OPERATING AGREEMENT

FOR

IMPLEMENTING AND MANAGING

THE DRINKING WATER

STATE REVOLVING FUND PROGRAM

BETWEEN THE

STATE OF CALIFORNIA

AND THE

U.S. ENVIRONMENTAL PROTECTION AGENCY

REGION IX

I. INTRODUCTION

A. Background and Objective of the DWSRF

The Safe Drinking Water Act (SDWA), as amended in 1996 (Public Law 104-182), authorized the creation of a Drinking Water State Revolving Fund (DWSRF) Program to assist public water systems to finance the costs of infrastructure needed to achieve or to maintain compliance with SDWA requirements and to protect public health. Section 1452 of the SDWA authorizes the Administrator of the U.S. Environmental Protection Agency (EPA) to award capitalization grants to states, which in turn can be used to provide low cost loans and other types of financial assistance to eligible public water systems. (Throughout this Operating Agreement, the Section numbers referred to are those Sections of the SDWA, as amended in 1996.)

The 1996 amendments to the SDWA have established a strong new emphasis on preventing contamination problems through source water protection and enhanced public water system management. Central to this emphasis is the development of state prevention programs, including source water protection, capacity development and operator certification. States have the option to use a portion of their capitalization grants to fund these eligible activities. The success of these activities will act to safeguard the DWSRF funds that are loaned for improving public water system compliance and public health.

The intent of the DWSRF Program is to:

- Provide additional assurance that the nation's drinking water remains safe and affordable;
- Assure that public drinking water systems which receive funding will be properly operated and maintained; and
- Ensure that effectively managed and permanent institutions will exist in each state to provide financial support for eligible public water systems and drinking water related needs for years to come.

Congress has placed particular emphasis on assisting smaller public drinking water systems and those public drinking water systems serving less affluent populations. This is done by providing greater funding flexibility for these public water systems under the DWSRF to ensure that public water systems have adequate technical, managerial, and financial

resources to maintain compliance and provide safe water.

The DWSRF is fundamentally a state program. Each state will have considerable flexibility to determine the design of its program and to direct funding toward its most pressing compliance and public health protection needs. Only minimal Federal requirements will be imposed.

Congress authorized $599 million for Federal Fiscal Year (FFY) 1994 and about $1 billion per fiscal year from 1995 through 2003 to implement the provisions of the SDWA. The amount of funds available to the national DWSRF program from the FFY 1997 appropriation was $1.275 billion. Funds available to states from the FFY 1997 appropriation have been allotted according to the formula used for distributing Public Water System Supervision (PWSS) grants under Section 1443 in FFY 1995. Funds available to each state from the FFY 1998 appropriation and beyond will be allotted according to a formula that reflects the proportional share of each state's needs identified in the most recent "Needs Survey" conducted pursuant to Section 1452(h). In each case, the minimum proportional share for a state will be one percent of the total funds available for allotment to all of the states. Funds are available to states during the fiscal year in which they are authorized and during the following federal fiscal year (Section 1452(a)(1)(C)).

B. Purpose, Format and Structure of the Operating Agreement

This Operating Agreement establishes a contractual relationship between the EPA and the State of California (hereinafter referred to as "the STATE").

The purpose of this Operating Agreement is to describe the framework and procedures of the STATE's DWSRF program, and the relationships and activities between the EPA and the STATE that are not expected to change annually. In summary, this document specifically:

- Lists the parties to the Operating Agreement;
- Outlines and defines the roles and responsibilities of all of the parties involved;
- Documents the necessary assurances;
- Explains the financial administration framework;
- Discusses the reporting and review requirements of the DWSRF programs; and
- Explains how the DWSRF program will be carried out.

This Operating Agreement will continue from year to year and will be incorporated by reference into the annual Capitalization Grant Agreement. Information that changes from year to year shall be contained in the annual Capitalization Grant Application. The STATE agrees that any modifications to this Operating Agreement that may be required by EPA regulations, policies, or program guidance will be made and implemented as necessary and as quickly as possible as permitted by the STATE's legislative and regulatory processes.

In February 1997, the EPA published a document, EPA 816-R-97-005, entitled "Drinking Water State Revolving Fund Program Guidelines" (DWSRF Program Guidelines). This Operating Agreement addresses many of the requirements for the Capitalization Grant Application for the STATE's DWSRF as outlined in Table 1 of the DWSRF Program Guidelines. Additional program requirements and conditions that are not covered in this Operating Agreement may be addressed in the DWSRF Program Guidelines.

C. Timing and Application Review

Upon implementation of this Operating Agreement, the EPA agrees to review the Capitalization Grant Application and take appropriate action within 60 calendar days of receipt of a completed Capitalization Grant Application in the Regional Office of EPA, Region IX. The application consists of:

- Standard Form 424A (Application for Federal Assistance) and supporting documentation and certifications;
- The Operating Agreement and any modifications thereto;
- The annual Intended Use Plan (Section 1452(b)); and
- A proposed capitalization grant payment schedule.

The EPA shall either approve the Capitalization Grant Application and offer to award the capitalization grant, or shall notify the STATE in writing of issues requiring resolution. The STATE and the EPA agree to negotiate promptly, cooperatively, and in good faith to clarify or resolve questions, which may arise during review of the Capitalization Grant Application

II. IMPLEMENTATION

A. Responsible Parties

1. The STATE, through the California Department of Health Services, is the instrumentality responsible for the overall management and conduct of the STATE's DWSRF program. Specifically, the Division of Drinking Water and Environmental Management, a division within the California Department of Health Services, is the STATE Agency with the responsibility to perform, or cause to be performed, all SDWA primacy activities and functions in conformance with applicable federal laws, regulations, orders and policies.

2. The EPA, Region IX, is responsible for the award of capitalization grants and oversight of the STATE's DWSRF Program and notifies the STATE of any violations of federal laws, regulations, orders and policies.

B. Parties to the Agreement

The parties to this Operating Agreement are the EPA and the STATE.

1. For the STATE: California Department of Health Services
Raye Harrington
601 North 7th Street, MS 92
P.O. Box 942732
Sacramento, CA 94234-7320

2. For the EPA: U.S. Environmental Protection Agency
Region IX
Felicia Marcus, Regional Administrator
75 Hawthorne Street
San Francisco, CA 94105-3109

Memoranda of Understanding (MOU) and/or Interagency Agreements between various STATE agencies may be established or changed from time to time. Copies of those MOU and Interagency Agreements (Attachment 3) will be submitted to EPA and included in the STATE's annual Capitalization Grant Application.

C. Summary of STATE and EPA Roles and Responsibilities

1. The STATE has enacted legislation that authorizes the development of the STATE's DWSRF Program. A copy of that legislation is included as Attachment 1. A more specific description of this authority is included in Paragraph D.1 of this section and Paragraph C of Section IV of this Operating Agreement.

2. The STATE will adopt an Environmental Review Process (ERP), subject to approval by the EPA. This ERP will be incorporated into the STATE's regulations that govern the administration of the STATE's DWSRF Program. The STATE will apply the ERP procedures for all Section 1452 projects. A copy of the STATE regulations, which incorporates the ERP, is part of Attachment 4. See also Paragraph E.5 of this section for binding commitments.

3. The STATE will develop or revise an Intended Use Plan in accordance with Section 1452 of the SDWA and the DWSRF Program Guidelines. To develop the Intended Use Plan and the associated project priority list, the STATE will solicit public comment and review. The STATE will submit the Intended Use Plan and the project priority list with a new or an amended Capitalization Grant Application to the EPA. More specific descriptions of these requirements are included in Paragraphs E.3 and E.4 of this section.

4. The STATE will maintain a competent organization and a staff skill mix to assure that projects meet acceptable technical, environmental and financial requirements as established or referenced in this Operating Agreement and that the STATE's DWSRF will be continuously and effectively operated. See also Paragraph D.3 of this section for STATE assurances.

5. The EPA agrees to provide funding through the award of capitalization grants to the STATE upon joint acceptance of this Operating Agreement and approval of an annual Capitalization Grant Application in accordance with Section 1452, and as federal funds are available for this purpose.

6. The EPA will provide grant funds to the STATE in accordance with a negotiated payment schedule as a condition of the Capitalization Grant Agreement. See Paragraph D.4 of this section.

7. The EPA may provide technical assistance to the STATE as needed and will be available to assist the STATE in developing and conducting in-service training programs and will provide advice and consultation to the STATE.

8. The STATE, upon receiving approval of the Capitalization Grant Application, agrees to manage the STATE's DWSRF Program in accordance with this Operating Agreement, the terms of the Capitalization Grant Agreement, the SDWA, as amended, and applicable EPA policy/guidance and regulations.

9. The EPA will allow the STATE as much discretion and flexibility in implementing and managing its DWSRF Program as is permissible under the SDWA, and the applicable EPA policy/guidance and regulations.

10. The EPA will oversee the STATE's DWSRF Program to assure compliance with the SDWA and applicable EPA policy/guidance and regulations. Generally, specific projects for which the STATE has provided financial assistance will not be reviewed. However, if evidence of non-compliance with the applicable requirements exists, the EPA may conduct specific project reviews.

    If the Annual Review or Audit reveals that the STATE has not complied with its Capitalization Grant Agreement or other requirements under Section 1452, the EPA will notify the STATE of such non-compliance and prescribe the necessary corrective action. Failure to satisfy the terms of the Capitalization Grant Agreement, including unmet assurances or invalid certifications, will be grounds for a finding of non-compliance.

D. STATE ASSURANCES FOR THE DWSRF PROGRAM

The STATE is responsible for providing assurances in the Capitalization Grant Application on how it will comply with a minimum of **fifteen (15)** assurances or elements of the DWSRF Program, **as well as** other requirements for all DWSRF funding to comply with applicable Federal requirements (refer to Table 1 of the DWSRF Program Guidelines). In some cases, the STATE must simply agree or provide certification in the Capitalization Grant Application that it will comply with the specifications. In other cases, additional documentation on the procedures by which the

STATE plans to ensure compliance with the specifications must be furnished. This Operating Agreement is one method for the STATE to document its agreement (by reference, if appropriate) to many of these requirements. The following addresses the manner in which the STATE will meet many of these assurances and requirements (with some of the assurances/requirements described in more detail elsewhere in this Operating Agreement):

1. **STATE Instrumentality and Authority to Establish the STATE's DWSRF Program**

The STATE through legislation enacted by the California State Legislature has established the STATE's DWSRF program. A copy of the enabling legislation and the pertinent NRS sections are included as part of this Operating Agreement (Attachment 1). This legislation authorizes the STATE to adopt procedures, rules, and regulations to manage and operate the DWSRF program. It specifically authorizes the establishment of the **account for the revolving fund** and the **account for set-aside programs**. The State Attorney General has certified that this legislation grants powers and authorities necessary to implement and administer the DWSRF program in accordance with the SDWA, as amended, and applicable federal regulations. A copy of this letter of certification is also attached (Attachment 2). See also Paragraph C of Section IV of this Operating Agreement.

If more than one STATE agency is involved in the DWSRF Program, the STATE will describe the roles and responsibilities of each Agency in the Capitalization Grant Application. The STATE will submit to the EPA a copy of any MOU and/or Interagency Agreement(s) that describe the roles and responsibilities between agencies as part of its annual Capitalization Grant Application (see Attachment 3). The STATE agrees that it retains ultimate responsibility for properly executing the Capitalization Grant Agreement under Federal grant regulations (40 CFR 31.3).

2. **STATE Compliance with Applicable STATE Laws and Procedures**

The STATE agrees to comply with STATE statutes and regulations that are applicable to DWSRF program funds, including Federal capitalization grant funds, STATE match, interest earnings, bond proceeds and repayments, and funds used for set-aside account activities.

3. **STATE Technical Capability**

The STATE agrees to provide documentation demonstrating that it has adequate personnel and resources to establish and manage the STATE's DWSRF program (e.g. current and future staffing

plan, background/qualification statements, schedule for planned training, etc.). The documentation will be submitted as part of the annual Capitalization Grant Application submittal.

4. **Acceptance of Capitalization Grant Funds in Accordance with a Payment Schedule**

The STATE agrees to accept federal grant payments in accordance with the negotiated payment schedule and use those payments for the activities of its DWSRF program as permitted by Section 1452. As part of its Capitalization Grant Application, the STATE must submit a proposed schedule of grant payments that is consistent with its proposed binding commitments outlined in its Intended Use Plan for providing project loans and for expending set-aside funds. The payment schedule will become part of the Capitalization Grant Agreement. The STATE will receive Federal funds in accordance with the provisions of the EPA-Automated Clearing House (EPA-ACH), formerly known as Letter of Credit.

5. **Depositing of All Capitalization Grant Funds into the Account for the Revolving Fund or the Account for Set-Aside Programs**

The STATE agrees to deposit capitalization grants into either the account for the revolving fund, or the account for set-aside programs as authorized under the SDWA (Section 1452(a)(1)(B)) and the STATE's legislative authority. Once funds are deposited into the account for the revolving fund, such monies may only be used as authorized under Section 1452(f). The STATE will provide certification for these accounts as part of the Capitalization Grant Agreement.

6. **STATE Matching Funds (20%) for DWSRF Account**

The STATE agrees to deposit into the account for the revolving fund (Fund) an amount equaling at least 20 percent of the amount of each capitalization grant. Except for federal payments made from FFY 1997 appropriations, the STATE match must be deposited into the Fund on or before the date that each Federal capitalization grant payment is made to the STATE (Section 1452(e)). The STATE shall have until September 30, 1999 to provide the STATE match for capitalization grant payments received from FFY 1997 capitalization awards. The STATE will

identify the source and provide certification of the match as part of its Capitalization Grant Agreement.

7. **Depositing of All Proceeds Back into the Fund**

The STATE agrees to credit all net proceeds from the sale of securities, interest earnings, and loan repayments into the Fund. Fund assets may be used as a source of revenue or security for bonds, as long as the net proceeds of the sale of securities will be deposited into the Fund (Section 1452(f)(4)).

Loans for land acquisition and source water protection, made pursuant to section 1452(k)(1)(A), must be repaid. The STATE may deposit these repayments, including principal and interest, either into the Fund, or into a separate account dedicated to Section 1452(k)(1) activities, subject to the same management oversight requirements as the Fund.

8. **STATE Dollar-for-Dollar Match for Section 1452(g)(2) Set-Asides**

The STATE may use up to 10% of its capitalization grant for 1452(g)(2) activities. The STATE must match the use of these funds with an equivalent amount of STATE expenditures, or provide documentation of in-kind services. The STATE cannot use any of the STATE's 20% match required pursuant to Section 1452(e) to also match the allocation requested by the STATE under the 10% set-aside. The STATE certifies that it will provide the required dollar-for-dollar match with an equivalent amount of current year expenditures, or provide current year funds and documentation that at least one-half of the STATE's match funds is in addition to the amount expended for the PWSS program in FFY 93.

9. **Utilization of Generally Accepted Accounting Principles**

The STATE agrees to establish fiscal controls and accounting principles, as promulgated by the Government Accounting Standards Board that are sufficient to account for and report STATE's DWSRF activities. The accounting system used for the STATE's program DWSRF must allow for proper measurement of

conditions outlined in the DWSRF Program Guidelines.

10. **Annual DWSRF Audit in Accordance with Generally Accepted Government Auditing Standards**

The STATE agrees to have the STATE's DWSRF program audited on an annual basis. These audits will be conducted in accordance with generally accepted government auditing standards (GAGAS) issued by the Comptroller General of the United States. The EPA is relying on the Annual Audit of the DWSRF program to minimize the risk of waste, fraud and abuse and increase the chance that such occurrences will be detected and reported.

11. **Policies and Procedures to Assure Borrowers Have Dedicated Source of Repayment or Demonstration of Adequate Security**

The STATE agrees to adopt regulations to assure that borrowers have a dedicated source of repayment and must apply these policies and procedures to the portion of the loan that must be repaid except for any disadvantaged subsidy portion. The STATE will submit and receive EPA approval of the STATE's regulations prior to the award of the first project loan. The STATE will develop criteria to evaluate an applicant's financial ability to repay a loan, in addition to paying for operation and maintenance costs, and other necessary expenses. The STATE's regulations and policies and procedures are included in Attachments 4 and 7.

12. **Efficient, Expeditious and Timely Expenditure of Funds**

The STATE agrees to commit and expend all DWSRF funds "as efficiently as possible" (Section 1452(g)(3)) and in a timely and expeditious manner. The STATE will enter into binding commitments with recipients of DWSRF fund assistance equal to the total amount of each grant payment plus the required STATE match deposited in the Fund within one year of the grant payment.

13. **Funds to be used in Accordance with the Intended Use Plan**

The STATE agrees to expend DWSRF funds in accordance with an Intended Use Plan that has undergone public review and comment (Section 1452(b)).

14. **Annual Report**

The STATE agrees to complete and submit an Annual Report on the uses of the its capitalization grants. The scope of the Annual Report covers the STATE's Fund and all other set-aside activities funded by the STATE's DWSRF Program. The contents of the Annual Report will conform to the requirements/format outlined in the DWSRF Program Guidelines.

15. **STATE Compliance with all Federal Cross-Cutting Authorities**

The STATE agrees to comply with all applicable Federal cross-cutting authorities (Attachment 5). See also Paragraph E.7 of this section for additional requirements.

E. STATE Requirements for the Capitalization Grant Agreement

The following are additional requirements listed on Table 1 of the DWSRF Program Guidelines that may not have been addressed by the above 15 STATE Assurances or later in this Operating Agreement.

1. **40 CFR Part 31 Assurances**

The STATE agrees to comply with 40 CFR Part 31 - Uniform Administrative Requirements for Grants and Cooperative Agreements to State and Local Governments.

2. **Review of Technical, Managerial, and Financial (TMF) Capability of Assistance Recipients**

Upon the effective date of the administrative regulations (Attachment 4), the STATE will review and evaluate the technical, managerial and financial capability of loan assistance recipients to maintain compliance with the SDWA (Section 1452(a)(3)(A)(i)). The STATE's authority for doing this review is contained in the enabling legislation (see Attachment 1). Procedures for conducting TMF Reviews are in the Policy and Procedures Manual (see Attachment 7).

3. **Significant Non-Compliance (SNC) Return to Compliance Reviews**

The State will review and evaluate whether the proposed project, after completion, will resolve the SNC problem, as referenced in Attachment 7.

4. **Preparation of an Intended Use Plan**

The STATE will prepare an Intended Use Plan and provide it to the public for review and comment prior to submitting it to the EPA as part of its Capitalization Grant Application. The Intended Use Plan must include specific details on how the STATE will use all available capitalization grant funds, including funds allocated for set-asides. The STATE will prepare an Intended Use Plan as long as the STATE's DWSRF Fund accounts remain in operation, not just for those years in which the STATE submits its Capitalization Grant Application.

As part of the Intended Use Plan, the STATE will, at a minimum:

a) Propose a list of projects, including description and size of the public water system;
b) Describe criteria and method for distributing funds;
c) Describe financial status of the DWSRF;
d) Describe short and long-term DWSRF goals;
e) Describe, if applicable, the amounts transferred between the DWSRF and CWSRF;
f) Describe all set-aside activities to be supported, including percentage of funds;
g) Describe, if applicable, how disadvantaged communities are defined;
h) Provide specific assurances and proposals (may have been already addressed elsewhere in the document), which include:
   (i) Document/certify environmental review performed in accordance with EPA-approved ERP,
   (ii) Agree to comply with Federal cross-cutters,
   (iii) Agree to enter into binding commitments with loan

recipients in an amount equal to each grant payment that is deposited into the Fund and State match within one year after the receipt of each grant payment,

(iv) Agree to timely expenditures of funds.

5. **Development and Submittal of a Project Priority Ranking System**

The STATE will develop a project priority ranking system to determine the annual priority project list required for the Intended Use Plan. After public review and comment, it will be submitted as part of the Capitalization Grant Application. This system will describe in detail by-pass procedures which clearly identify the conditions which will allow a project to be by-passed and the way the STATE will identify which other projects would receive the bypassed funds.

6. **Environmental Review**

The STATE agrees that binding commitments on DWSRF projects will be made only after the STATE has conducted an environmental review, and a determination is made and distributed using the EPA-approved ERP (part of Attachment 4).

7. **Entering into Binding Commitments with Assistance Recipients**

The STATE agrees to enter into binding commitment with assistance recipients. To the extent known, projected schedules for commitment of the STATE's DWSRF funds to specific projects shall be provided in the annual Intended Use Plan.

8. **STATE/Recipient Compliance with Applicable Federal Cross-Cutting Authorities**

The STATE agrees that it and all recipients of DWSRF funds made available by the capitalization grant are subject to, and must comply with, applicable federal cross-cutting authorities (see Attachment 5 for the most recent list). Federal cross-cutting authorities are specific federal laws, executive orders and government-wide policies in existence at the time that a loan

recipient receives a binding commitment from the Fund. They apply by their own terms to projects and activities receiving federal financial assistance. The STATE agrees to inform the EPA when consultation or coordination is necessary to resolve issues regarding compliance with those requirements.
Certain of the cross-cutters will apply to an amount of funds equaling the amount of the federal capitalization grant. The STATE will determine which "equivalency" projects will be subject to these Federal cross-cutters. However, all projects funded with DWSRF funds are subject to Federal anti-discrimination laws. The STATE agrees that it will ensure that assistance recipients comply with all applicable cross-cutters. The STATE acknowledges that applicable laws and regulations may change with time.

F. Financial Administration of the Fund

1. Loan Assistance Provided by the Fund

The STATE certifies that only the types of assistance authorized under Section 1452 of the SDWA will be awarded. The types of assistance for each DWSRF project shall be identified in the Intended Use Plan. The Fund may:

- Make direct loans to construct projects;
- Provide loans for engineering and environmental review purposes;
- Purchase or refinance local debt obligations;
- Guarantee or purchase insurance for local debt issues;
- Provide revenue for or to secure STATE bonds if the proceeds of the bonds are deposited in the Fund; and
- Earn interest on amounts deposited in Fund accounts (Section 1452(f)).

The types of assistance must adhere to the requirements and conditions as outlined in the DWSRF Program Guidelines or applicable federal regulations and policies.

2. Administration of the DWSRF

Up to four percent (4%) of the capitalization grant may be reserved for the costs of administering the STATE's DWSRF program. A separate account will be established for the use of the 4%

administrative cost set-aside. Allowable administrative costs include all costs incurred for management of the DWSRF program and for management of projects receiving financial assistance from the DWSRF. Reasonable costs unique to the STATE's DWSRF, such as costs of servicing loans and issuing debt, DWSRF program start-up costs, financial management, legal fees, and reimbursement costs for support services from other STATE agencies are also allowable. Expenses incurred for issuing securities guaranteed by the Fund, including costs of insuring the issue, may be absorbed by the proceeds of the bonds and need not be charged against the 4 percent administrative costs ceiling. The net proceeds of those bonds issued must be deposited in the account for the revolving fund.

3. **Leveraging**

The account for the revolving fund may be used for leveraging. At such time as the leveraging of funds is determined to be appropriate, the STATE will submit a proposed leveraging to the EPA for review and approval.

4. **Administration of Set-Aside Program Activities and Expenditures**

Set-aside programs and expenditures are outlined in the Intended Use Plan. In order to accomplish the goals of the DWSRF through the implementation of these programs, it may be necessary to supplement existing resources and personnel with assistance from other STATE agencies, or from non-profit groups and private consultants. MOU or Interagency Agreements will define and establish the relationships, services to be provided and proposed payment schedules between STATE agencies. Services to be provided by entities other than STATE agencies will be solicited by a request for qualifications or proposals, and will be administered in accordance with STATE contract requirements.

G. Federal Funding Process

With respect to the overall DWSRF funding process, a number of STATE requirements and/or conditions (e.g. appropriate STATE matches, entering into binding commitments with assistance recipients, payment schedules, etc.) have already been addressed in earlier Sections (D

through F) of this document. The following are additional requirements as discussed in the DWSRF Program Guidelines.

1. **THE EPA-ACH Payment System**

   The STATE will receive each capitalization grant payment in the form of an increase to the ceiling of funds available through the EPA-ACH. Funds will be transferred to the STATE from the U.S. Treasury on a reimbursement basis after the assistance recipient has billed the STATE's DWSRF for work completed and the STATE's DWSRF requests reimbursement from the EPA. The STATE then reimburses assistance recipients for costs incurred, a process known as disbursements from the DWSRF. The STATE will adhere to the EPA-ACH Payment System and will follow EPA-ACH Payment System procedures indicated in the EPA-ACH Payment System Recipient's Manual. See Attachment 6 for details.

2. **Cash Draws**

   The STATE agrees to adhere to the conditions and rules with respect to Cash Draw that apply to the different types of assistance in accordance with the DWSRF Program Guidelines and applicable federal regulations.

H. **Fund Administration**

Many of the items under this category (e.g. Staffing and Management, Accounting and Auditing Procedures, the development of the Intended Use Plan, etc.) have been addressed in the STATE Assurances section of this Operating Agreement and/or in the Attachments to this Operating Agreement. The following are additional conditions:

1. **Fund Perpetuity**

   The STATE will consider the long-term health and viability of the fund when selecting its mix of projects and determining the uses of DWSRF funding. Each year the STATE will assess the financial health of the DWSRF by examining fund balances, sources of funds, repayment stream, etc., and revise procedures as necessary to promote fund perpetuity.

2. **Fund Maintenance**

The STATE will maintain the investment of cash in the same manner as it maintains other cash reserves.

I. **Withholding of Funds**

The EPA will withhold funds if the STATE does not have the **Capacity Development Authority**, does not develop and implement a **Capacity Development Strategy**, and/or does not develop and implement an **Operator Certification Program** in accordance with Section 1452(a)(1)(G) and under the provisions described in the DWSRF Program Guidelines.

III. **REPORTING AND REVIEW RESPONSIBILITIES**

A. **STATE Responsibilities**

1. **Annual Report**

The STATE agrees to submit an Annual Report containing detailed information on how the STATE has met the goals and objectives of the previous fiscal year as stated in the Intended Use Plan. The contents and required elements of the Annual Report will conform to the DWSRF Program Guidelines, 40 CFR Parts 31 and 35, and applicable federal regulations. The STATE recognizes that Annual Reports are required for the life of the DWSRF program. A report submittal date will be included in the final grant agreement. At a minimum, the Annual Report shall identify loan recipients, loan amounts, loan terms, project categories, and other details as negotiated between the STATE and the EPA with emphasis on how the STATE has met the goals set forth in the Intended Use Plan and how the STATE will assure the financial health of the fund.

2. **Annual Audit**

The STATE agrees to conduct an Annual Audit in order to assure adequate financial management of the program in accordance with the DWSRF Program Guidelines (and appropriate federal regulations, when promulgated). The audit requires a separate

independent auditor's opinion on DWSRF financial statements and internal controls.

3. **Information Management System**

Once an information management system for regularly updating data on projects receiving DWSRF assistance and other information on the status of the DWSRF is developed by the EPA in cooperation with the States, the STATE will agree to enter relevant DWSRF information into the system. The EPA will have access to information in the system as needed, but will not be able to modify STATE-entered data. The EPA will utilize this information to assess the DWSRF program on a national basis and to monitor the STATE's progress on the DWSRF. The EPA will use the information to assist in conducting its Annual Review of the STATE's DWSRF program.

4. **Compliance Assurance—A System to Minimize Risk of Waste, Fraud, Abuse and Corrective Action**

Based on EPA guidance, the STATE agrees to devise and institute measures which will alert its staff to project deficiencies as they emerge and which will set forth STATE actions to correct such deficiencies as quickly as possible so as to preclude the need for corrective action by the EPA. If the recipient of financial assistance from the STATE's DWSRF fund exhibits evidence of waste, fraud or abuse, the STATE will impose sanctions on the recipient.

5. **Construction Progress**

The STATE will conduct periodic inspections to review construction progress in order to coordinate and schedule outlay requests. Construction inspections and outlay procedures will be documented by the STATE.

6. **Third Quarter Estimate**

At the end of the third quarter of each Federal Fiscal Year after the

first capitalization grant award, the STATE will provide the EPA with a schedule of estimated disbursements from the State DWSRF for the upcoming Federal Fiscal Year. This schedule will be the basis for negotiating the STATE's outlay commitments. Estimates of third quarter outlays may appear as a condition on the grant award.

B. EPA Responsibilities

1. Annual Review of the DWSRF

The EPA will conduct an Annual Review of the STATE's DWSRF program to assess the success of the program in meeting the objectives of Section 1452. The purposes of the Annual Review are to:

a) Assess the success of the STATE's performance of activities identified in the Intended Use Plan, the STATE's Annual Report, the Operating Agreement, and DWSRF information management system,

b) Determine how the DWSRF is achieving the intent of Section 1452 and the overall goals and objectives of the SDWA as amended,

c) Determine compliance with the Capitalization Grant Agreement, and

d) Assess the financial status of the DWSRF.

The Annual Review will adhere to the terms and conditions outlined in the DWSRF Program Guidelines (and appropriate federal regulations as they are promulgated). The EPA will complete an Annual Review of the Intended Use Plan and Annual Report covering the same fiscal year according to the schedule established in the Capitalization Grant Agreement, generally within 60 days of receipt of the Annual Report. At a minimum, the compliance/general program management, the pace of the program, the project level management, and financial management of the DWSRF Program are review topics that may be included as part of the Annual Review.

Upon completion of its Annual Review, the EPA will prepare a Program Evaluation Report (PER). The EPA shall submit the draft

PER to the STATE for review and comment prior to preparing the final PER.

2. **Compliance Assurance—A System to Minimize Risk of Waste, Fraud, Abuse and Corrective Action**

The EPA will develop guidance necessary to assure effective program management to prevent waste, fraud and abuse (Section 1452(g)(3)). The EPA will assist the STATE in achieving and maintaining compliance with program objectives and requirements.

If the Annual Review or Audit reveals that the STATE has not complied with its Capitalization Grant Agreement or other requirements under Section 1452, or if the STATE does not manage the STATE's DWSRF in a financially sound manner, the EPA will notify the STATE of such non-compliance and prescribe the necessary corrective action.

If within 60 days of receipt of the non-compliance notice, the STATE fails to take the necessary actions to obtain the results required by the EPA, or provide an acceptable plan to achieve the results required, the EPA may suspend payments to the STATE until the STATE has taken acceptable actions (40 CFR 31.43(a)(3)). Once the STATE has taken corrective action deemed necessary and adequate by the EPA, the withheld payments shall be released and scheduled payments shall resume.

If the STATE fails to take the necessary corrective action deemed adequate by the EPA within twelve months of receipt of the original notice, any suspended payments may be de-obligated and re-allotted to other States. All future payments may be withheld from the STATE and re-allotted until such time that adequate corrective action is taken and the Administrator certifies that the STATE is back in compliance.

3. **Dispute Resolution**

Any applicant for, or recipient of, DWSRF assistance that has been adversely affected by an EPA action or omission may request a review of such action or omission. The procedures are codified in

the EPA's general grant regulations at 40 CFR Part 31, Subpart F.

C. Records

1. Files

The STATE will receive and review project documents from loan fund assistance applicants. These documents, together with the STATE's review memos and the summary checklists, will be filed in official project files maintained by the STATE. The STATE will maintain the official financial review files and the loan agreement. The STATE shall make the project files available to the EPA for review upon reasonable notice.

2. Records Retention

The STATE will retain project files in accordance with 40 CFR Part 31 and STATE record retention requirements. The STATE will arrange for the retention and storage of required records for a period in accordance with the STATE's laws for records retention following completion of repayment, but not less than the repayment period on any DWSRF assistance.

3. Access to Records

Access to all records in the possession of the STATE will be in accordance with STATE laws governing access to information. Access to all records in the possession of the EPA will be in accordance with the U.S. Freedom of Information Act, Public Law 93-502. Information related to the Capitalization Grant Agreement and supporting documents located in the EPA Regional Office is available from the EPA in accordance with the U.S. Freedom of Information Act.

IV. EXECUTION

A. Designated Signatories

1. Authorization

The following officials are authorized to effect program changes (items significantly altering the Operating Agreement):

a) For the STATE:

Raye Harrington, Chief, Budgets
California Department of Health Services
601 North 7th Street, MS 92
P.O. Box 942732
Sacramento, CA 94234-7320

b) For the EPA:

Felicia Marcus, Regional Administrator U.S. Environmental Protection Agency
Region IX
75 Hawthorne Street
San Francisco, CA 94105-3109

2. **Other Changes**

Items not altering the Operating Agreement, but involving changing implementation or review procedures, may be implemented through the agreement of:

(a) For the STATE:

David P. Spath, Ph.D., P.E., Chief
Division of Drinking Water and Environmental Management
California Department of Health Services
601 North 7th Street, MS 92
P.O. Box 942732
Sacramento, CA 94234-7320

(b) For the EPA:

Michelle Moustakas, Project Officer
(Or her successor)
U.S. Environmental Protection Agency
Region IX
75 Hawthorne Street
San Francisco, CA 94105-3109

B. Revising the Operating Agreement

1. This Operating Agreement may be amended at any time by mutual agreement between the authorized signatories in writing. Revisions will be particularly considered following reviews of the Annual Report and/or Annual Audit.

2. All revisions regarding modifications to any attachment or procedures shall be made through the designated officials indicated above.

C. Authority

The authority of this Operating Agreement is found in Senate Bill No. 302, 1997 California Legislature, Sixty-Ninth Session, Pages 1821 to1827 (Attachment 1). The sections of Senate Bill No. 302 pertinent to the DWSRF are codified in Chapter 445A of the California Revised Statutes and are found at NRS 445A.200 to 445A.295, inclusive (Attachment 1).

In lieu of federal regulations that have yet to be promulgated for the DWSRF Program, the Section 1452 of the SDWA and the DWSRF Program Guidelines currently serve as the regulatory authority for the development of the DWSRF program. In the future, should any conflict result between the federal regulations and this Operating Agreement, the federal regulations will take precedence.

D. Effective Date

This Operating Agreement will be effective upon execution of the initial Capitalization Grant Agreement by DHS.

Felicia Marcus Regional Administrator U.S. Environmental Protection Agency Region IX	for George Otto 7/30/98 Raye Harrington Chief, Budgets California Department of Health