capacity development strategy. EPA plans to issue separate guidance for States to use in developing these strategies.

The total amount that will be withheld if a state fails to meet the requirements of both of these provisions is 20 percent of the capitalization grant (section 1452(a)(1)(G)(I)).

3. Operator Certification Program -- The Administrator will withhold 20% of a State's funds unless the State has adopted and is implementing a program for certifying operators of community and nontransient, noncommunity public water systems. This withholding provision will begin two years after the Administrator publishes guidelines for certification of operators. The Administrator is required to publish guidelines no later than February 6, 1999. Funds will cease to be withheld once a State complies with the requirement (section 1452(a)(1)(G)(ii)).
4. Loss of Primacy -- A state may not receive capitalization grant funds if the State had primacy on the date of enactment of the Safe Drinking Water Amendments of 1996 (August 6, 1996) and subsequently lost primary enforcement responsibility for the drinking water program pursuant to section 1443 (section 1452(a)(1)(F)). Wyoming and the District of Columbia did not have primacy prior to August 6, 1996, and consequently, they are eligible to receive DWSRF funds. The Administrator may reserve funds from the allotment of a State that loses full primacy, for use by EPA to administer primary enforcement responsibilities in that State. The balance of the funds not used by EPA to administer primacy will be reallocated to other States pursuant to section 1452(a)(1)(E).

b. Reallocation of Withheld Funds

1. All funds withheld from a State because the State does not have the capacity development authority, does not develop and implement a capacity development strategy, and/or does not develop and implement an operator certification program, will be reallocated, after the period of availability, using the same formula that was originally used to allot those funds. A State that has funds withheld for any one of these three activities is not eligible to receive reallocated funds for that activity. Thus, if a State does not develop an operator certification program but does have a capacity development strategy, the State would be eligible to receive a reallocation from withheld funds from States without capacity development programs but would not be eligible for reallocated funds under the operator certification provision. A State would also have to be eligible to receive reallocated funds in accordance with the reallocation provisions in section 1452(a)(1)(E) prior to being eligible to receive reallocated funds under the specified withholding provisions. This section limits reallocation to those States that have obligated all of their allotment during the period of availability.

B. Set-asides from the national appropriation and ceilings on state allotments

Section 1452 authorizes numerous national set-sides from the appropriation for that section and allows States to use certain percentages of their allotment for various purposes other than project construction. Table 2 below provides an overview of the available set-asides and Table 3 presents a flow chart for calculating these set-asides. EPA strongly encourages States to carefully evaluate and balance the needs related to the set-asides with the need to maintain an adequate level of funding for infrastructure projects in the DWSRF fund.

1. National Set-asides

The National set-asides are reserved from the funds appropriated by Congress to carry out section 1452. These set-asides are:

a. Indian Tribes/Alaska Native Villages

The Administrator may reserve (the Administrator will provide these funds) up to 1.5% from annually appropriated funds for grants to Indian Tribes and Alaska Native Villages (section 1452(l)). EPA will provide separate guidance regarding the selection of projects, project management, and program oversight.

b. Health Effects Studies

The Administrator will reserve \$10 million from annually appropriated funds to conduct health effects studies on drinking water contaminants (section 1452(n)).

c. Unregulated Contaminant Monitoring

The Administrator will reserve \$2 million from annually appropriated funds, starting in FY 1998, to pay for the costs of monitoring unregulated contaminants under section 1445(a)(2)(C)(section 1452(o)).

d. Small System Technical Assistance

The Administrator may reserve up to 2% of the funds annually appropriated in FYs 1997-2003 to carry out the technical assistance provisions of section 1442(e) to the extent that the total amount of funding appropriated under section 1442 is not sufficient. The set-aside from section 1452(q) plus the appropriation in 1440(e) cannot exceed \$15 million per year (section 1452 (q)).

e. Operator Training Reimbursement

The Administrator shall provide reimbursement to States for training and certification costs for some operating systems serving 3,300 persons or fewer (section 1419(d)). The Congress has authorized to be appropriated \$30 million annually from FY1997 through FY2003. If the appropriation is not sufficient to meet these requirements, the Administrator, prior to allocating funds to the States, shall reserve such sums from 1452(m) as are necessary to provide grants to State for reimbursement of training and certification costs mandated by the

SDWA.

2. Set-asides Based on State Allotment

a. D.C. and Other Jurisdictions

The Administrator will reserve up to 0.33% of the total funds allotted to the States for grants to the Virgin Islands, the Commonwealth of the Northern Mariana Islands, American Samoa, and Guam. The funds will be allotted according to the formula for allotting PWSS grants under section 1443(a)(4), and may be used to fund projects eligible for assistance under section 1452(a)(2). The District of Columbia will receive one percent of funds allotted to the States. EPA will provide separate guidance regarding the management of this set-aside.

3. Ceilings on State Non-project activities

Section 1452 authorizes States to provide funding for certain non-project activities, described below, provided that the amount of that funding does not exceed certain ceilings. A State must describe in the IUP the amount of funds that it will use for these activities. A separate account must be set up to accept these funds. If a State does not expend all of its non-project funds, a State may transfer the monies to the DWSRF account, or it may redirect the funds to another non-project activity as long as the maximum allowed for that activity has not been reached for the Fiscal Year from which the funds were derived.

a. DWSRF administrative expenses

A State may use up to four percent of the funds allotted to it for the reasonable costs of administering the programs under section 1452 (section 1452(g)(2)). These costs include such activities as loan portfolio management; debt issuance; DWSRF program start-up costs; financial, management and legal consulting fees; and support services from other State agencies.

Expenses incurred issuing bonds guaranteed by the DWSRF may be absorbed by the proceeds of the bonds rather than charged against the four percent administrative costs allowance. The net proceeds of those issues must be deposited in the Fund.

The State may charge an application fee to process, manage or review an application for DWSRF Fund assistance. Such fees may be collected in a fund outside the DWSRF Fund account and used to supplement administrative expenses. Monies in this non-project fee account must be dedicated to the administrative purposes associated with the DWSRF program. If fees are collected and deposited into the DWSRF Fund account, they are subject to the stipulated uses of the DWSRF Fund, which does not include the use of funds for administrative purposes.

States may recover reasonable costs associated with the development of the DWSRF program, if the costs were incurred between August 6, 1996, the date of enactment of the SDWA Amendments of 1996, and the date on which the first capitalization grant for a State is awarded. Documented reimbursement costs will be counted as part of the 4% in FY1997, not in addition to it.

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Funds that a State chooses to use for administrative purposes cannot be deposited into the DWSRF Fund. Instead, these funds must be deposited into a separate account, or with other non-project funds.

If the state does not use the entire four percent for administrative costs in one year, it can bank the excess balance and use it for administrative costs in later years.

b. State Program Management

A State may use up to a total of 10 percent of its allotment to:

- o administer the State PWSS program;
- o administer or provide technical assistance through source water protection programs, which includes the Class V portion of the Underground Injection Control Program;
- o develop and implement a capacity development strategy; and
- o develop and implement an operator certification program.
(section 1452(g)(2)).

The State must provide a dollar for dollar match for capitalization grant funds used for these purposes. At least one-half of the State match funds provided by the State must be in addition to the amount the State expended for the PWSS program in FY1993. Federal grant regulations preclude a State from using the same State funds to meet match requirements for two different programs. Thus, the same State dollar cannot be used to match this provision and the match provision in Section 1443 of the SDWA (PWSS program grants).

If the state does not use the entire 10 percent for these activities in any one year, it can bank the excess balance and use it for the same activities in later years.

To calculate the required match, a State must determine the level of State funds it spent for its PWSS program in FY1993. The State can use the amount spent to satisfy up to half of the required match. The State would then have to come up with the remaining balance from new monies. State funds counted toward the PWSS match are not eligible to be counted.

c. Small Systems Technical Assistance

A State may use up to two percent of its allotment to provide technical assistance to public water systems serving 10,000 people or fewer (section 1452(g)(2)). If the state does not use the entire 2 percent for these activities in one year, it can bank the excess balance and use it for the same activities in later years.

d. Local Assistance and Other State Programs

A State may fund several other categories of activities to assist development and/or implementation of local drinking water protection initiatives (section 1452). A State may use up to 15% of the capitalization grant amount for any of the specified uses below, with the stipulation that not more than 10% of the capitalization grant amount can be used for any one activity. A State is not allowed to bank any of these funds for use in future years.

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1. Assistance to a public water system to acquire land or a conservation easement for source water protection purposes:

A State may provide assistance, only in the form of a loan, to a public water system to acquire land or a conservation easement from a willing party for the purpose of protecting the system's source water(s) and ensuring compliance with national drinking water regulations. To be eligible for this loan assistance, the land must be an identified need that is included in an approved source water protection program under section 1453.

If a State elects to use this set-aside, the State must develop a list of systems that will receive loans, giving priority to projects that promote compliance and public health protection, and then seek public review and comment on this list.

2. Assistance to a community water system to implement voluntary, incentive-based source water quality protection measures:

A State may make a loan to assist a community water system implement voluntary, incentive-based source water protection measures in areas delineated under a source water assessment program described in section 1453 and for source water petitions. Only community (as opposed to noncommunity) water systems are eligible for this assistance. A State may establish a source water petition program and receive petitions from owners/operators or local governments requesting State assistance in the development of a voluntary, incentive-based partnership among systems, local governments, and others likely to be affected by the management measures. Only pathogenic organisms, chemicals in source water at levels above a drinking water standard, or chemicals that are not reliably and consistently below the drinking water standard can be identified as contaminants in a petition.

If a State elects to use this set-aside, the State must develop a list of systems that will receive loans, giving priority to projects that promote compliance and public health protection, and then seek public review and comment on this list.

Note: Funds loaned out for land acquisition and source water protection activities under (1) and (2) must be repaid within 20 years. The funds must be repaid, either to the DWSRF account or if the State so chooses, to a subaccount within the DWSRF account. This option would allow a State to continue funding eligible land acquisition and source water activities, which are not eligible for funding in the main DWSRF account.

3. Provide funding to delineate and assess source water protection areas:

A State may use up to 10% of its FY 1996 and FY1997 capitalization grant to delineate and/or assess source water protection areas for public water systems in accordance with section 1453. Assessments include the identification of potential sources of contamination within the delineated areas. Funds set-aside for this purpose must be expended within four fiscal years after the State receives its grant.

Funds are available from the capitalization grant only for fiscal years 1996 and 1997 to

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delineate and assess source water protection areas in accordance with section 1453. Since there are no FY1996 funds available for the DWSRF, FY 1997 is the only year when funds will be available for this important activity. EPA encourages States to determine how much it would cost to delineate and assess their source water protection areas, and then take the necessary amount, up to the full 10% allowed, from the FY 1997 funds. EPA will review the State's determination as part of the capitalization grant application review. Source water assessments are required of primacy States.

4. To support the establishment and implementation of wellhead protection program:

The State may make expenditures from the DWSRF Fund to establish and implement wellhead protection programs under section 1428. Only a State with an EPA-approved State wellhead protection program may participate in this funding. To establish a WHP program, a State must submit a program to the EPA Region for approval and spend all the funds it receives for that purpose in accordance with its intended use plan.

5. To provide funding to a Community Water System to implement a project under the capacity development strategy:

A State may provide assistance to a public water system as part of a capacity development strategy under section 1420(c).

e. Transfer of funds

Section 302 of the SDWA Amendments of 1996 allows a State to transfer up to 33% of the capitalization grant funds allotted to a State under section 1452(m) to the CWSRF or a equivalent amount from the CWSRF to the DWSRF. This transfer is at the Governor's discretion and cannot occur until at least a year after the State has received its first DWSRF capitalization grant. EPA plans to issue guidance at a later date concerning this transfer.

TABLE 2

Set-Asides and funding ceilings in the Drinking Water SRF ProgramBefore Allotment to States

Programmatic	\$10 M
- Health Effects Research	\$ 2 M
- Unregulated Contaminant Monitoring (starting in FY 98)	up to 2.0 % **
- Technical Assistance to Small Systems (cap is \$15 M when combined with funding appropriated under 1442) (OPTIONAL)	
- Reimbursement of operator training expenses projects	unknown
- Indian Tribes/Alaska Native Villages	1.5 %

Based on Allotment to States

Projects	
- DC	1.0 %
- Virgin Islands/Territories	0.33%

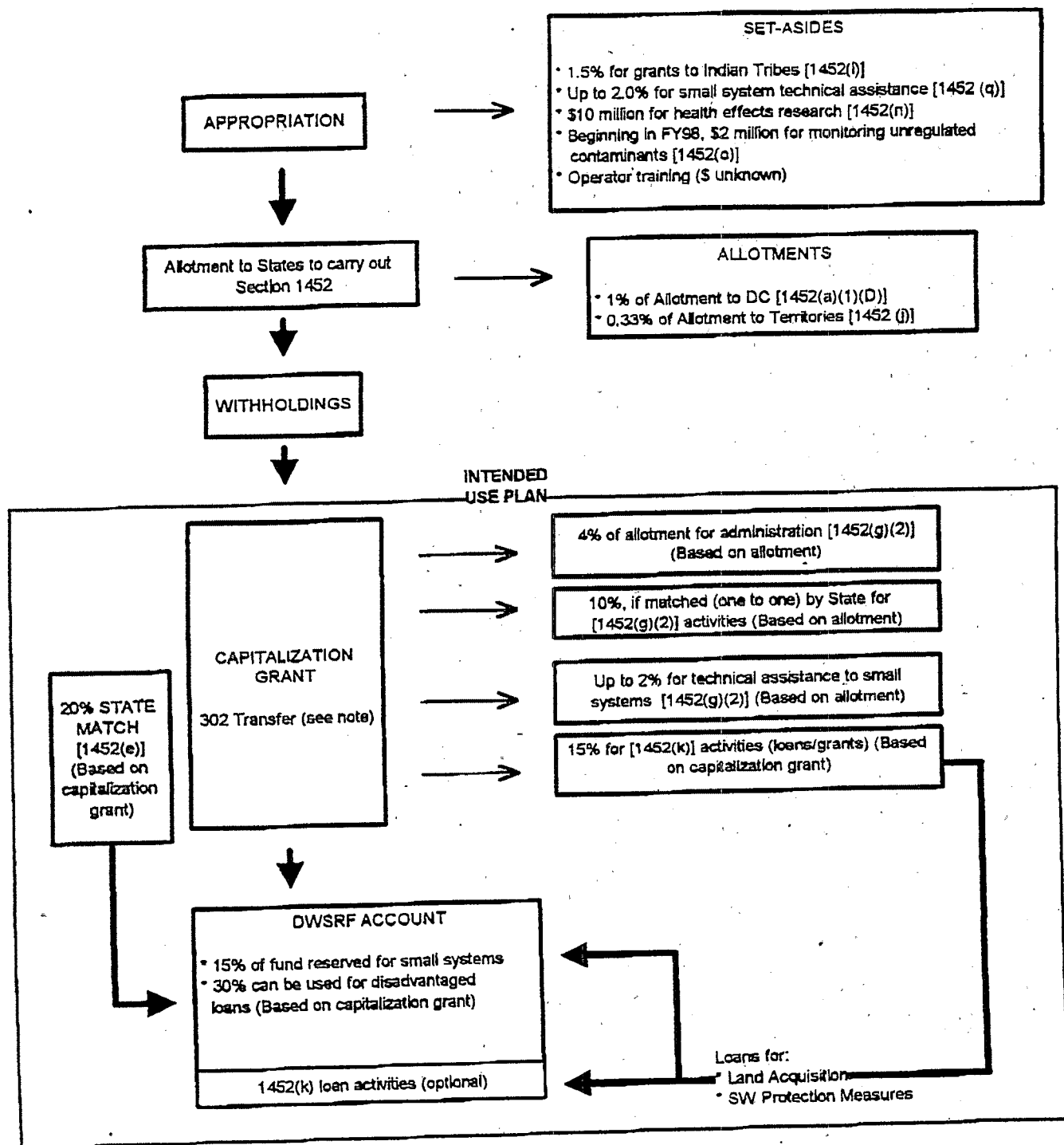
After Allotment to States

Programmatic	
- Administration of SRF	4.0 %
- Technical Assistance to Small Systems	2.0 %
- Assistance to State programs (PWSS, SWP, capacity Development, operator certification)	10.0 %
- Combination of the Following:*	15.0%
- Loans for public water systems to acquire land or conservation easements.	
- Loans for community water systems to implement SWP measures or to implement recommendations in SW petitions.	
- Technical and financial assistance to public water systems for capacity development.	
- Expenditures to delineate or assess SWP areas.	
- Expenditures to establish and implement WHP programs.	

*Although 15% can be used on the combination of these activities, each separate activity cannot receive greater than 10%.

Projects	
- Loan Subsidies for Disadvantaged Communities	30.0%

DWSRF SET-ASIDES



*Note: The Governor of a State may transfer up to 33% of the DWSRF capitalization grant amount to the CWSRF or an equivalent amount may be transferred from the CWSRF to the DWSRF, to be used for eligible fund activities. If the CWSRF funds are used for DWSRF set-asides, the maximum amount of funds available for these purposes is the amount stated in Section 1452.

C. Types of Financial Assistance that the DWSRF Fund may provide

A DWSRF Fund may make direct loans for project construction, purchase or refinance 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 (section 1452(f)).

1. Loans

A DWSRF Fund may make loans with interest rates that are less than or equal to the market interest rate, including zero percent loans. The State is responsible for identifying the economic method it will use to determine the "prevailing" market interest rate at the time a particular loan is executed with an assistance recipient. As part of its capitalization grant application, the State should outline its policy with respect to interest rate terms for various potential categories of assistance recipients.

A state may issue separate loans for planning, design, and construction costs. If the State had made prior loans to a recipient, the Fund may "roll over" the separate loans into a subsequent loan for construction. A State may also provide "incremental" assistance to finance a multi-year construction activity (e.g., for particularly large, expensive projects).

a. Repayment of Loan

Assistance recipients (borrowers) must begin repayment of principal and payment of interest as provided in the loan agreement, but which cannot be later than one year after completion of the project. A project is considered complete when the operations are initiated or are capable of being initiated. Recipients must complete loan repayment not later than 20 years after the completion of the project. However, States which establish a disadvantaged community loan program pursuant to section 1452(d) 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.

b. Dedicated repayment source

Each loan recipient must establish a dedicated source of revenue for repayment of the loan. In most cases, this will be a pledge of revenues from user charges, tap fees, development charges, among others, and for privately owned systems, they could include the pledge of accounts receivable and proceeds therefrom.

c. Financial security of privately-owned systems

Eligible water systems that are privately owned must demonstrate, in addition to establishing a dedicated source of revenue for repayment, that there is adequate security to assure repayment of the loan. In some cases a State may determine that it is appropriate to require such systems to provide credit enhancements, to pledge a variety of collateral, and/or to provide other types of security, such as corporate or personal guarantees.

d. Financial, technical, and managerial capability analysis

The State shall review the financial capability of the recipient to repay the loan as well as technical and managerial capability of the assistance recipient to maintain compliance with the SDWA (section 1452(a)(3)(A)(i)). Findings of the financial capability analysis may be used to determine the terms of assistance for applicants.

2. Disadvantaged communities

A DWSRF Fund may provide additional subsidies (e.g., principal forgiveness, negative interest rate loans) to communities meeting the definition of "disadvantaged" or which the State expects to become disadvantaged as a result of the project. A "disadvantaged community" is one in which the service area of a public water system meets affordability criteria established after public review and comment by the State in which the public water system is located (section 1452(d)). The Administrator shall publish information, within 18 months after enactment, to assist States in developing affordability criteria. EPA will undertake this effort in consultation with States and the Rural Utilities Service.

The State should take its affordability criteria into account when deciding the level of subsidy a disadvantaged community will receive, in order to make the loan affordable. Where capacity of the system is an issue, the loan subsidy should, along with other actions, ensure that the system has adequate financial, technical and managerial capacity to maintain compliance.

The total value of disadvantaged community subsidies a DWSRF Fund may provide in any year cannot exceed 30 percent of the capitalization grant for that year. The State cannot bank the excess balance and use it for this purpose in later years.

3. Buy or refinance existing debt obligations

A DWSRF may buy or refinance debt obligations of municipal, intermunicipal or interstate agencies at or below market rates, where the initial debt was incurred after July 1, 1993 (section 1452(f)(2)). Refinancing may entail purchasing existing municipal debt such that the proceeds of the transaction may be used to call the bonds. This provision is intended to encourage projects to proceed using their own means of financing in advance of the availability of DWSRF assistance, by offering the prospect of project refinancing at better financial terms at a later date.

Projects incurring debt and initiating construction between July 1, 1993 and the effective date of a State capitalization grant must meet the eligibility requirements of section 1452 to be eligible for refinancing. Where the original debt for a project was in the form of a multi-purpose bond incurred for purposes in addition to eligible purposes under section 1452, a DWSRF may provide refinancing only for eligible purposes, not for the entire debt.

If a State has credited repayments of loans made under a pre-existing State loan program as part of its State match (see section V.A.), the State cannot also refinance the projects under the DWSRF. If the State has already counted certain projects toward its State

match which it now wants to refinance, the State must provide replacement funds for the amounts previously credited as match.

The State should seek the advice of bond counsel or tax attorneys to ensure that these refinances do not conflict with Federal law.

4. Guarantee or purchase insurance for local debt obligations

A DWSRF Fund may provide assistance to improve the marketability of local debt obligations or to reduce interest rates to attract potential buyers of the bonds and loans (section 1452(f)(3)). These credit enhancements may take the form of guarantees or purchases of insurance, which is available from a number of insurance companies. Assistance of this type is limited to local debt obligations that are undertaken to finance projects eligible for assistance under section 1452.

5. A source of revenue or security for payment of DWSRF debt obligations

The State may use assets deposited in the DWSRF Fund to "leverage" (i.e., increase) the total amount of funds available within the DWSRF (section 1452(f)(4)). Leveraging is accomplished by using DWSRF assets as a source of revenue or security for the payment of the principal and interest on revenue or general obligation bonds issued by the State. The net proceeds of the sale of the bonds secured by the DWSRF must be deposited into the DWSRF.

The security may be provided by any of the assets of the DWSRF, including an existing DWSRF balance and future revenues from loan repayments. The State may also choose to borrow against the repayment stream from outstanding loans made from an initial set of capitalization grants (or part of the capitalization grant or State match), thus increasing the financial resources of the DWSRF much sooner than would otherwise be possible. Bonds may be issued by an instrumentality of the State, including the State agency responsible for administering the DWSRF.

Note that the use of a capitalization grant to leverage does not, in and of itself, satisfy any requirements on the use of DWSRF funds. The proceeds of the bond issue must ultimately be used for providing loans and other assistance to satisfy the requirements of section 1452.

For the purposes of this section, "net proceeds" is defined as the funds raised from the sale of the bonds minus issuance costs (e.g., the underwriting discount, underwriter's legal counsel fees, bond counsel fees, financial advisor fees, rating agency fees, printing of disclosure documents/bond certificates, trustee banks' fees).

The State may use funds in the DWSRF as security for the issuance of State bonds used to provide the State match, provided that the net proceeds of the bond issue were deposited into the DWSRF and the amount of security subject to being paid out is limited to an amount equal to the interest earning of the Fund.

6. Earn interest on Fund accounts

Sections 1452(c) and 1452(f)(5) authorize the State to earn interest on Fund accounts prior to disbursement of assistance (e.g., on reserve accounts used as security or guarantees). Funds should not remain in the DWSRF primarily to earn interest. States and municipalities should obtain the legal opinion of a bond counsel or tax attorney with respect to using the DWSRF to earn interest on the proceeds of a tax-exempt issue.

There are limits to the type of investments that a State can make with Fund accounts. Section 1452(c) requires that funds not required for current obligation or expenditure should be invested in interest bearing obligations. The authority to earn interest does not include investment methods that earn dividends or yields other than interest. Most States have State laws that restrict the eligible investments of these fund accounts. Furthermore, if a State engages in a leveraged program, there may be restrictions on eligible investments in the trust indenture securing the bonds. In certain cases, the Federal tax code may limit the investments a leveraged program can make with fund accounts.

III. ELIGIBLE SYSTEMS AND PROJECTS

A. Eligible Systems

Drinking water systems that are eligible for DWSRF Fund assistance are community water systems, both privately and publicly owned, and nonprofit noncommunity water systems. Federally-owned systems are not eligible to receive DWSRF Fund assistance (section 1452(a)(2)).

The DWSRF should seek tax advice if it plans to issue bonds, to ensure that the requirements of the Private Activity Use Rule are met, particularly with regard to funding eligible private systems.

Drinking water systems that have components of their system in more than one State are eligible to receive funding from a DWSRF. However, the system can only apply to a State DWSRF to receive loan or other assistance for the portion of the facility that provides service in that particular State.

B. Eligible Projects

1. Compliance and Public Health

A DWSRF Fund may provide assistance for expenditures (not including monitoring, operation, and maintenance expenditures) "of a type or category which the Administrator has determined, through guidance, will facilitate compliance with national primary drinking water regulations applicable to the system under section 1412 or otherwise significantly further the health protection objectives of this title." (section 1452(a)(2)).

Capital investments to upgrade or replace infrastructure in order to continue providing the public with safe drinking water are eligible for assistance.

Projects to address exceedances of SDWA health standards or prevent future violations of the rules are eligible for funding. These include projects to maintain compliance with existing regulations for contaminants with acute health effects (i.e., the Surface Water Treatment Rule, the Total Coliform Rule, and nitrate standard) and regulations for contaminants with chronic health effects (i.e., Lead and Copper Rule, Phases I, II, and V rules, and safety standards for total trihalomethanes, arsenic, barium, cadmium, chromium, fluoride, mercury, selenium, combined radium-226, -228, and gross alpha particle activity). In addition, projects to comply with the recently promulgated Information Collection Rule are eligible.

Projects to replace aging infrastructure are also eligible. Examples of these include projects to:

- rehabilitate or develop sources to replace contaminated sources;
- install or upgrade treatment facilities if, in the State's opinion, the project would improve the quality of drinking water to comply with primary or secondary standards;
- install or upgrade storage facilities, including finished water reservoirs, to prevent microbiological contaminants from entering the water system; and

- install or replace transmission and distribution pipes to prevent contamination caused by leaks or breaks in the pipe.

Projects to consolidate water supplies -- for example, when individual homes or other public water supplies have an inadequate quantity of water, the water supply is contaminated, or the system is unable to maintain compliance for financial or managerial reasons -- are eligible for DWSRF Fund assistance.

The purchase of a portion of another systems's capacity is eligible for a loan, if the purchased system is a small system which is part of a consolidation plan to bring the system into compliance., and it is the most cost-effective solution for that small system, when considering the buy-in fee and user fees.

2. Loan assistance to systems that meet the definition in section 1401(4)(B)

This section refers to entities that receive water through constructed conveyances, other than piped water systems, and which are not currently considered a public water supply. The SDWA Amendments would classify such systems as public water systems unless they comply with provisions of 1401(4)(B). Such systems are eligible for funding for the purposes specified in 1401(4)(B)(i)(III).

3. Land acquisition

Land is eligible only if it is integral to a project. In this instance, integral is defined to include only the land needed to locate an eligible project. In addition, the acquisition has to be from a willing seller who receives fair market value for the land. Land that is necessary for source water protection may be eligible to receive a loan under section 1452(k).

The cost of complying with the Uniform Relocation Assistance and Real Property Acquisition Policies Act of 1970 (the Uniform Act) is an eligible cost to be included in a DWSRF loan. See (Section on Cross-cutters) for a more detailed discussion of the Uniform Act.

4. Planning and design of a drinking water project

A DWSRF Fund may provide assistance for the costs of project planning, design and other related costs. The provision of assistance for design and planning costs does not guarantee a system that the DWSRF will provide funding for the construction of the project. The State may choose to combine the loan for planning and design with a construction loan.

Costs to municipalities of preparing environmental assessment reports may be included as part of the costs of planning a project. Costs incurred by the State in reviewing the environmental assessments are considered DWSRF administrative costs.

5. Restructuring of systems that are in noncompliance or that lack the technical, managerial and financial capability to maintain the system

A DWSRF may provide assistance to an eligible public water system to consolidate with other public water system(s) only if the assistance will ensure that the system returns to and

maintains compliance with SDWA requirements (section 1452(a)(3)(B)).

If the system does not have the technical, managerial, and/or financial capability to ensure compliance, or is in significant noncompliance, the system may receive assistance only if (1) the assistance will ensure compliance, or (2) the owner or operator of the system agrees to undertake appropriate changes in operations. These changes include consolidation or management changes that will ensure that the system has the technical, managerial, and financial capability to ensure and maintain compliance with SDWA requirements.

A State should establish criteria or guidelines to help assess what types of operational or management changes may be appropriate for a water system. Further, a State should define when a system would be a good candidate for physical consolidation to solve a compliance or long-term financial issue, or when a system could consolidate by other means, such as through management consolidation.

C. Projects not eligible for funding

The following projects and activities are *not* eligible for funding:

- Laboratory fees for monitoring.
- Operation and maintenance expenses.
- Projects needed mainly for fire protection.
- Systems that lack technical, managerial and financial capability, unless assistance will ensure compliance.
- Systems in significant noncompliance, unless funding will ensure compliance.
- Projects primarily intended to serve future growth.
- Construction of dams or reservoirs, except for finished water reservoirs.
- Land necessary for the construction or storage of water related to reservoirs or dams, except for finished water reservoirs.

1. Lack of technical, managerial and financial capability

A DWSRF Fund may not provide assistance to a system that lacks the technical, managerial or financial capability to maintain SDWA compliance, unless the State determines that the financial assistance from the DWSRF will allow the system to maintain long-term capability to stay in compliance (section 1452(a)(3)(B)(i)).

2. Significant noncompliance

A DWSRF Fund may not provide assistance to any system that is in significant noncompliance with any national drinking water regulation or variance unless the State conducts a review and determines that the project will enable the system to return to compliance and the system will maintain an adequate level of technical, managerial and financial capability to maintain compliance (section 1452(a)(3)(B)(ii)).

3. Growth

A DWSRF Fund cannot provide assistance to finance the expansion of any drinking water

system in anticipation of future population growth (section 1452(g)(3)(C)). Eligible projects, however, can be designed and funded at a level which will serve the population that a system expects to serve over the useful life of the facility. In determining whether or not a project is eligible for assistance, the State must determine the primary purpose of the project. If the primary purpose is to supply or attract growth, the project is not eligible to receive SRF funds. If the primary purpose is to solve a compliance or public health problem the entire project, including the portion necessary to accommodate a reasonable amount of growth over its useful life, is eligible. In reviewing the proposed project, the State should review the basis of, and the reasonableness of the population projections.

A State must also consider the extent of current risk to public health in establishing funding priorities. Consequently, if a project includes substantial growth, it would presumably be placed at the lower end of the priority list. It would be contrary to the intent of Congress, as reflected in the "anticipation of growth" provision, to fund a project with a substantial amount of growth ahead of a project where a significant portion is attributable to rectifying a current health threat.

D. Compliance without DWSRF funding

The inability or failure of any public water system to receive assistance from a DWSRF Fund or any other funding agency, shall not alter the obligation of a drinking water system to comply in a timely manner with all applicable drinking water standards and requirements of section 1452 (section 1452(l)).

E. Impact of System Mergers and Sales

1. Disadvantaged Community Loans

In the event that a system which has received assistance under the disadvantaged community provision is purchased or acquired in some other form by another public water system that would not itself be eligible for a disadvantaged loan, the acquiring entity must agree to assume the remaining balance (principal only) on the original loan. The time period should be the remaining length of time on the assistance agreement, but no longer than 20 years (beginning from the date of the original loan agreement). The State has the option to decide the terms of the loan.

IV. STATE/PROJECT LEVEL AUTHORITIES

A. Cross-cutting Federal Authorities

There are a number of Federal laws, executive orders and government-wide policies that apply *by their own terms* to projects and activities receiving Federal financial assistance, regardless of whether the statute authorizing the assistance makes them applicable. These "cross-cutting Federal authorities" (cross-cutters) include environmental laws such as the National Historic Preservation Act and the Wild and Scenic Rivers Act, and social and economic policy authorities such as Executive Orders on Equal Employment Opportunity and government-wide debarment and suspension rules.

A few cross-cutters apply by their own terms only to the State as the grant recipient (e.g., Drug-Free Workplace Act, Pub. L. 100-692 § 5152 *et. seq.*), because the authorities explicitly limit their application to *grant* recipients.

The DWSRF Fund may consist of funds from several sources: Federal grant dollars, State match amounts, loan repayments, and, perhaps, bond proceeds. It is therefore difficult to identify which projects are receiving Federal financial assistance and are thus, subject to the cross-cutters. Consequently, the cross-cutters will apply to an *amount* of funds equaling the amount of the Federal grant. Requirements imposed by the cross-cutters must be met by projects whose cumulative DWSRF funding equals the amount of the capitalization grant ("equivalency projects").

The concept of equivalency was developed for the CWSRF program, although in that program it had an additional feature. In the CWSRF program, equivalency projects were subject to a number of specific requirements listed in the Clean Water Act (section 602(b)(6)), as well as the cross-cutters. In the DWSRF program, the concept of equivalency is only used to describe which projects must comply with cross-cutters.

Projects funded with DWSRF monies in amounts greater than the capitalization grant are not subject to these requirements. However, all programs, projects and activities undertaken by the DWSRF are subject to Federal anti-discrimination laws, including the Civil Rights Act of 1964, section 504 of the Rehabilitation Act of 1973 and the Age Discrimination Act of 1975.

Because of the similarities between the DWSRF and CWSRF programs, and because the State plays a more substantial role in these two programs than in other federal assistance programs (particularly in its relationship with assistance recipients), the method for applying cross-cutters in the DWSRF program will be the same as that used in the CWSRF program. The Agency will remain ultimately responsible for ensuring that assistance recipients comply with the cross-cutters, but will carry out this responsibility mainly through its annual oversight and approval roles. Day-to-day responsibility for overseeing funding recipients implementation of the cross-cutters will fall upon the State. For example, where a cross-cutter requires consultation with another federal agency, such as the U.S. Fish and Wildlife Service, the State will take this action initially. If a compliance issue cannot be resolved for a particular project through that consultation, then the State may seek the Regional Offices's assistance in settling the matter.

B. Environmental Reviews

The environmental review principles developed for the CWSRF program will provide the basis for the development of a State environmental review process (SERP) in the DWSRF program. The SERP that applies to DWSRF equivalency projects must be the same as the process for CWSRF equivalency projects. Non-equivalency projects must also undergo an environmental review, but the State may elect to apply an alternative SERP to these projects.

1. Equivalency Projects

Equivalency projects are reviewed under a State environmental review process (SERP) that conforms generally to the National Environmental Policy Act (NEPA). The State may elect to apply the procedures at 40 CFR Part 6, Subpart E and related subparts, or apply its own "NEPA-like" SERP for conducting environmental reviews. For equivalency projects, a SERP must contain the elements described below.

Legal foundation: The State must have the legal authority to conduct environmental reviews of construction projects receiving DWSRF assistance. The legal authority and supporting documentation must specify:

- The mechanisms to implement mitigation measures to ensure that a project is environmentally sound;
- The legal remedies available to the public to challenge environmental review determinations and enforcement actions;
- The State agency that is primarily responsible for conducting environmental reviews; and
- The extent to which environmental review responsibilities will be delegated to local recipients and will be subject to oversight by the primary State agency.

Interdisciplinary approach: The State must employ an interdisciplinary approach for identifying and mitigating adverse environmental effects including, but not limited to, those associated with cross-cutting Federal environmental authorities.

Decision documentation: The State must fully document the information, processes and premises that influence its decisions to:

- Proceed with a project contained in a finding of no significant impact (FNSI) following documentation in an environmental assessment (EA);
- Proceed or not proceed with a project contained in a record of decision (ROD) following preparation of a full environmental impact statement (EIS);
- Reaffirm or modify a decision contained in a previously issued categorical exclusion (CE), EA/FNSI or EIS/ROD following a mandatory 5 year environmental reevaluation of a proposed project; and

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- If a State elects to implement processes for either partitioning an environmental review or CE from environmental review, the State must similarly document these processes in its proposed SERP.

Public Notice and Participation:

The State must provide public notice when a CE is issued or rescinded, a FNSI is issued but before it becomes effective, a decision issued 5 years earlier is reaffirmed or revised, and prior to initiating an EIS. Except with respect to a public notice of a categorical exclusion or reaffirmation of a previous decision, a formal public comment period must be provided during which no action on a project will be allowed.

A public hearing or meeting must be held for all projects except for those having little or no environmental effect.

Alternatives Consideration: The State must have evaluation criteria and processes which allow for:

- Comparative evaluation among alternatives, including the beneficial and adverse consequences on the existing environment, the future environment and individual sensitive environmental issues that are identified by project management or through public participation; and
- Devising appropriate near-term and long-range measures to avoid, minimize or mitigate adverse impacts.

2. Non-equivalency Projects

The State may elect to apply an alternative SERP to non-equivalency construction projects assisted by the DWSRF, provided that the process:

- Is supported by a legal foundation which establishes the State's authority to review construction projects;
- Responds to other environmental objectives of the State;
- Provides for comparative evaluations among alternatives and accounts for beneficial and adverse consequences to the existing and future environment;
- Adequately documents the information, processes and premises that influence an environmental determination; and
- Provides for notice to the public of proposed projects and for the opportunity to comment on alternatives and to examine environmental review documents. For projects determined by the State to be controversial, a public hearing must be held.

3. EPA Approval and Review Process

The RA must review and approve any State "NEPA-like" alternative procedures to ensure that the requirements for both have been met. The RA will conduct these reviews on the basis of the criteria for evaluating NEPA-like reviews contained in Appendix B to these guidelines. Because these criteria are also used in the CWSRF program (Appendix A to the CWSRF regulations), a state may simply adopt those for the DWSRF program. Significant changes to State environmental review procedures must be approved by the RA. The approved SERP may be incorporated in the State's operating agreement, if it elects to prepare one. (See section I.D. above)

States should establish administrative procedures for monitoring, collecting and summarizing environmental review information and provide documentation of these activities in the Biennial Report. EPA's annual review will include a review of a sample of DWSRF projects to verify the application and the adequacy of the SERP.

V. FUNDING PROCESS

A. State Match

The State must agree to deposit into the DWSRF an amount equaling at least 20 percent of the amount of each grant payment (section 1452(e)). The State matching funds must be from State sources and must be deposited on or before the date when grant payments are made to the State, except for grant payments from FY1997 appropriations. As discussed in the next section, a grant payment under the DWSRF does not involve the transfer of Federal funds to the State.

For grant payments made to the State from funds appropriated in FY 1997, the State may defer deposit of its matching amount to no later than September 30, 1999. This flexibility is provided to States which may need additional time to secure State funding for the required matching amount. Note that even if the State defers deposit of its matching amounts, it must identify the source of its matching funds in the capitalization grant application and certify that the State funds will be available by September 30, 1999.

States that fail to provide their match on a timely basis will lose their eligibility to receive grants from future federal appropriations. Any State allotment that is not awarded to a State will be reallocated to the other eligible States.

States may acquire the matching amount from a variety of sources, including legislative appropriations, proceeds from State issued bonds, revenues from State taxes or assessments, and funds maintained in other State accounts. Bonds issued by the State to derive the match may be retired from the interest payments made to the DWSRF on loans awarded by the DWSRF if the net proceeds from the State issued bonds are deposited in the fund. Loan repayments on the principal of a loan must be repaid to the DWSRF and cannot be used as a source of funds to retire State bond issues that provide the State match. This flexibility to retire State debt should not be used to the extent that it endangers the long term financial goals and objectives, and financial condition of the DWSRF, as described in the IUP. If the State provides a match in excess of the required amount, the excess balance may be banked toward match requirements associated with subsequent capitalization grants.

The State may already manage a dedicated revolving fund which provides assistance for activities consistent with section 1452(a)(2) of the SDWA. The State may credit toward its match requirement State monies deposited into this dedicated fund between July 1, 1993 and prior to the receipt of a capitalization grant under section 1452(a) of the SDWA if:

- (1) the monies were deposited in an SRF that subsequently received a capitalization grant and, if the deposit was expended, it was expended in accordance with section 1452 of the SDWA;
- (2) the monies were deposited in a separate fund that has not received a capitalization grant, they were expended in accordance with section 1452 of the SDWA and an amount equal to all repayments of principal and payments of interest from these loans will be deposited in the Federally capitalized fund; or
- (3) the monies were deposited in a separate fund and used as a reserve consistent with

section 1452 and an amount equal to the reserve is transferred to the Federally capitalized fund as its function is satisfied.

B. Federal Funding Process

1. Generally

A State will receive each capitalization grant payment in the form of an increase to the ceiling of funds available through the EPA-Automated Clearing House (EPA-ACH). Funds will be transferred to the State from the U.S. Treasury on a reimbursement basis, after the assistance recipient has billed the DWSRF for work completed and the DWSRF requests reimbursement from EPA. The State then reimburses assistance recipients for costs incurred -- a process known as the disbursement from the DWSRF.

2. Schedule of Payments

A State must include a payment schedule in its capitalization grant agreement that is based on its projection of binding commitments (see below) in the State's Intended Use Plan. Increases in the ceiling of funds available in the EPA-ACH will track this schedule of payments. All payments will be made by the earlier of 8 quarters from the date of when a State could receive a capitalization grant or 12 quarters from the date of allotment. The schedule of payments applies to all funds in the capitalization grant, including those funds that are used for non-project activities.

3. Binding Commitments

In order to demonstrate continuing progress in project initiation, and to further the intent of Congress to "commit(s) and expend(s) funds ... as efficiently as possible..." (section 1452(g)(3)(A)), the State must agree to enter into binding commitments with assistance recipients to provide financial assistance under the DWSRF program. A binding commitment is a legal obligation by the state to a recipient of assistance that defines the terms for DWSRF assistance. In most cases, the binding commitment will be an executed loan document. The binding commitment should include a description of the project to receive financial assistance, the expected terms of the assistance, and expected date of project initiation and project completion.

Binding commitments must be made in an amount equal to the amount of each quarterly grant payment that is deposited into the Fund and state match within one year after the receipt of each grant payment.

If a project on the Intended Use Plan is not able to proceed with entering into an assistance agreement from the DWSRF, the State must expeditiously identify a substitute project(s), amend the IUP in accordance with the grant agreement, and work with the public water system to enter into an assistance agreement in a timely manner.

The State must continue to make progress in providing DWSRF assistance by entering into binding commitments equaling the amount of the grant payment and state match within one year after it receives a grant payment. If the binding commitment requirement is not met, the

Agency may withhold future grant payments and require adjustments to the payment schedule before releasing further grant payments. To facilitate compliance with this requirement, the State may wish to plan for binding commitments greater than the 120 percent requirement. Then, if some projects are unable to proceed for unforeseen reasons, the State will still be able to comply with the requirement. The State may make binding commitments for more than the required amount, and bank the "excess" balance towards the binding commitment requirements of subsequent grant payments.

If a State is concerned about its ability to comply with the binding commitment requirement, it should notify the RA before it fails to fulfill its responsibility, and propose a revised payment schedule.

4. Cash Draw

The ACH process is structured so that neither the DWSRF nor the assistance recipients will be required to provide interim financing on financial transactions of the DWSRF. Transfer procedures have been established to ensure that cash will be in the DWSRF account within two days after the Agency receives a valid request for cash draw from the State. To effect this two day transfer, the Agency will only subject requests to account verification. The Agency will not review the DWSRF program (e.g., construction status of projects, adequacy of voucher documentation) as part of the cash draw process.

Cash draws from the DWSRF-ACH are limited by the ceiling available in the DWSRF-ACH, and by the amount of the DWSRF-ACH that is dedicated to the various types of assistance a DWSRF program can provide. However, in the event of an imminent default (e.g., debt service payments to bondholders and resulting need for a cash draw from a DWSRF-ACH for use as a security or guarantee), the Agency can amend the grant agreement and payment schedule to allow for an increased cash draw not to exceed the amount of the capitalization grant. The DWSRF or the assistance recipient must first incur a cost, but not necessarily disburse funds for that cost, in order for cash to be drawn against the DWSRF-ACH. The State may draw cash from the DWSRF-ACH for the proportionate Federal share of eligible costs at the time those costs have been incurred. For example, if a non-leveraged DWSRF that consists of a \$1 million ACH ceiling and \$200,000 in State match receives a request for disbursement of \$120 based on construction costs incurred, the State may draw cash for \$100 from the DWSRF-ACH and the remaining \$20 must come from the State match.

The following subsections describe the cash draw rules that apply to the different types of assistance a DWSRF Fund can provide.

a. Loans

The State may draw cash from the DWSRF-ACH when the DWSRF receives a request from a loan recipient, based on incurred costs, including pre-building and building costs.

b. Refinance or purchase of municipal debt

For completed construction, cash draws will be made at a rate no greater than equal amounts over the maximum number of quarters that capitalization grant payments are

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made, and up to the portion of the DWSRF-ACH committed to the refinancing or purchase of the local debt. Cash draws for incurred building costs will generally be treated as refinanced costs. With the approval of the RA, the State may draw cash immediately when it is prepared to refinance for up to five percent of each fiscal year's capitalization grant or two million dollars, whichever is greater, to refinance or purchase local debt.

For projects or portions of projects that have not been constructed, the State may draw cash based on incurred construction costs according to the rule for loans.

For the purchase of incremental disbursement bonds from local governments, cash draws will be based on a schedule that coincides with the rate at which construction related costs are expected to be incurred for the project.

c. Purchase of insurance

The State may draw cash to purchase insurance as premiums are due.

d. Guarantees and security for bonds

In the event of an imminent default in debt service payments on a guaranteed or secured debt, the State can draw cash immediately up to the total amount of the DWSRF-ACH that is dedicated to the guarantee or security. If a balance remains after the default is covered, the State must negotiate a revised schedule for the remaining amount dedicated to the guarantee or security.

In the absence of default, the State can draw cash up to the amount of the DWSRF-ACH dedicated for the guarantee or security in accordance with a schedule that is based on actual construction cost. The amount of the cash draw would be the actual construction costs multiplied by the Federal share of the reserve multiplied by the ratio of the reserve to either the amount guaranteed or the proceeds of the bond issue.

In addition, in the case of a security the State can identify a group of projects whose value equals approximately the total of that portion of the DWSRF-ACH and the State match dedicated as a security. The State can then draw cash based on the incurred construction costs of the selected projects only, multiplied by the ratio of the Federal portion of the security to the entire security.

Where the cash draw rules discussed immediately above would significantly frustrate a State's program, the Agency may permit an exception to these cash draw rules and provide for a more accelerated cash draw, where the State can demonstrate that:

- there are eligible projects ready to proceed in the immediate future with enough costs to justify the amount of the secured bond issue;
- the absence of cash on an accelerated basis will substantially delay these projects;
- if accelerated cash draws are allowed, the SRF will provide substantially more assistance; and
- the long term viability of the State program to meet water quality needs will be

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protected.

When the ACH is used for securing State issued bonds, cash draws cannot be made at a rate greater than equal amounts over the maximum number of quarters that payments can be made. Exceptions to this limitation are in cases of default and where cash draws are based on construction costs for all projects.

e. Administrative expenses

One payment will be made at the time of the grant, based on the portion of the ACH estimated to be used for administrative expenses. The State can draw cash based on a schedule that coincides with the rate at which administrative expenses will be incurred, up to that portion of the ACH dedicated to administrative expenses.

VI. REPORTING/REVIEW RESPONSIBILITIES

Each State must submit a Biennial Report to the Administrator discussing the State's activities which receive funding through the Federal capitalization grant (section 1452(g)(4)).

The Administrator has determined that the Agency shall conduct reviews of the DWSRF program on an annual basis. The Annual Review is necessary to carry out the Agency's Federal fiduciary responsibilities and to assure that States are implementing the program "as efficiently as possible" (section 1452(g)(3)(A)). Specific elements of the Agency's Annual Review are outlined below.

Several other programs may receive funding from the State's allotment, including operator certification, small systems technical assistance, source water protection, and wellhead protection. Agency review of these other programs shall generally be conducted separately in accordance with procedures described in program specific guidance. The Agency may develop additional guidance to reflect new components for the other eligible programs receiving funds pursuant to section 1452.

A. State Responsibilities

1. Biennial Report

The State should submit its Biennial Report to the RA according to the schedule established in the grant agreement.

The Biennial Report should contain detailed information on how the State has met the goals and objectives of the previous two fiscal years as stated in the IUP and grant agreement. The Report should provide information on loan recipients, loan amounts, loan terms, project categories of eligible cost, and similar details on other forms of assistance. This information should be provided in a format and a manner that is consistent with the needs of the Regional Office. The Report should also describe the extent to which the existing DWSRF financial operating policies, alone or in combination with other State financial assistance programs, will provide for the long term fiscal health of the Fund, attain and maintain compliance with the Safe Drinking Water Act, and carry out other provisions specified in the legislation.

The State must submit a detailed financial report as part of the Biennial Report. At a minimum, the financial report shall include the financial statements and footnotes required under GAAP to present fairly the financial condition and results of operations. These financial statements should measure and demonstrate the DWSRF's ability to maintain its contributed capital. The financial report should follow generally accepted accounting principles and should follow enterprise fund reporting standards.

In addition, the State must establish in its DWSRF Biennial Report that it has:

- reviewed all DWSRF funded projects in accordance with the approved State Environmental Review Procedures;

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- deposited its match on or before the date on which each grant payment was made;
- made binding commitments to provide assistance equal to 120 percent of the amount of each grant payment within one year after receiving the grant payment, except for FY1997;
- managed the Fund in a fiscally prudent manner and adopted policies and processes which promote the long-term financial health of the Fund;
- complied with Agency grant regulations (40 CFR Part 31) and specific conditions of the grant;
- complied with Federal cross-cutting authorities that apply to the State as a Federal grantee and those which flow through to assistance recipients;
- provided assistance only to eligible water systems and for eligible purposes under section 1452; and
- funded only the highest priority projects listed on the IUP, according to their priority and readiness to proceed, and any procedures for by-passing priority projects on the IUP.

While the focus of the report should be on DWSRF Fund activities, the State should also include summary information about the use of funds provided in the capitalization grant for other eligible programs authorized by section 1452. The State must provide, in the biennial report, all information necessary to demonstrate that the State remains eligible to receive its full allotment of funds provided under section 1452(m). Information on the other eligible programs provided in the State's biennial DWSRF report shall not replace reporting requirements of other Agency program-specific guidance. At its option, the State may wish to incorporate by reference or attach copies of the most recent copies of other reports to the Agency describing progress under the other eligible programs.

2. Annual Audit

States will conduct annual audits in order to assure adequate financial management of the program.

The program requirements are being reviewed in the CWSRF and this section will be written to correspond with the CWSRF requirements.

3. Information Management System

In conjunction with the States, the Agency shall develop and implement an information management system which includes regularly updated data on projects receiving DWSRF assistance and other information on Fund status. To the extent practical, this system will be coordinated with the implementation of a similar effort in the CWSRF program. Once developed, States will be required to enter information into the information system. The Agency will have access to information in the system as needed, but will not be able to

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modify State-entered data. The Agency will use this information to assess the program on a national basis and to monitor State progress in years in which biennial reports are not required. In particular, the Regional Offices will use the information to assist in conduct of the annual reviews.

B. EPA Responsibilities

1. Annual Review of DWSRF

EPA will conduct annual reviews of each DWSRF to assess the success of each program in meeting the objectives of section 1452. See Appendix B for additional details.

2. Evaluation

The Administrator will prepare an evaluation of the effectiveness of the DWSRF program's operations through FY 2001 (section 1452(r)).

3. Compliance Assurance

The Administrator will develop guidance necessary to assure effective program management and to prevent waste, fraud, and abuse (section 1452(g)(3)). The Agency will assist the State in achieving and maintaining compliance with program objectives and requirements. There may be cases, however, when technical support may be insufficient or where a State may be reluctant or unable to correct identified problems. This section of the guidance outlines procedures and potential actions which may arise in cases of non-compliance.

If the annual review or audit reveals that the State has not complied with its capitalization grant agreement or other requirements under section 1452, the Agency will notify the State of such non-compliance and prescribe the necessary corrective action. Failure to satisfy the terms of the capitalization grant agreement, including unmet assurances or invalid certifications, is grounds for a finding of non-compliance.

In addition, if the State does not manage the DWSRF in a financially sound manner (e.g., allows consistent and substantial failures of loan repayments), the Agency may take corrective action as provided under this guidance.

In making a determination of non-compliance with the capitalization grant agreement and devising the corrective action, the Agency will identify the nature and cause of the problems. The State's corrective action must remedy the specific instance of non-compliance and adjust program management to avoid non-compliance in the future.

If within 60 days of receipt of the non-compliance notice, a State fails to take the necessary actions to obtain the results required by the EPA, or provide an acceptable plan to achieve the results required, the Agency may withhold payments to the DWSRF until the State has taken acceptable actions. Once the State has taken the corrective action deemed necessary and adequate by the Agency, the withheld payments shall be released and scheduled payments shall recommence.

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If the State fails to take the necessary corrective action deemed adequate by the Agency within twelve months of receipt of the original notice, any withheld payments may be deobligated and reallocated to other States. All future payments may be withheld from a State, and reallocated, until such time that adequate corrective action is taken and the Administrator certifies that the State is back in compliance.

4. Dispute Resolution

Any State applicant or recipient that has been adversely affected by an Agency action or omission may request a review of such action or omission. The procedures are codified in the Agency's general grant regulations at 40 CFR Part 31, Subpart F.

VII. APPENDICES

A. ANNUAL REVIEW

The purposes of the Annual Review are to (1) assess the success of the State's performance of activities identified in the IUP, the State's Biennial Report, the Operating Agreement (if used), and the DWSRF information management system, (2) determine how the DWSRF is achieving the intent of section 1452 and the overall goals and objectives of the SDWA as amended, (3) determine compliance with the capitalization grant agreement, and (4) assess the financial status of the DWSRF. The time period for conduct of Agency Annual Reviews is not connected to the period of award of Federal capitalization grants (i.e., Annual Reviews will continue even after Federal appropriations are no longer available).

EPA will complete an Annual Review of the IUP and the Biennial Report covering the same fiscal year according to the schedule established in the grant agreement (generally within 60 days of receipt of the Biennial Report in the year it is due, and approximately the same date on the year the biennial report is not due). After reasonable notice by EPA, the State or loan recipient shall make available to the EPA such records as the EPA reasonably requires to review and determine State compliance with the requirements of section 1452 of the SDWA as amended in 1996. EPA may conduct on-site visits as needed to provide adequate programmatic review. During years in which a State Biennial Report is not required, the Region will, to the extent practicable, obtain information necessary to conduct its Annual Review from the DWSRF Information System. If necessary, the Region will request the State to clarify information in the system or provide additional information. Requests for such supplemental information shall be kept to a minimum necessary for conduct of the Annual Review.

The State has lead responsibility for resolving project specific issues. If questions of waste, fraud or abuse arise, however, EPA may require project level review in some cases. In conducting its audits, the Office of Inspector General may find it necessary to review recipient records. In addition, in some cases, at the request of the State or another Federal agency, EPA may participate in the review or resolution of some issues related to compliance with cross-cutting Federal authorities.

Upon completion of its on-site Annual Review, the Regional review team shall conduct a brief exit interview with the State DWSRF program manager and other appropriate State staff summarizing principal findings of the review. Within a reasonable time, the review team shall prepare a draft Program Evaluation Report (PER) which will: (1) summarize findings of the on-site review, (2) provide comments on the State's Biennial Report (if appropriate), (3) highlight areas of concern and suggestions for improved program operations, and (4) note progress made on issues raised in prior year PERs and other correspondence with the State DWSRF manager. The Region shall submit the draft PER to the State for review and comment prior to preparing the final PER.

Identification and resolution of issues need not be limited to the Annual Review process. As the Region becomes aware of issues in DWSRF program operations, the Region shall consult with the State as appropriate. The Region shall assist the State in resolving DWSRF

program issues as requested by the State or when deemed necessary by the Region.

Prior to the on-site Annual Review visit, the State and Region may wish to consult on the scope, format, detail, and timing of the particular visit, which may vary somewhat from year to year. Note also that some topics may be reviewed while on-site, while other topics may be addressed based on a "desktop review" of information provided by the State or available in the DWSRF information system. For example, EPA staff may use DWSRF financial information to conduct financial analysis, including the preparation of financial ratios and indicators. There may be some areas of review which merit attention each year, whereas other topics may be addressed on a less regular basis, particularly once the DWSRF program becomes established. In general, the EPA review team will be reviewing the adequacy of State program management procedures and compliance with procedures as described in the State's capitalization grant application and Operating Agreement (if used). On a sample basis, it may be necessary to examine selected project files to complete the assessment.

The following is a list of review topics which may be included as part of the Annual Review:

Compliance/General Program Management

- Compliance with capitalization grant conditions and EPA grant regulations;
- Compliance with the State assurances incorporated in the capitalization grant agreement(s);
- Consistency of DWSRF program operations with the State's short and long term goals and objectives as reflected in the DWSRF capitalization grant application(s) and grant agreements;
- Coordination between the DWSRF and other State drinking water program management activities (e.g., source water protection, wellhead protection, capacity development, assistance to small systems);
- Compliance with requirements of section 1452 (e.g., eligibility of recipients, types of projects, and types of financial assistance provided); and
- Program administration costs; adequacy of staffing.
- Adequacy of State in filing timely "UCC Financing Statements" to ensure security on loans to private systems.

Pace of Program

- Status of binding commitments and progress in initiating and completing projects;
- Compliance with projections of Federal outlays and adequacy of efforts to manage outlays, both for the current year as well as the period covered by the Annual Review;
- Size of uncommitted fund balance.

Project Level Management

- Compliance with cross-cutting Federal authorities;
- Adequacy of State environmental review procedures (including consideration of mitigation, consultation with appropriate State and Federal environmental officials, and adequacy of project documentation);
- Adequacy of State procedures for reviewing assistance applicants' financial (financial

- capability and credit analysis), managerial and technical capabilities;
- Adequacy of State procedures to review proposed dedicated repayment sources and financial security demonstrations;
- Adequacy of loan agreements (e.g., inclusion of assistance terms; accounting, audit, and record keeping procedures; default management provisions; and compliance with applicable State and Federal requirements);
- Adequacy of on-going State oversight of the financial, managerial and technical capability of assistance recipients and appropriateness of State actions to resolve areas of concern.
- Consistency of assistance recipients with IUPs (e.g., names of recipients, assistance amounts, terms of assistance); and
- Adequacy of construction management oversight (e.g., change orders, compliance with applicable labor laws, adherence to schedule, record keeping).

Financial Management

- Adequacy of State financial management system (including documentation relating to Federal cash draws, deposit of State matching funds, posting of repayments and interest earnings);
- Timeliness of flow of funds to assistance recipients;
- Adequacy of financial statement of the DWSRF program;
- Adequacy of fund balance to meet financial responsibilities (e.g., current operating expenses, debt service payments, funding of reserves, long-term financial assistance needs);
- Comparison of actual expenditures to budget;
- Adequacy of State internal controls to prevent waste, fraud and abuse (e.g., processing of payments, financial accounting);
- Adequacy of loan portfolio management (including billing and collections, aging of accounts, actions to prevent payment default);
- Repayment record, including defaults and potential for defaults;
- Mix and relative risk of financial assistance types (e.g., various interest rates, guarantees, refinancings, disadvantaged community assistance);
- Adequacy and reasonableness of State fund investment practices;
- Appropriateness of State policies and strategies with respect to impacts on the long-term financial viability of the DWSRF account;
- Reasonableness of the disadvantaged community program and consistency of its implementation with the approved program; and
- Adequacy of the State's cash flow analysis, review of financial trends, and long term forecasting of project assistance needs.

B. Definition Section

Administrative Expenses - Costs incurred in managing and operating the SRF program. A State may use up to 4% of its allotment for program administration expenses.

Biennial Report - The State's SRF Report to EPA which contains information on how the State has met the goals and objectives of the previous two fiscal years as stated in the Intended Use Plan and grant agreement.

Annual Review - EPA's assessment of the success of a State DWSRF program.

Appropriations - Statutory authority that allows Federal agencies to obligate funds and make payments from the Treasury for specified purposes.

Assurances - Certifications or pledges by the State that it will meet the requirements of the SDWA and other requirements of the program.

Automated Clearing House - A federal payment mechanism that transfers cash to States and other recipients of Federal assistance using electronic transfers from the Treasury through the Federal Reserve System.

Bank/Banking - Crediting amounts (contributed by the State to SRF eligible projects or activities) to the SRF in excess of amounts required towards meeting certain requirements of future capitalization grants.

Binding Commitment - A legal obligation by the State to a local recipient that defines the terms and the timing for assistance under the SRF.

Capitalization Grant - The assistance agreement by which EPA obligates and awards funds allotted to a State for purposes of capitalizing that State's revolving fund and funds for other purposes authorized in section 1452.

Capitalization Grant Application - An application for Federal assistance submitted by a State, which in addition to the application form includes an Intended Use Plan, proposed payment schedule, and operating agreement or other documents describing how the State intends to operate its SRF.

Certification/Certify - Documentation signed by the responsible party that specific requirements or standards have been or will be met.

Community Water System - A public water system that: (a) serves at least 15 service connections used by year-round residents of the area served by the system; or (b) regularly serves at least 25 year-round residents.

Cross-cutting Authorities - Federal laws and authorities that apply by their own terms to projects or activities receiving federal assistance.

Default - Failure to meet a financial obligation such as a loan payment.

Debt Obligation - A legal obligation or liability to pay something to someone else.

Disadvantaged Community - The service area of a public water system that meets affordability criteria established after public review and comment by the state in which the public water system is located.

Disbursement - The transfer of cash from the SRF to the assistance recipient.

Disbursement Schedule - A quarterly schedule of estimated disbursements from the SRF.

Eligible System - Community water systems, both privately or publicly owned, and nonprofit noncommunity water systems.

Environmental Review - An environmental review process conducted by States that complies with 40 CFR Part 6, Subpart E or an alternative "NEPA-like" state environmental review.

Equivalency Projects - Projects that must total the amount equal to the federal capitalization grants and must comply with environmental review requirements and federal cross-cutting authorities.

Financial Health/Integrity - The ability of the DWSRF to address SDWA needs and to be continually available to meet future needs.

Guarantee - A promise to provide municipal bondholders with full and timely payment of principal and interest on the municipal debt obligation to the limit of the guarantee, in the event of default by the municipality.

Intended Use Plan - A document prepared each year by the State, which identifies the intended uses of the funds in the SRF and describes how those uses support the goals of the SRF.

Leveraging - The use of the capitalization grant as the security for the sale of State bonds. Leveraging does not include State financing arrangements in which repayment streams, rather than capitalization grant or ACH are used as the primary security for the bond issue.

Loan - An agreement between the DWSRF and the local recipient through which the SRF provides funds for eligible assistance and the recipient promises to repay the principle sum back to the SRF over a period not to exceed 20 years, except for disadvantaged communities that may receive a loan for up to 30 years (that does not exceed the life of the project), at an interest rate established at or below market interest rates (may be interest free).

Noncompliance - Failure to satisfy the terms of the capitalization grant agreement, including unmet assurances, invalid certifications, or failure to manage the DWSRF in a financially sound manner.

Noncommunity Water System - A public water system that is not a community system.

Nonprimacy States - States that do not exercise primary enforcement responsibility for public water systems.

Operating Agreement - An optional document in which the State may establish the basic framework and procedures of the DWSRF that are not expected to change annually.

Payment/Payment Schedule - A payment is an action by EPA to increase the amount of funds

available for cash draw in the Automated Clearing House. A payment is not a transfer of cash to the State, but only an authorization making funds available for transfer to the State when a cash draw request is submitted. A payment schedule, indicating the timing and size of the payments to be made, will be agreed upon by EPA and the State based on the State's projection of binding commitments.

Refinancing - Purchase of a previously executed debt obligation where initial debt was incurred and construction initiated after July 1, 1996.

Set-Aside - Non-project use of allotted State funds for a range of specific SDWA related activities identified in Section 1452, to encourage source water protection and other State drinking water program activities..

State Match - Funds equaling at least 20% of the amount of the capitalization grants which the State must deposit into the DWSRF Fund. The State must also provide a 10% match if the State uses the 1452(g)(2) set-aside.

