

PROGRAM EVALUATION REPORT
California Safe Drinking Water State Revolving Fund Program
Based on State Fiscal Year 2014 Annual Report
On-site Reviews Conducted February 9-13 and February 24-25, 2015
FINAL REPORT: 3 August 2015

I. Introduction

In accordance with the Safe Drinking Water Act, EPA provides funds to states to capitalize their Drinking Water State Revolving Fund (DWSRF) programs. EPA is required to conduct an annual oversight review of each state's DWSRF program. The purpose of the annual review process is to assess the cumulative program effectiveness; fiscal health; compliance with the statutes and regulations; Operating Agreement (OA); and grant conditions governing the state's DWSRF.

The American Recovery and Reinvestment Act (ARRA), signed into law February 17, 2009 by President Obama, made available federal monies for both the Clean Water State Revolving Fund and the DWSRF. The ARRA funds are also subject to an annual oversight review to be carried out by EPA.

Based on continued active evaluation of the California Safe Drinking Water State Revolving Fund (SDWSRF) program, EPA issued a Notice of Non-compliance to the California Department of Public Health (CDPH) on April 19, 2013. EPA determined that CDPH had not committed and expended SDWSRF funds efficiently and in a timely and expeditious manner or employed adequate financial resources to operate the SDWSRF in a sound financial manner. In response, CDPH submitted a Corrective Action Plan (CAP), which EPA approved on July 23, 2013.

During February 9-13, and February 24-25, 2015, EPA conducted its on-site annual reviews of the SDWSRF base and ARRA program activities. Staff from EPA visited the State offices to review selected project files and cash draws, and to talk with state staff about various aspects of the SDWSRF program. EPA included a review of ARRA grant and project activities to ensure compliance with ARRA grant conditions and requirements. To ensure that the annual review addressed all of the major review elements for both base program and ARRA requirements, EPA staff completed the SRF Annual Program and Financial Review checklist, Attachment A.

This year's annual review was prolonged because of budgetary actions taken by the California Governor to transfer the California Drinking Water Program including the SDWSRF program from CDPH to another state agency, the State Water Resources Control Board (State Water Board). With the transfer of the Drinking Water Program and SDWSRF to the State Water Board, permitting and funding functions are now handled separately by two Divisions within the State Water Board, the Division of Drinking Water (DDW) for permits and the Division of Financial Assistance (DFA) for funding. However, during state fiscal year (SFY) 2013/2014, the SDWSRF program was still

administered by CDPH and because of the Governor's proposal to transfer the programs, SDWSRF staff was encumbered with numerous requests for complex information, and operational and transitional proceedings. This extra workload, in addition to the rigors of implementing and complying with the deliverables of the CAP, resulted in extra time needed by both SDWSRF and EPA staff to research and reconcile transactions, and program and project activities.

In an effort to provide EPA with timely information on the progress and many accomplishments of the SDWSRF program, CDPH submitted to EPA a draft SDWSRF Annual Report dated January 7, 2015. The report was subsequently finalized and submitted to EPA on March 5, 2015, and covered program activities performed during SFY 2013/2014, i.e., July 1, 2013 through June 30, 2014.

Based on the SDWSRF annual report for SFY 2013/2014, evaluation conducted at EPA's office and the on-site visits, EPA has prepared this PER documenting the results of this year's annual review. The PER covers all program activities from program inception to the present, with major emphasis on the activities performed during SFY 2013/2014. The PER evaluates the State's ability to achieve the intent of the DWSRF program and comply with the grant agreement. The PER contains findings and observations from the review and identifies follow-up actions to be addressed in SFY 2015/2016, referencing EPA's Notice of Non-compliance and SDWSRF's CAP, as appropriate.

II. Background and Scope

The SDWSRF uses federal capitalization grants, state match funds, loan repayments, and interest earnings to make loans for construction of drinking water treatment facilities and support several Safe Drinking Water Act programs. Since the program began in 1998 through June 30, 2014, the SDWSRF has executed base and ARRA loans totaling 355 and equal to approximately \$2.1 billion.

The SDWSRF program is required to maintain the following program and financial elements, which EPA assessed during its review. Elements noted with an * are discussed in Section III of this report. The other elements do not require further discussion.

Required Program Elements

- A. Annual/Biennial Report
- B. Funding Eligibility*
- C. Compliance with DBE Requirements
- D. Compliance with Federal Cross-Cutting Authorities
- E. Compliance with Environmental Review Requirements
- F. Operating Agreement
- G. Staff Capacity
- H. Set-aside Activity*

I. Status of Corrective Action Plan*

Required Financial Elements

- J. State Match*
- K. Binding Commitment Requirements
- L. Rules of Cash Draw (including improper payments)*
- M. Timely and Expeditious Use of Funds*
- N. Compliance with Audit Requirements
- O. Assistance Terms
- P. Use of Fees
- Q. Assessment of Financial Capability and Loan Security
- R. Financial Management*
- S. Other Program and/or Financial Elements related to ARRA

The scope of the annual review includes consideration of the legal, managerial, technical, financial and operational capabilities of CDPH to manage the SDWSRF program.

EPA Region 9 used the SRF Annual Review Guidance, SRF Annual Program Review Checklist, Project File Review Checklist, Transaction Testing Checklist, and data collected in the National Information Management System for SRFs to ensure that all major elements of the program were reviewed and discussed with the SDWSRF management and staff.

In response to the Improper Payments Elimination and Recovery Act of 2012 the Office of Management and Budget through the EPA Office of the Chief Financial Officer directed that the State Revolving Funds be subject to testing of a random selection of SRF transactions to develop a national estimate of improper payments from these programs. Therefore, for this review, nine SDWSRF base program cash transactions selected by the Office of the Chief Financial Officer were tested. In addition, two SDWSRF ARRA cash transactions were tested.

III. Observations and Follow-up Actions

EPA's review assessed certain program, financial and project management practices as they relate to the State's ability to effectively administer base and ARRA DWSRF program activities. This section presents EPA's specific observations and/or suggested action items to be incorporated into the future operations, annual reports, and/or management of the program. EPA will continue to meet regularly with the State to discuss these and other issues related to the SDWSRF.

A. Program Management

1. Funding Eligibility and Payroll Expense Allocation Procedures

Last year's PER recommended the SDWSRF develop: 1) standard written reimbursement policy and procedures that specifies the types of expenditures that can receive reimbursement under the SDWSRF; and, 2) establish efficient and effective procedures for its payroll time accounting system and other expenses.

In response to the first recommendation, the SDWSRF program has begun to develop a standard, written reimbursement eligibility policy that will be consistent with the soon-to-be national EPA DWSRF eligibility guidance, which is still under development.

With respect to the second recommendation, the SDWSRF program acknowledged and agreed to enhance its existing desktop procedures to efficiently and effectively define the program's expense allocation processes and procedures by June of 2015. The SDWSRF program has already taken steps in SFY 2013/2014 to evaluate the protocol used for allocating payroll expenses to help streamline the process and improve accountability.

Follow-up: EPA asks that the SDWSRF program share a copy of its eligibility guidance once developed and also provide an update in its SFY 2014/2015 California SDWSRF Annual Report on the improvements to its expense allocation procedures.

2. Status of Corrective Action Plan

On April 19, 2013, EPA issued a notice of non-compliance to the CDPH for non-compliance with the requirements of the Safe Drinking Water Act, its implementing regulations, and the terms and conditions of the SDWSRF grant agreements funded by the EPA for federal fiscal years 2009-2011. The EPA determined in its notice of non-compliance that the CDPH had not timely and efficiently committed and expended the funds in the SDWSRF program, and did not have the financial capability to operate the program and provide and follow a cash draw schedule. In response to the EPA's notice of noncompliance, CDPH submitted to EPA a Safe Drinking Water State Revolving Fund Corrective Action Plan (CAP) on June 24, 2013, which, after subsequent revisions requested by EPA, was approved by EPA on July 23, 2013. The CAP identifies the actions needed to address each of the required elements in the notice of non-compliance, and includes a schedule of deliverables and their due dates.

CDPH has successfully met or exceeded every CAP deliverable through June 30, 2014, and has demonstrated substantial progress in improving the performance of the program. For example, deliverables #10 and #13 of the CAP required CDPH to commit 100% of the \$260 million in SFY 2013/2014 available capacity and disburse \$321 million in cumulative funds, respectively, by June 30, 2014. CDPH exceeded these targets by having committed more than \$356 million to both infrastructure planning and construction projects, and by having disbursed \$333 million in cumulative funds during this period. This is a commendable achievement that has improved the pace of the program as well as reduced the amount of unliquidated funds.

Follow-up: Monthly meetings between EPA and the SDWSRF program are held to discuss progress on the CAP, including the completion of the CAP deliverables aimed at improving financial oversight and management within the program. Once the deliverables of the CAP are successfully met the SDWSRF program will no longer be out of compliance.

3. Set-aside Activity

- a) DWSRF Withholding Determinations: EPA is authorized to withhold up to 40% of each year's Capitalization Grant when it determines that a recipient is not adequately implementing an Operator Certification (OP CERT) and/or Capacity Development (CAP DEV) (20% each) program. For the purposes of this program evaluation, EPA delved into California's CAP DEV Program and finds the state to be implementing the program. While the review of CAP DEV program was not comprehensive, EPA does have a few recommendations that are described more thoroughly below. EPA is also actively engaged with California's OP CERT program through other means and finds that the state is implementing the program.
- i. Ensuring new system capacity: In California new and significantly modified systems are required to complete a Technical, Managerial, and Financial (TMF) Assessment and supply supporting documentation to demonstrate sufficient TMF capacity when applying for DWSRF funding and/or a permit. The assessment is a self-evaluation that is performed by the system and required for all permitting and funding actions.
 - ii. Capacity Development Program: The State has continuously implemented their Capacity Development (CAP DEV) program since its inception with little change. The CAP DEV program is comprised, primarily of outreach, education, and direct technical assistance to systems. Drinking Water Program District Engineers (DE's) also refer systems for additional CAP DEV assistance which is then administered via both third-party contractors (Rural Community Assistance Corporation, Self-Help Enterprises, and California Rural Water Association) and state staff engineers. There is a scoring process to prioritize resources, and it was noted during the interview that no referrals have gone unattended. The program has a coordinator who facilitates the third-party contractors as well as manages referrals from state staff engineers. The CAP Dev program also includes an online assessment tool called the TMF Tune-up. The TMF Tune-up is a voluntary activity that evaluates the capacity of the person participating in the assessment tool by asking questions that span the TMF fields. The participant will receive a score and some pre-populated suggestions for improving the individual's capacity. The Drinking Water Program does receive a notification that someone from that system has taken the Tune-up in addition to their score; however, the results of the Tune-up do not lead to further targeted outreach or education.

The CAP DEV program recently initiated a Small System Newsletter, which is distributed via email to those systems with email access. Systems that lack internet access, and therefore lack email access, do not receive the newsletter. The Newsletter provides information about educational events as well as other TMF resources. The EPA viewed this as a positive outreach effort and a worthwhile aspect of the CAP DEV program.

EPA's analysis of the workplan finds that as much as 10% of the set-asides are going towards the CAP DEV program. Although identified in the workplan under distinct set-aside activities (Tasks B, C, E and F), the cumulative effect is that the work performed in these various set-aside activities is largely within the realm of TMF (i.e. Capacity Development). When asked about how much funding goes towards CAP DEV, the replies vary between 2-6%. It is probable that the State's CAP DEV program is far more robust in practice than what is reported. Acknowledging that certain funds can only go towards certain activities such as utilizing the 2% Small Water System Set-aside to provide technical assistance for small water systems, a comprehensive CAP DEV strategy that identifies all the activities and funding sources for those activities would help the state to capture the true breadth of the CAP Dev Program.

- iii. Operator Certification: As noted, EPA is actively engaged with California and its OP CERT program. As part of EPA's engagement on the California OP CERT program, EPA has already communicated findings and recommendations about the program. There is no additional evaluation of the California OP CERT program in this report.

Follow-up(s): DFA should mail paper copies of the newsletters directly to the systems that lack email access.

Tools such as the TMF Tune-up could be incorporated into the State's permitting process and become a periodic requirement to ensure adequate TMF capacity which may also benefit the Operator Certification Program.

With modification of the tool, results received from the Tune-ups can provide locational information about TMF capacity needs which can help the program target TMF outreach and education to areas and regions in particular need. Further, when topic-specific events are held, notification can be provided to systems that scored poorly in those specific topics.

The Capacity Development Strategy in its entirety should be re-evaluated and updated as appropriate. Among the updates, the program should include the institutional practices that have been adopted since inception of the program such as the Small System Newsletter and associate these activities with their respective funding sources. Guidance for coordination between DDW and DFA could also be incorporated into a CAP DEV strategy as a way to clarify roles and responsibilities.

- b) DWSRF Coordination with Public Water System Support (PWSS) Program: The transfer of the Drinking Water Program from CDPH to the State Water Board has separated the SDWSRF and PWSS Programs. EPA recognizes the findings from the SFY 2013/2014 SDWSRF program review are not necessarily indicative of future performance and coordination due to functional modifications resulting from the transition of the both the PWSS and SDWSRF programs.

As previously noted, TMF assessments are required for both funding and permitting actions. Under the prior system, a CDPH engineer would oversee both funding and permitting aspects for systems, and would review the TMF Assessment in addition to all the supporting documentation prior to issuance of the Public Water System (PWS) permit and funding agreement. With the separation of the SDWSRF and PWSS program, EPA expressed some concern about potential duplication of effort and confusion for the drinking water systems with respect to the TMF assessments since both programs require the assessments for their respective actions and EPA remains unclear on how the two programs share information from the assessments when they are generated by the system.

Follow-up: The State Water Board may wish to consider establishing an MOU or SOP to support ongoing coordination between the DFA-SDWSRF and DDW-PWSS programs and ensure mutually reinforcing program operation. Whatever arrangement is reached by the State Water Board, it should, at a minimum, recapture the extent of coordination that existed prior to the transfer of the Drinking Water Program at both management and staff levels.

DFA and DDW should establish a Memorandum of Understanding (MOU) or another form of intra-agency guidance on how the TMF Assessment reviews will be handled to eliminate potential duplication of efforts as well as potentially divergent conclusions.

- c) SDWSRF Coordination with PWSS Enforcement Program: EPA suggests better coordination between the SDWSRF program and the PWSS Enforcement program. Currently, when enforcement orders require capital improvements, the PWSS enforcement program requires a funding plan as a milestone in the process to return to compliance. It would then be the public water system's prerogative to select the best funding options for themselves. The enforcement staff did not appear to share with respondent systems information identifying SDWSRF as a funding source to resolve system compliance issues. Additionally, SDWSRF does not actively engage with the PWSS Enforcement program to provide a list of systems under orders so that the SDWSRF program could solicit these systems. However, upon consideration of the

question during EPA's interview with State Water Board staff, the staff stated that they would strongly consider adopting this practice.

The only set-aside assistance offered to systems facing enforcement/compliance issues is the CAP DEV Program. As previously noted, all CAP DEV Program referrals from District Engineers have been fully funded.

Follow-up(s):

The SDWSRF and PWSS Enforcement Programs could benefit from greater coordination where they discuss potential and recent enforcement actions. For example:

- 1) SDWSRF Program could recommend requirements to include in an enforcement action, such as a requirement to participate in a TMF Tune-up or other tool to help ensure sufficient system capacity;
- 2) Enforcement Program could distribute informational brochures on the SDWSRF Program to systems with compliance issues;
- 3) Enforcement Program could periodically (e.g. monthly) provide SDWSRF with a list of recent enforcement actions; and
- 4) SDWSRF Program could reach out to systems with compliance issues.

B. Financial Management

1. State Match

CDPH provided the appropriate 20 percent state match equal to each SDWSRF capitalization grant payment as required by 40 CFR §35.3550(g). However, the SDWSRF did not draw the state match at the proper proportion and overdrew federal dollars by \$56,302.

When a loan recipient submits a request for reimbursement, CDPH must pay the claim with a combination of federal and state match funding or have already disbursed an entire federal capitalization grant's state match prior to reimbursing such a claim with 100% federal funds of such capitalization grant.

Based on the reconciliation by SDWSRF staff at the time of the cash draws, sufficient state match was identified for drawing 100% federal dollars. Reconciliation continued in SFY 2014/2015 at which time it was identified that the draws from the 2010 grant that occurred in SFY 2013/2014 were drawn without 100% of the state match fully disbursed. The resulting shortfall of state match disbursements was \$56,302. This was recognized as an improper payment and by January 2015 the SDWSRF had remedied this improper payment by reimbursing subsequent payment requests from loan recipients using 100% state match

funds. The total amount of federal and state match funds drawn are back in balance, and the SDWSRF is now paying payment requests in accordance with the federal requirements.

Follow-up: EPA has received and accepted from CDPH detailed expenditure transaction sheets as evidence of satisfactorily correcting the improper payment due to disbursing 100% of the federal grant prior to disbursing the full state match. EPA appreciates CDPH’s rapid correction of this problem. EPA understands that the SDWSRF intends to draw the entire amount of its required state match in advance of drawing federal funds. Each year, initial payment requests will be funded with 100% state match funds. Once all state match funds have been drawn, subsequent payment requests will be funded with 100% federal funds. CDPH is reminded to identify in future SDWSRF Intended Use Plans the calculation of proportionate federal share and state match share as required under 40 CFR §35.3560(g).

2. Rules of Cash Draw and Improper Payments

Cash draws from the federal treasury for DWSRF expenses must be based on eligible incurred project or set-aside costs. Any inconsistency between the eligible incurred cost, the allowable draw proportion, and amount drawn is considered an improper payment. EPA’s oversight of the DWSRF program includes reviewing state cash draws to protect against waste, fraud and abuse, and to minimize and document improper payments.

To comply with the Improper Payments Elimination and Recovery Act 2012 and implementing requirements established by the Office of Management and Budget to evaluate improper payments, EPA is required to perform transaction testing of separate payments for state base and ARRA DWSRF funded transactions annually.

EPA tested a total of eleven SDWSRF cash transactions comprised of both ARRA and base funded transactions as described in Table I. Of the eleven transactions selected, nine cash draws were selected through statistical sampling. The other two draws randomly selected were from the ARRA funds and were reviewed to confirm the eligibility of expenses paid by the SDWSRF program.

Table I. SDWDRF SFY 2014 Cash Transactions Tested

Total Number of Transactions Tested	Transactions Selected		Dollar Amount of Improper/Proper Transactions Identified			
			Improper		Proper	
<i>Base and ARRA</i>	<i>Base Statistically Selected</i>	<i>ARRA Randomly Selected</i>	<i>Base</i>	<i>ARRA</i>	<i>Base</i>	<i>ARRA</i>
11	9	2	\$519,530.45	\$160,539.37	\$11,263,194.04	\$89,595.74

EPA reviewed all of the invoices or accounting records associated with each cash draw. This effort was conducted on February 9-13 and February 24-25, 2015. In addition, the state

provided substantial information and additional back-up documentation via email in the following weeks to clarify issues. As noted in Table II, EPA identified a total of \$680,069.82 in improper payments that occurred during SFY 2014. This SFY's improper payment amount is substantially less than the previous two years, which consisted of combined improper payments totaling over \$18 million.

The SFY 2014 improper payments identified occurred because of the following reasons: 1) the SDWSRF did not draw the state match at the proper proportion and overdrew federal dollars by \$56,302; 2) the State miscalculated and overpaid a claim to the City of Santa Barbara by \$80.00; 3) there was an underdrawn and two overdrafts of ARRA funds totaling \$160,539.37; and, 4) the State overdrew federal dollars in the amount of \$463,148.45. The transaction testing worksheets for each ARRA and base cash draw tested can be found in Attachments B and C, respectively. Also, a summary chart of the improper payments and their resolution is included in Attachment D, *Chart of Improper Payments and Payment Resolution*.

Concerned with its history of improper payments, CDPH undertook fundamental SDWSRF program and organizational restructuring, along with staffing and operational changes. These changes included the restructuring of the Fiscal Services Unit, the creation of the Disbursement Unit, and the hiring of a Financial Operations and Infrastructure Support Branch Chief, and Infrastructure Funding and Administrative Section Chief. These positive changes proceeded the transfer of the SDWSRF program to the State Water Board, and have greatly improved the overall financial administration and operations of the program. For example, these constructive initiatives have reduced the amount of time to process claims, reduced the number of accounting and transaction errors, and enhanced financial modeling and cash flow projections. In light of the SDWSRF program's transition from CDPH to the State Water Board, the program has provisionally adopted the CA Clean Water SRF eligibility guidelines to the SDWSRF, and has adopted new payroll allocation procedures. The State Water Board will continue to refine accounting protocols to ensure compliance with the federal DWSRF program cash draw rules and reduce the occurrence of improper payments.

Follow-up: The SDWSRF remedied their improper payment amount of \$680,069.82 by reimbursing subsequent payment requests from loan recipients using 100% state match funds, off-setting the amount of a future claim, or reconciling the account balances. The program provided documentation or references as evidence of satisfactorily correcting these improper payments. The total amount of federal and state match funds drawn are back in balance, and the SDWSRF is now paying payment requests in accordance with the federal requirements. EPA encourages the SDWSRF to continue to monitor the payment of claims

and cash draw transactions, and install the necessary internal controls to avoid improper payments.

3. Timely and Expeditious Use of Funds

A State must agree to commit and expend all funds as efficiently as possible and in an expeditious and timely manner. Timely and expeditious use of the funds is critical to maximizing the use and effectiveness of DWSRF assets and in meeting the public health needs of the State per 40 CFR § 35.3550(i).

On April 19, 2013, EPA found the CDPH SDWSRF in non-compliance with the federal regulation and the terms and conditions of the capitalization grant agreement governing expeditious and timely use of the DWSRF funds. The Notice of Non-compliance noted that the SDWSRF is faced with major cash flow and fund management challenges, such as (1) optimizing and aligning the rate at which loans are committed and disbursed with the funding capacity of the fund; and (2) balancing the need to disburse federal funds quickly while ensuring that recycled and other non-federal funds are also used in a timely and expeditious manner.

In response to the Notice of Non-compliance and in accordance with 40 CFR § 35.3585(c), CDPH submitted the CAP to EPA, addressing the elements required in the Notice of Non-Compliance to improve its financial management and performance of the program. The SDWSRF performed well in SFY 2013/2014 and exceeded the binding commitment goal set in the CAP by over \$96 million. This is a commendable accomplishment that has improved the pace of the program.

As developed through the State/EPA SRF Workgroup, several DWSRF financial performance indicators are incorporated in the DWSRF National Information Management System (NIMS) and used annually to measure the progress of the DWSRF program. These financial indicators serve as tools to help understand and assess state programs. In general, these indicators are used as a suite, and not individually. EPA considers all the indicators together to gain a comprehensive picture of the State's program. Because every state program is unique in structure and circumstances, it is often helpful to look at a state's performance year-to-year to note possible trends in addition to comparing the state's performance to national averages.

The DWSRF financial indicators for states that have not leveraged such as California, show that California's SFY 2013/2014 DWSRF performance varies, see Table II. California made significant improvements over its previous year's performance, and now exceeds the national average for pace or fund utilization rate. However, when compared to the national averages for non-leveraged states, the SDWSRF remains below the national averages for the other performance indicators.

Table II. Performance Measures California SDWSRF

DWSRF Performance Measures - Cumulative	June 2013		June 2014	
	National Average	California	National Average	California
Fund Utilization Rate	87.4%	95.4%	92.0%	108.1%
Disbursements as % of Assistance Provided	81.1%	67.9%	79.6%	64.5%
Set-aside Spending Rate	80.5%	77.3%	85.5%	83.8%
Return on Federal Investment	125.5%	108.3%	126.6%	107.5%
DWSRF Unliquidated Obligations As a % of Federal Cap Grants	11.3%	25.9%	8.5%	16.6%
\$ Amount of DWSRF Unliquidated Obligations (not calculated as an average)	\$1.78 billion	\$377.9 million	\$1.4 billion	\$255.8 million
Unliquidated Obligations (federal only)* based on federal fiscal year, 1 Oct – 30 September		69.0%		51.0%

*Based on a 7-year average

a. Fund Utilization Rate: Fund utilization rate or pace of the program represents the cumulative assistance committed as a percentage of cumulative SRF funds available for projects. It is one indicator of how quickly funds are made available to finance DWSRF eligible projects and reflects a state’s ability to utilize funds in a timely and expeditious manner.

As described in the CAP, CDPH has taken steps to improve its commitment and utilization of funds. The NIMS report showed that SDWSRF fund utilization rate progressively and substantially over the past couple of years. EPA commends the CDPH for this rapid improvement. CDPH has demonstrated additional programmatic strides by exceeding the EPA corrective action requirement of executing \$260 million in assistance agreements by actually funding over \$365 million in agreements by June 30, 2014.

Follow-up: Successful completion of the following CAP deliverables aimed at improving fund utilization will satisfy the required follow-up:

- ATTACHMENT E, *Corrective Action Plan*, Items # 9, 10, 11, 15, 16, 17, 18, 19, 20, 24, 25, and 26

b. Unliquidated Obligations (ULO) – Use of Federal and Non-federal Funds:

As of May 5, 2011, EPA has established new federal fund utilization expectations for water programs, consisting of two inter-related elements. The first element is to accelerate the pace of fund obligation with a long-term goal of obligating all federal funds during the fiscal year in which they are appropriated. For the past five years, the California SDWSRF program has applied for (and EPA has therefore obligated) all federal funds during the fiscal year in which they were appropriated.

The second element is to encourage and monitor the prompt and full utilization of federal funds. One measure of the prompt and full utilization of federal funds is unliquidated obligations (ULO). Funds that EPA has awarded to a state in a capitalization grant, but that the state has not yet drawn from the U.S. Treasury, are considered ULO. Although not a formal performance indicator under the DWSRF program, EPA has placed an increasing emphasis on managing ULOs in response to the attention ULO have received.

To further promote the goal of reducing ULO under the DWSRF, the Office of Ground Water and Drinking Water (OGWDW) established a national strategy that was put forward in a memorandum from Peter Grevatt, Director of the OGWDW, and dated April 14, 2014 (Attachment G). The DWSRF ULO reduction strategy is directed to the timely expenditure of federal funds and to support a broader collective goal of maximizing the use of all DWSRF resources to advance investment in the reliable delivery of safe drinking water to the American people.

The strategy focuses on two key objectives: 1) liquidation of past years' grant funds; and 2) maintenance of lower levels of ULO in future years. The strategy aims to reduce DWSRF ULO for both loan and set aside funds to lower yet practical levels, targeted to occur within financially manageable timeframes as indicated by the experience of states with low ULO, while respecting that there will be differences among states. This aim is conveyed in the strategy's objectives:

- (1) Full utilization of funds from previous DWSRF grants (FY 2013 and prior years' funds) by the end of September 2016.
- (2) Complete draw down of funds from future years' grants within two years from the date of grant award.

This strategy is for immediate implementation and EPA Region 9 has conferred closely with states in our Region to ensure that ULO reduction practices are in place to achieve the strategy's objectives.

The SDWSRF program is moving towards meeting the strategy's first objective of using funds from previous DWSRF grants by the end of September 2016. The SDWSRF program closed out the FY 2009 capitalization grant in SFY 2013/2014. This capitalization grant consisted of the allotments from federal fiscal years 2008 and 2009, which totaled over \$132.8 million. Of the remaining four (4) capitalization grants, two (2) were closed in SFY 2014/2015 and two (2) remain open with a total ULO balance of approximately \$87.6 million.

As required by CAP item 21, the SDWSRF developed a quarterly schedule of estimated federal cash draws for SFY 2015/2016, which are based upon estimated project disbursements derived from the cash-flow model analysis. This quarterly schedule shows that the SDWSRF will draw an estimated \$183.5 million in federal funds by June 30, 2016, well above the ULO balance of \$87.6 million. In doing so, the SDWSRF will fully use all funds from FY 2013 and prior years' grants by the end of September 2016 to meet both the objectives of the strategy and the CAP.

The CAP commitment goal, item no. 29, of having a balance of no more than \$160 million in federal funds by June 30, 2016 supports the second objective of EPA's ULO reduction strategy. The SDWSRF has taken major steps to monitor project and disbursement activity to ensure that this CAP goal is met. The SDWSRF's ability to reduce the dollar amount of ULO to \$255.8 million in SFY 2013/2014 compared to \$377.9 million a year earlier demonstrates their commitment to meeting the CAP and the intent of the ULO reduction strategy. Monthly meetings between EPA and the State Water Board to review CAP deliverables helps closely monitor the SDWSRF progress in meeting this objective.

Follow-up: While EPA nationally is paying particular attention to unliquidated federal funds, the requirement to expend funds in an efficient and timely manner applies to state match, recycled and other non-federal funds as well. As such, EPA encourages the SDWSRF to continue its efforts to implement progressive program improvements that will efficiently use all funds. Likewise, EPA encourages the SDWSRF to continue its efforts to quickly and efficiently spend down federal funds from previous SDWSRF grants to meet the required objectives of the CAP and the September 2016 target date expressed in the ULO reduction strategy.

While the SDWSRF CAP goal of having a balance of available federal funds that does not exceed \$160 by June 2016 helps support the ULO reduction strategy, beginning in SFY 2015/2016, the SDWSRF program must adhere to the reduction strategy benchmark of completely drawing down funds from future years' grants within two years from the date of grant award.

The following CAP deliverables aimed at improving the disbursement of all funds help satisfy the required follow-up: □ ATTACHMENT E, *Corrective Action Plan*, Items #12, 13, 14, 17, 21, 22, 23, 27, 28, and 29.

c. Disbursements as a Percentage of DWSRF Assistance – Based on Cumulative Activity: While the fund utilization indicator reflects how quickly the SDWSRF commits funds to projects by signing assistance agreements, the disbursement rate

reflects how quickly the SDWSRF disburses funds to systems. In the case of California, the SDWSRF disbursed \$201 million in funds in SFY 2013/2014, resulting in a disbursement ratio of 65%, which is slightly below the previous year's value of 68% and the national average of 80%. The reason for SDWSRF's lower disbursement rate stemmed from the substantial increase in executed assistance agreements that have not yet moved to the disbursement cycle. An increase in disbursements is expected to occur in SFY 2014/2015 once projects begin, costs are incurred, and claims are submitted for reimbursement. The State's recent achievements of closing a number of high dollar value assistance agreements has demonstrated and ensured improved future performance in the rate SDWSRF funds are disbursed to systems.

Follow-up: The actions needed to address disbursements as a percentage of DWSRF assistance are the same as those listed above for ULOs, paragraph 2.b.

d. Set-aside Spending Rate – Based on Cumulative Activity: Expressed as a percentage, this indicator reflects the rate at which set-aside funds are disbursed to assist state and local activities. For the SDWSRF, the 2014 NIMs report shows a ratio of 83.8%, slightly below the national average of 85.5% but a significant improvement over the previous year's value of 77.3%. The spending rate improvement is in part a result of CDPH's efforts to hire skilled staff to reconcile and manage these accounts.

Follow-up: Successful completion of the following CAP deliverables aimed at improving the disbursement of set-aside funds will satisfy the required follow-up:

□ ATTACHMENT E, *Corrective Action Plan*, Items #14, 23, and 28

e. Return on Federal Investment: This indicator represents the cumulative assistance disbursed as a percentage of cumulative federal cash draws. This indicator is designed to show how many dollars of assistance were disbursed to eligible borrowers for each federal dollar spent. States with a direct loan program should have an expected value for this indicator of above 120%, which reflects the 83% federal and 17% state contribution ratio for funding projects along with any repayments. States that leverage should also have a higher value than 120% because they have more funds available relative to the amount of federal and state match funding than non-leveraged states.

This indicator estimates how many dollars in environmental investment have been generated for every federal dollar spent through the program. In the case of the SDWSRF, its SFY 2013/2014 cumulative return on federal investment was 107.5%. Based on this performance, EPA concluded that for every federal dollar spent by the SDWSRF there was \$1.08 of environmental investments created. CDPH's use of federal dollars to resolve drinking water problems and improve infrastructure is below the expected standard of 120% and the national average for nonleveraged states of 126.6%. This indicator also suggests that a low amount of non-federal SDWSRF dollars were disbursed to eligible borrowers. The substantial increase in executed assistance agreements that have not yet moved to the disbursement cycle, coupled with the disproportional draw of federal and state match funds, has skewed and effected the

amount of environmental dollars created. An increase in disbursements is expected to occur in SFY 2014/2015 once projects begin, costs are incurred, and claims are submitted for reimbursement.

Follow-up: The actions needed to address return on federal investment are the same as those listed above to increase fund utilization and reduce ULOs, paragraphs 2.a and 2.b.

C. Project File Review

EPA's review of project files found the projects to be eligible and in compliance with the program requirements. The project file review checklists for each of the projects listed below can be found in Attachments F.

1. Base Program

a. San Lucas WD, project #2701676007P - \$440,000 in SDWSRF funding was used to pay for a planning study to evaluate alternatives to solve nitrate compliance problems, options include treatment, new well, and consolidation.

b. Cutler PUD, project #541001-003C - \$997,693 in SDWSRF funding was used to replace existing undersized mains with 8-inch diameter mains.

2. ARRA Program

a. Downieville PUD, project cost \$144,504. The Downieville PUD installed a disinfection contact tank to ensure water safety.

b. Tennant Community Services District, project cost \$1,804,050. The Tennant CSD project consisted of constructing a new well and a water tank so that a "boil water advisory" was no longer required

IV. Conclusion

EPA conducted an annual review of the SDWSRF Program base and ARRA activities in accordance with EPA's SRF Annual Review Guidance. Based upon the file reviews, on-site project file reviews and interviews, EPA concludes that the State of California met all program requirements for the review period, with the following exceptions, which are to be addressed in the SFY 2014/2015 Annual Report:

- **Rules of Cash Draw and Improper Payments** – *EPA encourages the SDWSRF to continue to monitor the payment of claims and cash draw transactions, and install the necessary internal controls to avoid improper payments. EPA requests that State Water Board provide an update on the upgrade of its SDWSRF claim processing, payment, and internal control procedures in their SFY 2014/2015 Annual Report.*
- **Set-Asides** – *EPA encourages the SDWSRF to establish funding protocols and intra-agency guidance on various operational and financing activities between the lead agencies for the SDWSRF program, and the PWSS and Capacity Development programs. EPA asks that the State Water Board provide an update to this suggestion in its SFY 2014/2015 California SDWSRF Annual Report.*
- **Unliquidated Obligations** - *EPA encourages the SDWSRF to continue its efforts to implement progressive program improvements and cash management strategies that will support EPA’s DWSRF ULO Reduction Strategy beyond 2016, and the sound financial stewardship of federal funds.*
- **CAP Deliverables** - *EPA encourages the SDWSRF program to closely monitor the activities of the CAP to ensure the satisfactory and timely completion of its deliverables and the program’s return to compliance with the requirements of the Safe Drinking Water Act and the federal DWSRF program.*

Attachment A EPA Annual Report Program, Financial and Set-aside Review Checklist

Attachment B Transaction Testing Worksheets - ARRA

Attachment C Transaction Testing Worksheets – Base

Attachment D Chart of Improper Payments and Payment Resolution

Attachment E CDPH SDWSRF *Corrective Action Plan*

Attachment F EPA Project File Reviews – Base and ARRA

Attachment G U.S. EPA Memorandum, *Drinking Water State Revolving Fund (DWSRF) Unliquidated Obligations (ULO) Reduction Strategy*, signed by Peter Grevatt and dated April 14, 2014

