

Appendix D

Use of Cost Share

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Use of Cost Share

Clean Water State Revolving Fund and Water Pollutant Trading: What Funding Is Available?

What is the Clean Water State Revolving Fund?

The Clean Water State Revolving Fund (CWSRF) is the Environmental Protection Agency's largest water quality financing program. Operated in all 50 states and Puerto Rico, the CWSRF provides over \$5 billion in assistance for water quality projects each year. Most assistance is in the form of low interest loans. Municipal credit enhancements, such as guarantees for local debt and debt insurance, are also available and can mimic the CWSRF subsidy. Guarantees and insurance hold the promise of expanding CWSRF assistance to many more water quality projects.

Funding for the capital costs of water quality projects

A very broad array of projects are eligible for funding, including projects defined in Sections 212, 319 and 320 of the Clean Water Act. Section 212 projects include publicly owned municipal wastewater collection and treatment systems (POTWs), publicly owned municipal stormwater projects and publicly owned municipal landfill projects regulated by the National Pollutant Discharge Elimination System (NPDES) Program. Section 319 projects are nonpoint source projects defined in each state's Nonpoint Source Management Plan. Section 320 projects are water quality projects located in the watershed draining to a National Estuary that are defined in the 28 National Estuaries' Comprehensive Conservation Management Plans. These projects generally overlap with 212 and 319 projects. However, privately owned projects regulated by the NPDES program, such as Concentrated Animal Feeding Operations, some municipal stormwater and landfills projects and others are only eligible as Section 320 projects. Both public and private borrowers may receive CWSRF loans for nonpoint source and estuary projects, including farmers, homeowners, local governments, not-for-profit organizations, businesses and others. Projects likely to be involved in water quality pollutant trading for nutrients and sediment include advanced municipal wastewater treatment, manure management Best Management Practices (BMPs), cropland BMPs, riparian restoration and reforestation activities, septic system repair and upgrade and urban runoff BMPs. For more information about eligible projects visit www.epa.gov/owm/cwfinance/cwsrf/index.htm.

The CWSRF funds the capital expenses of a project. For Section 212 municipal wastewater projects, this includes pipe and plant. Capital costs associated with publicly owned stormwater, including traditional collection, storage and treatment projects, as well as green infrastructure, such as rain gardens, are eligible. Section 212 projects also include the water quality aspects of publicly owned municipal landfills, such as leachate collection and treatment, monitoring wells, liners, and caps. Reforestation, land conservation,

purchasing equipment and environmental cleanups are some of the many publicly and privately owned Section 319 projects eligible for CWSRF assistance. The loans are not available for costs associated with operation and maintenance. In addition, while there are many opportunities to combine CWSRF loans with other federal programs, the combined federal contribution to the projects may not exceed 100% of the capital costs. If other federal programs are used to cover operations and maintenance costs, those funds may exceed the capital costs of the project. CWSRF loan interest rates range from 0% to just under market rate. Loan repayment begins within one year of project completion and full repayment of the loan must occur within 20 years or the useful life of the underlying asset, whichever is less.

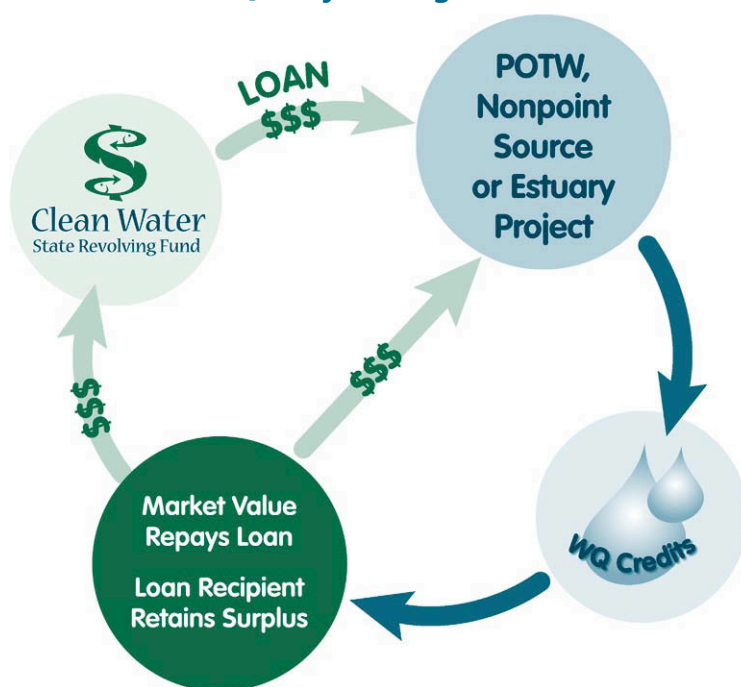
Clean Water State Revolving Fund Can Support Trading

There are three ways the CWSRF can support water quality pollutant trading—direct loans, conduit lending and investing in credit generating projects. Direct loans involve the typical assistance relationship between the CWSRF and a POTW, nonpoint source, or estuary project. The CWSRF provides assistance, such as a low interest loan, to a project. Loan repayments must begin within one year of project completion. After the project is completed,

The CWSRF can pay for projects that generate water pollution removal credits. CWSRF assistance can be funnelled through a POTW who needs the credit.

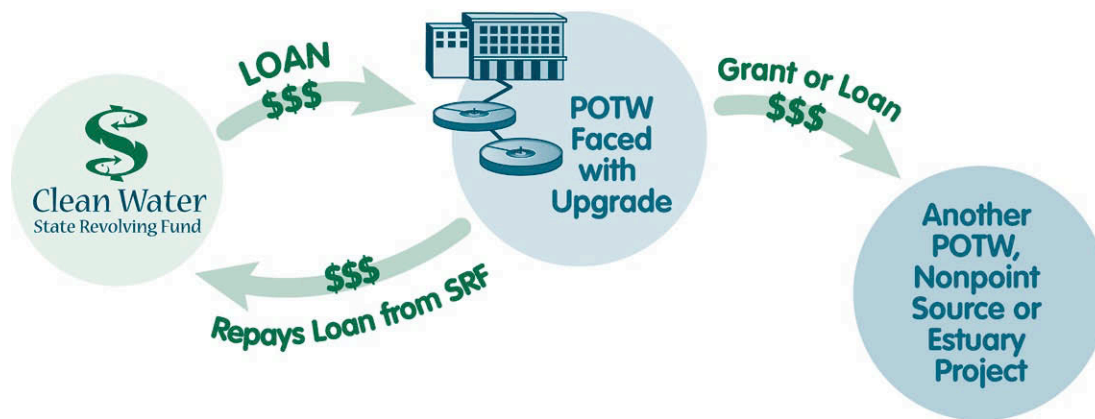
the project may generate water pollution removal credits. Despite the federal subsidy from the lower than market rate interest on the loans or municipal debt guarantees or insurance, proceeds from the sale of these credits can be kept by the borrower. Indeed, the revenue from these credit sales could be used to repay the CWSRF loan. See *Scenario 1*

Water Quality Trading Scenario #1



The CWSRF can also support financial arrangements between a POTW and other POTWs or nonpoint sources, also called Single Facility Offset in the Trading Policy and conduit lending in the CWSRF program. In these arrangements, a POTW borrows from the CWSRF for pollutant removal projects offsite of the treatment plant. The POTW may either re-lend that funding or provide a grant (where the POTW repays the loan) for capital pollutant removal projects that will benefit the water body. This could involve a POTW paying for upgrades at another POTW in the watershed or a POTW paying for nonpoint source BMPs or estuary protection projects within the watershed. See *Scenario 2*

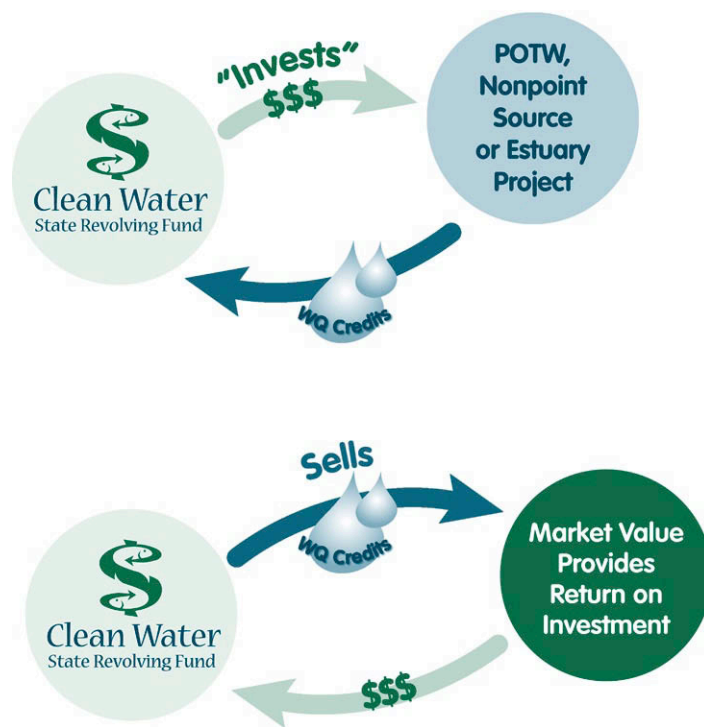
Water Quality Trading Scenario #2 (Offsets)



When a trading broker acts as an intermediary/integrator in a water pollutant trading market, the transaction to provide financial support for a capital project between the POTW and a pollutant credit generator needs to be clear so that CWSRF eligibility can be ascertained. Primarily, CWSRF assistance is limited to the capital costs of the project. The CWSRF needs to be able to identify the project that is being financed to determine if it is eligible, how much it costs and what other federal funds are contributing to it. The CWSRF must also be able to conclude that a state's funds are used within the same state or by an eligible interstate agency. The trading broker can continue to serve as the intermediary, as well as the credit enforcement arm to ensure the project is completed and maintained.

The CWSRF can also support water quality trading through investments in projects that generate credits. Instead of investing in traditional investment vehicles, such as U.S. Treasury notes and certificates of deposit, States can use idle funds to invest in a state fund that sponsors eligible projects that generate credits. In return for the capital to build the project, the project gives the state investment fund the water quality credit generated by the project. The sale of the fund's shares provides the CWSRF with the return on its investment. By ensuring that an adequate supply of credits is available, states can help establish a credit market. See *Scenario 3*

Water Quality Trading Scenario #3



Conclusions

While the CWSRF cannot be used to purchase credits directly under a water pollution trading program, the resources of the CWSRF can support a water pollutant trading market by providing funding for pollutant removal projects both directly and through a conduit. States have wide latitude to select and fund their highest priority water quality projects. With trading as a catalyst for a watershed level focus, the potential exists for CWSRF funds to effect more water quality improvements in individual watersheds.

Section 319 Funds and Water Quality Trading

Since 1990, Congress has annually appropriated grant funds to states, territories and tribes (hereinafter referred to as "states") under section 319(h) of the Clean Water Act to help them to implement management programs to control nonpoint source pollution. Section 319 grant funds are important resources available to states to restore impaired waters and to protect threatened and unimpaired waters. EPA awards funds to states in two portions—base funds and incremental funds. The base funds are to be used by the states to generally implement all aspects of their nonpoint source programs, while the incremental funds are to be primarily focused upon the implementation of watershed-based plans to restore waters impaired by nonpoint source pollution.

The recipients of state awarded section 319 grants (i.e., subgrantees) are subject to restrictions on the use of awarded funds, including those grantees that will sell pollutant

credits that result from a section 319 project. If a section 319 subgrantee receives financial remuneration during the subgrant period for a best management practice produced with these funds that qualifies as creditable under a water quality trading program, that payment is considered program income and would be required to be used in one of three ways:

- The amount of financial remuneration for the credit(s) created is deducted from the total allowable costs incurred by the subgrantee (if the income was not anticipated at the time of the subgrant award, it must be deducted from the grant and cannot be used in either of the subsequent methods);
- If authorized, it may be added to the subgrant funds and must be used for the purposes and under the conditions of the subgrant agreement; or
- If authorized, it may be used to meet the cost sharing or matching requirement of the subgrant (in which case, the amount of the subgrant remains the same).

Any income received after the subgrant award period has expired is not subject to these program income restrictions. If section 319 grant funds are only a portion of the cost of the project, then only that portion of the credit received would be program income (assuming that other funding for the project is not federal).

As the number of water quality trading programs that create opportunities to achieve nonpoint source pollutant reductions increases, the amount of section 319 grant funds that are sought for credit generating activities may increase. As more nonpoint source trading programs are instituted, EPA may need to evaluate the conditions under which section 319 funds are used for the purpose of generating credits and may issue a specific policy on the application of section 319 grant funds for water quality trading.

