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Part II

Environmental Protection Agency

40 CFR Parts 9 and 35
Drinking Water State Revolving Funds; Interim Final Rule

ENVIRONMENTAL PROTECTION AGENCY

40 CFR Parts 9 and 35

[FRL–6846–5]

RIN 2040–AD20

Drinking Water State Revolving Funds

AGENCY: Environmental Protection Agency.

ACTION: Interim final rule.

SUMMARY: The national Drinking Water State Revolving Fund (DWSRF) program, which was established by the Safe Drinking Water Act (SDWA) Amendments of 1996, authorizes the U.S. Environmental Protection Agency (EPA) to award capitalization grants to States, which in turn may provide low-cost loans and other types of assistance to eligible public water systems to finance the costs of infrastructure projects needed to achieve or maintain compliance with SDWA requirements. States are also authorized to set aside a portion of their capitalization grants to fund a range of activities including source water protection, capacity development, and operator certification.

This interim final rule codifies the DWSRF Program Final Guidelines published in February 1997 and explains: what States must do to receive a capitalization grant; what States may do with capitalization grant funds intended for infrastructure projects; what States may do with funds intended for set-aside activities; and the roles of both the States and EPA in managing and administering the program. Each State has considerable flexibility to determine the design of its DWSRF program and to direct funding toward its most pressing compliance and public health needs.

DATES: This interim final rule is effective August 7, 2000. Public comments must be received by EPA, in writing, by October 6, 2000. Comments will be considered and, if necessary, EPA will issue a revised final rule changing today's interim final rule to respond to these comments.

ADDRESSES: Send written comments on this interim final rule to the Comment Clerk (Docket W–00–11), Water Docket (MC–4101), U.S. Environmental Protection Agency, Ariel Rios Building, 1200 Pennsylvania Avenue, NW, Washington, DC 20460. Comments may be hand-delivered to the Water Docket, U.S. Environmental Protection Agency, 401 M Street, SW, East Tower Basement, Room EB57, Washington, DC 20460. Comments may also be submitted electronically to ow-docket@epa.gov.

Please submit an original and three copies of your comments and enclosures (including references). The Agency requests that commentors follow the following format: Type or print in ink, and cite, where possible, the paragraphs in this interim final rule to which each comment refers. Electronic comments must be submitted as a WordPerfect 5.1, 6.1, or 8.0 file or as an ASCII file avoiding the use of special characters and forms of encryption. Electronic comments must be identified by Docket W–00–11. Comments and data will also be accepted on disks in the formats above. Electronic comments may be filed online at many Federal Depository Libraries. Commentors who want EPA to acknowledge receipt of their comments should include a self-addressed, stamped envelope. No facsimiles (faxes) will be accepted.

The record for this interim final rule has been established under Docket W–00–11, which includes supporting documentation, and is available for review at the Water Docket, U.S. Environmental Protection Agency, 401 M Street, SW, East Tower Basement, Room EB57, Washington, DC 20460. For access to the Docket materials, please call (202) 260–3027 between 9 a.m. and 3:30 p.m. (Eastern Time), Monday through Friday, for an appointment and reference Docket W–00–11.

FOR FURTHER INFORMATION CONTACT: For technical inquiries, contact Kimberley Roy, Implementation and Assistance Division, Office of Ground Water and Drinking Water (MC–4606), U.S. Environmental Protection Agency, Ariel Rios Building, 1200 Pennsylvania Avenue, NW, Washington, DC 20460. The telephone number is (202) 260–2794 and the e-mail address is roy.kimberley@epa.gov. For general information, contact the Safe Drinking Water Hotline, toll free at (800) 426–4791. The Safe Drinking Water Hotline is open Monday through Friday, excluding Federal holidays, from 9:00 a.m. to 5:30 p.m. (Eastern Time). DWSRF program information, including a copy of this interim final rule, are available on EPA's Office of Ground Water and Drinking Water website at http://www.epa.gov/safewater/dwsrf.html.

SUPPLEMENTARY INFORMATION: *Regulated Entities:* Entities listed in § 35.3500 are regulated by this rule. Regulated categories and entities include:

Category	Regulated entities
Government	Governments/Agencies of the 50 States and the Commonwealth of Puerto Rico.

This table is not intended to be exhaustive, but rather provides a guide for readers regarding entities likely to be regulated by this action. This table lists the types of entities that EPA is now aware could potentially be regulated by this action. Other types of entities not listed in this table could also be regulated by this action. To determine whether your organization is regulated by this action, you should carefully examine the applicability criteria in § 35.3500 of this rule. If you have questions regarding the applicability of this action to a particular entity, consult the person listed in the preceding **FOR FURTHER INFORMATION CONTACT** section.

Preamble Outline

I. Statutory Authority

This interim final rule implements section 1452 of the SDWA (42 U.S.C. 300j–12) which establishes a national DWSRF program to assist public water systems in financing the cost of drinking water infrastructure projects needed to achieve or maintain compliance with SDWA requirements and to further the public health objectives of the Act. Section 1452(g)(3) of the SDWA states that ''the Administrator shall publish guidance and promulgate regulations as may be necessary to carry out the provisions of this section.''

II. Purpose

This interim final rule codifies and implements requirements for the national DWSRF program under section 1452 of the SDWA. This interim final rule supplements EPA's general grant regulations at 40 CFR part 31 which contain administrative requirements that apply to governmental recipients of EPA grants and subgrants. With the exception of requirements for the participation of minority and women's business enterprises (MBE/WBEs), EPA's general grant regulations at 40 CFR part 31 do not apply to recipients of loans and other types of assistance from a State DWSRF program Fund. The requirements for the participation of MBE/WBEs apply to assistance recipients under EPA's fiscal year 1993 Appropriations Act (Pub. L. 102–389). In developing this interim final rule, EPA has attempted to identify all the major program requirements. To that end, this rule includes items required by the SDWA and those additional program requirements that EPA considers necessary for effective program management.

This interim final rule applies to States (i.e., each of the 50 States and the Commonwealth of Puerto Rico) which receive capitalization grants and are authorized to establish a Fund under section 1452 of the SDWA. While eligible public water systems and other assistance recipients are not regulated by this interim final rule, they may be indirectly affected because it includes requirements that they must meet in order to receive funding from the State for purposes authorized under section 1452 of the SDWA. This interim final rule does not apply to Indian Tribes and Alaska Native Villages, the District of Columbia, and other jurisdictions (i.e., Virgin Islands, the Commonwealth of the Northern Mariana Islands, American Samoa, and Guam) that receive grants under section 1452 because they are not authorized to establish a Fund. Grants under section 1452 to Indian Tribes and Alaska Native Villages, the District of Columbia, and other jurisdictions are administered by the EPA Regional Offices under separate guidance.

III. DWSRF Program Background

The SDWA authorizes EPA to award capitalization grants to States that have established DWSRF programs complying with the requirements of section 1452. States use a portion of these grants to capitalize a revolving Fund from which low-cost loans and other types of assistance are provided to publicly-owned and privately-owned community water systems and non-profit noncommunity water systems to finance the costs of infrastructure projects. States must also contribute to the capitalization of their DWSRF programs by depositing State monies equaling at least 20 percent of each grant into the Fund. Loan repayments made by assistance recipients to the States return to the Fund and provide a continuing source of financing for projects. States are responsible for developing a priority system that identifies how projects will be ranked for funding and a list of projects, in priority order, that are eligible for funding.

While it is essential to address infrastructure needs of public water systems, Congress recognized the value of establishing programs which will prevent drinking water problems in the future. Therefore, States may set aside a portion of their capitalization grants to fund activities that encourage enhanced water system management and help to prevent contamination problems through source water protection measures. The success of these set-aside activities will act to safeguard the DWSRF program funds that are provided for improving system compliance and public health protection. The SDWA also places particular emphasis on assisting small systems serving fewer than 10,000 people and on systems serving less affluent populations by providing greater funding flexibility for these systems.

A State may combine the financial administration of the Fund with the financial administration of any other revolving fund established by the State, including the Clean Water State Revolving Fund (CWSRF) program established under Title VI of the Clean Water Act (CWA). However, section 1452(g)(1)(B) of the SDWA requires that ''the authority to establish assistance priorities and carry out oversight and related activities (other than financial administration) with respect to assistance remains with . . .'' the State primacy agency, after consultation with other appropriate State agencies.

In view of this language and the overall role of the State primacy agency in SDWA programs, EPA has determined that Congress intended for the primacy agency to be the State agency which determines assistance priorities for the DWSRF program, including priorities assigned to projects and allocation of funds between the Fund and set-asides, regardless of whether or not a State combines financial administration of the Fund. Further, although the primacy agency has the authority to carry out oversight and related activities, memoranda of understanding or interagency agreements may be entered into with other State agencies to manage aspects of the DWSRF program which could include reviewing assistance applications and project bid documents, monitoring projects, and ensuring compliance with environmental review and other program requirements.

Beginning one year after a State establishes its Fund (i.e., one year after the State has received its first DWSRF program capitalization grant for projects), a State 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. This provision linking the national DWSRF and the CWSRF programs signals Congressional intent for EPA and the States to implement and manage the two programs in a similar manner. To the

maximum extent practicable, EPA intends to administer the financial aspects of the national DWSRF program in a manner that is consistent with the policies and procedures of the national CWSRF program. Each State has considerable flexibility to determine the design of its program and to direct funding toward its most pressing compliance and public health protection needs.

IV. Allocation of National Appropriation for DWSRF Program

Section 1452(m) of the SDWA authorizes Congress to appropriate a total of $9.6 billion for the national DWSRF program for fiscal years 1994 through 2003.

A. National Set-Asides

National set-asides are reserved from funds annually appropriated by Congress under section 1452 of the SDWA. These national set-asides are:

(1) Indian Tribes/Alaska Native Villages. Section 1452(i) of the SDWA indicates that the Administrator may reserve 1.5 percent from annually appropriated funds under section 1452 to make grants to Indian Tribes and Alaska Native Villages. Projects for Indian Tribes and Alaska Native Villages that have not otherwise received either grant or DWSRF program assistance under section 1452 for a specific project are eligible for grant financing under this provision. EPA published the Tribal Set-aside Program Final Guidelines (EPA 816–R–98–020) in October 1998 establishing requirements for the selection of projects, project management, and program oversight for these grants. The Tribal Set-aside Program is administered by the EPA Regional Offices.

(2) Health effects studies. Section 1452(n) of the SDWA requires the Administrator to reserve $10 million from annually appropriated funds under section 1452 to conduct health effects studies on drinking water contaminants. However, the Department of Veteran Affairs and Housing and Urban Development, and Independent Agencies Appropriations Acts, 1998, 1999, and 2000 (Public Law 105–65, Public Law 105–276, and Public Law 106–74, respectively) have precluded the Administrator from reserving these funds from annually appropriated funds under section 1452 and have instead provided funding for health effects studies from other sources.

(3) Unregulated contaminant monitoring. Starting in fiscal year 1998, section 1452(o) of the SDWA requires the Administrator to reserve $2 million from annually appropriated funds under section 1452 to pay for the costs of monitoring unregulated contaminants under section 1445(a)(2)(C).

(4) Small system technical assistance. Section 1452(q) of the SDWA indicates that the Administrator may reserve up to 2 percent of the funds appropriated under section 1452 in fiscal years 1997 through 2003 to carry out the technical assistance for small systems provisions of section 1442(e) to the extent that the total amount of funding appropriated under section 1442(e) is not sufficient. The total combined amount of funds made available under this set-aside and the funds appropriated under section 1442(e) cannot exceed $15 million per year.

(5) Operator training reimbursement. Section 1419(d)(1) of the SDWA requires the Administrator to provide grants to States to reimburse the costs of training and certifying operators of public water systems serving 3,300 persons or fewer to meet the requirements of the Final Guidelines for the Certification and Recertification of the Operators of Community and Nontransient Noncommunity Public Water Systems published in the **Federal Register** (64 FR 5916) on February 5, 1999. Congress has authorized $30 million annually for fiscal years 1997 through 2003 for grants for reimbursement under section 1419(d)(3). If the appropriation for any fiscal year is not sufficient to meet training and certification costs, the Administrator will, prior to any other allocation or reservation, reserve the necessary funds from those appropriated under section 1452.

B. Allotment to States

The funds available for allotment to the States for capitalization grants are those funds appropriated by Congress under section 1452 of the SDWA less the national set-asides. For fiscal year 1997 appropriations only, section 1452(a)(1)(D)(i) required EPA to allot funds according to the formula used for distributing public water system supervision (PWSS) grants in fiscal year 1995 under section 1443. The minimum proportional share that each State received was one percent of the funds available for allotment to all of the States. This interim final rule does not include this requirement for determining the State allotment formula for fiscal year 1997 appropriations.

Beginning with fiscal year 1998 appropriations, section 1452(a)(1)(D)(ii) of the SDWA requires EPA to allot funds to each State based on the State's proportional share of total eligible needs reported for the most recent Drinking Water Infrastructure Needs Survey conducted under section 1452(h) of the SDWA. The minimum proportional share that each State can receive is one percent of funds available for allotment to all of the States.

The first Drinking Water Infrastructure Needs Survey: First Report to Congress (EPA 812-R–97–001) was presented to Congress on January 29, 1997. Prior to finalizing this January 1997 report, EPA solicited public comment on six options for using the results to determine the allotment formula for fiscal year 1998, 1999, 2000, and 2001 appropriations and finalized the allotment formula in the **Federal Register** (62 FR 12900) on March 18, 1997.

Subsequent Drinking Water Infrastructure Needs Surveys are due to Congress every four years after the January 1997 report. The State allotment formula for fiscal year 2002 appropriations and subsequent appropriations will be adjusted to reflect the needs identified in the most recently published report.

C. Allotment to Other Jurisdictions and the District of Columbia

Section 1452(j) of the SDWA requires the Administrator to reserve up to 0.33 percent of the funds available for allotment to the States to provide grants to the Virgin Islands, the Commonwealth of the Northern Mariana Islands, American Samoa, and Guam. Section 1452(a)(1)(D) of the SDWA requires the Administrator to reserve one percent of the funds available for allotment to the States to provide grants to the District of Columbia. These grants are administered by the EPA Regional Offices.

V. DWSRF Program Implementation

The DWSRF Program Interim Guidance was distributed on October 4, 1996, to allow States to begin to develop their DWSRF programs and to allow capitalization grants to be awarded as soon as possible. The notice of availability of the Interim Guidance was published in the **Federal Register** (61 FR 55635) on October 28, 1996, and announced a public comment period which ended on November 28, 1996. EPA subsequently held a series of public meetings with stakeholders to provide information about the program and to review the Interim Guidance. Comments received during the period of public comment and from attendees of the public meetings were critical in developing the DWSRF Program Final Guidelines.

The DWSRF Program Final Guidelines (EPA–816-R–97–005) were

signed by the Assistant Administrator for Water on February 28, 1997. The Final Guidelines were made widely available to stakeholders, including the appropriate State agencies that are recipients of the DWSRF program capitalization grants and were published in the **Federal Register** (63 FR 59844) on November 5, 1998.

Program requirements contained in the DWSRF Program Final Guidelines are superceded by this interim final rule. However, the Final Guidelines, the DWSRF program management manual, and other memoranda such as periodic question and answer documents will continue to provide guidance to States on DWSRF program implementation.

VI. Rule Development Process

This interim final rule is the result of a thorough stakeholder consultation process. Because States have the responsibility for managing and administering the DWSRF program, members of a State/EPA SRF Work Group (formed to address policy implementation issues for the national DWSRF and CWSRF programs) were given the opportunity to review and comment on previous drafts of this rule. The State/EPA SRF Work Group is comprised of State DWSRF managers, State CWSRF managers, and managers of State financial agencies as well as EPA Regional and Headquarters staff. In May 1998, comments on a draft outline of the interim final rule were solicited and discussed at a State/EPA SRF Work Group meeting in Washington, District of Columbia. All comments on the draft outline were considered in developing the first draft of this rule.

In September 1998, the first draft of this rule was sent to the State/EPA SRF Work Group for a 30 day comment period. Work Group members were encouraged to share the draft rule with their colleagues from other States. EPA received comments from 27 parties, 18 of whom were Work Group members. A number of comments that EPA considered significant (because they addressed policy issues or because they were submitted by more than one commentor) were discussed at a Work Group meeting in Seattle, Washington in November 1998. After the meeting, all comments were considered in developing the second draft of this rule.

The second draft of this rule was posted on the Internet on April 12, 1999, for a 45 day public comment period to give all interested parties an opportunity to comment. National stakeholder organizations, the State/EPA SRF Work Group, and State DWSRF managers were notified by EPA when the rule was posted. EPA received comments from 32 parties representing State government agencies, national trade organizations, and national State government organizations. All comments were considered in developing this interim final rule.

VII. Major Matters in This Rule

This interim final rule includes several modifications or additions to the DWSRF Program Final Guidelines based on policies that have evolved as the DWSRF program has been implemented. These modifications or additions to the Final Guidelines provide additional flexibility to States in implementing their programs. The policies released after the DWSRF Program Final Guidelines went through rounds of comment and revisions in memoranda, guidance documents, or were published in the **Federal Register** for public comment. The requirements in these policies are reflected in this interim final rule.

A. Withholdings of Funds (40 CFR 35.3515 (b)(1)(i) Through (b)(1)(iii))

In order to avoid a withholding of DWSRF program funds, each State is required to: (1) Ensure that new community water systems and new nontransient, noncommunity water systems demonstrate adequate technical, managerial, and financial capacity; (2) develop and implement a strategy to assist existing systems in acquiring and maintaining capacity; and (3) adopt and implement a program for certifying operators of community and nontransient, noncommunity water systems.

EPA published the Draft Guidance on Implementing the Capacity Development Provisions of the SDWA Amendments for public comment in February 1998 for a 60 day comment period and published Final Guidance (EPA–816-R–98–006) in July 1998. The Final Guidance established national policy regarding the implementation of capacity development related provisions of the SDWA including how EPA would assess State capacity development programs for purposes of making withholding decisions.

This interim final rule reflects the requirements in sections 1420(a) and 1452(a)(1)(G)(i) of the SDWA that EPA withhold 20 percent of a State's allotment unless the State has the legal authority or other means to ensure that all new community water systems and new nontransient, noncommunity water systems commencing operations after October 1, 1999, demonstrate technical, managerial, and financial capacity with respect to each drinking water regulation in effect, or likely to be in effect, on the date of commencement of operations.

EPA made the determination in the Final Guidance on Implementing the Capacity Development Provisions that, for fiscal year 1999 allotments only, States would receive 100 percent of their allotments if they had the necessary basis of authority (statutory authority or other means) and were in the process of a scheduled administrative rulemaking, or were otherwise developing implementing authorities with a realistic schedule and expectation to have fully functional programs as of October 1, 1999. States failing to meet this requirement at the time of their capitalization grant awards would have 20 percent of their allotments ''held back.'' This 20 percent holdback of fiscal year 1999 allotments would become a permanent withholding for any State that could not demonstrate by September 30, 1999, that it would have a fully functional program in place on October 1, 1999.

EPA also made the determination in the Final Guidance on Implementing the Capacity Development Provisions that, for fiscal year 2000 allotments and beyond, withholdings would be based on an assessment of the status of the State program as of October 1 of the fiscal year for which the funds were allotted. This interim final rule only reflects the withholding provisions in the Final Guidance for fiscal year 2000 allotments and beyond.

This interim final rule reflects the requirements in sections 1420(c)(1) and 1452(a)(1)(G)(i) of the SDWA that EPA withhold funds from any State unless the State is developing and implementing a strategy to assist public water systems in acquiring and maintaining technical, financial, and managerial capacity. The amount of a State's allotment that will be withheld is 10 percent for fiscal year 2001, 15 percent for fiscal year 2002, and 20 percent for each subsequent fiscal year. EPA made the determination in the Final Guidance on Implementing the Capacity Development Provisions that withholdings would be based on an assessment of the status of the State strategy as of October 1 of the fiscal year for which the funds were allotted. This interim final rule reflects the withholding provisions in the Final Guidance.

EPA published the Public Review Draft Guidelines for the Certification and Recertification of the Operators of Community and Nontransient Noncommunity Public Water Systems in the **Federal Register** (63 FR 15064) for public comment on March 27, 1998, and the Final Guidelines in the **Federal**

Register (64 FR 5916) on February 5, 1999. This interim final rule reflects the requirements in sections 1419(b) and 1452(a)(1)(G)(ii) of the SDWA that, beginning on February 5, 2001 (two years after the Operator Certification Final Guidelines were published), EPA will withhold 20 percent of a State's allotment unless the State has adopted and is implementing a program for certifying operators of community and nontransient, noncommunity water systems that meets the requirements of section 1419 of the SDWA.

This interim final rule also states that the determination for withholdings will be based on an assessment of the status of the State program for each fiscal year. After seeking comment, EPA will finalize the specific process for reviewing and making withholding determinations for operator certification program submittals and publish it in the **Federal Register**. This process will be included as part of the Operator Certification Final Guidelines in Section III (Program Submittal Process), Subsection A (Submittal Schedule and Withholding Process), which is currently reserved in these Final Guidelines.

B. Use of Examples of Projects Eligible for Assistance From the Fund (40 CFR 35.3520(b))

During development of this interim final rule, several commentors expressed concern that the use of examples of projects that are eligible for assistance from the Fund could be perceived as exclusionary. Specifically, commentors were concerned that if there is a project that falls under a particular category but does not closely match an example, then it could be construed that the project would be ineligible. The use of examples of eligible projects is not exclusionary. Examples of eligible projects are used simply to clarify the types of projects that fall under a particular project category in order to improve the readability of this interim final rule. For instance, although water meters are not included in this interim final rule as a funding example under the transmission and distribution project category, they are eligible if owned and maintained by a public water system. Questions about the eligibility of specific types of projects are generally handled by EPA on a case by case basis.

C. Eligibility of Creation of New Public Water Systems for Assistance From the Fund (40 CFR 35.3520(b)(2)(vi))

Section 1452(a)(2) of the SDWA authorizes a State to provide assistance from the Fund to a public water system, which is defined in section 1401 of the SDWA as ''a system for the provision to the public of water for human consumption through pipes or other constructed conveyances, if such system has at least 15 service connections or regularly serves at least 25 individuals * * *'' Several States expressed concern that this provision could be interpreted to prevent them from providing assistance to an entity (*e.g.*, homeowners' association, township) that has a public health problem and is not currently a public water system, but which would become a Federally regulated public water system upon construction of a piped system.

In response to State concerns, EPA proposed a policy on the eligibility of providing assistance from the Fund to create a public water system. This policy was published in the **Federal Register** (63 FR 32208) on June 12, 1998, for a 30 day comment period. EPA also held a stakeholder meeting to discuss the policy. After consideration of comments, a final policy was published in the **Federal Register** (63 FR 59299) on November 3, 1998. The final policy allows for assistance to be provided for the creation of a Federally regulated community water system to address an existing public health problem caused by unsafe drinking water provided by individual wells or surface water sources. This policy also applies to situations where a new regional community water system is created by consolidating several existing systems that have technical, financial, or managerial difficulties.

A proposed project may only receive assistance if the following conditions are met: (1) Upon completion of the project, the entity responsible for the loan must meet the definition of a Federal community water system; (2) the project must be on the State's priority list of projects eligible for funding and must address an actual public health problem with serious risks; (3) the project must be limited in scope to the specific geographic area affected by contamination; (4) the project can only be sized to accommodate a reasonable amount of growth expected over the life of the facility—growth cannot be a substantial portion of the project; (5) the project must meet the same technical, financial, and managerial capacity requirements that the SDWA requires of all DWSRF program assistance recipients; and (6) the project must be a cost-effective solution to the public health problem.

Condition (1) is specifically included in § 35.3520(a)(2). The statement in condition (2) that ''the project must be on the State's priority list of projects eligible for funding,'' the statement in condition (4) that ''the project can only be sized to accommodate a reasonable amount of growth expected over the life of the facility,'' and condition (5) are not specifically included in § 35.3520 (b)(2)(vi) of this interim final rule because the provisions in these conditions are addressed in other sections of the rule (§ 35.3555(c)(2), § 35.3520(e)(5), and § 35.3520(d)(2), respectively) as general requirements that all projects must meet to be eligible for assistance.

The latter part of condition (2) stating that a project ''must address an actual public health problem with serious risks'' and condition (6) are specifically included in § 35.3520 (b)(2)(vi). Condition (3) is clarified in § 35.3520(b)(2)(vi) by indicating that 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. Condition (3) is also clarified in § 35.3520(b)(2)(vi) by indicating that 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. The latter part of condition (4) stating that ''growth cannot be a substantial portion of the project'' is specifically included in § 35.3520 (b)(2)(vi) of this interim final rule as an additional test that projects must meet to be eligible for assistance. As noted earlier, a general requirement for an applicant to receive DWSRF program funding is that a project must be sized only to accommodate a reasonable amount of growth expected over the life of the facility. However, if a substantial portion of a project to create a new system involves funding capacity for future populations anticipated by reasonable growth projections, then the project is not eligible. The purpose of conditions (3) and (4) is to focus the use of funds from the DWSRF program on solving existing public health problems rather than financing new development.

D. Ineligibility of Dams, Reservoirs, Water Rights, and Future Population Growth for Assistance From the Fund (40 CFR 35.3520(e)(1) Through (e)(3) and (e)(5))

During development of the DWSRF Program Final Guidelines and this interim final rule, many comments were received on EPA's decision to make the construction and rehabilitation of dams and reservoirs and the purchase of water rights ineligible for assistance from the Fund. In making the decision to restrict

these types of projects and activities from funding, EPA considered the intent of Congress in passing the SDWA Amendments and, in particular, the required criteria of section 1452(a)(2) that financial assistance under the DWSRF program ''* * * may be used by a public water system only for expenditures * * * of a type or category which the Administrator has determined * * * will facilitate compliance with the national primary drinking water regulations applicable to the system under section 1412 or otherwise significantly further the health protection objectives of the Act.''

EPA also considered the required criteria of section 1452(b)(3)(A) of the SDWA to focus limited dollars on projects needed to address the most serious risk to human health, to ensure that the nation's drinking water is safe through compliance with the national primary drinking water regulations, and to assist those systems with the greatest economic need. Examples of such projects include installation of filtration facilities to help systems meet the Surface Water Treatment Rule, treatment technologies to meet SDWA regulated contaminants, and consolidation of systems that fail to maintain adequate technical, financial, and managerial capacity.

EPA believes that the foremost purpose of the construction and rehabilitation of dams and reservoirs and the purchase of water rights is not to improve drinking water quality, but to satisfy demand for drinking water. Providing DWSRF program assistance for these types of projects will not further the objectives Congress set out in the SDWA to the same extent as the other projects eligible under this interim final rule. The position that the construction and rehabilitation of dams and reservoirs and the purchase of water rights are ineligible for assistance from the Fund has been maintained in this interim final rule in § 35.3520 (e)(1) through (e)(3).

The DWSRF Program Final Guidelines and this interim final rule do allow for specific exceptions to the restrictions on using DWSRF program funds for the purchase of water rights and for the construction and rehabilitation of reservoirs. The exception to the restriction on the purchase of water rights is for those rights that are owned by a system that is being purchased through consolidation as part of a capacity development strategy. The exceptions to the restriction on reservoirs are finished water reservoirs and those reservoirs that are part of the treatment process and are on the property where the treatment facility is located.

The DWSRF Program Final Guidelines and this interim final rule limit the use of DWSRF program funds for costs associated with population growth. Section 1452(g)(3) of the SDWA calls on EPA to publish guidance and regulations as may be necessary to carry out the program, including ''guidance to avoid the use of funds made available under * * * [section 1452] to finance the expansion of any public water system in anticipation of future population growth.'' In the legislative history to the SDWA Amendments, Congress explained that EPA is not to implement this provision in a manner that would ''* * * preclude the use of SRF financing for facilities with the capacity necessary to meet the objectives of the Safe Drinking Water Act for the population to be served by the facility over its useful life.'' [H. Conf. Rep. No. 104–741, at 89 (1996).]

It is clear that Congress did not intend for DWSRF program funds to be used to expand drinking water facilities solely in anticipation of future population growth. However, when read together, the language of the SDWA and its legislative history demonstrate that Congress did allow for the use of DWSRF program funds to accommodate a reasonable amount of population growth, which at the time that funding is provided, is expected to occur over the useful life of a facility. This concept is reflected in this interim final rule in § 35.3520(e)(5).

E. Inclusion of Eligible Project Reimbursement Costs Within Loans (40 CFR 35.3525(a)(2))

Several States wanted to have the flexibility to notify eligible privately-owned and publicly-owned systems that they will receive funding from the State, allow those systems to move ahead with construction, and then reimburse the systems for costs incurred in the time period between the notification and execution of the loan agreement. This flexibility would encourage systems to move ahead with construction in order to, for example, take advantage of seasonal construction cycles. This flexibility was particularly needed for privately-owned systems which cannot benefit from the refinancing provisions under section 1452(f)(2) of the SDWA.

In response to State concerns, EPA proposed a policy on the eligibility of reimbursement of incurred costs for approved projects. This policy was published in the **Federal Register** (63 FR 32208) on June 12, 1998, for a 30 day comment period. EPA also held a stakeholder meeting to discuss the policy. After consideration of comments, a final policy was published in the **Federal Register** (64 FR 1802) on January 12, 1999. The final policy stated that a project (for a privately-owned or publicly-owned system) that has been given approval, authorization to proceed, or any similar action by the State prior to initiation of construction would be eligible for reimbursement for construction costs incurred after such State action, provided that the project meets all of the requirements of the DWSRF program and certain criteria. Planning and design and associated pre-project costs are eligible for reimbursement regardless of when the costs were incurred.

A project must be on the State's fundable list, developed using a priority system approved by EPA. However, a project on the comprehensive list which is funded due to the bypass of a project on the fundable list may be eligible for reimbursement of costs incurred after the system has been informed that it will receive funding. Projects receiving reimbursement of incurred costs are also subject to all other DWSRF program requirements applicable to a recipient of funds, including an environmental review which must consider the impacts of the project based on the pre-construction site conditions. Failure to comply with the State's environmental review process cannot be justified on the grounds that costs have already been incurred, environmental impacts have already been caused, or contractual obligations have been made prior to the binding commitment. This interim final rule reflects the provisions in the final policy.

F. Assistance From the Fund for Disadvantaged Communities (40 CFR 35.3525(b))

Section 1452(d) of the SDWA allows a State to provide additional loan subsidies to benefit communities meeting the State's definition of ''disadvantaged'' or which the State expects to become ''disadvantaged'' as a result of the project, provided that ''* * * for each fiscal year, the total amount of loan subsidies made by a State * * * may not exceed 30 percent of the amount of the capitalization grant received by the State for the year.''

This interim final rule clarifies EPA's interpretation of this provision which is that the 30 percent allowance for loan subsidies to disadvantaged communities refers to the amount of loan subsidies (*e.g.*, loans which include principal forgiveness, negative interest rate loans) that can be provided from funds associated with a particular fiscal year's capitalization grant. If a State does not

take the entire 30 percent allowance for loan subsidies associated with a particular fiscal year's capitalization grant, it cannot reserve the authority to take the remaining balance from future capitalization grants. For example, if a State indicates that it will use an amount equal to 20 percent of the amount of a capitalization grant for loan subsidies, it cannot reserve the authority to take an additional 10 percent from a future capitalization grant. 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.

A State must indicate in its Intended Use Plan (IUP) how much of the 30 percent allowance in loan subsidies it plans to make available to disadvantaged communities. To the maximum extent practicable, a State must identify in its IUP the projects that will receive disadvantaged assistance and the respective amounts. A State can then provide loan subsidies for those projects it has identified in its IUP. Because this approach provides a great deal of flexibility to States, EPA believes that there should be constraints on the time period that States can have to commit funds taken for loan subsidies. Therefore, this interim final rule requires States to commit capitalization grant and required State match dollars taken for loan subsidies in accordance with the binding commitment requirements in § 35.3550(e). In addition, States must 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.

G. Program Administration: Fees Paid Directly by an Assistance Recipient (40 CFR 35.3530(b)(2))

Many States assess fees on assistance recipients to supplement program administration and other program costs. Examples of these fees include annual loan servicing fees, application fees, loan origination fees, and processing fees. A State may assess fees on an assistance recipient which are paid directly by the recipient (discussed in this section). A State may also assess fees on an assistance recipient and provide the recipient with the funds for the fees as principal in a loan (discussed in the next section).

Fees assessed on assistance recipients, 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 SDWA, or combined financial administration of the DWSRF program and CWSRF program Funds where the programs are administered by the same State agency. Allowing fees to be used for combined financial administration enables States which administer the CWSRF and DWSRF programs under the same State agency to combine eligible funds to pay costs for financial oversight of the two programs and thereby ease their administrative burden. The uses of fees assessed on assistance recipients as provided in this interim final rule are consistent with the program income requirements of EPA's general grant regulations at 40 CFR 31.25 and offer a great deal of flexibility to States.

A State must provide information in its IUP on the rates and uses of fees it assesses on assistance recipients and give an accounting of the total dollar amount of funds it is holding in fee accounts. A State must establish in its Biennial Report that it has used the fees only for eligible purposes and must submit information on the total dollar amount in fee accounts as part of the detailed financial reports.

H. Program Administration: Fees Included as Principal in a Loan (40 CFR 35.3530(b)(3))

A State may assess fees on an assistance recipient and, within the principal of a loan, provide the recipient with the funds to pay the fees (*i.e.,* the recipient pays the fees from the proceeds of the loan). EPA determined that such fees are permissible if they enable the State to make a loan which ''* * * facilitate(s) compliance with national primary drinking water regulations * * * or otherwise significantly further(s) the health protection objectives'' of the SDWA under section 1452(a)(2). However, this interim final rule imposes requirements and limitations on the amount and use of fees included as principal in a loan.

Fees included as principal in a loan, 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 SDWA or combined financial administration of the DWSRF program and CWSRF program Funds. EPA believes that the authorized uses for fees included as principal in a loan offer a great deal of flexibility to States.

After discussions with the State/EPA SRF Work Group during meetings in July 1998 and November 1998, the following three specific limitations on fees included as principal in a loan were included in this interim final rule: (1) Fees cannot be assessed on a disadvantaged community which receives a loan subsidy provided from the 30 percent allowance in § 35.3525(b)(2); (2) fees cannot cause the effective rate of a loan (which includes both interest and fees) to exceed the market rate; and (3) fees 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 SDWA.

A State must provide information in its IUP on the rates and uses of fees included as principal in a loan and give an accounting of the total dollar amount of funds it is holding in fee accounts. A State must establish in its Biennial Report that it has used the fees only for eligible purposes and must submit information on the total dollar amount in fee accounts as part of the detailed financial reports.

I. Transfer and Cross-Collateralization of Funds Between the DWSRF and CWSRF Programs (40 CFR 35.3530 (c) Through (d))

Section 302 of the SDWA authorizes a State to transfer up to 33 percent of the amount 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 Department of Veteran Affairs and Housing and Urban Development, and Independent Agencies Appropriations Acts, 1998 and 1999 (Pub. L. 105–65 and Pub. L. 105–276, respectively) authorize cross-collateralization between the DWSRF and CWSRF programs.

EPA released a draft policy entitled ''Transfer/Cross-collateralization Policy for the DWSRF and CWSRF'' in June 1998 which specifies the provisions that States must meet in order to gain EPA approval for incorporating transfers and cross-collateralization provisions into their programs. This draft policy was developed with substantial input from EPA Regional staff, the State/EPA SRF

Work Group, and national stakeholder organizations. The final policy will be published in the **Federal Register**. This interim final rule includes the transfer and cross-collateralization requirements for both the DWSRF program and the CWSRF program.

J. Authorized Set-Aside Activities (40 CFR 35.3535(a)(2))

As in the DWSRF Program Final Guidelines, set-aside funds may not be used for projects or project-related costs eligible for funding from the Fund or for those projects or project-related costs explicitly identified as ineligible for assistance from the Fund in this interim final rule. This requirement was included in this rule because EPA determined that projects that are eligible for loans or other types of assistance from the Fund should not also be eligible to receive assistance from the set-asides in the form of grants which would not be required to be repaid. In addition, set-aside funds should not be used to provide assistance to projects that are explicitly ineligible for assistance from the Fund since it has been determined that these types of projects will not further the objectives Congress set out in the SDWA to the same extent as the projects that are eligible in this interim final rule.

During development of this interim final rule, several commentors indicated that the requirement that set-aside funds may not be used for any projects that are eligible or explicitly ineligible for assistance from the Fund is overly restrictive because there are some eligible project costs that States would want the flexibility to be able to finance from the set-asides. Specifically, commentors noted that they wanted the flexibility to provide grants to small systems for drinking water infrastructure planning and design as part of a State's technical assistance program, with the reasonable expectation that as a result of a grant, a recipient would then be in a position to apply for a loan from the Fund at a future time. In addition, commentors wanted the flexibility to provide grants to systems for projects that would assist in implementation of capacity development provisions.

In response to commentor concerns, this interim final rule allows for two exceptions to the requirement that a State may not use set-aside funds for those projects or project-related costs that are eligible or explicitly ineligible for assistance from the Fund. These exceptions are: (1) A State may use set-aside funds for project planning and design costs for small systems, and (2) a State may use set-aside funds for costs associated with restructuring a system as part of a capacity development strategy. EPA believes that these exceptions provide the flexibility that commentors wanted.

K. State Program Management Set-Aside Match Requirement (40 CFR 35.3535(d)(2))

Section 1452(g)(2) of the SDWA states that ''* * * each State may use up to an additional 10 percent of the funds allotted to the State under this section [for specified purposes] * * * if the State matches the expenditures with at least an equal amount of State funds. At least half of the match must be additional to the amount expended by the State for public water supervision in fiscal year 1993.'' This interim final rule states that ''* * * a State is authorized to use the amount of State funds it expended on its PWSS program in fiscal year 1993 (including PWSS match) as a credit toward meeting its match requirement. The value of this credit can be up to, but not greater than, 50 percent of the amount of match that is required. After determining the value of the credit that it is eligible to receive, a State must provide the additional funds necessary to meet the remainder of the match requirement. The source of these additional funds can be State funds (excluding PWSS match) or documented in-kind services.''

During development of this interim final rule, commentors had questions about how the match for the State program management set-aside is specifically calculated. Suggestions were made to include a specific example of how to calculate the match requirement in this interim final rule. Rather than include a lengthy example within the text of this rule, EPA worked to make the language describing the match for the set-aside more clear than it had been in the DWSRF Program Final Guidelines. The Final Guidelines, which can still serve as a resource for States, does include a lengthy example that States may refer to if they have any questions.

Commentors also suggested that a list of the specific types of in-kind services that are eligible for a State to use to meet the remainder of the match requirement should be included in this interim final rule. EPA determined that listing all of the eligible types of in-kind services in this interim final rule would be unnecessarily limiting and that in-kind services are sufficiently addressed in the DWSRF Program Final Guidelines and specific questions can be handled by EPA on a case by case basis.

L. Reserving Set-Aside Funds (40 CFR 35.3540(d))

The DWSRF Program Final Guidelines allowed States to ''bank'' (*i.e.,* reserve) certain set-aside funds and/or authority that it could not use in the current year for use in future years to give States flexibility in implementing set-aside activities. Several early capitalization grant applications indicated that States were reserving a high percentage of set-aside funds with the intention of using only a small percentage in the short-term and leaving the remaining funds as undrawn reserves. Because EPA was concerned that reserved set-aside funds would sit idle while needed infrastructure projects went unfunded, a proposed policy was developed to describe how set-aside funds should be managed in the DWSRF program. The proposal was distributed to EPA Regional staff, States, and the State/EPA SRF Work Group in February 1998. After several rounds of review and comment, an interim final policy entitled ''Management of Set-asides for the DWSRF Program'' was released and became effective on March 15, 1999.

The interim final policy allowed a State to reserve set-aside funds from a capitalization grant and expend them over a period of time, provided that the State identifies the amount of funds reserved in the IUP and describes the use of the funds in workplans approved by EPA. With the exception of the local assistance and other State programs set-aside authorized under section 1452(k) of the SDWA, a State may also reserve the authority to take from future capitalization grant awards those set-aside funds that it has not included in workplans. The State must identify in its IUP the amount of authority reserved from a capitalization grant for future use.

States can submit annual or multi-year workplans in accordance with schedules identified by EPA Regional staff to describe how funds will be used. The length of workplans must be less than four years, unless a longer term is approved by EPA, and must be updated if the State significantly changes planned activities or budgets. This interim final rule reflects the provisions in the interim final policy.

M. State Match Requirement (40 CFR 35.3550(g))

This interim final rule reflects the requirement in section 1452(e) of the SDWA that a State deposit into the Fund an amount from State monies that equals at least 20 percent of each capitalization grant payment. However,

this interim final rule does not include the provision in section 1452(e) which allowed States to defer their matching requirement for fiscal year 1997 appropriations. Specifically, for grant payments made to States from funds appropriated in fiscal year 1997, States were authorized to defer deposit of their matching amount to no later than September 30, 1999. This flexibility was provided to those States that needed additional time to secure State funding for the required matching amount. States were required to identify the source of the matching funds in their capitalization grant applications and to agree to provide the State match for grant payments already received from fiscal year 1997 appropriations by September 30, 1999. In addition, after September 30, 1999, States could not draw Federal dollars from the EPA Automated Clearing House (ACH) for projects until the deferred State match had been expended and the States reached proportionality with previously drawn Federal dollars.

N. Preparation of an IUP (40 CFR 35.3555(a))

This interim final rule reflects the requirement in the DWSRF Program Final Guidelines that a State prepare an annual IUP as long as the Fund or set-aside accounts remain in operation. During development of this interim final rule, several commentors objected to this requirement because they believe that the SDWA only ties the preparation of an IUP to the award of a capitalization grant and is silent on what is required of States after capitalization ends. Section 1452(b)(1) of the SDWA states that ''after providing for public review and comment, each State that has entered into a capitalization grant agreement pursuant to this section shall annually prepare a plan that identifies the intended uses of the amounts available to the State loan fund of the State.'' Thus, a State that has entered into an agreement to receive a capitalization grant under section 1452 must prepare an IUP each year, regardless of whether it receives a capitalization grant in that year.

In addition, section 1452(c) requires that ''the fund corpus shall be available in perpetuity for providing financial assistance under this section.'' This provision shows that Congress intended for State DWSRF programs to continue after capitalization ends. The primary means by which the public and EPA can ensure that this provision and the intent of Congress is satisfied is through review of the IUP. Therefore, the language in this interim final rule has not been changed as a result of the comments received.

O. Meaningful Public Review of the IUP (40 CFR 35.3555(b))

Section 1452(b)(1) of the SDWA requires a State to provide for public comment and review during the development of its IUP. Any State process that solicits input from a variety of interested parties, allows adequate time for the public to comment, and allows time for the State to address major comments meets the SDWA's public participation requirements for the IUP. This interim final rule reflects the requirement in the DWSRF Program Final Guidelines that a State seek ''meaningful public review and comment'' during the development of its IUP. During development of this interim final rule, comments were received that EPA should define the term ''meaningful public review.''

This interim final rule does not include specific requirements as to what constitutes ''meaningful public review'' of the IUP. Due to the variation among States, no single approach will work under all conditions. However, at a minimum, States should make an effort to include interested parties, such as environmental and public health groups, that extend beyond those on existing mailing lists when seeking public review. In addition, as a guide, States should strive to achieve the following objectives when seeking public review: (1) Assure that the public has the opportunity to understand official programs and proposed actions, and that the State fully considers the public's concerns; (2) assure that the State does not make any significant decision on any activity under section 1452 without consulting interested and affected segments of the public; (3) assure that the State action is as responsive as possible to public concerns; (4) encourage public involvement in implementing section 1452; (5) keep the public informed about significant issues and proposed project or program changes as they arise; (6) foster a spirit of openness and mutual trust between the State and the public; and (7) use all feasible means to create opportunities for public participation, and to stimulate and support public participation.

P. Priority System Requirements in the IUP (40 CFR 35.3555(c)(1))

This interim final rule requires that the IUP ''* * * include a priority system for ranking individual projects for funding that provides sufficient detail for the public and EPA to readily understand the criteria used for ranking.'' During development of this interim final rule, several commentors indicated that EPA should not require a State to include its priority system in the IUP, but instead should allow a State to provide a summary of the priority system or a reference to where the priority system can be found. Commentors gave the following primary reasons for not wanting to include the priority system in the IUP: (1) Many of the priority systems are complex and are not readily understood by the public, especially if the systems are in regulation; (2) including the priority system within the text of the IUP simply elongates and clutters the IUP and discourages people from reading it; and (3) including the priority system gives the impression to the public that the State is seeking additional comments when, in actuality, the priority system has already undergone public review and comment.

The language in this interim final rule has not been changed as a result of the comments received because EPA believes that the public should be given every opportunity to understand the basis for ranking projects. EPA believes that the language in this rule does not preclude a State that has a very complicated priority system which is difficult for the public to understand from developing a detailed summary that describes the criteria used to assess the priority for ranking individual projects, including points. In addition, if a State does not want to include the priority system within the text of the IUP, it can include the system as an attachment that is distributed with the IUP. Finally, a State can indicate in the IUP that the priority system was developed with public comment and therefore it is not taking additional comments, but the State is providing the information so that the public can understand the basis for ranking of projects.

Q. Cash Draw Rules (40 CFR 35.3560 and 35.3565)

This interim final rule details the specific requirements for how States access capitalization grant funds through the EPA ACH, which is a Federal funds transfer system to electronically deposit funds into a grant recipient's bank account. In § 35.3560 of this interim final rule, the general cash draw rules are provided for how States access capitalization grant funds through the ACH, including the formula for calculating the proportionate Federal share. In § 35.3565 of this interim final rule, the specific cash draw rules are provided for how States access capitalization grant funds through the

ACH for each of the authorized types of assistance from the Fund.

EPA published a Guide to Using EPA's Automated Clearing House for the DWSRF Program (EPA–832–B98–003) in September 1998 to explain, in more detail, the process States must use to access capitalization grant funds through the ACH. This Guide provides easy to understand examples, using sample capitalization grant amounts, of how to calculate the proportionate Federal share and how to calculate the cash draw ratios for each of the types of assistance from the Fund.

In the future, the EPA ACH will be replaced by a new Federal funds transfer system called the Automated Standard Application for Payments (ASAP). This change to ASAP will not have any effect on the cash draw rules in this interim final rule.

R. Audit Requirements (40 CFR 35.3570(b))

The DWSRF Program Final Guidelines, published in February 1997 after release of the Single Audit Act Amendments of 1996, reflected EPA's previous audit strategy which was to require annual independent audits of the DWSRF program—a policy that was consistent with requirements in the CWSRF program. However, provisions of the Single Audit Act Amendments of 1996 necessitated changes to this strategy. Specifically, since independent audits were not required by the Single Audit Act Amendments of 1996, EPA revised its audit strategy to request voluntary agreements from States to conduct these audits. The strategy was based on EPA's belief that independent audits of financial statements, beyond the Single Audit Act, are important to ensure the financial integrity of the DWSRF program. On October 16, 1997, a memorandum entitled ''Clean Water and Drinking Water State Revolving Fund Financial Audit Strategy'' was released after discussions among representatives from EPA Headquarters and Regional Offices, the Office of the Inspector General, the Office of Management and Budget, and many States.

Under the revised audit strategy for the DWSRF program, a State must comply with the provisions of the Single Audit Act Amendments of 1996 and Office of Management and Budget's Circular A–133 and Compliance Supplement. States may agree to implement, on an annual basis, independent audits and document these agreements in the Operating Agreements or in other parts of the capitalization grant agreements. These independent audits are expected to be conducted according to Generally Accepted Government Auditing Standards (GAGAS) and provide an auditor's opinion on the DWSRF program financial statements, reports on internal controls, and reports on compliance with section 1452 of the Act, applicable regulations, and EPA's general grant requirements. Based on a determination by EPA, those States that do not conduct independent audits will be periodically audited by the EPA Office of Inspector General.

For those States that conduct independent audits, the audit report should be completed and submitted to EPA within one year of the end of the fiscal year adopted by the State for the DWSRF program. Specifically, copies of the audit report should be submitted to the EPA DWSRF Regional Coordinator and to the Western Audit Division, Divisional Inspector General for Audit. This interim final rule reflects the provisions in the revised audit strategy. Exclusive of requirements associated with the Single Audit Act, a State must include detailed financial statements presenting the financial status of the DWSRF program in its Biennial Report.

S. Application of Federal Cross-Cutting Authorities (Cross-Cutters) (40 CFR 35.3575)

There are a number of Federal laws, executive orders, and government-wide policies that apply by their own terms to projects and activities receiving Federal financial assistance, regardless of whether the statute authorizing the assistance makes them applicable. These Federal cross-cutting authorities (*i.e.,* cross-cutters) include Federal laws such as the Endangered Species Act (ESA) and the Age Discrimination Act (ADA). A few cross-cutters apply by their own terms only to the State as the grant recipient because the authorities explicitly limit their application to grant recipients.

Federal cross-cutter requirements, which include environmental review requirements, must be applied to projects and activities receiving Federal dollars. Because each State's Fund consists of an indistinguishable combination of Federal, State, and recycled monies, EPA determined that Federal cross-cutter requirements must be applied to projects identified by the State whose cumulative funding is equivalent to the amount of the capitalization grant (*i.e.,* equivalency projects). The cross-cutter discussion in the DWSRF Program Final Guidelines resulted in some confusion among States as to how cross-cutter requirements must be applied to set-aside activities.

Due to requirements related to the deposit of funds in the DWSRF program, almost all of the funds used to conduct set-aside activities are Federal dollars. Therefore, Federal cross-cutter requirements must be applied to all set-aside activities for which a State provides assistance from capitalization grant funds deposited into set-aside accounts. However, in the case of most set-aside activities, the cross-cutter requirements will not be implicated because of the nature of the activities conducted under the set-asides. For example, if a State makes an expenditure from its set-aside accounts for the salaries of State employees, the requirements of cross-cutters such as the ESA and the National Historic Preservation Act (NHPA) are not implicated.

This interim final rule reflects EPA's determination that the requirements of Federal cross-cutters must be applied to all activities for which a State provides assistance from capitalization grant funds deposited into set-aside accounts, to the extent that cross-cutter requirements are applicable. The requirements of Federal cross-cutters must also be applied to all projects for which a State provides assistance in amounts up to the amount of the capitalization grant deposited into the Fund. Federal anti-discrimination law requirements apply to all programs, projects, and activities for which a State provides assistance from the DWSRF program. Minority and women's business enterprise (MBE/WBE) procurement requirements and environmental review requirements (discussed in the following sections) apply to specific types of DWSRF program actions and are treated separately in this interim final rule.

Generally, a State that elects to impose the requirements of the Federal cross-cutters to projects and activities in amounts that are more than the amount of the capitalization grant may only credit this excess to meet future cross-cutter requirements on assistance provided from the respective accounts. For example, if a State takes $2 million from a $10 million capitalization grant for set-aside activities and then proceeds to apply cross-cutter requirements to set-aside activities in an amount equal to $2.5 million (because the State has contributed $500,000 of its own funds to these activities), the State can only credit the excess $500,000 to meet future cross-cutter requirements for set-aside activities. A State cannot use this excess $500,000 to meet future cross-cutter requirements for projects funded from the Fund.

This interim final rule provides clarification with respect to the role of States in ensuring compliance with Federal cross-cutters. Although EPA is ultimately responsible for ensuring compliance with Federal cross-cutters, primarily through DWSRF program oversight and approval, States review the projects and activities being funded under the program. Therefore, this interim final rule indicates that States are responsible for ensuring that assistance recipients comply with the cross-cutter requirements, including initiating any required consultations with State or Federal agencies responsible for individual cross-cutters. For example, before a Federally-assisted action that may affect an endangered species can begin, the Department of Interior's Fish and Wildlife Service must be consulted pursuant to section 7 of the ESA. States must notify EPA when it is necessary for the Agency to resolve any issues that may arise during consultations with other Federal agencies.

A list of the Federal cross-cutters that apply to the DWSRF program is provided in Appendix A of the DWSRF Program Final Guidelines. This list is subject to change.

T. Minority and Women's Business Enterprise (MBE/WBE) Procurement Requirements (40 CFR 35.3575(d))

The requirements for the participation of MBE/WBEs apply to assistance recipients under EPA's fiscal year 1993 Appropriations Act (Public Law 102–389), which states that ''the Administrator of the Environmental Protection Agency shall, hereafter, to the fullest extent possible, ensure that at least 8 per centum of Federal funding for prime and subcontracts in support of authorized programs, including grants, loans and contracts * * * be made available to business concerns * * * owned or controlled by socially and economically disadvantaged individuals * * * [including] women.''

This interim final rule requires that a State negotiate a fair share goal with the Regional Administrator (RA) of EPA for the participation of MBE/WBEs. The fair share goal must be based on the availability of MBE/WBEs in the relevant market area (*i.e.*, availability of MBE/WBEs State-wide or availability of MBE/WBEs in particular geographic areas of the State) to do the work under the DWSRF program. Each capitalization grant agreement must describe how a State will comply with MBE/WBE procurement requirements, including how it will apply the fair share goal to assistance recipients to which the requirements apply and how it will assure that assistance recipients take the following six affirmative steps described in the general grant regulations at 40 CFR 31.36(e): (1) Include small, minority and women's businesses on solicitation lists; (2) assure that small, minority and women's businesses are solicited whenever they are potential sources; (3) divide total requirements, when economically feasible, into smaller tasks or quantities to permit maximum participation by small, minority and women's businesses; (4) establish delivery schedules, when the requirements of the work permits, which will encourage participation by small, minority and women's businesses; (5) use the services of the Small Business Administration and the Minority Business Development Agency of the U.S. Department of Commerce, as appropriate; and (6) require the contractor to take the affirmative steps in (1) through (5) if the contractor awards subagreements.

Currently, the application of MBE/WBE requirements in the DWSRF program is described in a memorandum released on November 5, 1998, entitled ''Application of Minority and Women-Owned Business Enterprise Requirements in the Clean Water and Drinking Water State Revolving Fund Programs'' and in a memorandum released on December 29, 1998, entitled ''FY 1999 MBE/WBE Terms and Conditions.'' These memoranda were released in response to the Supreme Court decision in *Adarand Constructors, Inc.* v. *Pena*, 515 U.S. 200 (1995), which was a case arising out of the Department of Transportation. As a result of that decision, it became necessary to make changes in the application of MBE/WBE procurement requirements in all EPA grant programs.

These memoranda indicate that the fair share goal may be based either on the availability of MBE/WBEs State-wide or on the availability of MBE/WBEs in particular geographic areas of the State to do the work for procurement. The fair share goal applies to all procurement activities undertaken with assistance from the Fund or from set-aside accounts up to the amount of the capitalization grant (*i.e.*, ''identified procurement activities''). The State may elect to apply the fair share goal in place for the year in which the DWSRF program assistance is awarded to the recipient or for the year in which the procurement action occurs. The method a State elects to use to apply the fair share goal must be described in the Operating Agreement or in another part of the capitalization grant agreement. For identified procurement activities, the State must assure that the recipients of funding for these activities take the six affirmative steps as described in 40 CFR 31.36(e). A State must submit a MBE/WBE Utilization Report (EPA Form 5700–52A) to EPA within 30 days after the end of each Federal fiscal quarter.

EPA's Office of Small and Disadvantaged Business Utilization (OSDBU) is in the process of a rulemaking to address the use of MBE/WBE firms in procurements under EPA financial assistance agreements and will consolidate these requirements in a new 40 CFR part 33. This rulemaking process will address the application of MBE/WBE requirements in the DWSRF program, including reporting requirements. When the OSDBU's rule is promulgated, the MBE/WBE requirements in that rule will supercede the requirements in this interim final rule.

U. Environmental Review Requirements (40 CFR 35.3580)

As stated previously, cross-cutter requirements, which include environmental review requirements, must be applied to all set-aside activities for which a State provides assistance from capitalization grant funds deposited into set-aside accounts. In § 35.3580 (c), it is indicated that a State may elect to apply the procedures at 40 CFR part 6 and related subparts, which set out the requirements for EPA actions which are subject to the National Environmental Policy Act (NEPA), or apply its own ''NEPA-like'' State environmental review process (SERP) for conducting environmental reviews, provided that specific elements are met. In implementing environmental review requirements applicable to the DWSRF program, EPA has taken an approach similar to that of the CWSRF program whereby States must develop and implement environmental provisions for projects and activities receiving assistance.

EPA recognizes that there are types of activities conducted under set-asides that are not likely to have a potential environmental impact. Therefore, in this interim final rule, EPA has identified types of set-aside activities for which a State is not required to conduct environmental reviews because they are not likely to have a potential environmental impact. A State does not need to include provisions in its SERP for excluding these types of activities.

EPA's Office of Federal Activities (OFA) is currently revising 40 CFR part 6. However, this effort to revise 40 CFR part 6 is not expected to affect the environmental review requirement provisions in this interim final rule or

the SERPs that are currently approved and in effect in the States, since State environmental review procedures, although they may be based on 40 CFR part 6, are implemented under State statutes and authorities.

VIII. Administrative Requirements

A. Executive Order 12866: Regulatory Planning and Reviews

Under Executive Order 12866, (58 FR 51735 (October 4, 1993)) the Agency must determine whether the regulatory action is ''significant'' and therefore subject to OMB review and the requirements of the Executive Order. The Executive Order defines ''significant regulatory action'' as one that is likely to result in a rule that may:

(1) Have an annual effect on the economy of $100 million or more or adversely affect in a material way the economy, a sector of the economy, productivity, competition, jobs, the environment, public health or safety, or State, local, or tribal governments or communities;

(2) Create a serious inconsistency or otherwise interfere with an action taken or planned by another agency;

(3) Materially alter the budgetary impact of entitlements, grants, user fees, or loan programs or the rights and obligations of recipients thereof; or

(4) Raise novel legal or policy issues arising out of legal mandates, the President's priorities, or the principles set forth in the Executive Order.

It has been determined that this rule is not a ''significant regulatory action'' under the terms of Executive Order 12866 and is therefore not subject to OMB review.

B. Regulatory Flexibility Act (RFA), As Amended by the Small Business Regulatory Enforcement Fairness Act of 1996 (SBREFA), 5 U.S.C. 601 et seq.

Today's interim final rule is not subject to the RFA, which generally requires an agency to prepare a regulatory flexibility analysis for any rule that will have a significant economic impact on a substantial number of small entities. The RFA applies only to rules subject to notice and comment rulemaking requirements under the Administrative Procedure Act (APA) or any other statute. This rule is not subject to notice and comment requirements under the APA or any other statute. This rule pertains to grants which the APA expressly exempts from notice and comment rulemaking requirements. 5 U.S.C. 553(a)(2). Moreover, the Safe Drinking Water Act, as amended, also does not require EPA to issue a notice of proposed rulemaking prior to issuing this rule.

Although this interim final rule is not subject to the RFA, EPA nonetheless has assessed the potential of this rule to adversely impact small entities subject to the rule. The Agency has determined that this rule does not adversely impact small entities because small entities are not subject to this rule.

C. Paperwork Reduction Act

The Office of Management and Budget (OMB) has approved the information collection requirements contained in this rule under the provisions of the Paperwork Reduction Act, 44 U.S.C. 3501 *et seq.* and has assigned OMB control number 2040–0185. OMB approved the information collection requirements contained in the February 1997 DWSRF Program Final Guidelines. This rule does not contain any collection of information requirements beyond those already approved. Since this action imposes no new or additional information collection, reporting or record keeping requirements subject to the Paperwork Reduction Act, 44 U.S.C. 3501 *et seq.*, no information request was submitted to the OMB for review. OMB has approved ICR 2040–0185 for use with this rule and authorized the inclusion of the OMB control number in 40 CFR part 9.

An Agency may not conduct or sponsor, and a person is not required to respond to a collection of information unless it displays a currently valid OMB control number. The OMB control numbers for EPA's regulations are listed in 40 CFR part 9 and 48 CFR Chapter 15. EPA is amending the table in 40 CFR part 9 of currently approved ICR control numbers issued by OMB for various regulations to list the information requirements contained in this rule.

D. Unfunded Mandates Reform Act

Title II of the Unfunded Mandates Reform Act of 1995 (UMRA), Public Law 104–4, establishes requirements for Federal agencies to assess the effects of their regulatory actions on State, local, and tribal governments and the private sector. Under section 202 of the UMRA, EPA generally must prepare a written statement, including a cost-benefit analysis, for proposed and final rules with ''Federal mandates'' that may result in expenditures to State, local, and tribal governments, in the aggregate, or to the private sector, of $100 million or more in any one year. Before promulgating an EPA rule for which a written statement is needed, section 205 of the UMRA generally requires EPA to identify and consider a reasonable number of regulatory alternatives and adopt the least costly, most cost-effective or least burdensome alternative that achieves the objectives of the rule. The provisions of section 205 do not apply when they are inconsistent with applicable law. Moreover, section 205 allows EPA to adopt an alternative other than the least costly, most cost-effective or least burdensome alternative if the Administrator publishes with the final rule an explanation why that alternative was not adopted. Before EPA establishes any regulatory requirements that may significantly or uniquely affect small governments, including tribal governments, it must have developed under section 203 of the UMRA a small government agency plan. The plan must provide for notifying potentially affected small governments, enabling officials of affected small governments to have meaningful and timely input in the development of EPA regulatory proposals with significant Federal intergovernmental mandates, and informing, educating, and advising small governments on compliance with the regulatory requirements.

Today's rule contains no Federal mandates (under the regulatory provisions of Title II of the UMRA) for State, local, or tribal governments or the private sector. The UMRA excludes from the definition of ''Federal intergovernmental mandate'' duties that arise from conditions of Federal assistance. Thus, today's rule is not subject to the requirements of sections 202 and 205 of the UMRA. EPA has determined that this rule contains no regulatory requirements that might significantly or uniquely affect small governments. Small governments are not subject to this rule, therefore it will not significantly or uniquely affect them. Many small governments will actually benefit through receipt of assistance from the DWSRF program. Thus, today's rule is not subject to the requirements of section 203 of the UMRA.

E. National Technology Transfer and Advancement Act

Section 12(d) of the National Technology Transfer and Advancement Act of 1995 (''NTTAA''), Public Law 104–113, section 12(d) (15 U.S.C. 272 note) directs EPA to use voluntary consensus standards in its regulatory activities unless to do so would be inconsistent with applicable law or otherwise impractical. Voluntary consensus standards are technical standards (*e.g.*, materials specifications, test methods, sampling procedures, and business practices) that are developed or adopted by voluntary consensus standards bodies. The NTTAA directs EPA to provide Congress, through OMB, explanations when the Agency decides

not to use available and applicable voluntary consensus standards.

This action does not involve technical standards. Therefore, EPA did not consider the use of any voluntary consensus standards.

F. Congressional Review Act

The Congressional Review Act, 5 U.S.C. 801 *et seq.*, as added by the Small Business Regulatory Enforcement Fairness Act of 1996, generally provides that before a rule may take effect, the agency promulgating the rule must submit a rule report, which includes a copy of the rule, to each House of the Congress and to the Comptroller General of the United States. EPA will submit a report containing this rule and other required information to the U.S. Senate, the U.S. House of Representatives, and the Comptroller General of the United States prior to publication of the rule in the **Federal Register**. A major rule cannot take effect until 60 days after it is published in the **Federal Register**. This action is not a ''major rule'' as defined by 5 U.S.C. 804(2). This rule will be effective August 7, 2000.

G. Executive Order 13132: Federalism

Executive Order 13132, entitled ''Federalism'' (64 FR 43255, August 10, 1999), requires EPA to develop an accountable process to ensure ''meaningful and timely input by State and local officials in the development of regulatory policies that have federalism implications.'' ''Policies that have federalism implications'' is defined in the Executive Order to include regulations that have ''substantial direct effects on the States, on the relationship between the national government and the States, or on the distribution of power and responsibilities among the various levels of government.''

Under Section 6 of Executive Order 13132, EPA may not issue a regulation that has federalism implications, that imposes substantial direct compliance costs, and that is not required by statute, unless the Federal government provides the funds necessary to pay the direct compliance costs incurred by State and local governments, or EPA consults with State and local officials early in the process of developing the proposed regulation. EPA also may not issue a regulation that has federalism implications and that preempts State law, unless the Agency consults with State and local officials early in the process of developing the proposed regulation.

This interim final rule does not have federalism implications. It will not have substantial direct effects on the States, on the relationship between the national government and the States, or on the distribution of power and responsibilities among the various levels of government, as specified in Executive Order 13132. This interim final rule mainly codifies and makes minor changes to the DWSRF Program Final Guidelines under which the program has been operating since 1997. Apart from the minor changes, this rule adds new provisions that increase State flexibility, so it does not have federalism implications as that phrase is defined for purposes of Executive Order 13132. Further, because this is a rule that primarily conditions the use of Federal assistance, it does not impose substantial direct compliance costs on the States. Thus, the requirements of section 6 of the Executive Order do not apply to this rule.

Although section 6 of Executive Order 13132 does not apply to this rule, EPA did consult with representatives of State governments in developing this rule. Specifically, members of a State/EPA SRF Work Group comprised of State DWSRF managers, State CWSRF managers, and managers of State financial agencies were given the opportunity to review and comment on drafts of this rule. In addition, stakeholders, including representatives from State government agencies and State government organizations, were given an opportunity to comment on a draft of the rule which was posted on the Internet for public comment. A summary of the concerns raised during that consultation and EPA's response to those concerns is provided in section VII. of this preamble.

H. Executive Order 13045: Children's Health

Executive Order 13045, ''Protection of Children from Environmental Health Risks and Safety Risks'' (62 FR 19885, April 23, 1997), applies to any rule that: (1) Is determined to be ''economically significant'' as defined under Executive Order 12866, and (2) concerns an environmental health or safety risk that EPA has reason to believe may have a disproportionate effect on children. If the regulatory action meets both criteria, the Agency must evaluate the environmental health or safety effects of the planned rule on children, and explain why the planned regulation is preferable to other potentially effective and reasonably feasible alternatives considered by the Agency.

This interim final rule is not subject to Executive Order 13045 because it is not ''economically significant'' as defined under Executive Order 12866. Further, it does not concern an environmental health or safety risk that EPA has reason to believe may have a disproportionate effect on children.

I. Executive Order 13084: Consultation and Coordination With Indian Tribal Governments

Under Executive Order 13084, EPA may not issue a regulation that is not required by statute, that significantly or uniquely affects the communities of Indian tribal governments, and that imposes substantial direct compliance costs on those communities, unless the Federal government provides the funds necessary to pay the direct compliance costs incurred by the tribal governments, or EPA consults with those governments. If EPA complies by consulting, Executive Order 13084 requires EPA to provide to the Office of Management and Budget, in a separately identified section of the preamble to the rule, a description of the extent of EPA's prior consultation with representatives of affected tribal governments, a summary of the nature of their concerns, and a statement supporting the need to issue the regulation. In addition, Executive Order 13084 requires EPA to develop an effective process permitting elected officials and other representatives of Indian tribal governments ''to provide meaningful and timely input in the development of regulatory policies on matters that significantly or uniquely affect their communities.''

Today's rule does not significantly or uniquely affect the communities of Indian tribal governments, nor does it impose substantial direct compliance costs on them. This rule only applies to each of the 50 States and the Commonwealth of Puerto Rico that receive capitalization grants and are authorized to establish a Fund under section 1452 of the Safe Drinking Water Act, as amended, 42 U.S.C. 300j–12. Accordingly, the requirements of section 3(b) of Executive Order 13084 do not apply to this rule.

J. Executive Order 12898: Environmental Justice

Under Executive Order 12898, ''Federal Actions to Address Environmental Justice in Minority Populations and Low-Income Populations,'' as well as through EPA's National Environmental Justice Advisory Council, EPA has undertaken to incorporate environmental justice into its policies and programs. EPA is committed to addressing environmental justice concerns, and is assuming a leadership role in environmental justice initiatives to enhance environmental quality for all residents of the United States. The Agency's goals are to ensure

that no segment of the population, regardless of race, color, national origin, or income, bears disproportionately high and adverse human health and environmental effects as a result of EPA's policies, programs, and activities, and all people live in clean and sustainable communities.

No action from this rule will have a disproportionately high and adverse human health and environmental effect on any segment of the population. In addition, this rule does not impose substantial direct compliance costs on those communities. Accordingly, the requirements of Executive Order 12898 do not apply.

List of Subjects

40 CFR Part 9

Environmental protection, Reporting and recordkeeping requirements.

40 CFR Part 35

Environmental protection, Drinking water, Grant programs—environmental protection, Public health, Safe drinking water act, State revolving funds, Water supply.

Dated: July 31, 2000.

Carol M. Browner,

Administrator.

For the reasons set out in the preamble, EPA is proposing to amend Title 40, chapter 1 of the Code of Federal Regulations to read as follows:

PART 9—[AMENDED]

1. The authority citation for part 9 continues to read as follows:

Authority: 7 U.S.C. 135 *et seq.*, 136–136y; 15 U.S.C. 2001, 2003, 2005, 2006, 2601–2671; 21 U.S.C. 331j, 346a, 348; 31 U.S.C. 9701; 33 U.S.C. 1251 *et seq.*, 1311, 1313d, 1314, 1318, 1321, 1326, 1330, 1342, 1344, 1345 (d) and (e), 1361; E.O. 11735, 38 FR 21243, 3 CFR, 1971–1975 Comp. p. 973; 42 U.S.C. 241, 242b, 243, 246, 300f, 300g, 300g–1, 300g–2, 300g–3, 300g–4, 300g–5, 300g–6, 300j–1, 300j–2, 300j–3, 300j–4, 300j–9, 1857 *et seq.*, 6901–6992k, 7401–7671q, 7542, 9601–9657, 11023, 11048.

2. In § 9.1 the table is amended under the indicated heading by adding new entries in numerical order to read as follows:

§ 9.1 OMB approvals under the Paperwork Reduction Act.

* * * * *

40 CFR citation	OMB control No.
* * * * * * *	
Drinking Water State Revolving Funds.	
* * * * * * *	
35.3540 (c)	2040–0185
35.3545 (a)–(f)	2040–0185
35.3550 (a)–(p)	2040–0185
35.3555 (a)–(d)	2040–0185
35.3560 (a), (d)–(g)	2040–0185
35.3565 (a)–(f)	2040–0185
35.3570 (a)–(d)	2040–0185
35.3575 (a)–(e)	2040–0185
35.3580 (a)–(h)	2040–0185
35.3585 (b)–(c)	2040–0185
* * * * * * *	

PART 35—STATE AND LOCAL ASSISTANCE

3. Part 35 is amended by adding Subpart L to read as follows:

Subpart L—Drinking Water State Revolving Funds

Sec.

Subpart L—Drinking Water State Revolving Funds

Authority: Section 1452 of the Safe Drinking Water Act, as amended, 42 U.S.C. 300j–12.

§ 35.3500 Purpose, policy, and applicability.

(a) This subpart codifies and implements requirements for the national Drinking Water State Revolving Fund program under section 1452 of the Safe Drinking Water Act, as amended in 1996. It applies to States (*i.e.*, each of the 50 States and the Commonwealth of Puerto Rico) which receive capitalization grants and are authorized to establish a Fund under section 1452. The purpose of this subpart is to ensure that each State's program is designed and operated in such a manner as to further the public health protection objectives of the Safe Drinking Water Act, promote the efficient use of all funds, and ensure that the Fund corpus is available in perpetuity for providing financial assistance to public water systems.

(b) This subpart supplements section 1452 of the Safe Drinking Water Act by codifying statutory and program requirements that were published in the Final Guidelines for the Drinking Water State Revolving Fund program (EPA 816–R–97–005) signed by the Assistant Administrator for Water on February 28,

1997, as well as in subsequent policies. This subpart also supplements general grant regulations at 40 CFR part 31 which contain administrative requirements that apply to governmental recipients of Environmental Protection Agency (EPA) grants and subgrants. EPA will not impose additional major program requirements without providing an opportunity for affected parties to comment.

(c) EPA intends to implement the national Drinking Water State Revolving Fund program in a manner that preserves for States a high degree of flexibility to operate their programs in accordance with each State's unique needs and circumstances. To the maximum extent practicable, EPA also intends to administer the financial aspects of the national Drinking Water State Revolving Fund program in a manner that is consistent with the policies and procedures of the national Clean Water State Revolving Fund program established under Title VI of the Clean Water Act, as amended, 33 U.S.C. 1381–1387.

§ 35.3505 Definitions.

The following definitions apply to terms used in this subpart:

Act. The Safe Drinking Water Act (Public Law 93–523), as amended in 1996 (Public Law 104–182). 42 U.S.C. 300f *et seq.*

Administrator. The Administrator of the EPA or an authorized representative.

Allotment. Amount available to a State from funds appropriated by Congress to carry out section 1452 of the Act.

Automated Clearing House (ACH). A Federal payment mechanism that transfers cash to recipients of Federal assistance using electronic transfers from the Treasury through the Federal Reserve System.

Binding commitment. A legal obligation by the State to an assistance recipient that defines the terms for assistance from the Fund.

Capitalization grant. An award by EPA of funds to a State for purposes of capitalizing that State's Fund and for other purposes authorized in section 1452 of the Act.

Cash draw. The transfer of cash from the Treasury through the ACH to the DWSRF program. Upon a State's request for a cash draw, the Treasury will transfer funds to the DWSRF program account established in the State's bank.

CWSRF program. Each State's clean water state revolving fund program authorized under Title VI of the Clean Water Act, as amended, 33 U.S.C. 1381–1387.

Disadvantaged community. The entire service area of a public water system that meets affordability criteria established by the State after public review and comment.

Disbursement. The transfer of cash from the DWSRF program account established in the State's bank to an assistance recipient.

DWSRF program. Each State's drinking water state revolving fund program authorized under section 1452 of the Act, as amended, 42 U.S.C. 300j–12. This term includes the Fund and set-asides.

Fund. A revolving account into which a State deposits DWSRF program funds (*e.g.,* capitalization grants, State match, repayments, net bond proceeds, interest earnings, *etc.*) for the purposes of providing loans and other types of assistance for drinking water infrastructure projects.

Intended Use Plan (IUP). A document prepared annually by a State, after public review and comment, which identifies intended uses of all DWSRF program funds and describes how those uses support the overall goals of the DWSRF program.

Net bond proceeds. The funds raised from the sale of the bonds minus issuance costs (*e.g.,* the underwriting discount, underwriter's legal counsel fees, bond counsel fee, and other costs incidental to the bond issuance).

Payment. An action taken by EPA to increase the amount of funds available for cash draw through the ACH. A payment is not a transfer of cash to the State, but an authorization by EPA to make capitalization grant funds available for transfer to a State after the State submits a cash draw request.

Public water system. A system as defined in 40 CFR 141.2. A public water system is either a ''community water system'' or a ''noncommunity water system'' as defined in 40 CFR 141.2.

Regional Administrator (RA). The Administrator of the appropriate Regional Office of the EPA or an authorized representative of the Regional Administrator.

Set-asides. State and local activities identified in sections 1452(g)(2) and (k) of the Act for which a portion of a capitalization grant may be used.

Small system. A public water system that regularly serves 10,000 or fewer persons.

State. Each of the 50 States and the Commonwealth of Puerto Rico, which receive capitalization grants and are authorized to establish a Fund under section 1452 of the Act.

§ 35.3510 Establishment of the DWSRF program.

(a) *General.* To be eligible to receive a capitalization grant, a State must establish a Fund and comply with the other requirements of section 1452 of the Act and this subpart.

(b) *Administration.* Capitalization grants must be awarded to an agency of the State that is authorized to enter into capitalization grant agreements with EPA, accept capitalization grant awards made under section 1452 of the Act, and otherwise manage the Fund in accordance with the requirements and objectives of the Act and this subpart. The State agency that is awarded the capitalization grant (*i.e.,* grantee) is accountable for the use of the funds provided in the capitalization grant agreement under general grant regulations at 40 CFR part 31.

(1) The authority to establish assistance priorities and to carry out oversight and related activities of the DWSRF program, other than financial administration of the Fund, must reside with the State agency having primary responsibility for administration of the State's public water system supervision (PWSS) program (*i.e.,* primacy) after consultation with other appropriate State agencies.

(2) If a State is eligible to receive a capitalization grant but does not have primacy, the Governor will determine which State agency will have the authority to establish priorities for financial assistance from the Fund. Evidence of the Governor's determination must be included with the capitalization grant application.

(3) If more than one State agency participates in implementation of the DWSRF program, the roles and responsibilities of each agency must be described in a Memorandum of Understanding or interagency agreement.

(c) *Combined financial administration.* A State may combine the financial administration of the Fund with the financial administration of any other revolving fund established by the State if otherwise not prohibited by State law under which the Fund was established. A State must assure that all monies in the Fund, including capitalization grants, State match, net bond proceeds, loan repayments, and interest are separately accounted for and used solely for the purposes specified in section 1452 of the Act and this subpart. Funds available from the administration and technical assistance set-aside may not be used for combined financial administration of any other revolving fund.

(d) *Use of funds.* (1) Assistance provided to a public water system from the DWSRF program may be used only for expenditures that will facilitate compliance with national primary drinking water regulations applicable under section 1412 or otherwise significantly further the public health protection objectives of the Act.

(2) The inability or failure of any public water system to receive assistance from the DWSRF program, or any delay in obtaining assistance, does not alter the obligation of the system to comply in a timely manner with all applicable drinking water standards and requirements of section 1452 of the Act.

§ 35.3515 Allotment and withholdings of funds.

(a) *Allotment.* (1) *General.* Each State will receive a minimum of one percent of the funds available for allotment to all of the States.

(2) *Allotment formula.* Funds available to States from fiscal year 1998 appropriations and subsequent appropriations are allotted according to a formula that reflects the infrastructure needs of public water systems identified in the most recent Needs Survey submitted in accordance with section 1452(h) of the Act.

(3) *Period of availability.* Funds are available for obligation to States during the fiscal year in which they are authorized and during the following fiscal year. The amount of any allotment not obligated to a State by EPA at the end of this period of availability will be reallotted to eligible States based on the formula originally used to allot these funds, except that the Administrator may reserve up to 10 percent of any funds available for reallotment to provide additional assistance to Indian Tribes. In order to be eligible to receive reallotted funds, a State must have been obligated all funds it is eligible to receive from EPA during the period of availability.

(4) *Loss of primacy.* The following provisions do not apply to any State that did not have primacy as of August 6, 1996:

(i) A State may not receive a capitalization grant from allotments that have been made if the State had primacy and subsequently loses primacy.

(ii) For a State that loses primacy, the Administrator may reserve funds from the State's allotment for use by EPA to administer primacy in that State. The balance of the funds not used by EPA to administer primacy will be reallotted to the other States.

(iii) A State will be eligible for future allotments from funds appropriated in the next fiscal year after primacy is restored.

(b) *Withholdings.*—(1) *General.* EPA will withhold funds under each of the following provisions:

(i) *Capacity development authority.* EPA will withhold 20 percent of a State's allotment from any State that has not obtained the legal authority or other means to ensure that all new community water systems and new nontransient, noncommunity water systems commencing operations after October 1, 1999, demonstrate technical, financial, and managerial capacity with respect to each national primary drinking water regulation in effect, or likely to be in effect, on the date of commencement of operations. The determination of withholding will be based on an assessment of the status of the State program as of October 1 of the fiscal year for which the funds were allotted.

(ii) *Capacity development strategy.* EPA will withhold funds from any State unless the State is developing and implementing a strategy to assist public water systems in acquiring and maintaining technical, financial, and managerial capacity. The amount of a State's allotment that will be withheld is 10 percent for fiscal year 2001, 15 percent for fiscal year 2002, and 20 percent for each subsequent fiscal year. The determination of withholding will be based on an assessment of the status of the State strategy as of October 1 of the fiscal year for which the funds were allotted. Decisions of a State regarding any particular public water system as part of a capacity development strategy are not subject to review by EPA and may not serve as a basis for withholding funds.

(iii) *Operator certification program.* Beginning on February 5, 2001, EPA will withhold 20 percent of a State's allotment unless the State has adopted and is implementing a program for certifying operators of community and nontransient, noncommunity public water systems that meets the requirements of section 1419 of the Act. The determination of withholding will be based on an assessment of the status of the State program for each fiscal year.

(2) *Maximum withholdings.* The maximum amount of funds that will be withheld if a State fails to meet the requirements of both the capacity development authority and the capacity development strategy provisions is 20 percent of the allotment in any fiscal year. The maximum amount of funds that will be withheld if a State fails to meet the requirements of the operator certification program provision and either the capacity development authority provision or the capacity development strategy provision is 40 percent of the allotment in any fiscal year.

(3) *Reallotment of withheld funds.* The Administrator will reallot withheld funds to eligible States based on the formula originally used to allot these funds. In order to be eligible to receive reallotted funds under the withholding provisions, a State must have been obligated all funds it is eligible to receive from EPA during the period of availability. A State that has funds withheld under any one of the withholding provisions in paragraphs (b)(1)(i) through (b)(1)(iii) of this section is not eligible to receive reallotted funds made available by that provision.

(4) *Termination of withholdings.* A withholding will cease to apply to funds appropriated in the next fiscal year after a State complies with the specific provision under which funds were withheld.

§ 35.3520 Systems, projects, and project-related costs eligible for assistance from the Fund.

(a) *Eligible systems.* Assistance from the Fund may only be provided to:

(1) Privately-owned and publicly-owned community water systems and non-profit noncommunity water systems.

(2) Projects that will result in the creation of a community water system in accordance with paragraph (b)(2)(vi) of this section.

(3) Systems referred to in section 1401(4)(B) of the Act for the purposes of point of entry or central treatment under section 1401(4)(B)(i)(III).

(b) *Eligible projects.*—(1) *General.* Projects that address present or prevent future violations of health-based drinking water standards are eligible for assistance. These include projects needed to maintain compliance with existing national primary drinking water regulations for contaminants with acute and chronic health effects. Projects to replace aging infrastructure are eligible for assistance if they are needed to maintain compliance or further the public health protection objectives of the Act.

(2) Only the following project categories are eligible for assistance from the Fund:

(i) *Treatment.* Examples of projects include installation or upgrade of facilities to improve the quality of drinking water to comply with primary or secondary standards and point of entry or central treatment under section 1401(4)(B)(i)(III) of the Act.

(ii) *Transmission and distribution.* Examples of projects include

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.

(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:

(i) Indicate in the Intended Use Plan (IUP) the amount of the allowance it is taking for loan subsidies;

(ii) Commit capitalization grant and required State match dollars taken for loan subsidies in accordance with the binding commitment requirements in § 35.3550(e); and

(iii) 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.

§ 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 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.

§ 35.3535 Authorized set-aside activities.

(a) *General.* (1) A State may use a portion of its capitalization grants for the set-aside categories described in paragraphs (b) through (e) of this section, provided that the amount of set-aside funding does not exceed the ceilings specified in this section.

(2) A State may not use set-aside funds for those projects or project-related costs listed in § 35.3520(b), (c), (e), and (f), with the following exceptions:

(i) Project planning and design costs for small systems; and

(ii) Costs for restructuring a system as part of a capacity development strategy.

(b) *Administration and technical assistance.* A State may use up to 4 percent of its allotment to cover the reasonable costs of administering the DWSRF program and to provide technical assistance to public water systems.

(c) *Small systems technical assistance.* A State may use up to 2 percent of its allotment to provide technical assistance to small systems. A State may use these funds for activities such as supporting a State technical assistance team or contracting with outside organizations or other parties to provide technical assistance to small systems.

(d) *State program management.* A State may use up to 10 percent of its allotment for State program management activities.

(1) This set-aside may only be used for the following activities:

(i) To administer the State PWSS program;

(ii) To administer or provide technical assistance through source water protection programs (including a Class V Underground Injection Control Program), except for enforcement actions;

(iii) To develop and implement a capacity development strategy; and

(iv) To develop and implement an operator certification program.

(2) Match requirement. A State must provide a dollar for dollar match for expenditures made under this set-aside.

(i) The match must be provided at the time of the capitalization grant award or in the same year that funds for this set-aside are expected to be expended in accordance with a workplan approved by EPA.

(ii) A State is authorized to use the amount of State funds it expended on its PWSS program in fiscal year 1993 (including PWSS match) as a credit toward meeting its match requirement. The value of this credit can be up to, but not greater than, 50 percent of the amount of match that is required. After determining the value of the credit that it is eligible to receive, a State must provide the additional funds necessary to meet the remainder of the match requirement. The source of these additional funds can be State funds (excluding PWSS match) or documented in-kind services.

(e) *Local assistance and other State programs.* A State may use up to 15 percent of its capitalization grant to assist in the development and implementation of local drinking water protection initiatives and other State programs. No more than 10 percent of the capitalization grant amount can be used for any one authorized activity.

(1) This set-aside may only be used for the following activities:

(i) A State may provide assistance only in the form of loans to community water systems and non-profit noncommunity water systems to acquire land or conservation easements from willing sellers or grantors. A system must demonstrate how the purchase of land or easements will protect the source water of the system from contamination and ensure compliance with national primary drinking water regulations. A State must develop a priority setting process for determining what parcels of land or easements to purchase or use an established priority setting process that meets the same goals. A State must seek public review and comment on its priority setting process and must identify the systems that received loans and include a description of the specific parcels of land or easements purchased in the Biennial Report.

(ii) A State may provide assistance only in the form of loans to community water systems to assist in implementing voluntary, incentive-based source water protection measures in areas delineated under a source water assessment

program under section 1453 of the Act and for source water petitions under section 1454 of the Act. A State must develop a list of systems that may receive loans, giving priority to activities that facilitate compliance with national primary drinking water regulations applicable to the systems or otherwise significantly further the health protection objectives of the Act. A State must seek public review and comment on its priority setting process and its list of systems that may receive loans.

(iii) A State may make expenditures to establish and implement wellhead protection programs under section 1428 of the Act.

(iv) A State may provide assistance, including technical and financial assistance, to public water systems as part of a capacity development strategy under section 1420(c) of the Act.

(v) A State may make expenditures from its fiscal year 1997 capitalization grant to delineate and assess source water protection areas for public water systems under section 1453 of the Act. Assessments include the identification of potential sources of contamination within the delineated areas. These assessment activities are limited to the identification of contaminants regulated under the Act or unregulated contaminants that a State determines may pose a threat to public health. A State must obligate funds within 4 years of receiving its fiscal year 1997 capitalization grant.

(2) A State may make loans under this set-aside only if an assistance recipient begins annual repayment of principal and interest no later than one year after completion of the activity and completes loan repayment no later than 20 years after completion of the activity. A State must deposit repayments into the Fund or into a separate account dedicated for this set-aside. The separate account is subject to the same management oversight requirements as the Fund. Amounts deposited into the Fund are subject to the authorized uses of the Fund.

§ 35.3540 Requirements for funding set-aside activities.

(a) *General.* If a State makes a grant or enters into a cooperative agreement with an assistance recipient to conduct set-aside activities, the recipient must comply with general grant regulations at 40 CFR part 30 or part 31, as appropriate.

(b) *Set-aside accounts.* A State must maintain separate and identifiable accounts for the portion of its capitalization grant to be used for set-aside activities.

(c) *Workplans.*—(1) *General.* A State must submit detailed annual or multi-year workplans to EPA for approval describing how set-aside funds will be expended. For the administration and technical assistance set-aside under § 35.3535(b), the State is only required to submit a workplan describing how it will expend funds needed to provide technical assistance to public water systems. In order to ensure that funds are expended efficiently, multi-year workplan terms negotiated with EPA must be less than four years, unless a longer term is approved by EPA.

(2) *Submitting workplans.* A State must submit workplans in accordance with a schedule negotiated with EPA. If a schedule has not been negotiated, the State must submit workplans no later than 90 days after the capitalization grant award. If a State does not meet the deadline for submitting its workplans, the set-aside funds that were required to be described in the workplans must be transferred to the Fund to be used for projects.

(3) *Content.* Workplans must at a minimum include:

(i) The annual funding amount in dollars and as a percentage of the State allotment or capitalization grant;

(ii) The projected number of work years needed for implementing each set-aside activity;

(iii) The goals and objectives, outputs, and deliverables for each set-aside activity;

(iv) A schedule for completing activities under each set-aside activity;

(v) Identification and responsibilities of the agencies involved in implementing each set-aside activity, including activities proposed to be conducted by a third party; and

(vi) A description of the evaluation process to assess the success of work funded under each set-aside activity.

(4) *Amending workplans.* If a State changes the scope of work from what was originally described in its workplans, it must amend the workplans and submit them to EPA for approval.

(d) *Reserving set-aside funds.* (1) A State may reserve set-aside funds from a capitalization grant and expend them over a period of time, provided that the State identifies the amount of funds reserved in the IUP and describes the use of the funds in workplans approved by EPA. For the administration and technical assistance set-aside under § 35.3535(b), the State is only required to submit a workplan to reserve funds needed to provide technical assistance to public water systems.

(2) With the exception of the local assistance and other State programs set-aside under § 35.3535(e), a State may reserve the authority to take from future capitalization grants those set-aside funds that it has not included in workplans. The State must identify in the IUP the amount of authority reserved from a capitalization grant for future use.

(e) *Fund and set-aside account transfers.* (1) A State may transfer funds among set-aside categories described in § 35.3535(b) through (e) and among activities within these categories, provided that set-aside ceilings are not exceeded.

(2) A State may transfer funds between the Fund and set-asides, provided that set-aside ceilings are not exceeded. Set-aside funds may be transferred at any time to the Fund. If a State has taken payment for the set-aside funds to be transferred to the Fund, it must make binding commitments for these funds within one year of the transfer. Monies intended for the Fund may be transferred to set-asides only if the State has not yet taken a payment that includes those funds to be transferred in accordance with the payment schedule negotiated with EPA.

(3) The capitalization grant agreement must be amended prior to any transfer among the set-aside categories or any transfer between the Fund and set-asides.

§ 35.3545 Capitalization grant agreement.

(a) *General.* A State must submit a capitalization grant application to EPA in order to receive a capitalization grant award. Approval of an application results in EPA and the State entering into a capitalization grant agreement which is the principal instrument by which the State commits to manage the DWSRF program in accordance with the requirements of section 1452 of the Act and this subpart.

(b) *Content.* In addition to the items listed in paragraphs (c) through (f) of this section, the capitalization grant agreement must contain or incorporate by reference the Application for Federal Assistance (EPA Form 424) and other related forms, IUP, negotiated payment schedule, State environmental review process (SERP), demonstrations of the specific capitalization grant agreement requirements listed in § 35.3550, and other documentation required by the Regional Administrator (RA). The capitalization grant agreement must also define the types of performance measures, reporting requirements, and oversight responsibilities that will be required to determine compliance with section 1452 of the Act.

(c) *Operating agreement.* At the option of a State, the framework and

procedures of the DWSRF program that are not expected to change annually may be described in an Operating Agreement. The Operating Agreement may be amended if the State negotiates the changes with EPA.

(d) *Attorney General certification.* With the capitalization grant application, the State's Attorney General, or someone designated by the Attorney General, must sign or concur in a certification that:

(1) The authority establishing the DWSRF program and the powers it confers are consistent with State law;

(2) The State may legally bind itself to the proposed terms of the capitalization grant agreement; and

(3) An agency of the State is authorized to enter into capitalization grant agreements with EPA, accept capitalization grant awards made under section 1452 of the Act, and otherwise manage the Fund in accordance with the requirements and objectives of the Act and this subpart.

(e) *Roles and responsibilities of agencies.* If more than one State agency participates in the implementation of the DWSRF program, the State must describe the roles and responsibilities of each agency in the capitalization grant application and include a Memorandum of Understanding or interagency agreement describing these roles and responsibilities.

(f) *Process for evaluating capability and compliance.* A State must include in the capitalization grant application a description of the following:

(1) The process it will use to assess the technical, financial, and managerial capability of all systems requesting assistance to ensure that the systems are in compliance with the requirements of the Act.

(2) If a State provides assistance to systems that lack technical, financial, and managerial capability, the process it will use to ensure that the systems undertake feasible and appropriate changes in operations to comply with the requirements of the Act over the long-term.

(3) If a State provides assistance to systems in significant noncompliance with any national primary drinking water regulation or variance, the process it will use to ensure that the systems return to compliance.

§ 35.3550 Specific capitalization grant agreement requirements.

(a) *General.* A State must agree to comply with this subpart, the general grant regulations at 40 CFR part 31, and specific conditions of the grant. A State must also agree to the following requirements and, in some cases, provide documentation as part of the capitalization grant application.

(b) *Comply with State statutes and regulations.* A State must agree to comply with all State statutes and regulations that are applicable to DWSRF program funds including capitalization grant funds, State match, interest earnings, net bond proceeds, repayments, and funds used for set-aside activities.

(c) *Demonstrate technical capability.* A State must agree to provide documentation demonstrating that it has adequate personnel and resources to establish and manage the DWSRF program.

(d) *Accept payments.* A State must agree to accept capitalization grant payments in accordance with a payment schedule negotiated between EPA and the State.

(e) *Make binding commitments.* A State must agree to enter into binding commitments with assistance recipients to provide assistance from the Fund.

(1) Binding commitments must be made in an amount equal to the amount of each capitalization grant payment and accompanying State match that is deposited into the Fund and must be made within one year after the receipt of each grant payment.

(2) A State may make binding commitments for more than the required amount and credit the excess towards the binding commitment requirements of subsequent grant payments.

(3) If a State is concerned about its ability to comply with the binding commitment requirement, it must notify the RA and propose a revised payment schedule for future grant payments.

(f) *Deposit of funds.* A State must agree to promptly deposit DWSRF program funds into appropriate accounts.

(1) A State must agree to deposit the portion of the capitalization grant to be used for projects into the Fund.

(2) A State must agree to maintain separate and identifiable accounts for the portion of the capitalization grant to be used for set-aside activities.

(3) A State must agree to deposit net bond proceeds, interest earnings, and repayments into the Fund.

(4) A State must agree to deposit any fees, which include interest earned on fees, into the Fund or into separate and identifiable accounts.

(g) *Provide State match.* A State must agree to deposit into the Fund an amount from State monies that equals at least 20 percent of each capitalization grant payment.

(1) A State must identify the source of State match in the capitalization grant application.

(2) A State must deposit the match into the Fund on or before the date that a State receives each payment for the capitalization grant, except when a State chooses to use a letter of credit (LOC) mechanism or similar financial arrangement for the State match. Under this mechanism, payments to this LOC account must be made proportionally on the same schedule as the payments for the capitalization grant. Cash from this State match LOC account must be drawn into the Fund as cash is drawn into the Fund through the Automated Clearing House (ACH).

(3) A State may issue general obligation or revenue bonds to derive the State match. The net proceeds from the bonds issued by a State to derive the match must be deposited into the Fund and the bonds may only be retired using the interest portion of loan repayments and interest earnings of the Fund. Loan principal must not be used to retire State match bonds.

(4) If the State deposited State monies in a dedicated revolving fund after July 1, 1993, and prior to receiving a capitalization grant, the State may credit these monies toward the match requirement if:

(i) The monies were deposited in a separate revolving fund that subsequently became the Fund after receiving a capitalization grant and they were expended in accordance with section 1452 of the Act;

(ii) The monies were deposited in a separate revolving fund that has not received a capitalization grant, they were expended in accordance with section 1452 of the Act, and an amount equal to all repayments of principal and payments of interest from loans will be deposited into the Fund; or

(iii) The monies were deposited in a separate revolving fund and used as a reserve for a leveraged program consistent with section 1452 of the Act and an amount equal to the reserve is transferred to the Fund as the reserve's function is satisfied.

(5) If a State provides a match in excess of the required amount, the excess balance may be credited towards match requirements associated with subsequent capitalization grants.

(h) *Provide match for State program management set-aside.* A State must agree to provide a dollar for dollar match for expenditures made under the State program management set-aside in accordance with § 35.3535(d)(2). This match is separate from the 20 percent State match requirement for the capitalization grant in paragraph (g) of this section and must be identified as an eligible credit, deposited into set-aside

accounts, or documented as in-kind services.

(i) *Use generally accepted accounting principles.* A State must agree to ensure that the State and public water systems receiving assistance will use accounting, audit, and fiscal procedures conforming to Generally Accepted Accounting Principles (GAAP) as promulgated by the Governmental Accounting Standards Board or, in the case of privately-owned systems, the Financial Accounting Standards Board. The accounting system used for the DWSRF program must allow for proper measurement of:

(1) Revenues earned and other receipts, including but not limited to, loan repayments, capitalization grants, interest earnings, State match deposits, and net bond proceeds;

(2) Expenses incurred and other disbursements, including but not limited to, loan disbursements, repayment of bonds, and other expenditures allowed under section 1452 of the Act; and

(3) Assets, liabilities, capital contributions, and retained earnings.

(j) *Conduct audits.* In accordance with § 35.3570(b), a State must agree to comply with the provisions of the Single Audit Act Amendments of 1996. A State may voluntarily agree to conduct annual independent audits.

(k) *Dedicated repayment source.* A State must agree to adopt policies and procedures to assure that assistance recipients have a dedicated source of revenue for repayment of loans, or in the case of privately-owned systems, assure that recipients demonstrate that there is adequate security to assure repayment of loans.

(l) *Efficient expenditure.* A State must agree to commit and expend all funds as efficiently as possible and in an expeditious and timely manner.

(m) *Use funds in accordance with IUP.* A State must agree to use all funds in accordance with an IUP that was prepared after providing for public review and comment.

(n) *Biennial report.* A State must agree to complete and submit a Biennial Report that describes how it has met the goals and objectives of the previous two fiscal years as stated in the IUPs and capitalization grant agreements. The State must submit this report to the RA according to the schedule established in the capitalization grant agreement.

(o) *Comply with cross-cutters.* A State must agree to comply with all applicable Federal cross-cutting authorities.

(p) *Comply with provisions to avoid withholdings.* A State must agree to demonstrate how it is complying with the requirements of capacity development authority, capacity development strategy, and operator certification program provisions in order to avoid withholdings of funds under § 35.3515(b)(1)(i) through (b)(1)(iii).

§ 35.3555 Intended Use Plan (IUP).

(a) *General.* A State must prepare an annual IUP which describes how it intends to use DWSRF program funds to support the overall goals of the DWSRF program and contains the information outlined in paragraph (c) of this section. In those years in which a State submits a capitalization grant application, EPA must receive an IUP prior to the award of the capitalization grant. A State must prepare an annual IUP as long as the Fund or set-aside accounts remain in operation. The IUP must conform to the fiscal year adopted by the State for the DWSRF program (e.g., the State's fiscal year or the Federal fiscal year).

(b) *Public review requirements.* A State must seek meaningful public review and comment during the development of the IUP. A State must include a description of the public review process and an explanation of how it responded to major comments and concerns. If a State prepares separate IUPs (one for Fund monies and one for set-aside monies), the State must seek public review and comment during the development of each IUP.

(c) *Content.* Information in the IUP must be provided in a format and manner that is consistent with the needs of the RA.

(1) *Priority system.* The IUP must include a priority system for ranking individual projects for funding that provides sufficient detail for the public and EPA to readily understand the criteria used for ranking. The priority system must provide, to the maximum extent practicable, that priority for the use of funds will be given to projects that: address the most serious risk to human health; are necessary to ensure compliance with the requirements of the Act (including requirements for filtration); and assist systems most in need, on a per household basis, according to State affordability criteria. A State that does not adhere to the three criteria must demonstrate why it is unable to do so.

(2) *Priority lists of projects.* All projects, with the exception of projects funded on an emergency basis, must be ranked using a State's priority system and go through a public review process prior to receiving assistance.

(i) The IUP must contain a fundable list of projects that are expected to receive assistance from available funds designated for use in the current IUP and a comprehensive list of projects that are expected to receive assistance in the future. The fundable list of projects must include: the name of the public water system; the priority assigned to the project; a description of the project; the expected terms of financial assistance based on the best information available at the time the IUP is developed; and the population of the system's service area at the time of the loan application. The comprehensive list must include, at a minimum, the priority assigned to each project and, to the extent known, the expected funding schedule for each project. A State may combine the fundable and comprehensive lists into one list, provided that projects which are expected to receive assistance from available funds designated for use in the current IUP are identified.

(ii) The IUP may include procedures which would allow a State to bypass projects on the fundable list. The procedures must clearly identify the conditions which would allow a project to be bypassed and the method for identifying which projects would receive funding. If a bypass occurs, a State must fund the highest ranked project on the comprehensive list that is ready to proceed. If a State elects to bypass a project for reasons other than readiness to proceed, the State must explain why the project was bypassed in the Biennial Report and during the annual review. To the maximum extent practicable, a State must work with bypassed projects to ensure that they will be prepared to receive funding in future years.

(iii) The IUP may allow for the funding of projects which require immediate attention to protect public health on an emergency basis, provided that a State defines what conditions constitute an emergency and identifies the projects in the Biennial Report and during the annual review.

(iv) The IUP must demonstrate how a State will meet the requirement of providing loan assistance to small systems as described in § 35.3525(a)(5). A State that is unable to comply with this requirement must describe the steps it is taking to ensure that a sufficient number of projects are identified to meet this requirement in future years.

(3) *Distribution of funds.* The IUP must describe the criteria and methods that a State will use to distribute all funds including:

(i) The process and rationale for distribution of funds between the Fund and set-aside accounts;

(ii) The process for selection of systems to receive assistance;

(iii) The rationale for providing different types of assistance and terms, including the method used to determine the market rate and the interest rate;

(iv) The types, rates, and uses of fees assessed on assistance recipients; and

(v) A description of the financial planning process undertaken for the Fund and the impact of funding decisions on the long-term financial health of the Fund.

(4) *Financial status.* The IUP must describe the sources and uses of DWSRF program funds including: the total dollar amount in the Fund; the total dollar amount available for loans, including loans to small systems; the amount of loan subsidies that may be made available to disadvantaged communities from the 30 percent allowance in § 35.3525(b)(2); the total dollar amount in set-aside accounts, including the amount of funds or authority reserved; and the total dollar amount in fee accounts.

(5) *Short- and long-term goals.* The IUP must describe the short-term and long-term goals it has developed to support the overall goals of the DWSRF program of ensuring public health protection, complying with the Act, ensuring affordable drinking water, and maintaining the long-term financial health of the Fund.

(6) *Set-aside activities.* (i) The IUP must identify the amount of funds a State is electing to use for set-aside activities. A State must also describe how it intends to use these funds, provide a general schedule for their use, and describe the expected accomplishments that will result from their use.

(ii) For loans made in accordance with the local assistance and other State programs set-aside under § 35.3535(e)(1)(i) and (e)(1)(ii), the IUP must, at a minimum, describe the process by which recipients will be selected and how funds will be distributed among them.

(7) *Disadvantaged community assistance.* The IUP must describe how a State's disadvantaged community program will operate including:

(i) The State's definition of what constitutes a disadvantaged community;

(ii) A description of affordability criteria used to determine the amount of disadvantaged assistance;

(iii) The amount and type of loan subsidies that may be made available to disadvantaged communities from the 30 percent allowance in § 35.3525(b)(2); and

(iv) To the maximum extent practicable, an identification of projects that will receive disadvantaged assistance and the respective amounts.

(8) *Transfer process.* If a State decides to transfer funds between the DWSRF program and CWSRF program, the IUPs for the DWSRF program and the CWSRF program must describe the process including:

(i) The total amount and type of funds being transferred during the period covered by the IUP;

(ii) The total amount of authority being reserved for future transfer, including the authority reserved from previous years; and

(iii) The impact of the transfer on the amount of funds available to finance projects and set-asides and the long-term impact on the Fund.

(9) *Cross-collateralization process.* If a State decides to cross-collateralize Fund assets of the DWSRF program and CWSRF program, the IUPs for the DWSRF program and the CWSRF program must describe the process including:

(i) The type of monies which will be used as security;

(ii) How monies will be used in the event of a default; and

(iii) Whether or not monies used for a default in the other program will be repaid, and if they will not be repaid, what will be the cumulative impact on the Funds.

(d) *Amending the IUP.* The priority lists of projects may be amended during the year under provisions established in the IUP as long as additions or other substantive changes to the lists, except projects funded on an emergency basis, go through a public review process. A State may change the use of funds from what was originally described in the IUP as long as substantive changes go through a public review process.

§ 35.3560 General payment and cash draw rules.

(a) *Payment schedule.* A State will receive each capitalization grant payment in the form of an increase to the ceiling of funds available through the ACH, made in accordance with a payment schedule negotiated between EPA and the State. A payment schedule that is based on a State's projection of binding commitments and use of set-aside funds as stated in the IUP must be included in the capitalization grant agreement. Changes to the payment schedule must be made through an amendment to the grant agreement.

(b) *Timing of payments.* All payments to a State will be made by the earlier of 8 quarters after the capitalization grant is awarded or 12 quarters after funds are allotted to a State.

(c) *Funds available for cash draw.* Cash draws will be available only up to the amount of payments that have been made to a State.

(d) *Estimated cash draw schedule.* On a schedule negotiated with EPA, a State must provide EPA with a quarterly schedule of estimated cash draws for the Federal fiscal year. The State must notify EPA when significant changes from the estimated cash draw schedule are anticipated. This schedule must be developed to conform with the procedures applicable to cash draws and must have sufficient detail to allow EPA and the State to jointly develop and maintain a forecast of cash draws.

(e) *Cash draw for set-asides.* A State may draw cash through the ACH for the full amount of costs incurred for set-aside expenditures based on EPA approved workplans. A State may draw cash in advance to ensure funds are available to meet State payroll expenses. However, cash should be drawn no sooner than necessary to meet immediate payroll disbursement needs.

(f) *Cash draw for Fund.* A State may draw cash through the ACH for the proportionate Federal share of eligible incurred project costs. A State need not have disbursed funds for incurred project costs prior to drawing cash. A State may not draw cash for a particular project until the State has executed a loan agreement for that project.

(g) *Calculation of proportionate Federal share*—(1) *General.* The proportionate Federal share is equal to the Federal monies intended for the Fund (capitalization grant minus set-asides) divided by the total amount of monies intended for the Fund (capitalization grant minus set-asides plus required State match). A State may calculate the proportionate Federal share on a rolling average basis or on a grant by grant basis.

(2) *State overmatch.* (i) The proportionate Federal share does not change if a State is providing funds in excess of the required State match.

(ii) Federal monies may be drawn at a rate that is greater than that determined by the proportionate Federal share calculation when a State is given credit toward its match amount as a result of funding projects in prior years (but after July 1, 1993), or for crediting excess match in the Fund in prior years and disbursing these amounts prior to drawing cash. If the entire amount of a State's required match has been disbursed in advance, the proportionate Federal share of cash draws would be 100 percent.

§ 35.3565 Specific cash draw rules for authorized types of assistance from the Fund.

A State may draw cash for the authorized types of assistance from the Fund described in § 35.3525 according to the following rules:

(a) *Loans*—(1) *Eligible project costs.* A State may draw cash based on the proportionate Federal share of incurred project costs. In the case of incurred planning and design and associated pre-project costs, cash may be drawn immediately upon execution of the loan agreement.

(2) *Eligible project reimbursement costs.* A State may draw cash to reimburse assistance recipients for eligible project costs at a rate no greater than equal amounts over the maximum number of quarters that capitalization grant payments are made. A State may immediately draw cash for up to 5 percent of each fiscal year's capitalization grant or 2 million dollars, whichever is greater, to reimburse project costs.

(b) *Refinance or purchase of local debt obligations*—(1) *Completed projects.* A State may draw cash up to the portion of the capitalization grant committed to the refinancing or purchase of local debt obligations of municipal, intermunicipal, or interstate agencies at a rate no greater than equal amounts over the maximum number of quarters that capitalization grant payments are made. A State may immediately draw cash for up to 5 percent of each fiscal year's capitalization grant or 2 million dollars, whichever is greater, to refinance or purchase local debt.

(2) *Portions of projects not completed.* A State may draw cash based on the proportionate Federal share of incurred project costs according to the rule for loans in paragraph (a)(1) of this section.

(3) *Purchase of incremental disbursement bonds from local governments.* A State may draw cash based on a schedule that coincides with the rate at which costs are expected to be incurred for the project.

(c) *Purchase insurance for local debt obligations.* A State may draw cash for the proportionate Federal share of insurance premiums as they are due.

(d) *Guarantee for local debt obligations*—(1) *In the event of default.* In the event of imminent default in debt service payments on a guaranteed local debt, a State may draw cash immediately up to the total amount of the capitalization grant that is dedicated for the guarantee. If a balance remains after the default is satisfied, the State must negotiate a revised cash draw schedule for the remaining amount dedicated for the guarantee.

(2) *In the absence of default.* A State may draw cash up to the amount of the capitalization grant dedicated for the guarantee based on actual incurred project costs. The amount of the cash draw would be based on the proportionate Federal share of incurred project costs multiplied by the ratio of the guarantee reserve to the amount guaranteed.

(e) *Revenue or security for Fund debt obligations (leveraging)*—(1) *In the event of default.* In the event of imminent default in debt service payments on a secured debt, a State may draw cash immediately up to the total amount of the capitalization grant that is dedicated for the security. If a balance remains after the default is satisfied, the State must negotiate a revised schedule for the remaining amount dedicated for the security.

(2) *In the absence of default.* A State may draw cash up to the amount of the capitalization grant dedicated for the security using either of the following methods:

(i) *All projects method.* A State may draw cash based on the incurred project costs multiplied by the ratio of the Federal portion of the reserve to the total reserve multiplied by the ratio of the total reserve to the net bond proceeds.

(ii) *Group of projects method.* A State may identify a group of projects whose cost is approximately equal to the total of that portion of the capitalization grant and the State match dedicated as a security. The State may then draw cash based on the incurred costs of the selected projects only, multiplied by the ratio of the Federal portion of the security to the entire security.

(3) *Aggressive leveraging.* Where the cash draw rules in paragraphs (e)(1) and (e)(2) of this section would significantly frustrate a State's leveraged program, EPA may permit an exception to these cash draw rules and provide for a more accelerated cash draw. A State must demonstrate that:

(i) There are eligible projects ready to proceed in the immediate future with enough costs to justify the amount of the secured bond issue;

(ii) The absence of cash on an accelerated basis will substantially delay these projects;

(iii) The Fund will provide substantially more assistance if accelerated cash draws are allowed; and

(iv) The long-term viability of the State program to meet drinking water needs will be protected.

(f) *Loans to privately-owned systems.* In cases where State monies cannot be used to provide loans to privately-owned systems, a State may draw 100 percent Federal monies for costs incurred by privately-owned systems. When Federal monies are drawn for incurred costs, the State must deposit or have previously deposited into the Fund the required match associated with the amount of cash drawn. Every 18 months, the State must submit documentation showing that it has met its proportionate Federal share within the last 6 months. If a State is unable to document that it has met its proportionate Federal share, State match deposited into the Fund must be expended before Federal monies are drawn for costs incurred by publicly-owned systems until the State meets its proportionate Federal share.

§ 35.3570 Reports and audits.

(a) *Biennial report*—(1) *General.* A State must submit a Biennial Report to the RA describing how it has met the goals and objectives of the previous two fiscal years as stated in the IUPs and capitalization grant agreements, including the most recent audit of the Fund and the entire State allotment. The State must submit this report to the RA according to the schedule established in the capitalization grant agreement. Information provided in the Biennial Report on other EPA programs eligible for assistance from the DWSRF program may not replace the reporting requirements for those other programs.

(2) *Financial report.* As part of the Biennial Report, a State must present the financial status of the DWSRF program, including the total dollar amount in fee accounts. This report must, at a minimum, include the financial statements and footnotes required under GAAP to present fairly the financial condition and results of operations.

(3) *Matters to establish in the biennial report.* A State must establish in the Biennial Report that it has complied with section 1452 of the Act and this subpart. In particular, the Biennial Report must demonstrate that a State has:

(i) Managed the DWSRF program in a fiscally prudent manner and adopted policies and processes which promote the long-term financial health of the Fund;

(ii) Deposited its match (cash or State LOC) into the Fund in accordance with the requirements of § 35.3550(g);

(iii) Made binding commitments with assistance recipients to provide assistance from the Fund consistent with the requirements of § 35.3550(e);

(iv) Funded only the highest priority projects listed in the IUP and

documented why priority projects were bypassed in accordance with § 35.3555(c)(2);

(v) Provided assistance only to eligible public water systems and for eligible projects and project-related costs under § 35.3520;

(vi) Provided assistance only for eligible set-aside activities under § 35.3535 and conducted activities consistent with workplans and other requirements of § 35.3535 and § 35.3540;

(vii) Provided loan assistance to small systems consistent with the requirements of § 35.3525(a)(5) and § 35.3555(c)(2)(iv);

(viii) Provided assistance to disadvantaged communities consistent with the requirements of § 35.3525(b) and § 35.3555(c)(7);

(ix) Used fees for eligible purposes under § 35.3530(b)(2) and (b)(3) and assessed fees included as principal in a loan in accordance with the limitations in § 35.3530(b)(3)(i) through (b)(3)(iii);

(x) Adopted and implemented procedures consistent with the requirements of § 35.3530(c) and § 35.3555(c)(8) if funds were transferred between the DWSRF program and CWSRF program;

(xi) Adopted and implemented procedures consistent with the requirements of § 35.3530(d) and § 35.3555(c)(9) if Fund assets of the DWSRF program and CWSRF program were cross-collateralized;

(xii) Reviewed all DWSRF program funded projects and activities for compliance with Federal cross-cutting authorities that apply to the State as a grant recipient and those which apply to assistance recipients in accordance with § 35.3575;

(xiii) Reviewed all DWSRF program funded projects and activities in accordance with approved State environmental review procedures under § 35.3580; and

(xiv) Complied with general grant regulations at 40 CFR part 31 and specific conditions of the grant.

(4) *Joint report.* A State which jointly administers the DWSRF program and the CWSRF program may submit a report that addresses both programs. However, programmatic and financial information for each program must be identified separately.

(b) *Audit.* (1) A State must comply with the provisions of the Single Audit Act Amendments of 1996, 31 U.S.C. 7501–7, and Office of Management and Budget's Circular A–133 and Compliance Supplement.

(2) A State may voluntarily agree to conduct annual independent audits which provide an auditor's opinion on the DWSRF program financial statements, reports on internal controls, and reports on compliance with section 1452 of the Act, applicable regulations, and general grant requirements. The agreement to conduct voluntary independent audits should be documented in the Operating Agreement or in another part of the capitalization grant agreement.

(3) Those States that do not conduct independent audits will be subject to periodic audits by the EPA Office of Inspector General.

(c) *Annual review*—(1) *Purpose.* The purpose of the annual review is to assess the success of the State's performance of activities identified in the IUP, Biennial Report (in years when it is submitted), and Operating Agreement (if used) and to determine compliance with the capitalization grant agreement, requirements of section 1452 of the Act, and this subpart. The RA will complete the annual review according to the schedule established in the capitalization grant agreement.

(2) *Records access.* After reasonable notice by the RA, the State or assistance recipient must make available such records as the RA reasonably considers pertinent to review and determine State compliance with the capitalization grant agreement and requirements of section 1452 of the Act and this subpart. The RA may conduct on-site visits as deemed necessary to perform the annual review.

(d) *Information management system*—(1) *Purpose.* The purpose of the information management system is to assess the DWSRF programs, to monitor State progress in years in which Biennial Reports are not submitted, and to assist in conducting annual reviews.

(2) *Reporting.* A State must annually submit information to EPA on the amount of funds available and assistance provided by the DWSRF program.

§ 35.3575 Application of Federal cross-cutting authorities (cross-cutters).

(a) *General.* A number of Federal laws, executive orders, and government-wide policies apply by their own terms to projects and activities receiving Federal financial assistance, regardless of whether the statute authorizing the assistance makes them applicable. A few cross-cutters apply by their own terms only to the State as the grant recipient because the authorities explicitly limit their application to grant recipients.

(b) *Application of cross-cutter requirements.* Except as provided in paragraphs (c) and (d) of this section and in § 35.3580, cross-cutter requirements apply in the following manner:

(1) All projects for which a State provides assistance in amounts up to the amount of the capitalization grant deposited into the Fund must comply with the requirements of the cross-cutters. Activities for which a State provides assistance from capitalization grant funds deposited into set-aside accounts must comply with the requirements of the cross-cutters, to the extent that the requirements of the cross-cutters are applicable.

(2) Projects and activities for which a State provides assistance in amounts that are greater than the amount of the capitalization grant deposited into the Fund or set-aside accounts are not subject to the requirements of the cross-cutters.

(3) A State that elects to impose the requirements of the cross-cutters on projects and activities for which it provides assistance in amounts that are greater than the amount of the capitalization grant deposited into the Fund or set-aside accounts may credit this excess to meet future cross-cutter requirements on assistance provided from the respective accounts.

(c) *Federal anti-discrimination law requirements.* All programs, projects, and activities for which a State provides assistance are subject to the following Federal anti-discrimination laws: Civil Rights Act of 1964, as amended, 42 U.S.C. 2000d *et seq.*; section 504 of the Rehabilitation Act of 1973, as amended, 29 U.S.C. 794; and the Age Discrimination Act of 1975, as amended, 42 U.S.C. 6102.

(d) *Minority and Women's Business Enterprise (MBE/WBE) procurement requirements.* A State must negotiate a fair share goal with the RA for the participation of MBE/WBEs. The fair share goal must be based on the availability of MBE/WBEs in the relevant market area to do the work under the DWSRF program. Each capitalization grant agreement must describe how a State will comply with MBE/WBE procurement requirements, including how it will apply the fair share goal to assistance recipients to which the requirements apply and how it will assure that assistance recipients take the following six affirmative steps:

(1) Include small, minority and women's businesses on solicitation lists;

(2) Assure that small, minority and women's businesses are solicited whenever they are potential sources;

(3) Divide total requirements, when economically feasible, into smaller tasks or quantities to permit maximum participation by small, minority and women's businesses;

(4) Establish delivery schedules, when the requirements of the work permits, which will encourage participation by small, minority and women's businesses;

(5) Use the services of the Small Business Administration and the Minority Business Development Agency of the U.S. Department of Commerce, as appropriate; and

(6) Require the contractor to take the affirmative steps in paragraphs (d)(1) through (d)(5) of this section if the contractor awards subagreements.

(e) *Complying with cross-cutters.* A State is responsible for ensuring that assistance recipients comply with the requirements of cross-cutters, including initiating any required consultations with State or Federal agencies responsible for individual cross-cutters. A State must inform EPA when consultation or coordination with other Federal agencies is necessary to resolve issues regarding compliance with cross-cutter requirements.

§ 35.3580 Environmental review requirements.

(a) *General.* With the exception of activities identified in paragraph (b) of this section, a State must conduct environmental reviews of the potential environmental impacts of projects and activities receiving assistance.

(b) *Activities excluded from environmental reviews.* A State must conduct environmental reviews of source water protection activities under § 35.3535, unless the activities solely involve administration (e.g., personnel, equipment, travel) or technical assistance. A State is not required to conduct environmental reviews of all the other eligible set-aside activities under § 35.3535 because EPA has determined that, due to their nature, they do not individually, cumulatively over time, or in conjunction with other actions have a significant effect on the quality of the human environment. A State does not need to include provisions in its SERP for excluding these activities. Activities excluded from environmental reviews remain subject to other applicable Federal cross-cutting authorities under § 35.3575.

(c) *Tier I environmental reviews.* All projects that are assisted by the State in amounts up to the amount of the capitalization grant deposited into the Fund must be reviewed in accordance with a SERP that is functionally equivalent to the review undertaken by EPA under the National Environmental Policy Act (NEPA). With the exception of activities excluded from environmental reviews in paragraph (b) of this section, activities for which a State provides assistance from capitalization grant funds deposited into set-aside accounts must also be reviewed in accordance with a SERP that is functionally equivalent to the review undertaken by EPA under the NEPA. A State may elect to apply the procedures at 40 CFR part 6 and related subparts or apply its own ''NEPA-like'' SERP for conducting environmental reviews, provided that the following elements are met:

(1) *Legal foundation.* A State must have the legal authority to conduct environmental reviews of projects and activities receiving assistance. The legal authority and supporting documentation must specify:

(i) The mechanisms to implement mitigation measures to ensure that a project or activity is environmentally sound;

(ii) The legal remedies available to the public to challenge environmental review determinations and enforcement actions;

(iii) The State agency that is primarily responsible for conducting environmental reviews; and

(iv) The extent to which environmental review responsibilities will be delegated to local recipients and will be subject to oversight by the primary State agency.

(2) *Interdisciplinary approach.* A State must employ an interdisciplinary approach for identifying and mitigating adverse environmental effects including, but not limited to, those associated with other cross-cutting Federal environmental authorities.

(3) *Decision documentation.* A State must fully document the information, processes, and premises that influence its decisions to:

(i) Proceed with a project or activity contained in a finding of no significant impact (FNSI) following documentation in an environmental assessment (EA);

(ii) Proceed or not proceed with a project or activity contained in a record of decision (ROD) following preparation of a full environmental impact statement (EIS);

(iii) Reaffirm or modify a decision contained in a previously issued categorical exclusion (CE), EA/FNSI or EIS/ROD following a mandatory 5 year environmental reevaluation of a proposed project or activity; and

(iv) If a State elects to implement processes for either partitioning an environmental review or categorically excluding projects or activities from environmental review, the State must similarly document these processes in its proposed SERP.

(4) *Public notice and participation.* A State must provide public notice when: a CE is issued or rescinded; a FNSI is issued but before it becomes effective; a decision that is issued 5 years earlier is reaffirmed or revised; and prior to initiating an EIS. Except with respect to a public notice of a CE or reaffirmation of a previous decision, a formal public comment period must be provided during which no action on a project or activity will be allowed. A public hearing or meeting must be held for all projects and activities except for those having little or no environmental effect.

(5) *Alternatives consideration.* A State must have evaluation criteria and processes which allow for:

(i) Comparative evaluation among alternatives, including the beneficial and adverse consequences on the existing environment, the future environment, and individual sensitive environmental issues that are identified by project management or through public participation; and

(ii) Devising appropriate near-term and long-range measures to avoid, minimize, or mitigate adverse impacts.

(d) *Tier II environmental reviews.* A State may elect to apply an alternative SERP to all projects and activities (except those activities excluded from environmental reviews in paragraph (b) of this section) for which a State provides assistance in amounts that are greater than the amount of the capitalization grant deposited into the Fund or set-aside accounts, provided that the process:

(1) Is supported by a legal foundation which establishes the State's authority to review projects and activities;

(2) Responds to other environmental objectives of the State;

(3) Provides for comparative evaluations among alternatives and accounts for beneficial and adverse consequences to the existing and future environment;

(4) Adequately documents the information, processes, and premises that influence an environmental determination; and

(5) Provides for notice to the public of proposed projects and activities and for the opportunity to comment on alternatives and to examine environmental review documents. For projects or activities determined by the State to be controversial, a public hearing must be held.

(e) *Categorical exclusions (CEs).* A State may identify categories of actions which do not individually, cumulatively over time, or in conjunction with other actions have a significant effect on the quality of the human environment and which the

State will exclude from the substantive environmental review requirements of its SERP. Any procedures under this paragraph must provide for extraordinary circumstances in which a normally excluded action may have a significant environmental effect.

(f) *Environmental reviews for refinanced projects or reimbursed project costs.* A State must conduct an environmental review which considers the impacts of a project based on conditions of the site prior to initiation of the project. Failure to comply with the environmental review requirements cannot be justified on the grounds that costs have already been incurred, impacts have already been caused, or contractual obligations have been made prior to the binding commitment.

(g) *EPA approval process.* The RA must review and approve any State ''NEPA-like'' and alternative procedures to ensure that the requirements for Tier I and Tier II environmental reviews have been met. The RA will conduct these reviews on the basis of the criteria for evaluating NEPA-like reviews contained in Appendix A to this subpart.

(h) *Modifications to approved SERPs.* Significant changes to State environmental review procedures must be approved by the RA.

§ 35.3585 Compliance assurance procedures.

(a) *Causes.* The RA may take action under this section and the enforcement provisions of the general grant regulations at 40 CFR 31.43 if a determination is made that a State has not complied with its capitalization grant agreement, other requirements under section 1452 of the Act, this subpart, or 40 CFR part 31 or has not managed the DWSRF program in a financially sound manner (e.g., allows consistent and substantial failures of loan repayments).

(b) *RA's course of action.* For cause under paragraph (a) of this section, the RA will issue a notice of non-compliance and may prescribe appropriate corrective action. A State's corrective action must remedy the specific instance of non-compliance and adjust program management to avoid non-compliance in the future.

(c) *Consequences for failure to comply.* (1) If within 60 days of receipt of the non-compliance notice a State fails to take the necessary actions to obtain the results required by the RA or fails to provide an acceptable plan to achieve the results required, the RA may suspend payments until the State has taken acceptable actions. Once a State has taken the corrective action deemed necessary and adequate by the RA, the suspended payments will be released and scheduled payments will recommence.

(2) If a State fails to take the necessary corrective action deemed adequate by the RA within 12 months of receipt of the original notice, any suspended payments will be deobligated and reallotted to eligible States. Once a payment has been made for the Fund, that payment and cash draws from that payment will not be subject to withholding. All future payments will be withheld from a State and reallotted until such time that adequate corrective action is taken and the RA determines that the State is back in compliance.

(d) *Dispute resolution.* A State or an assistance recipient that has been adversely affected by an action or omission by EPA may request a review of the action or omission under general grant regulations at 40 CFR part 31, subpart F.

Appendix A to Subpart L—Criteria for Evaluating a State's Proposed NEPA-Like Process

The following criteria will be used by the RA to evaluate a proposed SERP:

(A) *Legal foundation.* Adequate documentation of the legal authority, including legislation, regulations or executive orders and/or Attorney General certification that authority exists.

(B) *Interdisciplinary approach.* The availability of expertise, either in-house or otherwise, accessible to the State agency.

(C) *Decision documentation.* A description of a documentation process adequate to explain the basis for decisions to the public.

(D) *Public notice and participation.* A description of the process, including routes of publication (e.g., local newspapers and project mailing list), and use of established State legal notification systems for notices of intent, and criteria for determining whether a public hearing is required. The adequacy of a rationale where the comment period differs from that under NEPA and is inconsistent with other State review periods.

(E) *Alternatives consideration.* The extent to which the SERP will adequately consider:

(1) Designation of a study area comparable to the final system;

(2) A range of feasible alternatives, including the no action alternative;

(3) Direct and indirect impacts;

(4) Present and future conditions;

(5) Land use and other social parameters including relevant recreation and open-space considerations;

(6) Consistency with population projections used to develop State implementation plans under the Clean Air Act;

(7) Cumulative impacts including anticipated community growth (residential, commercial, institutional, and industrial) within the project study area; and

(8) Other anticipated public works projects including coordination with such projects.

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