



U.S. ENVIRONMENTAL PROTECTION AGENCY

OFFICE OF INSPECTOR GENERAL



# EPA Policy on Financing Local Reserves Needs Revision

Report No. 12-P-0231

January 25, 2012



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## Report Contributors:

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## Abbreviations

CFR	Code of Federal Regulations
CWSRF	Clean Water State Revolving Fund
DWSRF	Drinking Water State Revolving Fund
EPA	U.S. Environmental Protection Agency
OMB	Office of Management and Budget
SRF	State Revolving Fund

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# At a Glance

## Why We Did This Review

The U.S. Environmental Protection Agency (EPA) Office of Inspector General performed this audit as a result of observations made during an audit of Special Appropriations Act Project grants. Based on that review, we assessed EPA's policy that allows states to use revolving fund capitalization grants to fund local reserve accounts.

## Background

The Clean Water Act and the Safe Drinking Water Act authorize EPA to award grants to states that have established Clean Water and Drinking Water State Revolving Fund (SRF) programs. States use these grants to capitalize a revolving fund from which low-cost loans and other types of assistance are provided to finance infrastructure projects.

For further information, contact our Office of Congressional and Public Affairs at (202) 566-2391.

The full report is at:  
[www.epa.gov/oig/reports/2012/20120125-12-P-0231.pdf](http://www.epa.gov/oig/reports/2012/20120125-12-P-0231.pdf)

## ***EPA Policy on Financing Local Reserves Needs Revision***

### What We Found

EPA policy that allows states to use SRF funds to establish local reserve accounts conflicts with other regulations. Office of Water Policy Memorandum SRF 91-08 says: "These local reserve accounts, which are used to secure loan repayments, are eligible costs of the SRF." However, the financing of local reserve accounts does not represent eligible incurred project costs, a requirement for cash draws from the federal capitalization grants per the Code of Federal Regulations. When EPA allows use of funds for local reserves, funding is not available for needed wastewater and drinking water projects.

### What We Recommend

We recommend that the Assistant Administrator for Water rescind guidance allowing federal funds to be used to finance local reserve accounts. The Agency stated that it does not believe that any state SRF programs are currently drawing federal funds to finance local reserves, but would issue a memorandum to the states with instructions that only non-federal SRF funds may be used to finance local reserves.



UNITED STATES ENVIRONMENTAL PROTECTION AGENCY  
WASHINGTON, D.C. 20460

THE INSPECTOR GENERAL

January 25, 2012

**MEMORANDUM**

**SUBJECT:** EPA Policy on Financing Local Reserves Needs Revision  
Report No. 12-P-0231

**FROM:** Arthur A. Elkins, Jr.  
Inspector General

A handwritten signature in black ink, appearing to read "Arthur A. Elkins, Jr.", is written over the printed name.

**TO:** Nancy Stoner  
Acting Assistant Administrator for Water

This is our report on the subject audit conducted by the Office of Inspector General (OIG) of the U.S. Environmental Protection Agency (EPA). This report contains a finding that describes the problems the OIG has identified and corrective actions the OIG recommends.

**Action Required**

In responding to the draft report, the Agency provided a corrective action plan for addressing the recommendation with milestone dates. Therefore, a response to the final report is not required. The Agency should track corrective actions not implemented in the Management Audit Tracking System. We have no objections to the further release of this report to the public. The report will be available at <http://www.epa.gov/oig>.

If you or your staff have any questions regarding this report, please contact Melissa Heist, Assistant Inspector General for Audit, at (202) 566-0899 or [heist.melissa@epa.gov](mailto:heist.melissa@epa.gov); or Janet Kasper at (312) 866-3059 or [kasper.janet@epa.gov](mailto:kasper.janet@epa.gov).

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## Purpose

The primary objective of our audit was to determine whether EPA's policy on the use of federal funds to establish local reserve accounts conflicts with other regulations. The audit was performed as a result of observations made during an audit of Special Appropriations Act Project grants. Based on that review, we assessed EPA's policy that allows states to use revolving fund capitalization grants to fund local reserve accounts.

## Background

The Clean Water Act and the Safe Drinking Water Act authorize the U.S. Environmental Protection Agency (EPA) to award grants to states to capitalize Clean Water State Revolving Fund (CWSRF) and Drinking Water State Revolving Fund (DWSRF) programs. The revolving funds are used to issue low-cost loans and other types of assistance to finance infrastructure projects.

The funding sources for the CWSRF and DWSRF loans include federal capitalization grants, state matching funds, loan repayments, fund interest earnings, and leveraged funds (e.g., the sale of bonds by the program for additional capital). States are required to provide matching funds equivalent to 20 percent of the federal capitalization grant. States meet the match requirement from general fund monies or from the sale of general obligation bonds<sup>1</sup> or revenue bonds.<sup>2</sup> General obligation bonds are repaid from the state's general taxation and are guaranteed by the full faith and credit of the state. In contrast, revenue bonds are repaid and guaranteed solely by State Revolving Fund (SRF) program revenues. Because revenue bonds are guaranteed only by the states' SRF programs and not by the states, these bonds are considered to be of greater risk of default. For this reason, trustees<sup>3</sup> demand additional protection by requiring local reserve funds to be established. These reserve funds can be used by the trustee in the event of a default.

The Office of Inspector General is not questioning the validity of the existence of local reserve accounts; rather, the issue is that states may be using federal funds to establish the local reserve accounts to meet the trustees' requirements.

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<sup>1</sup> General obligation bonds are bonds secured by a pledge of the issuer's taxing powers. These bonds are considered to be the most secure of all municipal debt.

<sup>2</sup> Revenue bonds are municipal bonds whose debt service is payable solely from the revenues derived from operating the facilities acquired or constructed with the proceeds of the bonds.

<sup>3</sup> A trustee is a bank designated as the custodian of funds and official representative of bondholders. Trustees are appointed to ensure compliance with the trust indenture and represent bondholders to enforce their contract with the issuer.

## Scope and Methodology

We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives. We conducted our audit work from January 2008 to November 2011.<sup>4</sup> We examined EPA’s policy for local reserve accounts and reviewed other federal and EPA regulations.

## EPA Guidance Results in Unallowable Use of Federal Funds

EPA policy that allows states to use SRF funds to establish local reserve accounts conflicts with other regulations. Office of Water Policy Memorandum SRF 91-08 says: “These local reserve accounts, which are used to secure loan repayments, are eligible costs of the SRF.” However, the financing of local reserve accounts does not represent eligible incurred project costs, a requirement for cash draws from the federal capitalization grant per the Code of Federal Regulations (CFR) through 40 CFR Part 35. When funds are used to finance local reserves, funding is not available for needed wastewater and drinking water projects.

EPA regulations for the CWSRF and DWSRF identify how states may use SRF funds. There is no provision in the CWSRF or DWSRF regulations for funding local reserve accounts. With regard to local obligations, the regulations allow SRF funds to guarantee local debt obligations or purchase insurance where such action would improve credit market access or reduce interest rates. EPA interpreted the regulations to allow the use of federal funds to establish local reserve accounts. We do not agree with the interpretation and believe it conflicts with 40 CFR Part 35.3155 (d)(2) and 40 CFR Part 35.3560 (f) that define eligible incurred costs. In 1990, the EPA Office of Water issued Policy Memorandum SRF 91-08 allowing all states to use federal funds to establish reserve accounts. At the time, the state of Montana had requested approval to fund, with SRF assistance, local reserve accounts. The reserve accounts were to be used to satisfy a default, should it occur, on bonds for SRF-funded projects. EPA documented its decision in policy memorandum SRF 91-08, which provided national guidance to all SRF programs. EPA staff stated that they did not obtain a legal review of the decision.

CWSRF Regulations	DWSRF Regulations
The SRF may guarantee local debt obligations where such action would improve credit market access or reduce interest rates. 40 CFR Part 35.3120 (c)	A State may provide assistance by purchasing insurance or guaranteeing a local debt obligation to improve credit market access or reduce interest rates. 40 CFR Part 35.3525 (d)

<sup>4</sup> Work was suspended on the assignment from March 2009 to August 2010 due to higher priority audit work.

We do not agree with EPA's interpretation of the regulations for two reasons. First, the regulations allow federal funds to be used as a guarantee for local debt obligations where such action would improve credit market access or reduce interest rates. The use of federal funds to finance SRF reserves is not needed to achieve either of these purposes. Communities that obtain SRF loans have access to the SRF regardless of the existence of local reserve accounts, and interest rates in the SRF are already below market.

Second, the CWSRF and DWSRF regulations both require cash draws from the federal capitalization grant to be based on incurred project costs. The requirements of 40 CFR Part 35.3155 (d) (2) are that "the SRF or assistance recipient must first incur a cost...in order to draw cash" and the requirements of 40 CFR Part 35.3560 (f) are that "a State may draw cash through the Automated Clearing House for the proportionate Federal share of eligible incurred project costs." A reserve is not an eligible incurred cost as there is no expense or cost involved. Instead, the funds are, in most cases, transferred from the SRF to an interest-bearing bank account which holds the funds in the form of a "reserve." No services or goods have been provided.

EPA needs to rescind its policy on local reserves. When EPA allows use of funds for local reserves, funding is not available for needed wastewater and drinking water projects.

## **Recommendation**

We recommend that the Assistant Administrator for Water:

1. Rescind Office of Water Policy Memorandum SRF 91-08 regarding local reserves.

## **Agency Response and OIG Evaluation**

The Agency stated that it does not believe that any state SRF programs are currently drawing federal funds to finance local reserves. The Agency proposed an alternative corrective action of issuing a memorandum to the states, by January 31, 2012, with instructions that only non-federal SRF funds may be used to finance local reserves and that such financing will not result in a cash draw from the federal SRF capitalization grant. The alternative corrective action will address the finding and recommendation.



# **Status of Recommendations and Potential Monetary Benefits**

RECOMMENDATIONS						POTENTIAL MONETARY BENEFITS (in \$000s)	
Rec. No.	Page No.	Subject	Status <sup>1</sup>	Action Official	Planned Completion Date	Claimed Amount	Agreed-To Amount
1	3	Rescind Office of Water Policy Memorandum SRF 91-08 regarding local reserves.	O	Assistant Administrator for Water	1/31/12		

<sup>1</sup> O = recommendation is open with agreed-to corrective actions pending  
 C = recommendation is closed with all agreed-to actions completed  
 U = recommendation is unresolved with resolution efforts in progress

## ***Agency Response to Draft Report***

UNITED STATES ENVIRONMENTAL PROTECTION AGENCY  
WASHINGTON, D.C. 20460

OFFICE OF WATER

January 4, 2012

**MEMORANDUM**

**SUBJECT:** Response to Draft Report: EPA Policy on Financing Local Reserves Needs Revision, Project No. OA –FY08-0067

**FROM:** Nancy K. Stoner  
Acting Assistant Administrator

**TO:** Melissa M. Heist  
Assistant Inspector General for Audit

Thank you for the draft report transmitted on November 30, 2011, entitled, “EPA Policy on Financing Local Reserves Needs Revision.” We appreciate the opportunity to comment on this draft report and look forward to adequately resolving this matter.

As of today, EPA does not believe that any State SRF programs are currently drawing federal funds to finance local reserves. However, EPA will issue a memo to State SRF programs with instructions that only non-federal SRF funds may be used to finance local reserves, and that such financing will not result in a cash draw from a federal SRF capitalization grant.

Again, thank you for the opportunity to respond to these findings and recommendations. If you have any comments or questions regarding this response, please contact me or James A. Hanlon, Director, Office of Wastewater Management, at (202) 564-0748, or Cynthia C. Dogherty, Director, Office of Ground Water and Drinking Water, at (202) 564-3750.

## ***Distribution***

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