



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

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MEMORANDUM

SUBJECT: Financial Capability Assessment Framework for Municipal Clean Water Act Requirements

FROM: Ken Kopocis *Keneth Kopocis*
Deputy Assistant Administrator
Office of Water (OW)

Cynthia Giles *Cynthia Giles*
Assistant Administrator
Office of Enforcement and Compliance Assurance (OECA)

TO: Regional Administrators
Regional Water Division Directors
Regional Enforcement Division Directors

In May of 2012, we distributed the Integrated Municipal Stormwater and Wastewater Planning Approach Framework (Integrated Planning Framework). Since that time, we have made solid progress in promoting integrated approaches to meet Clean Water Act (CWA) obligations. Thanks to the hard work of regional and headquarters staff, and the active engagement of cities, many of our enforcement settlements now embody integrated planning principles in the structure and schedule for injunctive relief or explicitly include integrated planning as part of the settlement. We have also seen an increasing number of municipalities and local authorities moving towards developing integrated plans to support the development of their NPDES permits. We have been working with EPA Regions and States to assist in that process.

As the implementation of the Integrated Planning Framework has progressed and evolved, we have been actively engaged with stakeholders on ways to build on our efforts. Those discussions found a natural focus on issues related to the financial capability of permittees working toward our shared goals of clean water. One consistent theme that emerged was the benefit of more clearly articulating the flexibility available under the existing guidance. EPA continues to be guided by the 1997 "Combined Sewer Overflows – Guidance for Financial Capability Assessment

and Schedule Development” (FCA Guidance) that provides an aid for assessing financial capability as part of negotiating schedules for implementing CWA requirements for municipalities and local authorities. The FCA Guidance also encourages permittees “to submit any additional documentation that would create a more accurate and complete picture of their financial capability” that may “affect the conclusion” of the analysis described in the guidance.

As part of EPA’s commitment to implementing CWA objectives in a sustainable manner, we have developed the attached “Financial Capability Assessment Framework” (FCA Framework). The FCA Framework has been greatly informed by the comments and experiences of a variety of stakeholders and financial experts. The FCA Framework identifies the key elements EPA uses in working with permittees to evaluate how their financial capability should influence schedules. In addition, the FCA Framework provides examples of additional information that may help some communities provide a “more accurate and complete picture” of their financial capability as is envisioned in the FCA guidance. We will be posting the FCA Framework to our website as an important next step in the pursuit of integrated planning approaches and in our ongoing work with municipalities and local authorities to achieve our shared goals of protecting our nation’s waters. While this memorandum releases the FCA Framework, we know that we will continue to learn and refine our understanding of the issues surrounding financial capability assessments as we use it moving forward. We will continue to look for ways to improve the Framework as we gain new insights and additional information.

We look forward to continue working with the Regions on these important issues and encourage you to contact Deborah Nagle, Director, Water Permits Division (nagle.deborah@epa.gov) and Mark Pollins, Director, Water Enforcement Division (pollins.mark@epa.gov) with any questions you might have.

Attachment

cc: Regional Permit and Enforcement Liaisons

FINANCIAL CAPABILITY ASSESSMENT FRAMEWORK

November 24, 2014

Purpose

The Environmental Protection Agency (EPA) is committed to working with state and local government partners to assist local municipalities and local authorities to meet Clean Water Act (CWA) obligations in a manner that recognizes the unique financial challenges that local jurisdictions face. This financial capability assessment framework is intended to provide additional examples and greater clarity on the flexibilities built into existing guidance that local governments or authorities can use in assessing their financial capability, and the relationship between that assessment and consideration of schedules for permit and consent decree implementation. This framework builds on the progress already made in the May 2012 “Integrated Municipal Stormwater and Wastewater Planning Approach Framework,” and the experience gained from talking with communities about their financial capability in actual, on the ground circumstances. Integrated Planning has been helping in identifying a permittee’s relative priorities for projects based on the relative importance of adverse impacts on human health and water quality and the municipality’s financial capability.

Background

Local governments and authorities want to provide clean water for their communities, and they play an essential role in providing wastewater and stormwater infrastructure and services for their citizens, businesses and institutions. These municipal functions have been an important part of implementing the CWA to protect public health and improve water quality in streams, lakes, bays, and other waters nationwide. However, significant water quality challenges remain. Public officials remain strong supporters of the CWA goals and objectives by directing the public investments that are necessary to comply with the Act and to provide clean water for their citizens. Many local governments face complex water quality issues that are heightened by the need to address population growth or decline, increases in impervious surfaces, source water supply needs, and aging infrastructure. In recent years, many local governments and authorities have increased investments in their wastewater and stormwater infrastructure through capital projects to rehabilitate existing systems, improve operation and maintenance, and address additional regulatory requirements. As programs are implemented to improve water quality and attain CWA objectives, many state and local government partners find themselves facing difficult economic challenges with limited resources and financial capability. We recognize these challenging conditions and are working with states and local governments to develop and implement new approaches that will achieve water quality goals at lower costs and in a manner that addresses the most pressing problems first.

Long-term approaches to meeting CWA objectives should be sustainable and within a local government or authority’s financial capability. The financial capability of these entities and other relevant factors are important to consider when developing appropriate schedules for infrastructure projects in permits or enforcement actions to help protect human health and the environment. EPA’s financial capability assessment guidance, “Combined Sewer Overflows:

Guidance for Financial Capability Assessment and Schedule Development” (FCA Guidance) (EPA 832-B-97-004) provides a reference point to aid all parties in negotiating reasonable and effective schedules for implementing CWA requirements, and the flexibility to take into account local considerations that may not be fully captured by the approach detailed in the guidance. As described in more detail in this Framework, the guidance provides for consideration of the impact on residential rate payers and the financial capability of the permittee using a suite of indicators, as well as allowing schedules to be responsive to circumstances unique to that community, while advancing the mutual goal to protect clean water. The FCA Guidance encourages permittees to provide any additional information that would be useful in understanding those unique or atypical circumstances and how they may affect CWA schedules, so that all relevant information presented by a community can be taken into account to ensure that a full understanding of financial capability guides the development of schedules.

Financial Capability Assessment

The following are key elements of EPA’s approach to the evaluation of the financial capability of municipalities to inform implementation schedules, both in permits and enforcement actions. The elements are fully compatible with the FCA Guidance, integrated planning approaches, and the flexibility embodied in both.

- 1. The 1997 FCA Guidance identifies a valuable assessment that provides a common basis for financial burden discussions between the permittee, EPA and state NPDES authorities. Permittees have the option of submitting additional information that would create a more accurate and complete picture of their financial conditions.** The financial capability assessment described in the 1997 FCA Guidance identifies information that provides a basis for a general comparison of financial conditions between communities across the country and provides a consistent assessment of basic financial indicators as part of the overall analysis. Additional information that the community provides on its unique financial circumstances will be considered so that schedules take local considerations into account. Where appropriate, this information can result in schedules that are different than the schedules suggested by the baseline analysis suggested in the 1997 FCA Guidance.
- 2. Financial capability is on a continuum.** Although the FCA Guidance approach categorizes financial burden as “high, medium, or low,” this does not mean that schedules will be rigidly set according to the break points between the categories. For example, two communities whose total residential share of costs are 1.1% and 1.9% of median household income (MHI) are both categorized in the FCA Guidance as having a “medium” burden for the Residential Indicator (RI). All other things being equal, the appropriate schedules for those communities are likely to be different. Similarly, all other things being equal, two communities whose residential share of costs are 1.9% and 2.1% of MHI would be more likely to have similar overall compliance timeframes, even though one community is ranked as having a “medium” burden and the other as having a “high” burden. Finally, additional information submitted by the community may affect the length of the schedule regardless of where the community is on the “high, medium, and low” continuum.

- 3. EPA will consider all CWA costs presented in the analysis described in the FCA Guidance.** EPA originally published the FCA Guidance to assist in negotiating schedules for communities with combined sewer systems, as these typically represent the most expensive CWA compliance issues. The FCA Guidance has since been recognized as equally suitable for considering other municipal CWA obligations as well, such as those related to separate sanitary sewer systems. With the release of EPA’s 2012 Integrated Planning Framework, the Agency clarified that the financial capability analysis could include costs of: stormwater and wastewater; ongoing asset management or system rehabilitation programs; existing, CWA related capital improvement programs; collection systems and treatment facilities; and other CWA obligations required by state or other regulators. Where the costs of multiple CWA obligations are included in an FCA, each of those costs should be enumerated separately, so as to provide an understanding of how each contributes to the overall analysis.
- 4. When presented, Safe Drinking Water Act (SDWA) obligations will be considered, primarily as additional information about a permittee’s financial capability.** EPA believes that the SDWA obligations of a community can be an important consideration in establishing schedules for implementing integrated plans. EPA recognizes that both clean water and drinking water costs are often covered through charges on a single rate base. One component of a financial capability assessment includes an evaluation of the residential indicator that is based on only CWA costs as this best reflects the intended use of the metric and allows for comparisons with other communities. Drinking water costs may be reflected in other components of a financial capability assessment. For example, the financial capability indicator includes consideration of bond rating of the entity that issues debt to fund the permittee’s capital project, which can be impacted by both wastewater and drinking water obligations for a permittee that provides both services. If a community has incurred general obligation debt associated with the SDWA, these obligations would be considered in the indicator “overall net debt as a percent of full market property value.” In addition, as discussed below, additional information, including information regarding drinking water obligations, may be submitted for consideration in analyzing financial capability. To the extent that drinking water costs are not fully addressed by these other components, communities are encouraged to provide additional information about these costs.
- 5. Communities should demonstrate how the CWA work included as costs in the financial capability assessment will be implemented, including appropriate assurances that those expenditures will be made.**

The Financial Capability Assessment Guidance and Examples of Additional Information that are Relevant to a Consideration of Financial Capability

The specific approaches laid out in the FCA Guidance provide a good foundation for the assessment of financial capability. As stated in the guidance and outlined in this Framework, communities can build on that foundation to include additional relevant information. The FCA Guidance presents a two-phased approach to assessing overall financial capability. The first phase assesses the impact on residential customers, and the first step is to calculate the portion of

the annual costs that would be borne by residential households for both current and projected Clean Water Act related expenses. The residential share of the annual costs of CWA obligations is then compared to the MHI of the service area. MHI is calculated using current census data and may be adjusted based on the current Consumer Price Index. Finally, the CWA compliance costs per household are divided by the adjusted MHI to calculate the residential indicator (RI). The FCA Guidance then identifies various ranges of RI scores as “low, mid-range or high” levels of burden. In situations where there are unique circumstances that would affect the conclusion of the first phase of the assessment, additional information documenting unique financial conditions may be submitted.

The second phase of the financial capability analysis assesses the financial strength of the permittee. Six indicators are used to evaluate the debt, socioeconomic and financial conditions that affect a permittee’s financial capability to implement CWA controls necessary for compliance with the Act. These include bond ratings, overall net debt as a percent of full market property value, unemployment rate, median household income, property tax revenue collection rate, and property taxes as a percent of full market property value. In the Guidance, EPA has established benchmarks for each of the six indicators showing whether the indicator reflects a “weak”, “mid-range”, or “strong” financial capability. These benchmarks are used to generate an overall score of a permittee’s financial capability.

The residential indicator calculated in phase one and the permittee capability indicators analyzed in phase two are evaluated together in a Financial Capability Matrix to assess the level of financial burden. The level of burden is then used to inform discussions to establish an appropriate schedule for meeting CWA obligations in permits and enforcement actions. EPA uses these indicators, including the annualized costs as a percent of MHI, to help assess when costs are reaching levels that may represent a high burden on ratepayers and that longer compliance timeframes are likely to be appropriate to spread the cost over a longer period. EPA does not view or use the Financial Capability Matrix as a rigid metric that points to a given schedule length or threshold over which the costs are unaffordable.

Permittees have suggested and the FCA Guidance recognizes that the two step analysis may not provide a complete representation of financial capability. As noted above, other relevant financial or demographic information presented that illustrates the unique or atypical circumstances faced by a permittee will also be considered in evaluating financial capability. The presentation of additional information can be very valuable in analyzing financial capability, and the submission of this type of information has become fairly common practice. For example, in many consent decree negotiations, additional information has resulted in the establishment of schedules that differ from the ones suggested by the baseline analysis described in the FCA Guidance.

Some examples of information that may be relevant in negotiating schedules to be included in permits and consent decrees are given below. In order for such information to adequately illustrate that a permittee’s situation is atypical, EPA encourages permittees to compare any additional information on their circumstances to national averages or to that of other permittees.

The examples given below are not intended to be a complete list, nor a list of factors that will be relevant in every community. Rather it provides an illustration of information that may prove useful in some instances.

Examples of Information Related to Residential Impacts:

1. Income distribution by quintile, geography or other breakdown, illustrating how income distribution in the service area differs from comparable data on the national level or for similar cities.
2. Where cities have adopted differential rates for low income customers, the income distribution that led to that rate structure.
3. Information about service area poverty rates and trends.
4. Projected, current and historical sewer, and stormwater fees as a percentage of household income, quintile, geography or other breakdown.
5. Information on sewer and water usage for various classes of ratepayers or by type of dwelling unit.
6. Information on the percent of households who own versus rent.

Examples of Information Related to Financial Strength:

1. Historical population trends or population projections.
2. Service area unemployment data and trends, or other labor market indicators, including unemployment on an absolute basis.
3. Rate or revenue models, including dynamic financial planning models showing the projections of impacts over the program period. All revenue sources tied to CWA obligations may be included as appropriate.
4. Rate determination studies used to develop and support recent rate increases.
5. Data and trends on late payments, disconnection notices, service terminations, uncollectable accounts, or revenue collection rates.
6. Historical increases in rates or other dedicated revenue streams.
7. State or local legal restrictions or limitations on property taxes, other revenue streams or debt levels.
8. Other costs or financial obligations, such as those that relate to drinking water or other infrastructure, that significantly affect a permittee's ability to raise revenue.
9. Circumstances that may affect a permittee's bond rating. For instance, incurring debt beyond certain thresholds may negatively impact the permittee's bond rating, thus reducing the ability to raise capital.
10. Financial plans that show the implications of incurring additional debt for a permittee's ability to secure financing, including projections of metrics such as debt ratios, debt service coverage, debt per customer, days of cash on hand, days

of working capital and other metrics used by rating agencies. Such data should be benchmarked to metrics such as rating agency medians and relative to similar entities. This will be especially relevant where the permittee does not have a bond rating.

11. Extraordinary stressors such as those from natural disasters, municipal bankruptcies, unusual capital market conditions, or other situations which impact a permittee's ability to raise revenue or acquire needed financing. When such stressors occur, they may also provide support for making changes to existing schedules.