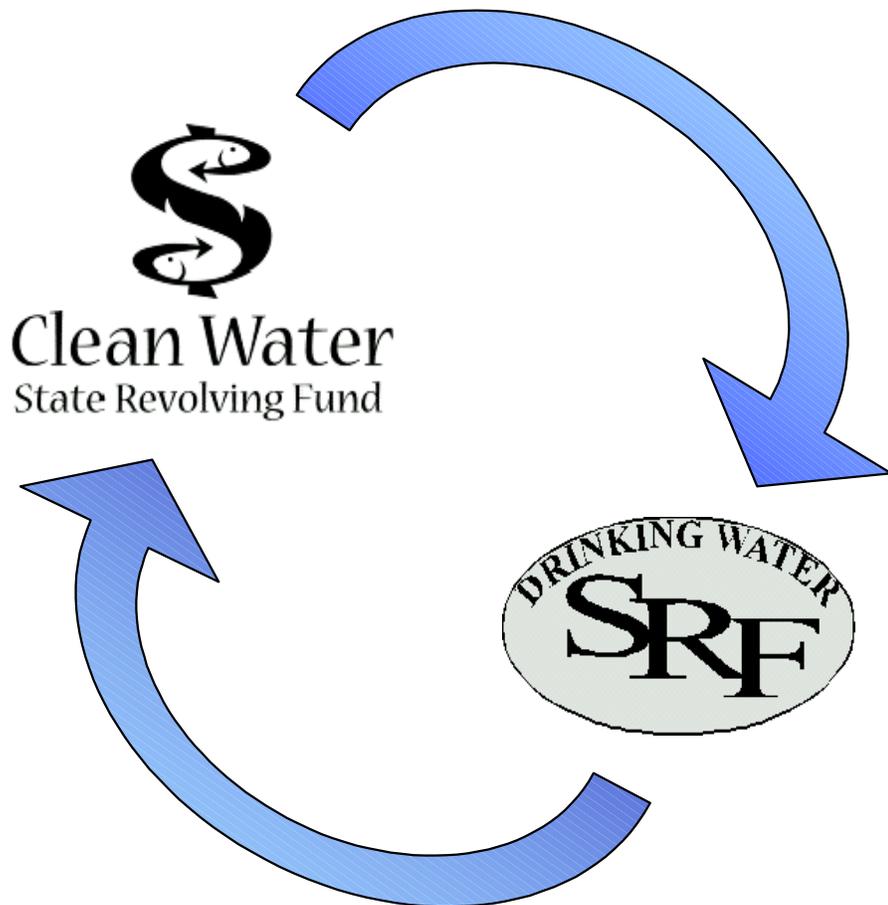




Implementation of Transfers in the Clean Water and Drinking Water State Revolving Fund Programs

Report to Congress



Executive Summary

Many communities across the nation face the challenge of making important investments in infrastructure to protect water quality and human health. The Clean Water and Drinking Water State Revolving Fund (SRF) programs, authorized by Congress in 1987 and 1996, respectively, have been important tools in helping states address these needs. Through the Clean Water SRF (CWSRF) program, states have provided more than \$26 billion in assistance for publicly-owned wastewater treatment work projects and a variety of projects addressing non-point source pollution and pollution confronting estuaries on our coasts. States have provided more than \$2 billion in assistance to address important projects needed to protect public health using the newer Drinking Water SRF (DWSRF) program. States have also reserved more than \$400 million from DWSRF grants to conduct state activities that support protection of the sources of drinking water and encourage enhanced water system management.

The 1996 Safe Drinking Water Act (SDWA) Amendments, which authorized the DWSRF program, included a provision allowing states to transfer up to 33 percent of their DWSRF grant to their CWSRF program, or an equivalent amount from their CWSRF program to their DWSRF program. The goal of the provision was to give states flexibility to address the most critical demands in either program at a given time. The provision allowed states to make transfers through September 30, 2001 and required that EPA report on use of the provision within four years of passage of the SDWA Amendments.

EPA is recommending that Congress continue to authorize transfers between the two SRF programs in order to give states flexibility to address their most pressing water infrastructure needs. This can be accomplished by removing the sunset date of September 30, 2001 from the provision.

Through April, 2000, five states had used the provision to transfer funds from their CWSRF programs to their DWSRF programs. After determining that a transfer would not impact their ability to fund important CWSRF projects, these five states (New York, New Jersey, Colorado, Maryland and Montana) transferred approximately \$83 million of CWSRF funds to address DWSRF projects. Each state appreciated the flexibility that transfers allowed them in addressing immediate drinking water demands for funding. Several other states have indicated an

intent to transfer funds between the two programs prior to October, 2001. Other states indicated that they were less likely to transfer funds due to a concern that funds could not be returned to the donating SRF prior to the sunset date.

Allowing transfers to continue into the future will give states another tool in addressing the great needs which exist in both the clean water and drinking water arenas. States have demonstrated that transferring funds requires a thorough decision-making process. Extending the ability to transfer into the future will allow them to better manage their drinking water and clean water projects in the short-term because they will be assured that transferred funds can be returned to either program in the long-term.

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Part I

Introduction and Background

One of the greatest challenges facing state and local leaders in the United States is the need to ensure adequate infrastructure for the citizens of the communities they serve. This infrastructure includes that needed for transportation, drinking water and wastewater. Much of the infrastructure in this country has been financed with the assistance of the federal government, with several federal agencies responsible for various infrastructure financing programs. During the mid-1900's, the wastewater needs in the country increased significantly as populations grew and spread out from urban centers. During the 1970's and 1980's the Construction Grants program, authorized by Congress and the Clean Water Act, provided grants to communities for the construction of publicly-owned wastewater treatment projects. The EPA Construction Grants program awarded \$50 billion in funds between 1972 and 1990 which resulted in the construction of, or improvements to, more than 10,000 wastewater facilities throughout the country.

In the late 1980's Congress began to consider a new way of providing assistance - one which would both encourage the recipients of assistance to more fully participate in the financing of infrastructure and provide a long-term source of funding that would not be dependent on federal contributions. In the Clean Water Act (CWA) Amendments of 1987, Congress authorized the Clean Water State Revolving Fund (CWSRF) program and changed the course of financing for wastewater infrastructure. Unlike EPA's construction grants, which provided direct assistance to communities for the construction of wastewater infrastructure, CWSRF grants are made to states. States use the grant funds to establish revolving loan Funds and are responsible for selecting which projects receive assistance - primarily in the form of loans, not grants. Repayments from the loans that are made return to each state's revolving Fund to provide additional assistance. Since the first grants were awarded in 1988, EPA has made available more than \$17 billion in grants to states to capitalize their CWSRF programs. Every state is required to contribute to the establishment of its state revolving Fund by providing a match equal to 20 percent of the grant. These Funds, which provide low-interest loans and other types of assistance to eligible projects, have in turn provided more than \$26 billion in assistance through June 1999.

Building on the success of the CWSRF program, Congress authorized the Drinking Water State Revolving Fund (DWSRF) program in the 1996 Amendments to the Safe Drinking Water Act (SDWA). Although there are significant differences between the two programs, Congress largely modeled the DWSRF program on the CWSRF program. Congress also expressed its intent for the two programs to work together by including a provision in the SDWA giving states the flexibility to transfer funds between the two programs to address their needs and priorities. States are allowed to transfer an amount equal to 33 percent of their DWSRF capitalization grant to the CWSRF program, or an equivalent amount from the CWSRF program to the DWSRF program. The SDWA included a sunset provision that does not allow for transfers beyond the end of fiscal year 2001 (Appendix A).

This report, required by the SDWA, describes implementation of the transfer provision in the CWSRF and DWSRF programs. An overview of the two SRF programs and a description of the linkages between them follows below. Part II discusses the policy that was developed to administer the transfer provision. Part III reviews the states that have transferred funds, including a discussion of their decision-making process. Finally, Part IV provides an assessment of the transfer provision and EPA recommendations for continuation of the provision.

Background

CWSRF Program

As noted above, the CWSRF program was initiated in 1988 and is widely viewed as a government success story. Although the program was only authorized to receive appropriations through 1994, appropriations have continued to the present. The CWSRF fiscal year 2000 budget included \$1.35 billion for states - bringing the total amount appropriated for the program to \$17.0 billion. Appropriated funds are allotted among the states using a formula included within the Clean Water Act.

<p>Examples of Projects Funded by the CWSRF</p> <ul style="list-style-type: none">- wastewater treatment plants- combined sewer overflow projects- projects to address non-point sources of pollution, including:<ul style="list-style-type: none">- septic systems- agricultural best management practices- brownfield remediation- estuary management projects
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The CWSRF program provides financing for traditional wastewater treatment projects, as well as estuary and non-point source projects that have been identified in state Comprehensive Conservation and Management Plans and Nonpoint Source Management Plans. In recent years, state CWSRF programs have increased their use of

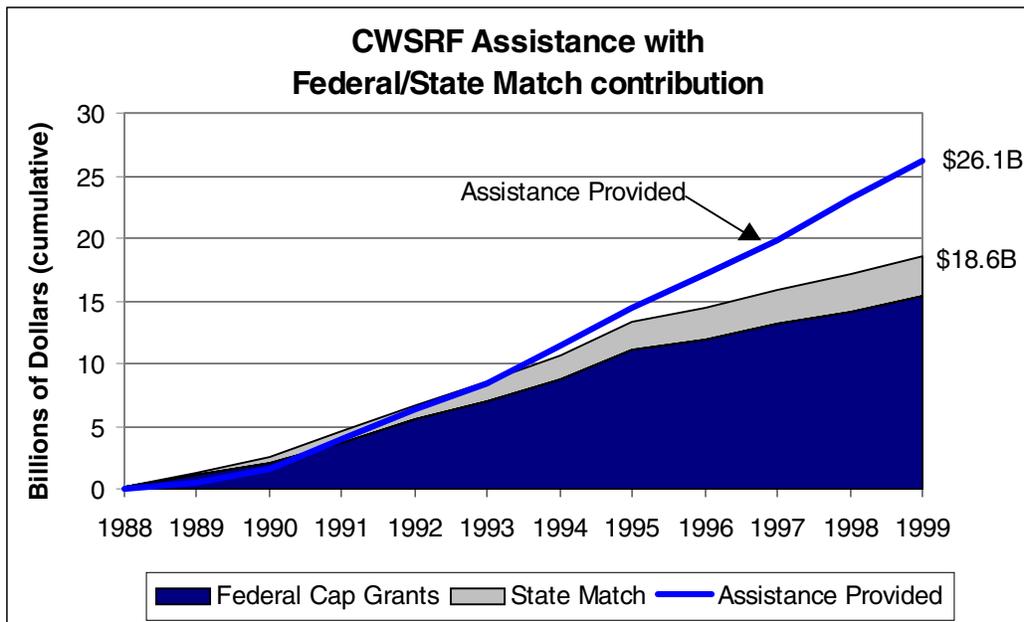
funds for projects that address non-point sources of pollution. While the CWSRF program has gone a long way in providing needed infrastructure and non-point pollution assistance, the needs remain daunting. The 1996 Clean Water Needs Survey identified a need of \$140 billion over the subsequent 20 years for wastewater treatment and other SRF eligible projects. The 1996 survey did not include most types of non-point source pollution needs. The next survey, recently initiated and scheduled for a November 2001 release, will include needs associated

with several types of non-point source pollution. Additional studies of clean water needs have been conducted, including the 2000 Water Infrastructure Network (WIN) report *Clean and Safe Water for the 21st Century* which suggests that needs may far exceed those identified by EPA. The WIN report indicates that \$23 billion per year in capital investments will be needed over the next 20 years for building new, and replacing old, wastewater facilities.

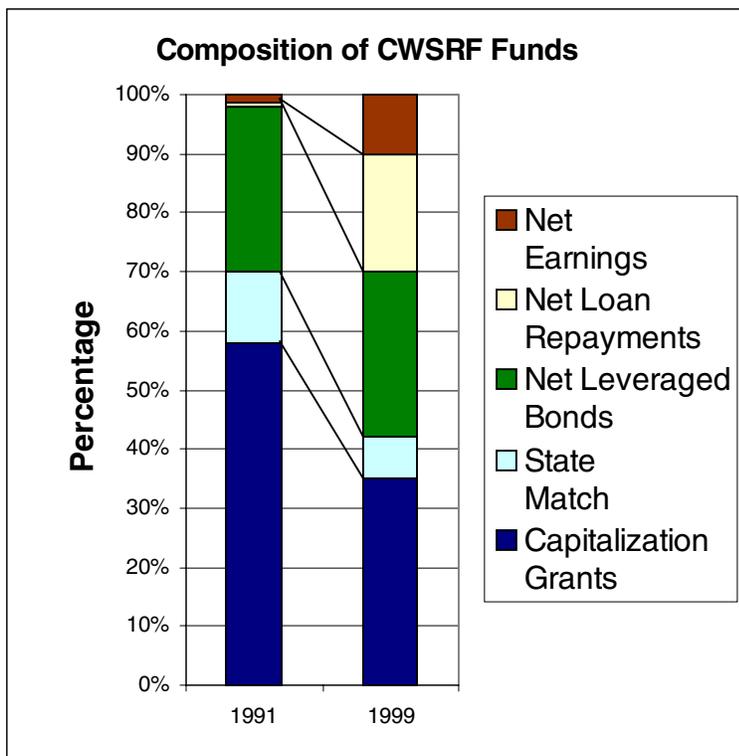
The CWSRF program provides loans to eligible recipients with interest rates that range between zero and market rate. Loan terms are limited to 20 years. States can also provide other types of assistance including refinancing of existing debt, purchase of debt, guarantees, and insurance. Many states have increased the amount of funding available for projects through issuance of bonds (i.e. leveraging). The financial community has high regard for SRF programs and has assigned AAA ratings to most of the SRF debt issued by state programs.

National CWSRF Program

Appropriated (1988-2000)	\$17.0 billion
Required state match	\$3.4 billion
Information through June 30, 2000	
Awarded grants	\$16.7 billion
Administration	4 percent
Information through June 30, 1999*	
Cumulative Assistance	\$26.1 billion
Cumulative Agreements	8208
Assistance in SFY 1999	\$3.4 billion
Agreements in SFY 1999	1281



*Information from CWSRF National Information Management System, an annual collection of data from states on a July-June state fiscal year (SFY) basis. States that are not on a July-June fiscal year are asked to report based on a July-June year. FY2000 data will be available in November 2000.



All repayments and investment earnings must return to the Fund to ensure that there is a long-term source of funding for assistance.

The concept of the revolving fund, while not new, has been shown to be impressive. Funds available in the program as of June 30, 1999 include \$15.4 billion in awarded capitalization grants, \$3.2 billion in state match, and an additional \$7.8 billion in proceeds from bonds issued to increase the amount of funding available for projects. The federal investment of \$15.4 billion, coupled with these other sources, has resulted in more than \$26.1 billion in assistance. The figure to the left shows the composition of CWSRF funds in 1991 and 1999.

Note the increasing influence of repayments relative to the contribution of the federal government. These funds are revolving, and the President's fiscal year 2001 budget request keeps EPA on track to meet the Administration's goal to capitalize the CWSRF program to revolve at a level of about \$2 billion in financial assistance annually over the next several decades while providing approximately \$3 billion in total annual assistance over the next several years.

DWSRF Program

The DWSRF program, established as part of the 1996 SDWA Amendments and authorized through 2003, was designed to be used by states as a flexible and comprehensive tool to provide funding for drinking water infrastructure and state and local activities needed to ensure the provision of safe drinking water. Congress also included provisions designed to help solve the compliance needs of small and financially distressed communities. The first state grant was awarded in March 1997. Through fiscal year 2000, Congress had appropriated \$3.6 billion for the program, including \$820 million for fiscal year 2000. EPA estimates that, with the \$9.6 billion in funding that has been authorized for the program, states will be able to provide more than \$500 million in annual assistance to eligible projects through 2035.

Infrastructure funding assistance can be provided for eligible drinking water projects that protect public health, ensure compliance with the SDWA, and assist systems most in need on a per household basis according to state affordability criteria. States are required to rank projects according to these three criteria and offer funding to those that rank highest. States are required to pro-

vide a minimum of 15 percent of available funds to small systems that serve fewer than 10,000 persons, to the extent such funds can be obligated for eligible projects of public water systems. It is impressive to note that most states have significantly exceeded this minimum requirement.

The types of assistance that can be provided from the Fund are generally the same as that provided for in the CWSRF program. However, a significant difference is that each state may use an amount equal to 30 percent of its capitalization grant to provide additional subsidies, generally in the form of principal forgiveness, to systems that the state has identified as disadvantaged, or likely to become disadvantaged as a result of the

project, using state-determined affordability criteria. States can also extend loan terms for these disadvantaged communities to up to 30 years, provided that the loan term does not exceed the useful life of the facility.

Each state may also set aside up to 31 percent of its capitalization grant to fund programs and activities that support the state's drinking water program, enhance the management ability of water systems, and protect sources of drinking water. States have generally been conservative in their use of set-asides due to the need for funding infrastructure projects. Approximately 17 percent of the grant funds that had been awarded through June 30, 2000 were reserved to conduct set-aside activities.

States faced challenges in the first three years of implementation of the DWSRF program. Over a short period of time, they had to obtain legislative authority for the program, promulgate regulations, develop priority systems for ranking projects and begin identifying projects for funding. Agencies responsible for DWSRF programs that are unfamiliar with the CWSRF program, or financing programs in general, have been especially challenged in implementation of their programs. States have also found that many public water systems, particularly those that are small, require a significant amount of time to prepare for construction of needed projects. However, notwithstanding the challenges, the progress of the program is impressive. Almost 1200 loans have closed since the first loan was made in April 1997. Translated into dollars, more than \$2.3 billion has been provided for important projects needed to ensure the continued provision of safe drinking water.

National DWSRF Program*	
Appropriated (1997-2000)	\$3.6 billion
Required state match	\$716 million
Information through June 30, 2000	
Awarded grants	\$2.7 billion
Set-Asides	17 percent
Cumulative Assistance	\$2.3 billion
Cumulative Agreements	1192
Assistance in SFY 2000	\$1.0 billion
Agreements in SFY 2000	555

*Information reflects data collected from states on a quarterly basis pending completion of DWSRF National Information Management System. Additional program data through state fiscal year (July-June) 2000 will be available in November 2000.

The needs for the drinking water community are significant. The first Drinking Water Infrastructure Needs Survey Report to Congress released in January 1997 identified more than \$138 billion (1995 dollars) in needs for the years 1995 through 2015. The next survey is scheduled for release in February, 2001. The 2000 WIN *Clean and Safe Water for the 21st Century* report indicated that \$24 billion per year in capital investments will be needed over the next 20 years for building new, and replacing old, drinking water facilities.

DWSRF-CWSRF Linkages

Congress recognized that in some states the responsibilities for administering the two SRF programs would be shared. While the responsibility for setting priorities and carrying out oversight of the DWSRF program remains with the agency with primary enforcement responsibility for the drinking water program, the financial administration of the program can be shared with other state agencies. In many states, the same agency that administers the CWSRF program shares responsibility for the financial administration of the DWSRF program. For example, in the State of New York, the Department of Health is responsible for programmatic DWSRF areas and the Environmental Facilities Corporation (NYSEFC), which also works with the CWSRF program, handles the financial portion of the DWSRF program. The NYSEFC administers the program's loan portfolio, monitors the Fund, and reviews the financial capacity of applicants. The partnership has proven to be successful as the NYSEFC has leveraged federal DWSRF capitalization grants to more than triple the amount of assistance than would have otherwise been provided. Additional information about the New York program is provided in Part III of this report.

For those states that leverage, a high credit rating from the financial community ensures a lower and more affordable interest rate for borrowers. Therefore, ensuring the strength of the portfolio of projects supporting the bond issuance is a matter of critical importance. In order to allow states to capitalize on the strength of either SRF program, Congress included language in the 1999 Appropriations Act indicating that states could "cross-collateralize" the two SRFs to increase the security of bond issuances. Generally, state bond issues can be used to support the other program with the proviso that revenues from the bonds be allocated to the respective funds in the same portion as they were used for security for the bonds. By taking advantage of the cross-collateralization provision, several states, including Colorado, New Jersey, Missouri, Maine, Arizona and Minnesota, have been able to obtain higher bond ratings (and thus, lower interest rates) for SRF financings. An additional discussion of the use of this provision has been provided in Appendix B to this report.

The most important linkage is the provision in Section 302 of the 1996 SDWA Amendments that allows states to transfer funds between the two SRF programs (Appendix A). Congress recognized that some states would want the flexibility to operate their SRF programs in a manner that would allow one to support the other to address their most pressing needs. The provision allows the Governor of the state to transfer an amount equal to 33 percent of the DWSRF grant to the CWSRF program or an equivalent amount from the CWSRF to the DWSRF program. States were required to wait until one year after establishing

their DWSRF Fund before making a transfer and can only make transfers prior to fiscal year 2002 (i.e., prior to October 1, 2001). An additional restriction in the SDWA disallows states from using transferred funds to provide the required 20 percent state match for either program. Through April 2000, five states (New York, New Jersey, Maryland, Colorado and Montana) had made use of the transfer provision to address demand in their drinking water programs. Their experiences are addressed in Part III of this report.

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Part II

Implementation of the Transfer Provision

In consultation with states, EPA developed a policy to implement the transfer provision that would give maximum flexibility to states to allow them to best manage the needs facing both SRF programs. The policy was published in the *Federal Register* on October 13, 2000 (65 FR 60940). The major requirements were also codified in the DWSRF program regulations published in the *Federal Register* on August 7, 2000 (65 FR 48286). This section reviews the requirements outlined in the statute and policy EPA developed to give states guidance in making use of the provision. The complete policy can be found in Appendix C.

Authorized Provisions

In accordance with the SDWA, funds can only be reserved and transferred prior to fiscal year 2002 (i.e., October 1, 2001). A State was required to wait until one year had elapsed after it established its DWSRF Fund (i.e. one year after award of the first DWSRF capitalization grant for Fund projects) before making a transfer. For example, if a DWSRF Fund was established on October 31, 1997 with the award of a capitalization grant, the first day funds could be transferred was November 1, 1998.

The amount of the DWSRF capitalization grant, including any portion awarded for set-aside activities, determines the amount of funds that can be reserved and transferred. The Governor of the State may reserve an amount equal to 33 percent of the DWSRF capitalization grant and transfer the funds to the CWSRF program. Alternatively, the Governor may reserve funds from the CWSRF in an amount equal to no more than 33 percent of the DWSRF capitalization grant and transfer those funds to the DWSRF program.

Policy

Types of Funds

Section 302 utilizes the DWSRF capitalization grant to calculate the amount of funds that can be transferred, however, this does not limit states to

transferring only those funds that are part of the capitalization grant. States may transfer any monies that are in the Fund, including federal capitalization grant dollars, state dollars, repayments, and investment earnings. In order to provide states with maximum flexibility, states were also allowed to use fiscal year 1997 grants in determining the amount of funds that could be transferred, although states were required to wait one year after establishing their DWSRF Fund before making a transfer.

Reserving Authority to Transfer

States may elect to reserve the authority to transfer funds in one year, but not actually transfer those funds until some later time (but prior to October 1, 2001). This gives states flexibility to better plan for the use of funds. Reserving the authority to transfer funds does not mean that the state is holding cash in reserve for future use. Rather, the authority serves as a “credit” for future transfer. The amount of authority reserved can accumulate with each subsequent DWSRF capitalization grant. For example, a state may reserve the authority to transfer \$33 associated with two successive \$100 DWSRF capitalization grants. In the third year the state could transfer \$66 from its DWSRF program to the CWSRF program. As noted in the previous section, any monies in the Fund totaling \$66 could be transferred.

Transferring on a Net Basis

A state may account for transfers on a net basis such that it can “loan” funds to its sister program by transferring funds knowing that it can transfer an equal amount of funds back into its program prior to October 1, 2001. The state need only ensure that it has not exceeded the 33 percent ceiling on transfer of funds. This provision was intended to allow states to address the highest priority projects at any given time. For example, a state may need additional funds in the DWSRF program because it lacks the financial resources to address an expensive drinking water project. However, the state may be reluctant to transfer funds from its CWSRF program because it will need those funds in the future to address important non-point source pollution projects. In order to allow states to address their most pressing needs, the policy allows for transfers on a net basis.

Requirements and Limitations

Calculation of State Match and Set-Asides

Because a transfer occurs after award of a capitalization grant, it does not affect the calculation of state match, set-asides calculations in the DWSRF program, or the administration (4 percent) or 604(b) calculations in the CWSRF program. The state match requirement for both programs is 20 percent of the capitalization grant. For example, if a state determines that it will transfer 33 percent of a \$10 million grant from the DWSRF program to the CWSRF program, the amount of the grant remaining for the DWSRF program would be \$6.7 million. However, the 20 percent match requirement for the DWSRF program would remain \$2 million, it would not decrease to \$1.34 million. Similarly, the CWSRF

program would not have to provide additional match for the \$3.3 million transferred into its program. Section 302 also stated that funds transferred under the provision cannot be considered as the required state match for the capitalization grant in either program. The transfer provision also cannot be used to acquire state match or serve as a source of security or repayment for state match bonds.

Set-aside ceilings in the DWSRF program are calculated based on the amount of the state's allotment or capitalization grant. Ceilings are not recalculated as a result of transferring funds. Thus, for the example above, the maximum amount of the grant that the state could reserve for set-asides (i.e., 31 percent) would not decrease to \$2.1 million, but would remain \$3.1 million.

Likewise the 4 percent ceiling on use of the CWSRF Fund for administration is based on the capitalization grants awarded. Therefore, the calculation does not change as a result of a transfer. Using the same example, for the \$3.3 million transferred into the CWSRF program, the state would not be able to use 4 percent of that amount, or \$0.13 million, for administration of the program, because the ceiling is based on the capitalization grants for the CWSRF program and does not include funds transferred into the program.

Project Funding for Small Systems in the DWSRF Program

The SDWA includes a provision requiring that states provide a minimum of 15 percent of available funds credited to the Fund to small systems serving fewer than 10,000 persons, to the extent that funds can be obligated to eligible projects. Funds transferred into the DWSRF Fund are considered to be part of the "available funds credited to the Fund" and as such are subject to the small systems provision.

Transferring Federal Funds

There are specific requirements which are attached to the use of federal funds in state SRF programs. If a state transfers federal funds and the associated state match, it can complicate the analysis of whether a state is complying with these requirements. In the SRF programs, federal capitalization grant dollars are deposited into the Fund where those dollars mix with state monies, repayments, and investment earnings. Because many states do not identify the source of money disbursed to a recipient (since every disbursement likely represents a mixture of funding), states must identify projects funded in an amount equal to the capitalization grant and apply applicable requirements to those projects. States must identify whether the transferred amount consists of federal dollars to which these requirements will apply and maintain sufficient procedures to ensure proper accounting for transferred dollars.

The policy included in Appendix C outlines the requirements that transferred funds are subject to if they are identified as federal dollars. These include requirements relating to the period over which states may accept payments of capitalization grant funds and obligate those funds (including state match).

States must also ensure that identified projects meet the requirements of other cross-cutting federal laws (e.g., Endangered Species Act, National Historic Preservation Act, etc.) in the same manner as they apply to capitalization grant funds in the SRF program. If a state transfers non-federal funds (i.e., principal and interest repayments, investment earnings), it may be able to reduce the number of requirements that apply to transferred funds, and thus reduce the burden on recipients of assistance.

Reporting

States are required to develop an annual Intended Use Plan (IUP) for both SRF programs that describes how funds are to be used in the program for that year. The IUP must be made available for public review and comment. If a state chooses to transfer funds it must describe the type of funds that will be reserved and/or transferred and identify how those funds will be used. The IUP must disclose how and why decisions were made to transfer funds by, for example, discussing the wastewater and drinking water needs in a effort to show the public that the highest priority projects are being funded.

States are also required to produce reports describing how funds in the program have been expended. The CWSRF program requires an Annual Report, while the DWSRF program requires a Biennial Report. With respect to transfers, these reports must identify the amount of funds transferred between the two programs and describe how those funds were used. The state must also report transfers in the financial statements of the SRF programs, with corresponding footnotes identifying the type of funds transferred.

Part III

Transfers in the SRF Programs

The Clean Water and Drinking Water Needs Surveys and related studies show that the needs confronting both the drinking water and clean water communities are considerable. While the amount of funding provided through the SRF programs is great, it cannot fund all of the documented needs. SRF program managers must assess the total needs in the state and target limited resources to those with the highest priority. As they make program decisions, state SRF managers must also consider the relative demand for funding. This demand can be affected by external factors (e.g., favorable interest rates in the private or municipal lending sectors, grant programs) or internal factors (e.g., readiness of projects targeted for SRF funding to proceed with construction). If the demand for funding exceeds the availability of funds in the program, states can make decisions that will increase the funds available for projects. For example, many states have increased the amount of funds available for their programs by issuing bonds secured by SRF funds (i.e. leveraging).

A state that makes the decision to increase the amount of available funding by transferring funds from one program to the other must weigh the relative needs in each program with the demand in each program and balance the impacts that any transfer will have on both programs. As of May 2000, five states - New York, New Jersey, Maryland, Colorado and Montana - had considered their needs and demand and made the decision to transfer funds. In each state, funds were moved from the CWSRF program to the DWSRF program. Four of the states chose to transfer non-federal funds, while one transferred capitalization grant funds. This section will provide a discussion of the process each state went through to arrive at the decision to transfer funds and the impact of transferring monies on both SRF programs.

New York

The New York CWSRF and DWSRF programs are among the strongest in the nation. The CWSRF program is administered by the New York State Environmental Facilities Corporation (NYSEFC) in cooperation with the New York State Department of Environmental Conservation (NYSDEC). The DWSRF program is administered by the New York State Department of Health (NYSDOH) in cooperation with NYSEFC. As mentioned previously, NYSEFC is responsible for financial management of the Fund for both programs. Both programs issue

bonds to increase the amount of funding available for projects. As can be seen in the table below, the amount of additional funds that have been made available by leveraging is significant.

The needs in New York for drinking water projects are great. Given the lack of a significant source of funding for drinking water projects and system needs to meet current drinking water standards such as the Surface Water Treatment Rule, the state found that there was a significant demand, particularly for assistance to disadvantaged systems. The state's federal fiscal year 2000 DWSRF IUP, issued in September 1999, identified more than \$3 billion in projects. In 1996, the Governor signed the Clean Air/Clean Water Environmental Bond Act which authorized more than \$365 million in bonds to assist public water systems. This funding, combined with the funding made available through the DWSRF program, represented the first serious provision of funding to assist public water systems in the state. In order to address the particular needs of disadvantaged communities, the state included an additional \$90 million in funds to be used as grants. Yet, even with the additional state funds and funds derived by leveraging federal monies, the state found that it still could not meet the demand for funding.

In the CWSRF program, the state is currently able to fund every eligible project which is ready to be financed. Therefore, the state determined that it would transfer an amount equal to 33 percent of its fiscal year 1997 through 2000 DWSRF grants from the CWSRF program to the DWSRF program - a total of \$66.2 million. The state has already transferred \$49.98 million and will transfer

the remaining amount sometime in late 2000. Because the state will leverage these funds, it anticipates that a significant number of additional drinking water projects will be funded as a result of transfers. The direct impact of the transferred funds is that it allows New York to expand its fundable list of DWSRF projects to address a greater number of high priority projects. An additional benefit is that it allows the state to fund more disadvantaged/hardship community projects. Should the CWSRF program need additional funds to finance high

New York	CWSRF	DWSRF
Infrastructure needs	\$15.9B (1996-2016)	\$10.1B (1995-2015)
Allotment (as % of appropriation)	11.18%	6.33%
Grantee	NYSDEC	NYSDOH
Cooperating agency	NYSEFC	NYSEFC
	(thru 6/30/99)	(thru 6/30/00)
Federal grants	\$1.6B	\$200.5M
DWSRF Set-asides		\$22.8M (11.4%)
Net bonds issued*	\$3.5B	\$396M
Assistance agreements	508	130
Assistance dollars	\$4.0B	\$465M
Dollars transferred thru April 2000 (% of total assistance \$)	\$49.98M (1.2%)	

*Net bonds = Gross bonds - costs of issuance - debt service reserve

priority drinking water projects, the state will return transferred funds by September 30, 2001 (the sunset date for transfers). If the authority to transfer continues beyond the sunset date, New York will reevaluate the need to continue transferring based on an assessment of the relative needs of the DWSRF and CWSRF programs. The state strongly supports extending the transfer provision beyond fiscal year 2001.

New Jersey

Both of New Jersey's SRF programs are jointly administered by the New Jersey Department of Environmental Protection (NJDEP) and the New Jersey Environmental Infrastructure Trust (NJEIT). Both SRFs include leveraging, secured by a portion of SRF funds, to increase the amount of funding available for projects.

The demand for drinking water projects in New Jersey is significant. The draft DWSRF federal fiscal year 2001 IUP project priority list identified 200 projects totaling \$554 million. The Department found that the CWSRF financing program is currently able to fund all eligible projects meeting program requirements and deadlines. Therefore, the NJDEP made the decision to pursue a transfer of funds from the CWSRF program into the DWSRF program in the amount of \$9.2 million. A transfer of CWSRF non-federal funds to the DWSRF account was completed in October 1999, allowing the state to fund one large project. The amount transferred is equal to 14 percent of the state's fiscal year 1997-1999 DWSRF grants. An additional \$11.7 million may be transferred during the latter part of 2000, which will bring the transferred amount to 33 percent of the 1997-1999 DWSRF grants. The state will transfer funds in the future as long as it does not jeopardize its ability to fund clean water projects that are ready to proceed.

The state supports extending the transfer provision beyond the fiscal year 2001 deadline because it will enhance its ability to meet drinking water and clean water financing needs.

New Jersey	CWSRF	DWSRF
Infrastructure needs	\$7.0B (1996-2016)	\$3.6B (1995-2015)
Allotment as % of appropriation	4.14%	2.44%
Grantee	NJDEP	NJDEP
Cooperating agency	NJEIT	NJEIT
	(thru 6/30/99)	(thru 6/30/00)
Federal grants	\$776.8M	\$63.5M
DWSRF Set-asides		\$8.2M (12.9%)
Net bonds issued	\$546M	\$39M
Assistance agreements	161	21
Assistance dollars	\$1.1B	\$77.3M
Dollars transferred thru April 2000 (% of total assistance \$)	\$9.2M (0.8%)	

Maryland

The Maryland SRF programs are administered by the same office within the Maryland Department of the Environment (MDE). In 1988, the State of Maryland created the Water Quality Financing Administration (WQFA) within MDE to encourage capital investment for water quality activities. The WQFA oversees the CWSRF and DWSRF Funds and is authorized to issue debt to increase the amount of funding available for projects. The CWSRF program has leveraged funds to finance additional projects, however, the WQFA has determined that it will not leverage funds in the DWSRF program at this time.

Because the state has been able to fund all eligible projects that are ready to proceed in the CWSRF program during the last two years, it determined it was appropriate to transfer funds to the DWSRF program in order to finance more drinking water projects. An additional factor in making the decision to transfer was that the amount eligible for transfer was relatively small compared to the availability of CWSRF funds. To date, the state has transferred \$10.6 million, an amount equal to 33 percent of its fiscal year 1997-1999 grants, which it has targeted for 24 projects on the state's IUP. The transferred funds will primarily be used to make direct loans to small systems. If demand is sufficient, the state may pledge the direct loans to future bond issues to increase the amount of funding available for projects. Because the funds that were transferred consisted of non-federal funds, the state was able to streamline the funding process for many of the small systems receiving assistance because the funds were not

subject to the same requirements which apply to federal funds.

The state will make a determination on the need to transfer annually based on demand in both the CWSRF and DWSRF programs. The state supports extending the flexibility to transfer beyond the end of fiscal year 2001.

Maryland	CWSRF	DWSRF
Infrastructure needs	\$1.7B (1996-2016)	\$1.3B (1995-2015)
Allotment as % of appropriation	2.45%	1.00%
Grantee	MDE	MDE
Cooperating agency	MDE/WQFA	MDE/WQFA
	(thru 6/30/99)	(thru 6/30/00)
Federal grants	\$344.6M	\$30.2M
DWSRF Set-asides		\$7.9M (26.4%)
Net bonds issued	\$178M	no leveraging
Assistance agreements	142	14
Assistance dollars	\$377.8M	\$23.9M
Dollars transferred thru April 2000 (% of total assistance \$)	\$10.6M (2.8%)	

Colorado

The Colorado Water Resources and Power Development Authority (CWRPDA) is responsible for the financial administration of both Colorado SRF programs. Programmatic management of both programs is handled by the Colorado Department of Public Health and Environment (CDPHE). Like the other states discussed previously, Colorado has leveraged its SRF programs to significantly increase the amount of funds available for projects and has funded more than \$260 million in projects through its CWSRF program.

Colorado made the determination that it had sufficient funding in the short-term to fund those CWSRF projects that were ready to proceed to construction. The state has more than \$116 million in drinking water projects on its fiscal year 1999 priority/fundable project list. Although the state is already leveraging DWSRF capitalization grant funds to increase the number of drinking water projects it can fund, by transferring funds from the CWSRF to the DWSRF program, it will add to the pool of funds it uses for leveraging. Thus, the \$8 million in funds that the state transferred will be able to fund more than \$20 million in drinking water projects.

Because of restrictions in the statutes authorizing the SRF programs in the state, Colorado can only transfer federal funds. The state calculated the amount available for transfer from its fiscal year 1997 and 1998 DWSRF grants at \$8.7 million. The state determined that it would transfer \$8.0 million of the \$10.8 million fiscal year 1998 CWSRF grant. The transfer was completed in December 1999.

The transferred monies were used to fund three projects, including a loan to the town of Julesburg (pop. 1262), which was on a compliance schedule due to high nitrate levels. If the transfer date is extended, Colorado would revise its statute to allow non-federal funds to be transferred and would continue to make transfers until more CWSRF projects move into construction mode.

Colorado	CWSRF	DWSRF
Infrastructure needs	\$0.65B (1996-2016)	\$1.9B (1995-2015)
Allotment as % of appropriation	0.81%	1.00%
Grantee	CWRPDA	CWRPDA
Cooperating agency	CDPHE	CDPHE
	(thru 6/30/99)	(thru 6/30/00)
Federal grants	\$134.1M	\$46.8M
DWSRF Set-asides		\$8.6M (18.4%)
Net bonds issued	\$226M	\$86M
Assistance agreements	66	23
Assistance dollars	\$263.4M	\$135.5M
Dollars transferred thru April 2000 (% of total assistance \$)	\$8.0M (3.03%)	

Montana

The Montana CWSRF and DWSRF programs are both managed by the Montana Department of Environmental Quality (MDEQ). Financial management of the Funds is conducted by the Montana Department of Natural Resources and Conservation (MDNRC). Unlike the other states profiled in this report, the state has never leveraged to increase the amount of funding for projects, choosing instead to operate a direct loan program for both SRFs.

The state made a decision to transfer additional funds into the DWSRF program due to the excessive demand for financing of drinking water infrastructure improvements throughout the state. Cash flow modeling for both programs was performed by MDNRC to evaluate the short- and long-term impacts of transferring on both SRF programs. No significant impacts were identified since the state anticipates that it will return transferred funds to the CWSRF program to fund wastewater projects if it finds that wastewater infrastructure needs are not being met.

The state transferred \$4.9 million from the CWSRF to the DWSRF program in 1999, which represented the maximum 33 percent of the fiscal year 1997 DWSRF capitalization grant allowed for transfer. The state funded four additional projects using transferred funds, including a \$1.3 million loan for a project that constructed a surface water treatment plant for a previously unfiltered system. This loan is significant in that it made the project more affordable for the community and allowed the system to expand the use of current resources for operations and maintenance and other improvement needs. The state also intends to

transfer amounts equal to 33 percent of its fiscal year 1998 and 1999 DWSRF grants, which will bring an additional \$2.3 million and \$2.4 million, respectively, into the program for the construction of additional projects. Thus far the state has transferred non-federal funds, which has afforded the state more latitude in the use of the funds to meet the individual needs of communities. The state has only received supportive comments with respect to its decision to transfer and strongly supports continuing the provision beyond fiscal year 2001.

Montana	CWSRF	DWSRF
Infrastructure needs	\$0.3B (1996-2016)	\$0.7B (1995-2015)
Allotment as % of appropriation	0.50%	1.00%
Grantee	MDEQ	MDEQ
Cooperating agency	MDNRC	MDNRC
	(thru 6/30/99)	(thru 6/30/00)
Federal grants	\$63.1M	\$29.4M
DWSRF Set-asides		\$4.2M (14.4%)
Assistance agreements	47	21
Net bonds issued	no leveraging	no leveraging
Assistance dollars	\$57.8M	\$31.9M
Dollars transferred thru April 2000 (% of total assistance \$)	\$4.9M (8.5%)	

Future Transfers

While only five states had made use of the transfer provision prior to the spring of 2000, several others have indicated an interest in making use of the provision within the next year.

Illinois wants to extend its DWSRF program to privately-owned community water systems. However, the state issues tax exempt bonds for the program. To fund privately-owned water systems using these state bond proceeds would be complicated and restricted due to IRS rules controlling tax exempt bonds. Therefore, as part of its fiscal year 2000 SRF grant applications, Illinois plans to transfer state match funds from the DWSRF program to the CWSRF program and an equal amount of fiscal year 2000 federal capitalization grant dollars from the CWSRF program back into the DWSRF program. Because this is essentially a net-zero transfer, the state could still choose to transfer dollars from one program to another before the end of fiscal year 2001. If the provision is extended beyond the end of fiscal year 2001, the state will likely continue to transfer DWSRF state match dollars into the CWSRF program until such time that the repayment stream for the DWSRF program becomes sufficiently large enough to permit funding of all privately-owned public water systems using repayments.

Wisconsin plans to transfer non-federal funds from the CWSRF program to the DWSRF program as an alternative to leveraging the DWSRF program. The state leverages its state program that complements the CWSRF program and can adjust its bond issues to make up for funds that are transferred to the DWSRF program. While the state has not yet made a final determination on how much it will transfer, it plans to transfer an amount equal to 33 percent of the fiscal year 2000 and 2001 DWSRF grants, and may transfer an amount equal to the fiscal year 1998 and 1999 grants as well.

Alabama plans to transfer approximately \$13 million in non-federal funds during fiscal years 2000 and 2001 from the CWSRF to the DWSRF program. The amount is based on the maximum percentage allowed using fiscal year 1997 through 2000 DWSRF grants. The state has determined that the transfer will not have an adverse effect on the CWSRF's ability to fund projects. The CWSRF program has been able to fund all projects that have applied for loans, mainly through leveraging to meet demand. While the state also leverages its DWSRF grant funds to increase the amount available for funding, many of the projects that are ranked high on the state's priority list require direct loans because they are not of sufficient credit quality to be included in a bond pool. The funds that are transferred into the DWSRF program will allow the state to provide assistance to these high ranked projects and also access the projects with a stronger credit quality further down on the priority list.

Missouri has indicated that it will transfer \$10.5 million in non-federal funds from its CWSRF program to the DWSRF program this year as part of its application for fiscal year 2000 funds. This represents 20 percent of the state's fiscal year 1997 through 2000 DWSRF grants. The state is transferring funds to meet an excess in demand for DWSRF project assistance, however, the state hopes to return the funds to the CWSRF program at some point in the future.

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Part IV

Assessment and Recommendation

Thus far, the provision allowing transfers has proven to be most useful in allowing states to address the needs facing public drinking water systems. More than \$83 million has been contributed to the DWSRF Funds of the five states that have transferred to date. These funds will have a significant impact on helping these states address demand for drinking water projects, yet only represent 1.4 percent of the assistance the five states have provided for clean water projects since 1988. As with the provision that allows cross-collateralization for states issuing bonds to support their programs (Appendix B), transfers have given these states flexibility to use one SRF to support the other in meeting needs and demand. Should the provision be continued beyond the fiscal year 2001 sunset date, additional states may take advantage of the flexibility the provision allows them in addressing their most pressing public health and water quality needs.

States that have not transferred were asked whether they had considered using the transfer provision thus far in their SRF programs. Roughly one-half of the 23 states responding had considered transfers. The most frequently cited reason for not transferring was that demand for both programs within a state exceeded the funding available for projects. When posed the question as to whether they would consider transferring at some point in the future, roughly one-half of the respondents indicated that the program would consider transfers in the future. Other respondents indicated that they were not likely pursue transfers in the future due to the great need for funding both programs or because the programs were in different agencies.

Obstacles

The policy developed by EPA to implement the transfer provision removed some of the obstacles that states could have faced in making decisions to transfer. For example, by allowing transfers on a net basis, EPA facilitated transfers because states can move funds from one program to the other with the assurance that an amount equal to those funds can be returned to the donor SRF at some point prior to September 30, 2001. EPA also allowed states to transfer any funds within their SRFs rather than just federal capitalization grant dollars. This allowed States to relieve certain recipients from having to comply with the requirements associated with the federal dollars in the SRF programs.

One of the primary factors affecting the decision to transfer is where the SRF programs are managed within the state. The five states discussed in this report either had the SRF programs within the same agency or had one agency that conducted financial management for both SRFs. When the same agencies are involved in the decision-making process, it allows for better communication and a more comprehensive look at needs and demands across the two programs. When the SRF programs are housed in entirely different agencies (e.g., Department of Health vs. Department of Environmental Quality), with different management chains, it becomes more difficult to consider moving funds from one program to the other.

Ensuring that adequate funds are available to administer SRF programs has been an issue in several states, particularly those states that leverage funds to increase the amount available for projects. Both SRF programs allow states to use four percent of their capitalization grant for administration of the program. However, if a state leverages, transfers funds or simply has a large balance of funds available due to repayments, the amount of funding provided by an amount equal to four percent of the grant may not be sufficient to maintain a large loan portfolio. Many states have made the decision to impose fees on borrowers to increase the amount of funds available for administration. One program indicated that a factor it considered in deciding not to transfer was that a large influx of funding would tax a small staff that is sufficiently challenged by maintaining the loans provided within the existing framework.

Suggested Improvements

Colorado found the experience of transferring federal funds to be a challenge and is moving to make changes to state law that would allow the state to transfer non-federal funds in the future. However, none of the five states that have transferred funds to date had specific recommendations about how to improve implementation of the provision. Their only recommendation, which was echoed by states that did not elect to transfer, was that the provision be extended beyond the fiscal year 2001 deadline.

Several states recommended that EPA allow a state that transfers funds to use some amount to administer the loans that will be made from those funds. This issue is difficult to address. The enacting legislation for the CWSRF program allows a state to use a portion of their Fund to administer the program, but clearly caps this use at an amount equal to four percent of the state's capitalization grants. The DWSRF program enacting legislation does not allow states to use a portion of the Fund for administration, but allows states to set aside four percent of their allotment for that purpose. EPA believes that it has given states sufficient flexibility to address administration funding needs by allowing them to impose fees on borrowers for program administration.

Some states recommended that EPA streamline requirements for public notification so as to allow states to transfer funds at any time provided that they not exceed a cumulative 33 percent of DWSRF capitalization grants. EPA believes that public notification is an important component of the SRF programs and that decisions the state makes with respect to either program should be communicated to the public with an opportunity to comment.

Recommendation

Providing states with the long-term ability to transfer funds between their SRF programs will add transfers to a toolbox that already includes leveraging and cross-collateralization. Each of these tools give states the ability to address their water infrastructure needs and demands. The states that have made use of the transfer provision have found it to be of significant assistance in allowing them to meet drinking water demands within their state. As critical drinking water needs are met and states work to implement new requirements related to the Clean Water Act, EPA anticipates that states will also look to transfer funds into the CWSRF program if the amount of funding is not sufficient to meet demand. While there may have been concerns that states would transfer DWSRF dollars into CWSRF programs which were more mature, this has not been the case. States have demonstrated that transferring funds requires a thorough decision-making process. Extending the ability to transfer into the future will allow them to better manage their drinking water and clean water projects in the short-term because they will be assured that transferred funds can be returned to either program in the long-term. Removing the time limitation from transferring funds will also allow states to further reduce the risk of default when they sell bonds to leverage their programs.

Therefore, **EPA recommends that Congress continue to authorize transfers between the two programs and remove the sunset date in the provision** to give states full flexibility to take advantage of the benefits transfers can provide in helping them meet important water infrastructure needs.

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Appendix A

Congressional authorization of transfers between the SRF programs

Safe Drinking Water Act Amendments of 1996

SEC. 302. <<NOTE: 42 USC 300j-12 note.>> TRANSFER OF FUNDS.

(a) In General.--Notwithstanding any other provision of law, at any time after the date 1 year after a State establishes a State loan fund pursuant to section 1452 of the Safe Drinking Water Act but prior to fiscal year 2002, a Governor of the State may--

(1) reserve up to 33 percent of a capitalization grant made pursuant to such section 1452 and add the funds reserved to any funds provided to the State pursuant to section 601 of the Federal Water Pollution Control Act (33 U.S.C. 1381);

(2) reserve in any year a dollar amount up to the dollar amount that may be reserved under paragraph (1) for that year from capitalization grants made pursuant to section 601 of such Act (33 U.S.C. 1381) and add the reserved funds to any funds provided to the State pursuant to section 1452 of the Safe Drinking Water Act.

(b) Report.--Not later than 4 years after the date of enactment of this Act, the Administrator shall submit a report to the Congress regarding the implementation of this section, together with the Administrator's recommendations, if any, for modifications or improvement.

(c) State Match.--Funds reserved pursuant to this section shall not be considered to be a State match of a capitalization grant required pursuant to section 1452 of the Safe Drinking Water Act or the Federal Water Pollution Control Act (33 U.S.C. 1251 et seq.).

Explanatory Statement of the Committee on Conference

Title III - Miscellaneous Provisions

Transfer of Funds (Sec. 302)

The following represents an understanding between the House of Commerce on Commerce and the House Committee on Transportation and Infrastructure. This understanding has no impact on the operation of law.

The House Commerce Committee, which has jurisdiction over the Safe Drinking Water Act, and the House Transportation and Infrastructure Committee, which has jurisdiction over the Federal Water Pollution Control Act, agree to share jurisdiction over the free-standing provision in section 302 of the Safe Drinking Water Act Amendments of 1996 involving transfer of revolving loan funds. This provision allows for the transfer of funds, under specified terms and conditions, between the Safe Drinking Water State Revolving Loan Fund which is under the exclusive jurisdiction of the Commerce Committee and the Clean Water State Revolving Fund which is under the exclusive jurisdiction of the Transportation and Infrastructure Committee.

For matters directly amending section 302, the two Committees agree that each should be given equal weight in bill referrals, conference appointments, and other jurisdictional assignments. For instance, a bill to amend section 302 to increase the percentage amount that may be transferred between the two revolving funds would be in the joint jurisdiction of the two Committees. Likewise, a direct or indirect amendment to the provisions of section 302 would be in the Committees' joint jurisdiction.

Enactment of this freestanding section does not give the Commerce Committee any jurisdiction over the Federal Water Pollution Control Act, nor does it give the Transportation and Infrastructure Committee any jurisdiction over the Safe Drinking Water Act. Jurisdiction for changes that amend provisions of the Federal Water Pollution Control Act or the Safe Drinking Water Act should be determined without regard to section 302. Thus, for example, a bill to change or impose conditions or limitations on the criteria applicable to a State for the receipt or expenditure of revolving funds under the Safe Drinking Water Act or Federal Water Pollution Control Act would be in the sole jurisdiction of the Committee on Commerce or the Committee on Transportation and Infrastructure respectively.

Appendix B

Cross-collateralization in the SRF programs

Cross-collateralization allows funds from one State Revolving Fund (SRF) program to be used to secure the other SRF program from revenue shortfalls. Cross-collateralization has had a significant positive impact on the State Revolving Fund program. States and bond rating agencies report that the use of cross-collateralization has resulted in the following benefits:

Stronger bond ratings for DWSRF bonds because they are supported by the very strong cash flows of the CWSRF program.

Stronger bond ratings that translate into lower interest rates on DWSRF bonds and cost savings to SRF borrowers. New DWSRF program access to the bond market that would not be possible without the credit backing provided by the CWSRF through cross-collateralization.

Stronger Bond Ratings for SRF Programs

Independent bond rating agencies all agree that cross-collateralization provides critical security for the DWSRF program. In a 1999 research report, “SRF Bonds Provide Safe Harbor,”¹ Fitch IBCA indicates that even though the average loan pool credit quality for the DWSRFs is weaker than that of existing CWSRFs due to increased lending to small systems, cross-collateralizing the new DWSRF program’s assets with those of the mature CWSRF programs has allowed states to compensate for this credit risk. Fitch IBCA’s SRF specialist elaborated on this position in a recent correspondence stating:

“Specifically, with regard to structures classified as cross-collateralized by EPA, cross-collateralization was - in all cases - a major factor justifying or supporting either upgrades, rating affirmations, or initial rating assignments at the ‘AA+’ or ‘AAA’ rating levels, Fitch IBCA’s two highest. Most notably, cross-collateralization was the major factor allowing Fitch IBCA to upgrade Colorado DWSRF bonds to ‘AAA’ from ‘AA’ last year. These upgrades or initial rating assignments were important in increasing the SRF bond sector’s median rating to ‘AAA’ from the ‘AA’ category. It is the only sector of the U.S. municipal market to achieve this distinction on its unenhanced debt.”²

Other major rating agencies (Standard & Poor's Corporation and Moody's Investor Service, Inc.) provide similar findings in published reports regarding cross-collateralization, noting that cross-collateralization is achieving its goals of enhancing start-up drinking water pools and enabling them to achieve a similar rating to their CWSRF counterparts.^{3,4}

The higher bond ratings that result from cross-collateralization translate into lower borrowing costs for DWSRF programs. The State of Colorado estimates that cross-collateralization reduced the interest rate on their DWSRF bonds by up to ½ percent - a very significant cost savings to the program. In Arizona, the state notes that "the presence of cross-collateralization positively contributed to our (Arizona's) ability to obtain a stand alone AA+ rating. In effect, the diversification present in our (Arizona's) CWSRF portfolio implicitly benefits the unknowns associated with lending to small water systems."⁵

Access to Leveraging Made Possible Through Cross-Collateralization

Some SRF programs view cross-collateralization as being critical to their efforts to employ leveraging in the DWSRF program. In Minnesota only two of the 72 DWSRF projects that are funded have what would be viewed as a strong credit rating ('A' or better). The other 70 cities, needing approximately \$60 million in funding, are generally weak credits ('BBB', 'Baa' and noninvestment grade borrowers). These borrowers combined would be viewed as a very weak portfolio of loans providing limited security for a leveraging program. Minnesota has found that by incorporating cross-collateralization into its financial structure it was able to obtain a 'AAA' rating on its DWSRF bonds.

Minnesota's leveraging has put them one and one-half years ahead of schedule in financing projects. They were able to include an additional 43 projects in their program as a result of leveraging and have the flexibility to provide greater amounts of funding in the future. Having the greater funding capacity provided by employing leveraging has helped Minnesota's cities because they know that funding through the DWSRF program will be available for them once they are finished with planning and are ready to fund a DWSRF project.

¹Fitch IBCA, "SRF Bonds Provide Safe Harbor," November 4, 1999

²Dickerson, Jason, Director, SRF Ratings Group, Correspondence, April 3, 2000

³Standard & Poor's, Standard & Poor's Credit Week Municipal, "Cross-Collateralization - The New Credit Tool for SRFs, November 2, 1998

⁴Moody's Investors Service, Municipal Credit Research - State Revolving Funds Outlook, December 1999

⁵ Swartz, Greg, Executive Director, Water Infrastructure Finance Authority of Arizona, Correspondence, April 4, 2000

Appendix C
EPA implementing policy for transfers
in the SRF programs

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**TRANSFER/CROSS-COLLATERALIZATION POLICY
FOR
DRINKING WATER STATE REVOLVING FUND and
CLEAN WATER STATE REVOLVING FUND**

I. INTRODUCTION

Enactment of the Safe Drinking Water Act Amendments of 1996 (SDWA) and the Department of Veterans Affairs and Housing and Urban Development, and Independent Agencies Appropriation Act of Fiscal Year 1999, (Appropriations Act) provide flexibility to States for both their drinking water and wastewater needs. The SDWA 1996 Amendments established the Drinking Water State Revolving Fund (DWSRF) and also contain a provision authorizing States to transfer funds between the DWSRF and the Clean Water State Revolving fund (CWSRF). Congress also created additional flexibility by authorizing a form of cross-collateralization in the Appropriations Act. With proper planning, priority setting, and public disclosure these two provisions can assist the States in maximizing their infrastructure funding programs by increasing the availability of funds where they are most needed, enhancing bond ratings, and lowering borrowing costs without increasing risks.

Since there are similarities between the two SRF programs, the Environmental Protection Agency (EPA) intends to administer the two programs in a similar manner in regard to transfers and cross-collateralization. This policy statement establishes EPA policy regarding the use of these two provisions in funding DWSRF and CWSRF projects. It identifies the process a State must undergo to gain EPA approval for incorporating transfers and/or cross-collateralization into its SRF program.

Based on the 1997 Drinking Water Needs Survey and the 1998 Clean Water Needs Survey, the combined needs for wastewater and drinking water infrastructure financing have been assessed at \$278 billion. EPA encourages States to use these two funding enhancements to finance projects on a priority basis.

II Transfers

A. Statutory Authority

Section 302 of the Safe Drinking Water Act (SDWA) Amendments of 1996 offers States the flexibility to transfer funds from one SRF program to the other. The transfer provision reads as follows:

Sec. 302. Transfer of Funds.

(a) In General.—Notwithstanding any other provision of law, at any time after the date 1 year after a State establishes a State loan fund pursuant to section 1452 of the Safe Drinking Water Act but prior to fiscal year 2002, a Governor of the State may--

(1) reserve up to 33 percent of a capitalization grant made pursuant to such section 1452 and add the funds reserved to any funds provided to the State pursuant to section 601 of the Federal Water Pollution Control Act (33 U.S.C. 1381); and

(2) reserve in any year a dollar amount up to the dollar amount that may be reserved under paragraph (1) for that year from capitalization grants made pursuant to section 601 of such Act (33 U.S.C. 1381) and add the reserved funds to any funds provided to the State pursuant to section 1452 of the Safe Drinking Water Act.

(b) REPORT.—Not later than 4 years after the date of enactment of this Act, the Administrator shall submit a report to Congress regarding the implementation of this section, together with the Administrator's recommendations, if any, for modifications or improvement.

*(c) STATE MATCH.—Funds reserved pursuant to this section shall not be considered to be a State match of a capitalization grant required pursuant to section 1452 of the Safe Drinking Water Act or the Federal Water Pollution Control Act (33 U.S.C. 1251 *et seq.*).*

Section 302 states that the governor of a State can reserve up to 33% of its DWSRF capitalization grant for transfer to its CWSRF or an equivalent amount from its CWSRF to its DWSRF. Therefore, a State has the flexibility to prioritize its funding where it has the greatest need.

Both the CWSRF and the DWSRF programs require that an Attorney General's opinion certifying that the SRF program is consistent with State law be submitted with each capitalization grant application. If a State receives a capitalization grant and later decides to transfer funds, the capitalization grant agreement must be amended and an Attorney General's opinion must be submitted certifying that State law permits the State to transfer funds. Transfers must be made by the Governor or by a State official acting pursuant to authorization from the Governor.

1. Authorized Time Period

Funds may be reserved and transferred only during a limited time period:

a. CWSRF or DWSRF funds may be transferred after one year has elapsed since a State establishes its DWSRF Fund (i.e., the date of the first DWSRF capitalization grant awarded to the State for projects), and may include an amount equal to the allowance associated with its fiscal year 1997 capitalization grant. For example, if a DWSRF Fund is established on October 31, 1997 with the award of a capitalization grant for project funds, the first day funds can be transferred is November 1, 1998.

b. Funds may only be transferred "prior to fiscal year 2002" (October 1, 2001).

2. Transfer Ceiling

The amount of the total DWSRF capitalization grant, including any portion awarded for set-aside activities, determines the amount of funds that can be reserved and transferred.

a. The Governor of a State may reserve an amount equal to 33% of the DWSRF capitalization grant and transfer the funds to the CWSRF.

b. The Governor may reserve funds from the CWSRF in an amount equal to no more than 33% of the DWSRF capitalization grant and transfer those funds to the DWSRF.

B. Transfer Flexibility

1. Transfer Funds

Based on section 302 of the SDWA, the DWSRF capitalization grant the State is basing the transfer amount on must have been awarded prior to the transfer of any funds. Section 302 does not limit the transfer of funds to Federal capitalization grant dollars. States may transfer Federal capitalization grant dollars, State match, investment earnings, or principal and interest repayments. When CWSRF Federal funds are transferred, the CWSRF capitalization grant must also have been awarded prior to the transfer of funds. As part of the transfer process, States must identify in both the CWSRF and DWSRF Intended Use Plans (IUPs) that funds will be transferred, the type of funds to be transferred (Federal capitalization grant dollars, State match, investment earnings, etc.), and the effect that transfers will have on the program's ability to fund projects. States may elect to reserve the authority to transfer funds in one year, but not actually transfer those funds until a later time, but no later than fiscal year 2001 (See Table #1).

2. Timely and Expeditious Use

Reserving the authority to transfer funds at a future date is not reserving the actual cash, but is a "credit" for future transfer. Funds must still be used for project or set-aside activities during the time period prior to when the actual transfer occurs. States may then transfer other moneys present in the respective SRF at the time of the transfer.

3. Expiration of Authority to Reserve or Transfer

Funds may not be reserved or transferred after September 30, 2001.

4. Transferring on Net Basis

Moneys may be transferred between the SRF programs on a net basis provided that the 33% ceiling is maintained. Once money has been transferred,

even if the donor SRF reaches the 33% limit, it may still be transferred back to the donor SRF from the receiving SRF by a subsequent transfer. Table #2 shows the effect of multiple capitalization grants of \$100 each and transfers between the SRF programs.

Another example is a situation where State law does not allow State funds to be used to fund private water systems in the State's DWSRF program. In this case, the State may designate that it will transfer State match funds from the DWSRF to the CWSRF and Federal funds, equal to the State match amount, from the CWSRF to the DWSRF. Since the dollar amounts of these transfers are equal, there is no effect on the amount available to transfer. Table #3 illustrates this example.

C. State Match, Set-asides, Administrative Ceiling and 604(b) Calculation

Transfers do not impact the State match calculation in the capitalization grants, the set-asides calculations in the DWSRF, or the 4% administration and 604(b) calculations in the CWSRF.

1. State Match

In both SRF programs, the State match requirement is 20% of the capitalization grant. Transfers do not affect the calculation of those required amounts in either program. Section 302 of the SDWA stipulates that funds transferred under this provision cannot be considered the required State match for the capitalization grant in either SRF program. The transfer provision cannot be used to acquire State match. Transferred funds cannot be used for the purposes of securing or repaying State match bonds.

2. DWSRF Set-asides

Since set-aside ceilings in the DWSRF are calculated based on the allotment or the capitalization grant, the ceilings are not recalculated as a result of transferring funds.

3. CWSRF Administrative Ceiling and 604(b) Calculation

The 4% administrative ceiling is not calculated using transferred amounts. The calculation of the 4% is based upon the initial capitalization grant. The 604(b) funds are calculated on the allotment.

The following example illustrates the fact that a transfer will have no impact on State match, the DWSRF set-asides, the CWSRF administrative ceiling, and the CWSRF 604(b) calculation. The CWSRF capitalization grant is \$10,000,000 and the State match is \$2,000,000. The DWSRF capitalization grant is \$10,000,000 and the State match is \$2,000,000. The State has determined it will use 31% of the capitalization grant for set-aside activities. The State also decided to transfer \$3,000,000 from the CWSRF to the DWSRF for addi-

tional SDWA project activities. After the transfer, the State match for each SRF program (\$2,000,000) remains unchanged because the CWSRF and DWSRF State match is based upon the initial capitalization grants. The DWSRF set-aside calculation does not change (\$3,100,000) because the set-asides are based upon the initial capitalization grant amount and/or the allotment. The CWSRF 4% administrative ceiling remains at \$400,000 and 604(b) is still calculated at \$100,000.

D. Project Funding for Small Systems

Transfers into or out of the DWSRF Fund could impact loan assistance for small systems that serve fewer than 10,000 persons. The SDWA requires that a State use a minimum of 15 percent of all dollars credited to the Fund to provide loan assistance to small public water systems to the extent such funds can be obligated for eligible projects of public water systems. Accordingly, 15 percent of all dollars transferred into the DWSRF Fund must also be used in accordance with the small systems provision of the SDWA.

E. Intended Use Plan and Operating Agreement

1. Intended Use Plan

States must develop an annual IUP for each SRF program for public review and comment that includes a description of the funds to be reserved and/or transferred and how those funds will be used. The IUPs must disclose how and why the decisions to transfer funds were made. EPA encourages States to include a discussion of wastewater and drinking water needs to show the public that the highest priorities are being funded. The IUP must provide sufficient information regarding transfers for the public to understand:

- a. the total amount of authority being reserved for future transfer including the authority from previous years;
- b. the total amount and type of funds being transferred during the term of the IUP;
- c. the impact on the current year's Fund and set-asides; and
- d. the long-term impact on the Fund.

Both CWSRF and DWSRF IUPs must be amended if a mid-year transfer is to occur that has not had prior disclosure to the public. For example, the State received its DWSRF capitalization grant in June 1998 and subsequently decides to transfer funds to its CWSRF. Because the current year IUPs did not contain information concerning transfers, the IUPs must be amended (and capitalization grants if transferring federal dollars) and distributed for public review and comment in accordance with the State procedures established for amending IUPs.

2. Operating Agreement

When a State initially decides to include the ability to transfer in its program, the Operating Agreement must be amended to include the method the State will use to transfer funds.

F. Transferring Federal Funds and State Match Funds

Because transfers can complicate the analysis of whether a State is complying with the proper payment schedule, binding commitments, and cross-cutting Federal authorities, the State must identify whether the transferred amount consists of dollars on which these requirements will apply or other dollars. The State must maintain sufficient procedures to ensure proper accounting for transferred dollars.

1. Payment Schedule/Grant Amendments

If a State decides to transfer Federal funds subsequent to establishing a payment schedule, a revised payment schedule will be necessary. Changes to the payment schedule will be effected through an amendment to the grant agreement.

2. Cash Draw Proportionality

Transfers of Federal capitalization dollars or State match dollars will impact cash draw proportionality. Please refer to the "Guide to Using EPA's Automated Clearing House for the Drinking Water State Revolving Fund Program" (EPA-832-B98-003) published in September 1998 for details concerning recalculating proportionality.

3. Binding Commitments

When Federal funds or State match funds are transferred from one SRF program's Fund into the other SRF program's Fund, the State must enter into binding commitments in the receiving SRF program for the transferred amount within one year after receipt of payment or, if payment has already been taken, within one year of the transfer date, in addition to the binding commitments required for its capitalization grant and State match. If funds are transferred from the CWSRF to the set-aside account in the DWSRF, the binding commitment requirement on the amount transferred will not apply. The donor SRF program will not be required to enter into binding commitments on the transferred funds.

4. Cross-cutting Federal Authorities

Cross-cutting Federal authorities apply to transferred Federal funds in the same manner as they apply to the capitalization grant funds in the receiving SRF program.

G. Transferring Other Funds

Since transfers do not relieve the State from complying with those requirements that apply to the amount of the capitalization grant, the State should consider transferring principal and interest repayments and investment earnings rather than transferring Federal and State match funds. Grant amendments, binding commitment requirements and cross-cutters, except for civil rights, do not apply to transferred funds consisting of repayments of principal and interest, and

investment earnings. Also, cash draw proportionality will not be impacted by transfers of repayment funds and investment earnings. Please refer to the “Guide to Using EPA’s Automated Clearing House for the Drinking Water State Revolving Fund Program.”

H. **Reporting, Monitoring and Review**

A State must report transfers in the DWSRF Biennial Report and in the CWSRF

Annual Report. The reports must identify the amount of funds transferred from one SRF program to the other and how those funds were used. Since the State must be able to track all transfers, a schedule of actual transfers must be included in the reports which can be reconciled with the schedule of expected transfers in the IUP. A State must also explain reasons that funds were not transferred in accordance with the plan described in the IUP, including the impact on the SRF programs.

The State must also report transfers in the financial statements of the SRF programs with corresponding footnotes explaining the type of funds transferred (Federal dollars, State match, principal and interest repayments, or investment earnings).

III. **Cross-Collateralization**

A. **Authorization**

The Departments of Veteran Affairs and Housing and Urban Development, and Independent Agencies Appropriations Act of Fiscal Year 1999 (Public Law 105-276) authorizes cross-collateralization between the DWSRF and the CWSRF programs. The language included in the law in regard to cross-collateralization is as follows:

... Provided , That, consistent with section 1452(g) of the Safe Drinking Water Act (42 U.S.C. 300j-12(g)), section 302 of the Safe Drinking Water Act Amendments of 1996 (Public Law 104-182) and the accompanying joint explanatory statement of the committee on conference (H. Rept. No. 104-741 to accompany S. 1316, the Safe Drinking Water Act Amendments of 1996), and notwithstanding any other provision of law, beginning in fiscal year 1999 and thereafter, States may combine the assets of State Revolving Funds (SRFs) established under section 1452 of the Safe Drinking Water Act, as amended, and title VI of the Federal Water Pollution Control Act, as amended, as security for bond issues to enhance the lending capacity of one or both SRFs, but not to acquire the State match for either program, provided that revenues from the bonds are allocated to the purposes of the Safe Drinking Water Act and the Federal Water Pollution Control Act in the same portion as the funds are used as security for the bonds. .

B. Purpose

The drinking water and wastewater community has advocated cross-collateralization to increase the financing flexibility of the CWSRF and the DWSRF. For States which issue bonds, the added security provided by the strength of the CWSRF will enhance the funding capacity in the DWSRF by achieving better bond ratings. Funds from one SRF program can be used to secure the other SRF program against a default.

C. Legislative Authority

The CWSRF and the DWSRF programs require that an Attorney General's opinion certifying that the SRF program is consistent with State law be submitted with each capitalization grant application. If a State receives a capitalization grant and later decides to cross-collateralize, the capitalization grant agreement must be amended and an Attorney General's opinion must be submitted certifying that State law permits the State to cross-collateralize.

D. Operating Agreement and Intended Use Plan

When a State initially decides to include cross-collateralization in its program, the Operating Agreement must be amended to detail how cross-collateralization will be implemented. The State must annually include in the IUP for each SRF program a description of how cross-collateralization will be used, and provide the IUPs to the public for review and comment prior to submitting them to the Region as part of the capitalization grant applications. The IUPs must, at a minimum, describe:

- a. the type of moneys which will be used as security;
- b. how moneys will be used in the event of a default;
- c. whether or not moneys used for a default in the other program will be repaid; and, if it will not be repaid, what will be the cumulative impact on the Funds.

E. Revenues from the Bonds

The proceeds generated by the issuance of bonds must be allocated to the purposes of the DWSRF and the CWSRF in the same proportion as the assets from the two Funds that are used as security for the bonds. States must demonstrate that at the time of bond issuance, the proportionality requirements have been or will be met. If a default should occur, and Fund assets from one SRF program are used for debt service in the other SRF program, the security would no longer need to be proportional.

Proportionality may be achieved at different levels of security. A State may achieve proportionality at the debt service reserve level. If the debt service reserve is the primary security and consists of 35% DWSRF funds and 65% CWSRF funds, the bond proceeds must be allocated 35% to DWSRF purposes and 65% to CWSRF purposes.

A State may also achieve proportionality by requiring that loan repayments on loans made from the CWSRF are pledged, as the primary security, only to the CWSRF bonds (or portion of a joint bond issue) and loan repayments

on loans made from the DWSRF are pledged, as the primary security, only to the DWSRF bonds (or portion of a joint bond issue). If principal forgiveness is used as a subsidy for disadvantaged communities funded with bond proceeds in the DWSRF program, this option may not be used since the security would be disproportionate to the security provided by the CWSRF program.

The above are only two examples which can be used to maintain the proportionality of the security for bonds. There may be other options the State will want to explore and submit for EPA approval.

F. State Match

States may not combine the assets of the SRF programs as security for bond issues to acquire State match for either program. States may not use the assets of one SRF program to secure match bonds of the other SRF program.

G. Operation of SRF Programs

States may use, in combination, the assets of the SRF programs as security for bond issues. However, the CWSRF and DWSRF must each continue to be operated separately. States must maintain records so that, for each SRF program, separate financial statements can be compiled and separate financial audits can be conducted. The debt service reserve and interest earned thereon for the DWSRF program and the CWSRF program must each be accounted for separately. Repayments on loans in the CWSRF program must be paid to the CWSRF and repayments on loans made in the DWSRF program must be paid to the DWSRF.

Cross-collateralization does not effect the calculation of set-asides, the 4% administrative ceiling and binding commitments. Payments and cash draw proportionality may be affected if there are defaults. The CWSRF Annual Report and the DWSRF Biennial Report must describe the use of assets of the SRF programs as security for bond issues and any use of moneys from one SRF program by the other as a result of cross-collateralization.

Table #1

Reserving the Right (Banking) to Transfer in Future Years				
Year	DWSRF Capitalization Grant	Amount Reserved for Transfer	Banked Transfer Ceiling	Amount Transferred
1997	\$100	\$33	\$33	\$00
1998	\$100	\$33	\$66	\$00
1999	\$100	\$33	\$99	\$00
2000	\$100	\$33	\$132	\$00
2001	\$100	\$33	\$165	\$165
2002	\$100	\$00 ¹	\$00 ¹	\$00 ¹
Total	\$600	\$165		\$165

¹ No funds may be reserved or transferred after fiscal year 2001.

Table #2

Transferring on a Net Basis						
In this example, the DWSRF capitalization grant in each year is \$100. Therefore, the transfer ceiling is \$33 for the first year, increasing to \$66 in the second year and \$99 in the third year, etc.						
Year	Transaction Description	Banked Transfer Ceiling	Transferred from CWSRF-DWSRF	Transferred from DWSRF-CWSRF	CW Funds Available for Transfer ¹	DW Funds Available for Transfer ¹
1997	CG Award	\$33	--	--	\$33 ²	\$33 ²
1998	CG Award	\$66	--	--	\$66	\$66
1998	Transfer	\$66	\$20	--	\$46	\$86
1999	CG Award	\$99	--	--	\$79	\$119
1999	Transfer	\$99	--	\$86	\$165	\$33
1999	Transfer	\$99	\$90	--	\$75	\$123
2000	CG Award	\$132	--	--	\$108	\$156
2000	Transfer	\$132	--	\$50	\$158	\$106
2001	CG Award	\$165	--	--	\$191	\$139
2001	Transfer	\$165	\$191	--	\$0	\$330
2002	CG Award	\$0	--	--	\$0	\$0

¹The maximum either SRF can transfer as the result of banking and previous transfers.
²Transfers cannot occur until one year after the DWSRF has been established.

Table #3

Year	Transaction Description	Banked Transfer Ceiling	Transferred from CWSRF-DWSRF	Transferred from DWSRF-CWSRF	CW Funds Available for Transfer ¹	DW Funds Available for Transfer ¹
1997	CG Award	\$33	-	-	\$33	\$33
1998	CG Award	\$66	-	-	\$66	\$66
1998	Transfer	\$66	\$40 (Federal)	\$40 (State)	\$66	\$66

¹The maximum either SRF can transfer as the result of banking and previous transfers.