



UNITED STATES ENVIRONMENTAL PROTECTION AGENCY
WASHINGTON, DC 20460

OFFICE OF
INSPECTOR GENERAL

June 21, 2002

MEMORANDUM

SUBJECT: Special Report 2002-M-0026
Potential Misuse of the Clean Water State Revolving Fund,
State of Missouri, Department of Natural Resources

FROM: Michael A. Rickey/s/
Director, Assistance Agreements Audits

TO: G. Tracy Mehan
Assistant Administrator, Office of Water

We recently received information that the Missouri House of Representatives had approved a measure to use about \$19 million from the Missouri Clean Water State Revolving Fund (SRF) to retire a portion of its general obligation bonds that are not a part of the SRF. On April 30, 2002, we received additional information that a conference committee between the Missouri House and Senate approved using the SRF for the same purpose, and that Senate approval was almost certain. Subsequently, we received a copy of an Environmental Protection Agency (EPA) letter to Missouri that threatened to suspend review of two SRF capitalization grants of about \$37 million each should Missouri enact the proposed legislation. While we applaud EPA for its quick action, we do not believe the threatened actions properly point out the full effect of the consequences that EPA or the Office of Inspector General (OIG) could take if Missouri uses SRF funds to retire general obligation bonds.

The purpose of this special report is to:

1. Identify a time-sensitive issue requiring immediate attention,
2. Identify additional actions that EPA should take if Missouri misuses SRF funds for non-SRF purposes, and
3. Serve as a deterrent to other states considering similar actions that would threaten the financial integrity of the SRF program nationwide.

This special report is not an audit conducted in accordance with government auditing standards. Had we performed additional procedures, other matters may have come to our attention that we would have reported to you.

Background

The Clean Water SRF Program was established pursuant to Title VI of the Federal Water Quality Act of 1987 (the Act) to finance:

- Construction of publicly owned treatment works as defined in section 212 of the Act,
- Implementing non-point source pollution control management programs under section 319 of the Act, and
- Developing and implementing estuary conservation and management plans according to section 320 of the Act.

These are the only authorized uses of the SRF in the Act. The Act also provides, “The fund shall be established, maintained, and credited with repayments, and the fund balance shall be available in perpetuity for providing such financial assistance.”

The SRF provides for low interest rate loans and other types of financial assistance to finance the entire cost of qualified projects. Other types of financial assistance include the use of the SRF as a source of revenue or security for the payments on revenue or general obligation bonds **provided the bond proceeds are deposited directly to the Clean Water SRF**. Under such cases, SRF funds can be used to pay both principal and interest on such bonds.

Current Issue

Missouri issued general obligation bonds to fund their match obligations, as well as other programs. The proceeds of the bond issue were not deposited directly into the SRF, as required. The requirement to have bond proceeds deposited directly to the SRF is so it can earn interest on the funds until disbursed, thereby off-setting the bonds’ interest cost. However, the SRF did not earn the interest on these funds. Using SRF funds to retire bonds not deposited to the SRF circumvents the requirement. Furthermore, EPA has not received any assurances that the bonds in question were used solely or in part for the SRF.

By accepting capitalization grants from EPA, Missouri agreed to comply with the Clean Water SRF provisions. Using SRF funds to retire \$19 million of Missouri’s general obligation bonds is not an authorized use of SRF funds, and would violate Section 603(c) of the Clean Water Act. The impetus behind Missouri’s intended use is its projected fiscal year 2003 budget deficit of about \$230 million to \$250 million.

According to Office of Water estimates, using \$19 million of SRF funds to retire non-SRF bonds could reduce future long term assistance by as much as \$86 million because of Missouri’s leveraging process. Future withdrawals for debt service of bonds outside the SRF would further

decrease the amount of assistance the Missouri SRF could provide. By using SRF funds to retire general obligations bonds, Missouri would:

- Violate EPA regulation 40 Code of Federal Regulations (CFR) 31.43(a) in that Missouri “materially failed to comply with any term of an award, whether stated in a Federal statute or regulation.”
- Violate Federal appropriation law 31 U.S. Code (USC) 1301(a) by using a Federal appropriation for anything other than the purpose specified by Congress. Also, 31 USC 1532 specifies that funds cannot be transferred to a different account or used for a different purpose absent the specific statutory authority from Congress.
- Be subject to “Debarment and Suspension” under Executive Order 12549 and 40 CFR Part 32, which could result in Missouri being ineligible for **any** type of Federal assistance.
- Be subject to being classified as a “high risk grantee” under 40 CFR 31.12, resulting in special conditions being placed on all prospective awards.
- Be subject to an OIG investigation to determine whether it had violated the False Claims Act in 31 USC 3729.

We urge you to have Missouri reconsider its proposed course of action. The possible ramifications of using SRF funds for anything other than the purposes intended by Congress are severe, and could cause deeper financial and legal woes than the state has envisioned.

Possible EPA Actions

There are several possible legal remedies that EPA could pursue separately or simultaneously. First, section 605 of the Act contains a corrective action section whereby EPA will notify the State that it is in noncompliance with Title VI of the Act. If a state does not take corrective action within 60 days of the notice, EPA can withhold future payments to the SRF until the State takes the necessary corrective action. If the State fails to take satisfactory corrective action within 12 months of the notice, the withheld payments that would have ordinarily been sent to the state are to be de-obligated and transferred to other states.

EPA could also pursue remedies under 40 CFR 31.43(a) if it determined that Missouri has “materially fail[ed] to comply with any term of an award, whether stated in a Federal statute or regulation.” These remedies could include: temporarily withholding cash payments pending corrective action; suspending or terminating the SRF program; withholding future awards; and other remedies that may be legally available under 40 CFR 31.43(a)(1)-(5).

Unlike the corrective action procedures under Title VI of the Act, EPA could pursue these remedies immediately upon discovery that SRF funds were used for any purposes besides those specified under the Act. Under 40 CFR 31.43(a)(1), EPA is not limited to withholding SRF payments; EPA could also withhold its payments for Missouri's other continuing environmental programs.

Further, the "other remedies" referred to in 40 CFR 31.43(a)(5) include the possibility that Missouri could be subject to "Debarment and Suspension" under Executive Order 12549 and 40 CFR Part 32. "Debarment and Suspension" could result in Missouri being ineligible for **any** federal grant, cooperative agreement, or loan program from any federal agency for a specified period. EPA could also classify Missouri as a "high risk grantee" under 40 CFR 31.12. As a "high risk grantee," special conditions could be placed on all prospective awards, such as: making cash draws on a reimbursement basis, requiring additional and more detailed financial reports, having additional program monitoring, requiring the grantee to obtain management assistance, or establishing additional prior approvals before receiving further awards.

Finally, if Missouri were to use the SRF to balance its general operating budget, EPA may be obligated to refer the matter to the OIG. Under the Inspector General Act of 1978, the OIG is responsible for identifying occurrences of waste, fraud, and abuse involving federally appropriated funds. By drawing monies from the SRF for unauthorized purposes, the OIG may consider Missouri's actions to violate the False Claims Act contained in 31 USC 3729, and refer the matter to the Department of Justice for review. Violations of the False Claims Act can result in a penalty of not less than \$5,000 and not more than \$10,000, plus three times the amount of damages the program sustains.

Conclusion

We recommend that EPA take immediate action to prevent Missouri and any other state from using SRF funds for any purpose not authorized in the Act. Such actions could include briefing certain members of Congress about Missouri's intentions, and taking a pro-active approach to prevent states from using SRF funds for unauthorized uses. Several other states are also considering using SRF funds in attempts to balance their budgets. At least one state has decided against borrowing \$50 million of SRF funds to offset projected budget deficits because of possible actions that could be taken by EPA and other Federal agencies. Any precedent set by EPA on this unauthorized use could have far-reaching consequences on the financial integrity of the national SRF program.

Action Required

In accordance with EPA Manual 2750, Change 2, you are requested to provide a written response to this report within 90 days. We have no objection to the further release of this report to the public. If you have any questions or if we can be of further assistance, please contact William Dayton at (916) 498-6590.

cc: Director, Municipal Support Division
Regional Administrator, Region 7
Water Division Director, Region 7
Inspector General
Assistant Inspector General for Audits
Divisional Inspector General, Kansas City
Director, Grants and Debarment
Director, Grants Administration
Agency Followup Coordinator
Associate Administrator for Congressional
and Intergovernmental Relations
Associate Administrator for Communications,
Education and Public Affairs