

Hon. Stephen L. Johnson
Administrator
United States Environmental Protection Agency
1200 Pennsylvania Avenue, NW
Washington, DC 20460

Dear Administrator Johnson:

The Environmental Financial Advisory Board is pleased to submit the enclosed report, "Expanding the Definition of SRF Financial Assistance" for the Agency's consideration and use. This report supports authorizing SRFs to provide a form of financial assistance to eligible projects that would not require that invested program equity be yield restricted under IRS arbitrage regulations. Without the restrictions, SRF programs could earn more interest and use that money for projects. The perpetuity requirement applicable to SRFs would remain unchanged.

Under EPA's current SRF regulations, a subsidy can be given to a borrower in order to provide a below market interest rate on a loan either made or local debt obligation purchased by the SRF. However, the use of SRF equity to provide a debt service subsidy triggers the federal arbitrage restrictions on the investment of SRF program equity. Efforts to obtain relief from the arbitrage regulations by exempting SRFs from application of the generally applicable arbitrage rules have not been successful thus far.

The proposed alternative is to permit SRF assistance to eligible projects for capital or operating costs. Project eligibility would be determined under the same set of rules as presently exist, so that the kinds of projects eligible for assistance would not change under this new program. For example, an SRF could provide assistance (in an amount equivalent to what would currently be provided as a debt service subsidy) either by funding construction costs or funding an annual operating subsidy for a project that receives a market rate SRF financing. The SRF would still have to be maintained in perpetuity. The effect of the perpetuity requirement is that whatever the form of the financial assistance (i.e., for debt service, capital or operating cost of an eligible project), it would have to be provided from accumulated, current or future earnings on SRF equity.

By combining a guaranty of borrower debt (or a market rate loan from the SRF to the borrower or a purchased local debt obligation) with the provision of capital or operating assistance, there would be no basis under the arbitrage regulations for any yield restriction of SRF money relating to the provision of that assistance. While the Department of the Treasury may have some concerns with this approach, we believe this idea derived from a guaranty approach, creates the possibility of realizing the benefit of arbitrage relief without the need to change existing IRS regulations.

Rather than requiring a change in or exception to IRS regulations, this approach allows SRF assistance to be structured in a way that does not trigger the application of the IRS arbitrage rules. Amendments to Clean Water SRF and Drinking Water SRF regulations that could be made to implement this concept (with complementary statutory authority) are offered in this paper.

No significant change in the administration or supervision of the state SRFs would be required under this approach. Also, this would not change the SRF program into a traditional “grant” program since the SRF would still be maintained in perpetuity. However, small communities, in particular, that may have previously been reluctant to take advantage of the SRF program because of lack of understanding of the benefits of reduced interest rates may be attracted to the idea of operating subsidies (even though the net financial impact would be the same). Thus, this programmatic change may have the collateral benefit of attracting new participants to the SRF program. This would be especially beneficial because a community that participates in the SRF program is subject to conditions that move the community toward improved financial management and full-cost pricing.

The Board appreciates the continuing opportunity to provide financial advisory assistance to the Agency on issues of national importance.

Sincerely,

A. James Barnes
Chair

A. Stanley Meiburg
Executive Director

Enclosure

cc: Ben Grumbles, Assistant Administrator for Water
Lyons Gray, Chief Financial Officer

Environmental Financial Advisory Board

EFAB

A. James Barnes
Chair

A. Stanley Meiburg
Designated Federal
Official

Members

Hon. Pete Domenici
Terry Agriss
Julie Belaga
John Boland
George Butcher
Donald Correll
Michael Curley
Rachel Deming
Kelly Downard
Mary Francoeur
Hon. Vincent Girardy
Steve Grossman
Jennifer Hernandez
Keith Hinds
Stephen Mahfood
Langdon Marsh
Greg Mason
Cherie Rice
Helen Sahi
Andrew Sawyers
Greg Swartz
James Smith
Sonia Toledo
Jim Tozzi
Billy Turner
Justin Wilson
John Wise

Expanding the Definition of SRF Financial Assistance

This report has not been reviewed for approval by the U.S. Environmental Protection Agency; and hence, the views and opinions expressed in the report do not necessarily represent those of the Agency or any other agencies in the Federal Government.

January 2007

Printed on Recycled Paper

Expanding the Definition of SRF Financial Assistance

The goal of the concept discussed herein is to permit SRFs to be managed more efficiently and provide more funding for SRF-eligible projects. The proposed mechanism for allowing more efficient operation is to authorize SRFs to provide a form of financial assistance to eligible projects that would not require that invested program equity be yield restricted under IRS arbitrage regulations. Without the restrictions, SRF programs could earn more interest and use that money for projects. The perpetuity requirement applicable to SRFs would remain unchanged.

Under EPA's current SRF regulations, a subsidy can be given to a borrower in order to provide a below market interest rate on a loan either made or local debt obligation purchased by the SRF. However, the use of SRF equity to provide a debt service subsidy triggers the federal arbitrage restrictions on the investment of SRF program equity. Efforts to obtain relief from the arbitrage regulations by exempting SRFs from application of the generally applicable arbitrage rules have not been successful thus far.

The proposed alternative is to permit SRF assistance to eligible projects for capital or operating costs. Project eligibility would be determined under the same set of rules as presently exist, so that the kinds of projects eligible for assistance would not change under this new program. For example, an SRF could provide assistance (in an amount equivalent to what would currently be provided as a debt service subsidy) either by funding construction costs or funding an annual operating subsidy for a project that receives a market rate SRF financing. The SRF would still have to be maintained in perpetuity. The effect of the perpetuity requirement is that whatever the form of the financial assistance (i.e., for debt service, capital or operating cost of an eligible project), it would have to be provided from accumulated, current or future earnings on SRF equity.

By combining a guaranty of borrower debt (or a market rate loan from the SRF to the borrower or a purchased local debt obligation) with the provision of capital or operating assistance, there would be no basis under the arbitrage regulations for any yield restriction of SRF money relating to the provision of that assistance. While the Department of the Treasury may have some concerns with this approach, we believe this idea derived from a guaranty approach, creates the possibility of realizing the benefit of arbitrage relief without the need to change existing IRS regulations.

Rather than requiring a change in or exception to IRS regulations, this approach allows SRF assistance to be structured in a way that does not trigger the application of the IRS arbitrage rules. Amendments to CWF and DWF regulations that could be made to implement this concept (with complementary statutory authority) are attached hereto.

No significant change in the administration or supervision of the state SRFs would be required under this approach (although a modest change of interpretation described below would maximize the benefits of the new approach). Also, this would not change the SRF program into a traditional "grant" program since the SRF would still be maintained in

perpetuity. However, small communities, in particular, that may have previously been reluctant to take advantage of the SRF program because of lack of understanding of the benefits of reduced interest rates may be attracted to the idea of operating subsidies (even though the net financial impact would be the same). Thus, this programmatic change may have the collateral benefit of attracting new participants to the SRF program. This would be especially beneficial because a community that participates in the SRF program is subject to conditions that move the community toward improved financial management and full-cost pricing.

Currently SRFs are permitted to provide assistance in an amount (the “Maximum Assistance Amount” or “MAA”) up to the cumulative retained earnings available at any time. (In the case of direct loans, the SRF forgoes earnings by making below-market investments in the form of borrower loans). The decision as to how much of the MAA to apply currently to provide assistance is made by each state. Each state certifies on an annual basis that it has not provided assistance in excess of that amount – i.e., that it is in compliance with the perpetuity requirement. Currently, the portion of the MAA applied to provide assistance is applied to provide an interest subsidy either:

- By paying down a portion of the interest on bonds used to fund a loan to or purchase a debt obligation from the borrower or
- By providing financing to the borrower from SRF equity at a below-market interest rate.

Under the proposed approach, each state SRF would also have the option of applying its accumulated earnings to fund construction or operating costs rather than to provide an interest subsidy. The provision of capital assistance would reduce the amount of SRF financing that the borrower would need for the project. The SRF would also make or guarantee the market-rate SRF financing (a loan or purchased debt obligation) for the balance of the borrower’s construction costs. In the case of operating assistance, the SRF would also make or guarantee financing for the construction costs of the project.

The reason that only 40% to 60% of the benefit of arbitrage relief would be obtained from the provision of capital assistance is that to provide an equivalent amount of capital assistance, at the outset the SRF would need to pay to the borrower an amount equal to the present value of the interest subsidy that is currently being provided. If the present value of the assistance were 40% of the amount of equity allocable to provide the subsidy, then only 60% of the equity would remain to be invested on an unrestricted basis. Hence, only 60% of the benefit of arbitrage relief would be achieved.

The payment of up-front capital assistance could raise a potential question of interpretation of the perpetuity rule. No question is raised to the extent that the capital assistance is funded from previously accumulated earnings. However, to the extent that future earnings on the SRF’s invested capital will be needed to maintain perpetuity, the current application of the rule (which looks only at earnings in hand) may limit the use of this more beneficial approach. This issue could be eliminated by interpreting the perpetuity requirement to allow SRFs to take into account of:

- Expected earnings on existing investments:
 - ▶ Since the SRF had credit exposure to the investment provider for both principal and interest, there is no reason to only consider investment earnings that have already been “earned”.
- Projected earnings on invested equity based on reasonable assumptions made by the SRF:
 - ▶ To maximize its investment earnings, an SRF may want to adopt a more innovative investment strategy than locking up its investments for the full period that it would otherwise have funded loans or purchased obligations. This should be encouraged by authorizing SRFs to make reasonable projections of future earnings on reinvestments of its existing equity.
 - ▶ Under this approach, the projections would be over the entire period for which the SRF has outstanding financial assistance in the form of loans, purchased local debt obligations or guarantees.

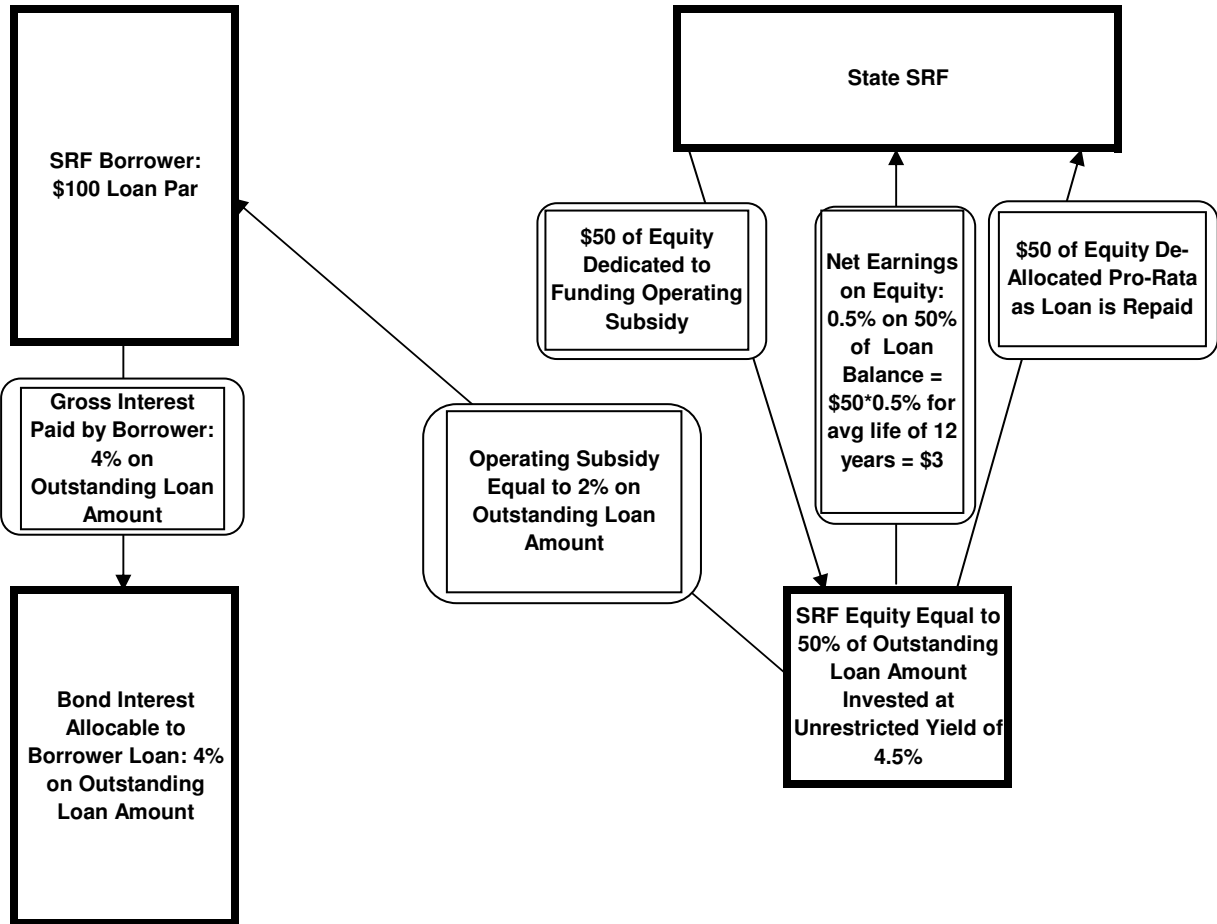
Providing operating assistance payable annually for a period equal to what the term of an SRF financing would be, has the benefit of allowing 100% of the SRF’s equity to be invested on an unrestricted basis. So, the full benefit of arbitrage relief would be achieved. Also, the current interpretation of the perpetuity rule would not pose any problem to implementation of this approach. The attached diagrams contrast the cash flows for an SRF providing operating assistance to the cash flows of an SRF that uses the reserve model.

For SRFs that currently use the Reserve Fund approach, there would likely be no federal budgetary impact of the proposal. The amount of borrowing by such SRFs would not change. Also, while they are currently required to invest at a restricted yield, they have not complied with such restriction by investing in SLGS (which benefit the US Treasury) but by investing in other lower yielding investments (from which the US Treasury derives no benefit). Those programs would modify their structures to look more like the General Revenue Bond approach adopted by Connecticut or the Subordinate Bonds approach utilized by New York which would permit unrestricted investment of program equity if financial assistance were provide for either capital costs of operating expenses.

However, if capital assistance or operating assistance were permitted, SRFs in states (a) that have to date made only direct loans (i.e., funded from program equity) or (b) that use a combination of direct financing and bond-funded financing (referred to as the Cash Flow approach), would be likely to convert to an approach in which SRF financing is provided from bond proceeds rather than from equity. This could significantly increase the amount of funding available for clean water and drinking water projects in those states, but it would also increase the amount of their tax-exempt borrowing. So, there

would be budgetary impact relating to the SRFs that use direct loans or the Cash Flow approach. The budgetary impact would be the same as if arbitrage relief were granted.

Cash Flows Under Revised Model



Proposed Language for CWF and DWF Regulation Amendments

35.3115 Eligible activities of the SRF.

Funds in the SRF shall not be used to provide grants. SRF balances must be available in perpetuity and must be used solely to provide loans and other authorized forms of financial assistance:

(a) to municipalities, intermunicipal, interstate, or State agencies for the construction of publicly owned wastewater treatment works as these are defined in section 212 of the Act and that appear on the State's priority list developed pursuant to section 216 of the Act; and

(b) for implementation of a nonpoint source pollution control management program under section 319 of the Act; and

(c) for development and implementation of an estuary conservation and management plan under section 320 of the Act.

§ 35.3120 Authorized types of assistance.

The SRF may provide seven general types of financial assistance.

(a) Loans. The SRF may award loans at or below market interest rates, or for zero interest.

(1) Loans may be awarded only if:

(i) all principal and interest payments on loans are credited directly to the SRF;

(ii) the annual repayment of principal and payment of interest begins not later than one year after project completion;

(iii) the loan is fully amortized not later than twenty years after project completion; and

(iv) each loan recipient establishes one or more dedicated sources of revenue for repayment of the loan.

(2) Where construction of a treatment works has been phased or segmented, loan repayment requirements apply to the completion of individual phases or segments.

(b) Refinancing existing debt obligations. The SRF may buy or refinance local debt obligations at or below market rates, where the initial debt was incurred after March 7, 1985, and building began after that date.

(1) Projects otherwise eligible for refinancing under this section on which building began:

(i) before January 28, 1988 (the effective date of the Initial Guidance for State Revolving Funds) must meet the requirements of title VI to be fully eligible.

Proposed Language for CWF and DWF Regulation Amendments

(ii) after January 28, 1988, but before the effective date of this rule, must meet the requirements of title VI and of the Initial Guidance for State Revolving Funds to be fully eligible.

(iii) after (effective date of the rule) must meet the requirements of this rule to be fully eligible.

(2) Where the original debt for a project was in the form of a multi-purpose bond incurred for purposes in addition to wastewater treatment facility construction, an SRF may provide refinancing only for eligible purposes, and not for the entire debt.

(c) Guarantee or purchase insurance for local debt obligations. The SRF may guarantee local debt obligations where such action would improve credit market access or reduce interest rates. The SRF may also purchase or provide bond insurance to guarantee debt service payment.

(d) Guarantee SRF debt obligations. The SRF may be used as security or as a source of revenue for the payment of principal and interest on revenue or general obligation bonds issued by the State provided that the net proceeds of the sale of such bonds are deposited in the SRF.

(e) Loan guarantees for "sub-State revolving funds." The SRF may provide loan guarantees for similar revolving funds established by municipal or intermunicipal agencies, to finance activities eligible under title VI.

(f) Earn interest on fund accounts. The SRF may earn interest on Fund accounts. Interest earned on Fund accounts may be used to provide financial assistance for debt service, capital expenditures, operations, treatment facilities or be retained to grow SRF balances. Such assistance may only be provided to support eligible activities, identified in §35.3115, and may be provided pursuant to or in connection with one of the seven general types of financial assistance.

(g) SRF administrative expenses.

(1) Money in the SRF may be used for the reasonable costs of administering the SRF, provided that the amount does not exceed 4 percent of all grant awards received by the SRF. Expenses of the SRF in excess of the amount permitted under this section must be paid for from sources outside the SRF.

(2) Allowable administrative costs include all reasonable costs incurred for management of the SRF program and for management of projects receiving financial assistance from the SRF. Reasonable costs unique to the SRF, such as costs of servicing loans and issuing debt, SRF program start-up costs, financial, management, and legal consulting fees, and reimbursement costs for support services from other State agencies are also allowable.

(3) Unallowable administrative costs include the costs of administering the construction grant program under section 205(g), permit programs under sections 402 and 404 and Statewide

Proposed Language for CWF and DWF Regulation Amendments

wastewater management planning programs under section 208(b)(4).

(4) Expenses incurred issuing bonds guaranteed by the SRF, including the costs of insuring the issue, may be absorbed by the proceeds of the bonds, and need not be charged against the 4 percent administrative costs ceiling. The net proceeds of those issues must be deposited in the Fund.

§ 35.3125 Limitations on SRF assistance.

(a) Prevention of double benefit. If the SRF makes a loan in part to finance the cost of facility planning and preparation of plans, specifications, and estimates for the building of treatment works and the recipient subsequently receives a grant under section 201(g) for the building of treatment works and an allowance under section 201(l)(1), the SRF shall ensure that the recipient will promptly repay the loan to the extent of the allowance.

(b) Assistance for the non-Federal share.

(1) The SRF shall not provide a loan for the non-Federal share of the cost of a treatment works project for which the recipient is receiving assistance from the EPA under any other authority.

(2) The SRF may provide authorized financial assistance other than a loan for the non-Federal share of a treatment works project receiving EPA assistance if the Governor or the Governor's designee determines that such assistance is necessary to allow the project to proceed.

(3) The SRF may provide loans for subsequent phases, segments, or stages of wastewater treatment works that previously received grant assistance for earlier phases, segments, or stages of the same treatment works.

(4) A community that receives a title II construction grant after the community has begun building with its own financing, may receive SRF assistance to refinance the pre-grant work, in accordance with the requirements for refinancing set forth under § 35.3120(b) of this part.

(c) Publicly owned portions. The SRF may provide assistance for only the publicly owned portion of the treatment works.

(d) Private operation. Contractual arrangements for the private operation of a publicly owned treatment works will not affect the eligibility of the treatment works for SRF financing.

(e) Water quality management planning. The SRF may provide assistance only to projects that are consistent with any plans developed under sections 205(j), 208, 303(e), 319 and 320 of the Act.

Proposed Language for CWF and DWF Regulation Amendments

48302 Federal Register / Vol. 65, No. 152 / Monday, August 7, 2000 / Rules and Regulations

installation or replacement of transmission and distribution pipes to improve water pressure to safe levels or to prevent contamination caused by leaks or breaks in the pipes.

(iii) *Source.* Examples of projects include rehabilitation of wells or development of eligible sources to replace contaminated sources.

(iv) *Storage.* Examples of projects include installation or upgrade of eligible storage facilities, including finished water reservoirs, to prevent microbiological contaminants from entering a public water system.

(v) *Consolidation.* Eligible projects are those needed to consolidate water supplies where, for example, a supply has become contaminated or a system is unable to maintain compliance for technical, financial, or managerial reasons.

(vi) *Creation of new systems.* Eligible projects are those that, upon completion, will create a community water system to address existing public health problems with serious risks caused by unsafe drinking water provided by individual wells or surface water sources. Eligible projects are also those that create a new regional community water system by consolidating existing systems that have technical, financial, or managerial difficulties. Projects to address existing public health problems associated with individual wells or surface water sources must be limited in scope to the specific geographic area affected by contamination. Projects that create new regional community water systems by consolidating existing systems must be limited in scope to the service area of the systems being consolidated. A project must be a cost-effective solution to addressing the problem. A State must ensure that the applicant has given sufficient public notice to potentially affected parties and has considered alternative solutions to addressing the problem. Capacity to serve future population growth cannot be a substantial portion of a project.

(c) *Eligible project-related costs.* In addition to costs needed for the project itself, the following project-related costs are eligible for assistance from the Fund:

(1) Costs for planning and design and associated pre-project costs. A State that makes a loan for only planning and design is not required to provide assistance for completion of the project.

(2) Costs for the acquisition of land only if needed for the purposes of locating eligible project components. The land must be acquired from a willing seller.

(3) Costs for restructuring systems that are in significant noncompliance with any national primary drinking water regulation or variance or that lack the technical, financial, and managerial

capability to ensure compliance with the requirements of the Act, unless the systems are ineligible under paragraph (d)(2) or (d)(3) of this section.

(d) *Ineligible systems.* Assistance from the Fund may not be provided to:

(1) Federally-owned public water systems and for-profit noncommunity water systems.

(2) Systems that lack the technical, financial, and managerial capability to ensure compliance with the requirements of the Act, unless the assistance will ensure compliance and the owners or operators of the systems agree to undertake feasible and appropriate changes in operations to ensure compliance over the long-term.

(3) Systems that are in significant noncompliance with any national primary drinking water regulation or variance, unless:

(i) The purpose of the assistance is to address the cause of the significant noncompliance and will ensure that the systems return to compliance; or

(ii) The purpose of the assistance is unrelated to the cause of the significant noncompliance and the systems are on enforcement schedules (for maximum contaminant level and treatment technique violations) or have compliance plans (for monitoring and reporting violations) to return to compliance.

(e) *Ineligible projects.* The following projects are ineligible for assistance from the Fund:

(1) Dams or rehabilitation of dams.

(2) Water rights, except if the water rights are owned by a system that is being purchased through consolidation as part of a capacity development strategy.

(3) Reservoirs or rehabilitation of reservoirs, except for finished water reservoirs and those reservoirs that are part of the treatment process and are on the property where the treatment facility is located.

(4) Projects needed primarily for fire protection.

(5) Projects needed primarily to serve future population growth. Projects must be sized only to accommodate a reasonable amount of population growth expected to occur over the useful life of the facility.

(6) Projects that have received assistance from the national set-aside for Indian Tribes and Alaska Native Villages under section 1452(i) of the Act.

(f) *Ineligible project-related costs.* The following project-related costs are ineligible for assistance from the Fund:

(1) Laboratory fees for routine compliance monitoring.

(2) Operation and maintenance expenses.

§ 35.3525 Authorized types of assistance from the Fund.

A State may only provide the following types of assistance from the Fund:

(a) *Loans.* (1) A State may make loans at or below the market interest rate, including zero

interest rate loans. Loans may be awarded only if:

(i) An assistance recipient begins annual repayment of principal and interest no later than one year after project completion. A project is completed when operations are initiated or are capable of being initiated.

(ii) A recipient completes loan repayment no later than 20 years after project completion except as provided in paragraph (b)(3) of this section.

(iii) A recipient establishes a dedicated source of revenue for repayment of the loan which is consistent with local ordinances and State laws or, for privately-owned systems, a recipient demonstrates that there is adequate security to assure repayment of the loan.

(2) A State may include eligible project reimbursement costs within loans if:

(i) A system received approval, authorization to proceed, or any similar action by a State prior to initiation of project construction and the construction costs were incurred after such State action; and

(ii) The project met all of the requirements of this subpart and was on the State's fundable list, developed using a priority system approved by EPA. A project on the comprehensive list which is funded when a project on the fundable list is bypassed using the State's bypass procedures in accordance with § 35.3555(c)(2)(ii) may be eligible for reimbursement of costs incurred after the system has been informed that it will receive funding.

(3) A State may include eligible planning and design and other associated pre-project costs within loans regardless of when the costs were incurred.

(4) All payments of principal and interest on each loan must be credited to the Fund.

(5) Of the total amount available for assistance from the Fund each year, a State must make at least 15 percent available solely for providing loan assistance to small systems, to the extent such funds can be obligated for eligible projects. A State that provides assistance in an amount that is greater than 15 percent of the available funds in one year may credit the excess toward the 15 percent requirement in future years.

(6) A State may provide incremental assistance for a project (e.g., for a particularly large, expensive project) over a period of years.

(b) *Assistance to disadvantaged communities.* (1) A State may provide loan subsidies (e.g., loans which include principal forgiveness, negative interest rate loans) to benefit communities meeting the State's definition of "disadvantaged" or which the State expects to become "disadvantaged" as a result of the project. Loan subsidies in the form of reduced interest rate loans that are at or above zero percent do not fall under the 30 percent allowance described in paragraph (b)(2) of this section.

Proposed Language for CWF and DWF Regulation Amendments

(2) A State may take an amount equal to no more than 30 percent of the amount of a particular fiscal year's capitalization grant to provide loan subsidies to disadvantaged communities. If a State does not take the entire 30 percent allowance associated with a particular fiscal year's capitalization grant, it cannot reserve the authority to take the remaining balance of the allowance from future capitalization grants. In addition, a State must:

- Indicate in the Intended Use Plan (IUP) the amount of the allowance it is taking for loan subsidies;
- Commit capitalization grant and required State match dollars taken for loan subsidies in accordance with the binding commitment requirements in § 35.3550(e); and
- Commit any other dollars (e.g., principal and interest repayments, investment earnings) taken for loan subsidies to projects over the same time period during which binding commitments are made for the capitalization grant from which the allowance was taken.

(3) A State may extend the term for a loan to a disadvantaged community, provided that a recipient completes loan repayment no later than 30 years after project completion and the term of the loan does not exceed the expected design life of the project.

(c) *Refinance or purchase of local debt obligations.*—(1) *General.* A State may buy or refinance local debt obligations of municipal, intermunicipal, or interstate agencies where the debt obligation was incurred and the project was initiated after July 1, 1993. Projects must have met the eligibility requirements under section 1452 of the Act and this subpart to be eligible for refinancing. Privately-owned systems are not eligible for refinancing.

(2) *Multi-purpose debt.* If the original debt for a project was in the form of a multi-purpose bond incurred for purposes in addition to eligible purposes under section 1452 of the Act and this subpart, a State may provide refinancing only for the eligible portion of the debt, not the entire debt.

(3) *Refinancing and State match.* If a State has credited repayments of loans made under a pre-existing State loan program as part of its State match, the State cannot also refinance the projects under the DWSRF program. If the State has already counted certain projects toward its State match which it now wants to refinance, the State must provide replacement funds for the amounts previously credited as match.

(d) *Purchase insurance or guarantee for local debt obligations.* A State may provide assistance by purchasing insurance or guaranteeing a local debt obligation to improve credit market access or to reduce interest rates. Assistance of this type is limited to local debt obligations that are undertaken to finance projects eligible for assistance under section 1452 of the Act and this subpart.

(e) *Revenue or security for Fund debt obligations (leveraging).* A State may use Fund assets as a source of revenue or security for the payment of principal and interest on revenue or general obligation bonds issued by the State in order to increase the total amount of funds available for providing assistance. The net proceeds of the sale of the bonds must be deposited into the Fund and must be used for

providing loans and other assistance to finance projects eligible under section 1452 of the Act and this subpart.

(f) *Application of interest earned on fund accounts.* Interest earned on fund accounts may be used to provide financial assistance for debt service, capital expenditures, operations, treatment facilities or be retained to grow SRF balances. Such assistance may only be provided to support eligible systems, projects and costs identified in §35.3520 and may be provided pursuant to or in connection with one of the eligible types of financial assistance identified in this Part.

§ 35.3530 Limitations on uses of the Fund.

(a) *Earn interest.* A State may earn interest on monies deposited into the Fund prior to disbursement of assistance (e.g., on reserve accounts used as security or guarantees). Monies deposited must not remain in the Fund primarily to earn interest. Amounts not required for current obligation or expenditure must be invested in interest bearing obligations.

(b) *Program administration.* A State may not use monies deposited into the Fund to cover its program administration costs. In addition to using the funds available from the administration and technical assistance set-aside under § 35.3535(b), a State may use the following methods to cover its program administration and other program costs.

(1) A State may use the proceeds of bonds guaranteed by the Fund to absorb expenses incurred issuing the bonds. The net proceeds of the bonds must be deposited into the Fund.

(2) A State may assess fees on an assistance recipient which are paid directly by the recipient and are not included as principal in a loan as allowed in paragraph (b)(3) of this section.

These fees, which include interest earned on fees, must be deposited into the Fund or into an account outside of the Fund. If the fees are deposited into the Fund, they are subject to the authorized uses of the Fund. If the fees are deposited into an account outside of the Fund, they must be used for program administration, other purposes for which capitalization grants can be awarded under section 1452, State match under sections 1452(e) and (g)(2) of the Act, or combined financial administration of the DWSRF program and CWSRF program Funds where the programs are administered by the same State agency.

(3) A State may assess fees on an assistance recipient which are included as principal in a loan. These fees, which include interest earned on fees, must be deposited into the Fund or into an account outside of the Fund. If the fees are deposited into the Fund, they are subject to the authorized uses of the Fund. If the fees are deposited into an account outside of the Fund, they must be used for program administration or other purposes for which capitalization grants can be awarded under section 1452. Fees included as principal in a loan cannot be used for State match under sections 1452(e) and (g)(2) of the Act or combined financial administration of the DWSRF program and CWSRF program Funds. Additionally, fees included as principal in a loan:

(i) Cannot be assessed on a disadvantaged community which receives a loan subsidy provided from the 30 percent allowance in § 35.3525(b)(2);

(ii) Cannot cause the effective rate of a loan (which includes both interest and fees) to exceed the market rate; and

(iii) Cannot be assessed if the effective rate of a loan could reasonably be expected to cause a system to fail to meet the technical, financial, and managerial capability requirements under section 1452 of the Act.

(c) *Transfers.* The Governor of a State, or a State official acting pursuant to authorization from the Governor, may transfer an amount equal to 33 percent of a fiscal year's DWSRF program capitalization grant to the CWSRF program or an equivalent amount from the CWSRF program to the DWSRF program. The following conditions apply:

(1) When a State initially decides to transfer funds:

(i) The State's Attorney General, or someone designated by the Attorney General, must sign or concur in a certification for the DWSRF program and the CWSRF program that State law permits the State to transfer funds; and

(ii) The Operating Agreements or other parts of the capitalization grant agreements for the DWSRF program and the CWSRF program must be amended to detail the method the State will use to transfer funds.

(2) A State may not use the transfer provision to acquire State match for either program or use transferred funds to secure or repay State match bonds.

(3) Funds may be transferred after one year has elapsed since a State established its Fund (i.e., one year after the State has received its first DWSRF program capitalization grant for projects), and may include an amount equal to the allowance associated with its fiscal year 1997 capitalization grant.

(4) A State may reserve the authority to transfer funds in future years.

(5) Funds may be transferred on a net basis between the DWSRF program and CWSRF program, provided that the 33 percent transfer allowance associated with DWSRF program capitalization grants received is not exceeded.

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

(d) *Cross-collateralization.* A State may combine the Fund assets of the DWSRF program and CWSRF program as security for bond issues to enhance the lending capacity of one or both of the programs. The following conditions apply:

(1) When a State initially decides to cross-collateralize:

(i) The State's Attorney General, or someone designated by the Attorney General, must sign or concur in a certification for the DWSRF program and the CWSRF program that State law permits the State to cross-collateralize the Fund assets of the DWSRF program and CWSRF program; and

(ii) The Operating Agreements or other parts of the capitalization grant agreements for the DWSRF program and the CWSRF program must be amended to detail the method the State will use to cross-collateralize.

(2) The proceeds generated by the issuance of bonds must be allocated to the purposes of the

Proposed Language for CWF and DWF Regulation Amendments

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

(3) A State may not combine the Fund assets of the DWSRF program and the CWSRF program as security for bond issues to acquire State match for either program or use the assets of one program to secure match bonds for the other program.

(4) The debt service reserves for the DWSRF program and the CWSRF program must be accounted for separately.

(5) Loan repayments must be made to the respective program from which the loan was made.



UNITED STATES ENVIRONMENTAL PROTECTION AGENCY

WASHINGTON, D.C. 20460

MAR 2 2007

OFFICE OF
WATER

Mr. A. James Barnes
Professor of Public and Environmental Affairs
Indiana University
1315 East 10th Street, Suite 418
Bloomington, Indiana 47405

Dear Mr. ^{Jim}Barnes:

Thank you for your letter of January 5, 2007, to Administrator Stephen L. Johnson, in which you transmit on behalf of the Environmental Financial Advisory Board (EFAB), the report, *Expanding the Definition of SRF Financial Assistance*. I appreciate the opportunity to review recommendations from EFAB.

The report proposes expanding existing State Revolving Fund (SRF) authority to allow SRFs to use fund earnings in a new way. The concept is to use earnings to provide assistance for project capital and operating cost subsidies. According to the report, this approach would allow the SRFs to earn more interest by relieving the programs from certain yield restriction provisions of Internal Revenue Service arbitrage regulations. The additional earnings retained in the fund could be used to assist more projects and provide subsidies to borrowers.

The Board presents a novel approach for using SRF resources. As the report acknowledges, however, the approach is beyond the existing authority of the clean water and drinking water SRF programs, and would require new statutory authority to the programs and amending the programs' regulations. As you know, Congress is considering legislation to reauthorize the SRF. The work of EFAB and this report will add value and additional perspective to that debate.

As you are aware, the Agency has undertaken an ambitious effort in collaboration with States, the water utility industry, and many other stakeholders, including the Board, to develop innovative ways to bolster limited financial resources and promote the sustainability of local water infrastructure. An important part of this effort is a conference on Paying for Sustainable Water Infrastructure in Atlanta from March 21-23. The conference will look at a full array of innovative and useful tools for addressing water infrastructure needs. I look forward to the participation of a number of the EFAB Board members in the conference.

Thank you again for providing this report. I encourage you to continue examining innovative methods for addressing the nation's water infrastructure needs, and I look forward to hearing recommendations in the future. If you have questions or wish to speak further about this issue, please contact James A. Hanlon, Director, Office of Wastewater Management, at (202) 564-0748.

Sincerely,

A handwritten signature in black ink, appearing to read "B H Grumbles", with a long horizontal flourish extending to the right.

Benjamin H. Grumbles
Assistant Administrator