UNITED STATES ENVIRONMENTAL PROTECTION AGENCY

Assistance Dispute of WORCESTER COUNTY SANITARY COMMISSION, MARYLAND Docket No. 03-86-AD27	Decision of the Assistant Administrator

DIGEST NOTES

GRL-120-275-000 Deobligation of Funds

Where EPA erroneously reduces a grant amount, the error is to be corrected promptly by EPA, without requiring the grantee to request a grant increase.

GRL-120-155-000 Audit; Government Right to

Approval of contract language by EPA does not make all contract costs allowable, exempt the costs from audit, or preclude EPA from recovering funds provided for such costs.

GRL-040-825-000 Refunds, Rebates, and Credits

Reimbursement of a grantee by a design engineer for the correction of design errors, whether received as a cash payment or as a credit against payments which would otherwise be due to the engineer, are not considered to be grant related income, and therefore have no effect on the determination of allowable costs.

GRL-040-075-000 Prior Approval of Costs

For grants awarded prior to May 12, 1982, prior approval of a grant amendment authorizing arbitration expenses is not required unless a grant increase is needed, although notice of rebudgeting

generally is required. For grants awarded on or after May 12, 1982, prior approval of arbitration expenses is required, and the failure of a grantee to secure prior approval cannot be remedied by the issuance of a grant amendment.

GRL-040-850-000 Scheduled Completion Date

Contract administration and resident inspection costs incurred after the original contract completion date are unallowable, even if a change order has been issued to extend the contract completion date, unless the extension was justified by unusual circumstances for which the contractor was not legally responsible.

PETITION FOR REVIEW

By letter dated October 17, 1989, the Worcester County Sanitary Commission, Maryland (the Commission) requested that I review a decision issued by Mr. Edwin B. Erickson, Regional Administrator of Region III. Mr. Erickson's decision, dated September 28, 1989, disallowed certain costs associated with the construction of the Commission's Ocean City wastewater treatment plant.

BACKGROUND

On September 30, 1977, EPA awarded a Step 3 grant to the Worcester County Sanitary Commission for the upgrading of its Ocean City treatment plant. On July 23, 1985, the grant was amended to decrease the grant amount to reflect the actual costs claimed by the Commission, but the Region mistakenly decreased the grant amount to $9,735,300. This was less than the proper amount of $9,748,719, which represented 75 percent of the allowable costs claimed by the Commission.

On March 26, 1986, the Office of the Inspector General issued an audit report setting aside certain claimed costs. On September 18, 1986, the Region III Water Management Division Director issued a final determination letter which disallowed these costs.

On October 22, 1986, the Commission filed a request for review of the final determination letter by the Regional Administrator. On September 28, 1989, the Regional Administrator issued a decision which upheld the FDL.

DISCUSSION

1. Entitlement to Funds

In its petition, the Commission contended that in issuing a grant amendment on July 23, 1985, EPA mistakenly reduced the grant amount below the Federal share of its claimed costs.

The relationship between a grantee and EPA establishes a commitment by EPA to pay the Federal share of the project's allowable costs within the scope of the grant. The execution of a grant agreement or a grant amendment "shall constitute a contractual obligation of the United States for the payment of the Federal share of the allowable project costs," and a grantee "shall be paid the Federal share of allowable project costs incurred within the scope of an approved project..." 40 CFR 35.930 and 35.945 (May 8, 1975).

The Regional Administrator was correct in stating that a grant award is to be reduced or increased to reflect actual costs claimed by a grantee. Franklin Township Municipal Sanitary Authority, Pennsylvania, 03-88-AD37 (July 31, 1989; discretionary review denied July 5, 1990). In this case, however, the Region erroneously reduced the grant amount below the 75 percent Federal share of the allowable project costs claimed by the Commission.

There was no legal basis for the Region to limit the Federal share to $9,735,300. The Commission was entitled to 75 percent of the project's allowable costs, and should not have been required to submit a formal request for funds to which it was legally entitled. When EPA mistakenly reduces a grant, EPA is required to correct its mistake promptly without requiring a grantee to submit a formal request.

2. Allowability of Basic Engineering Costs

The Commission initially claimed basic engineering costs of $552,973, but later increased this amount by $75,265 to $628,238, which was the total cost of a contract whose language had been approved by the Region in the course of its contract review process. Based on the findings of the final audit report, the Regional Administrator's decision disallowed $49,362 in basic engineering costs.

In its petition, the Commission claimed that EPA's disallowance was the result of an arithmetic error of $49,362. However, we have reviewed the documentation submitted by the Commission and have determined that the Region did not make an

arithmetic error, and that some engineering costs were correctly disallowed. Of the $49,362 at issue, $25,265 was disallowed because the Commission could not document the specific engineering services that had been performed; $19,231 in credits was disallowed, which is found eligible below; and $4,866 was disallowed for engineering services involving change orders, since those services were included in the basic services of the engineer, as described in the Commission's contract with the engineer.

The approval of the language of an engineering contract by EPA does not make all costs incurred under the contract automatically allowable for Federal grant participation, since all costs are subject to final audit. To be considered allowable for grant participation, costs must be reasonable, necessary, and allocable to the project. 40 CFR 30.705 and 35.940 (May 8, 1975).

EPA has consistently held that a grantee may only claim costs if it demonstrates through proper documentation that costs are reasonable, necessary, and allocable to the project. Medina County, Ohio, 05-86-AD04 (March 31, 1988); Stafford County, Virginia, 03-86-AD02 (December 31, 1987); Baraga County, Michigan, 05-86-AD07 (December 31, 1986).

Contract review and approval is conducted by EPA to ensure that the contract language reflects sound grantee management, is adequate for achieving the satisfactory completion of the scope of work, and is consistent with all Federal regulations. (See February 1976 Handbook of Procedures at page VI-7). Approval of contract language by EPA does not make all contract costs allowable, exempt the costs from audit, or preclude EPA from recovering funds provided for such costs. Pima County, Arizona, 09-86-AD16 (March 19, 1987); Village of Holgate, Ohio, 05-86-AD09 (December 31, 1986); Sacramento Regional County Sanitation District, California, 09-84-AD24 (June 6, 1985).

The approval by EPA of the language of the Commission's engineering contract did not constitute a final determination of allowability, and did not bind EPA to allow all costs associated with the approved engineering contract. Therefore, the Regional Administrator did not arbitrarily disallow claimed costs of $30,131 in basic engineering costs, since the Commission failed to document that the disallowed costs were reasonable, necessary, and allocable to the project.

3. Effect of Credits on Allowability

In its petition, the Commission claimed that the Regional Administrator had incorrectly disallowed $19,231 in credits which the engineer provided to the Commission for the correction of engineering design deficiencies, which resulted from design errors.

The Region's decision was based on the EPA requirement that "The Federal share of any refunds, rebates, credits, or other amounts (including any interest thereon) accruing to or received by the grantee with respect to the project, to the extent that they are properly allocable to costs for which the grantee has been paid under a grant, must be credited to the current State allotment or paid to the United States." (40 CFR 35.945(d), May 8, 1975). However, this requirement applies only to amounts which are allocable to costs for which a grantee has been paid under a grant. The Region incorrectly applied this regulation since in this case, the credit was not "allocable to costs for which the grantee has been paid under a grant," but was instead allocable to the cost of repairs required as the result of design errors. Amounts which are allocable to the cost of repairs required as the result of a design error are not governed by this regulation, since EPA has consistently held that repair costs are not allowable costs, and therefore are not allocable to a grant-assisted project and have no effect on the determination of allowable costs. (See similar discussion of allowable costs related to liquidated damages at page VII-4 of the February 1976 Handbook of Procedures, which was in effect on the date of grant award, and at page 940 of the October 1984 Handbook of Procedures, which is currently in effect and which includes a more comprehensive discussion of this important principle.) Therefore, reimbursement for such costs by the design engineer, whether received as a cash payment or as a credit against payments which would otherwise be due the engineer, are not considered to be grant related income, and therefore have no effect on the determination of allowable costs. The Commission has demonstrated that the credits constituted reimbursement for expenses incurred in correcting design errors. Therefore, the Region should not have disallowed $19,231 in credits.

4. Allowability of Arbitration Expenses

The Commission also claimed in its petition that the Region was incorrect in disallowing $140,082 in costs (consisting of engineering, legal, and American Arbitration Association tribunal expenses) which the Commission incurred in defending itself against a contractor's claim.

The cost of arbitration proceedings, including engineering, legal, and related expenses, which a grantee incurs in defending itself against a contractor's claim, requires prior EPA approval of a grant amendment which authorizes such costs only if:

a. the grant was awarded on or after May 12, 1982, and is therefore subject to 40 CFR Part 35, Subpart I, Appendix A (May 12, 1982), or

b. the arbitration expenses are expected to increase the cost of the project beyond the total project cost approved in the existing grant agreement.

Since the Commission's grant was awarded prior to May 12, 1982, and the arbitration expenses were not expected to increase the project costs beyond the total cost approved in the grant agreement (since there were contingency funds available in the project budget which exceeded the estimated arbitration expenses), prior EPA approval of a grant amendment authorizing the Commission's arbitration expenses was not required.

Where prior EPA approval of a grant amendment is not required, but unexpected expenses require a rebudgeting of costs in excess of $500 between approved line items in the project budget, grantees are required to promptly notify EPA (40 CFR 30.610(a), May 8, 1975), but prior EPA approval of such rebudgeting is only required for "project changes which may (i) substantially alter the design and scope of the project, (ii) alter the type of treatment to be provided, (iii) substantially alter the location, size, capacity, or quality of any major item of equipment, or (iv) increase the amount of Federal funds needed to complete the project" (40 CFR 35.935-11, December 29, 1976) and for change orders in excess of $100,000 (40 CFR 35.937-6(b) and 35.938-5(a), December 17, 1975).

The Commission incurred arbitration expenses which required a rebudgeting of costs between approved line items in the project budget, but did not alter the project's design, scope, location, size, capacity, quality, or type of treatment, and did not require a grant increase. Therefore, the Commission's rebudgeting did not require prior EPA approval.

Where notification was required, as in this case, but not provided, a grantee is at risk of the rebudgeted costs being declared unallowable. In such cases, EPA performs an allowability review to determine if the incurred costs were reasonable, necessary, and allocable to the project. If the

costs are determined to be unallowable, Federal participation is precluded. If the costs are determined to be allowable, the rebudgeting action is reflected in the official EPA grant file, but a formal grant amendment is not required.

Where prior approval is required by EPA regulations, but is not obtained by a grantee, the failure to obtain prior approval cannot subsequently be remedied by a grant amendment, unless EPA approves a deviation from the applicable regulations. Where prior approval is not required by EPA regulations, arbitration expenses are allowable costs if they are reasonable, necessary, and allocable to the project (40 CFR 35.940-1(c), February 11, 1974). Therefore, the Regional Administrator's decision disallowing $140,082 in arbitration expenses, and informing the Commission that in cases where prior approval is required, a grantee could request a grant amendment to remedy its failure to obtain prior approval is reversed.

5. Allowability of Costs Incurred after the Contract Completion Date

In its petition, the Commission asserted that the Region had incorrectly disallowed costs incurred after the contract completion date for contract administration and resident inspection. The Region held that these costs were unallowable for Federal grant participation, since the Commission had not demonstrated that the delay in contract completion was not due to the Commission's mismanagement or the contractor's failure to perform.

Costs incurred after the original contract completion date for contract administration and project inspection are unallowable for Federal grant participation, unless the grantee has demonstrated that the delay in contract completion was not due to grantee mismanagement or the contractor's failure to perform. Lucus County, Ohio, 05-85-AD17 (December 8, 1986); Wexford County, Michigan, 05-84-AD20 (August 7, 1986); City of Riverside, California, 09-85-AD01 (March 27, 1986).

The February 1976 Handbook of Procedures states at page VII-4 that "any additional costs - construction, engineering, legal, or administrative - generated because of a contractor's lack of [timely] performance should be covered by the liquidated damages received. Thus, any such increase in cost as a result of lack of performance is unallowable for participation even in the event that the grantee elects not to exercise his right to recover liquidated damages."

The Commission did not challenge these standards, but argued that its documentation demonstrated that these standards had been met. We have reviewed the documentation submitted by the Commission in support of the costs incurred after the original contract completion date, including Sections VIII and IX of its Response to Report of Final Audit (May 6, 1986), and pages 13-17 of its letter to the Regional Administrator (October 22, 1986). We have concluded that the Commission has failed to demonstrate that the disallowed costs were not caused by its mismanagement of the contractor's failure to perform.

The Commission claimed that a part of the delay occurred because of the need to redesign the project, due to the contractor's selection of a cryogenic ozonation system. The contract documents specified the use of a "pressure swing" ozonation system, and stipulated that if the contractor chose to substitute a cryogenic system, any redesign would be "at the contractor's expense after award and prior to commencing construction." Also, the contract documents did not provide for an extension of the contract time to accomplish the redesign. Therefore, the Regional Administrator correctly held that contract administration and project inspection costs incurred after the original contract completion date were unallowable, since these costs were incurred as a result of delays caused by the contractor's failure to comply with the construction completion date specified in the contract. These delays occurred because of the contractor's delay in accomplishing the redesign required by the contractor's selection of the cryogenic system, despite the fact that the contract language clearly required the contractor to accomplish the redesign without delaying the completion of the project.

The Commission claimed that the remainder of the delay occurred because of the need to refit the cryogenic system to deal with the flow surges experienced at the treatment plant, since the cryogenic system as originally installed by the contractor could not deal with these flow surges. However, since the contractor had selected this system, it was his responsibility to install a system that would function effectively under the actual operating conditions experienced at the treatment plant.

The Commission also claimed that a change order was executed as part of the arbitration/settlement process, which extended the contract completion date. However, the issuance of a change order which extends the contract completion date does not make the additional contract administration and project inspection

costs allowable unless the extension was justified by unusual circumstances for which the contractor was not legally responsible (e.g., unusually severe weather). In this case, the contractor was legally responsible for delays caused by redesign required as a result of the contractor's choice of a cryogenic system, as well as delays caused by the need to refit the cryogenic system to function effectively under the actual operating conditions experienced at the treatment plant.

EPA has consistently held that inspection costs incurred after the original contract completion date are not allowable if the costs were incurred because of delays caused by a contractor, his subcontractors, or his suppliers. Tuolumne County Water District No. 2, California, 09-84-AD40 (March 21, 1986). Accordingly, the Regional Administrator was correct in disallowing contract administration and project inspection costs incurred after the original contract completion date. However, the Regional Administrator's decision cited an incorrect amount ($32,489) for the disallowed costs. The correct amount, as stated in the final determination letter, is $115,449.

SUMMARY OF COSTS

DESCRIPTION	AMOUNT CLAIMED IN PETITION	AMOUNT DISALLOWED	AMOUNT ALLOWED
Mistaken Reduction of Grant Amount	$ 13,419		$ 13,419
Engineering Costs (includes Credits)	$ 49,362	$ 30,131	$ 19,231
Arbitration Costs	$140,082		$140,082
Costs Incurred After Contract Completion Date	$115,449	$115,449	

DECISION AND ORDER

I have reviewed the attached Regional Administrator's decision, and make the following determinations:

1. A decrease in a grant amount below the Federal share of the grantee's allowable costs must be promptly corrected by grant amendment, without requiring the grantee to request a grant increase.

2. The approval of contract language by EPA does not make all contract costs automatically eligible for Federal grant participation, since all costs are subject to final audit. Therefore, the Regional Administrator correctly disallowed $30,131 in basic engineering costs which the Commission had failed to document as reasonable, necessary, and allocable to the project.

3. Credits received by a grantee which are not allocable to costs for which the grantee has been paid under a grant, but are instead allocable to the cost of repairs required as the result of design errors, are not allocable to the grant-assisted project, since such costs are not part of the project's approved scope of work. Therefore, reimbursements for such costs by the design engineer, whether received as cash payments or as credits against funds which would otherwise be payable to the engineer, are not considered to be grant related income, and therefore have no effect on the determination of allowable costs. Accordingly, the Regional Administrator's decision disallowing $19,231 in credits which the design engineer had provided to the Commission for the correction of engineering design deficiencies is reversed.

4. For grants awarded prior to May 12, 1982, prior approval of a grant amendment authorizing arbitration expenses is not required by EPA regulations, if such costs do not require a grant increase. Accordingly, the Regional Administrator's disallowance of such costs is reversed. However, for grants awarded on or after May 12, 1982, prior approval of arbitration expenses is required. Where a grantee fails to secure the required prior approval, this failure cannot subsequently be remedied by the issuance of a grant amendment.

5. Costs incurred for contract administration and project inspection after the original contract completion date are unallowable where such costs are incurred as a result of the contractor's failure to comply with the contract completion date, unless an extension was justified by unusual circumstances for which the contractor was not legally responsible. Therefore, the Regional Administrator correctly disallowed contract administration and project inspection costs incurred after the approved contract completion date, but stated an incorrect amount for the disallowed costs. The correct amount of disallowed costs is $115,449.

CONCLUSION

The Regional Administrator's decision is hereby modified in accordance with the determinations set forth above. These determinations are the final Agency action for the five issues to which they pertain. In all other respects, the Regional Administrator's decision remains the final Agency action, pursuant to 40 CFR 30.1225.

SEP 28 1990

Date

LaJuana S. Wilcher
Assistant Administrator

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	CONCURRENCES							
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