

PROGRAM EVALUATION REPORT
California Drinking Water State Revolving Fund Program
Based on State Fiscal Year 2015 Annual Report
On-site Reviews Conducted February 1-5, and March 22-24, 2016
FINAL REPORT: August 18, 2016

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.

Based on continued active evaluation of the California Drinking Water State Revolving Fund (CA DWSRF) 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 CA DWSRF funds efficiently and in a timely and expeditious manner or employed adequate financial resources to operate the CA DWSRF in a sound financial manner. In response, CDPH submitted a Corrective Action Plan (CAP), which EPA approved on July 23, 2013.

On July 1, 2014, the California Governor transferred the California Drinking Water Program including the CA DWSRF program from CDPH to another state agency, the State Water Resources Control Board (State Water Board). Therefore, the CA DWSRF activities performed during the period under review, from July 1, 2014 to June 30, 2015, (state fiscal year (SFY) 2014/2015) were entirely under the administration of the State Water Board. In an effort to provide EPA with timely information on the progress and many accomplishments of the CA DWSRF program under this review period, the State Water Board submitted to EPA the CA DWSRF Annual Report dated February 1, 2016.

During February 1-5, and March 22-24, 2016, EPA conducted its annual on-site reviews of the CA DWSRF program. 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 CA DWSRF program. To ensure that the annual review addressed all of the major review elements for the base program, EPA staff completed the SRF Annual Program and Financial Review checklist, Attachment A.

Based on the CA DWSRF annual report for SFY 2014/2015, evaluation conducted at EPA's office and the on-site visits, EPA has prepared this program evaluation report (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 2014/2015. 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 2016/2017, referencing EPA's Notice of Non-compliance and CDPH's CAP, as appropriate.

II. Background and Scope

The CA DWSRF 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, 2015, the CA DWSRF has executed 379 loans totaling approximately \$2.25 billion, including loans funded by the American Recovery and Reinvestment Act.

The CA DWSRF 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*

The scope of the annual review includes consideration of the legal, managerial, technical, financial and operational capabilities of the State Water Board to manage the CA DWSRF 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 CA DWSRF 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, ten CA DWSRF program cash transactions, totally over \$35 million, elected by the Office of the Chief Financial Officer 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 DWSRF program activities. This section presents EPA's specific observations and suggested or required 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 CA DWSRF.

A. Program Management

1. Funding Eligibility - Planning and Design Assistance

The California DWSRF program offered eligible planning and design funding in SFY 2014/2015. One such planning and design assistance agreement was with the City of Westmorland. This assistance agreement provided CA DWSRF funds to pay for a planning/feasibility study to correct the city's disinfection by-products (DBP) levels which exceed the maximum contaminated level (MCL). The study would identify a number of improvements that could assist in lowering the DBP levels and improve the water system for this disadvantaged community.

In reviewing the project file, EPA noted that the contract agreement between the City of Westmorland and the consultant, PSOMAS, in the amount of \$500,000, sufficiently detailed the scope of work that was funded by the CA DWSRF. EPA found this contract agreement to be an excellent example of a "best practice". It is a planning and design contract between a consultant and a CA DWSRF recipient that is both thorough and project specific. EPA has seen cases where a consultant submits, and the DWSRF

assistant recipient accepts, a generic or broadly written planning and design agreement that is not project specific. It can lack the proper scope of work or detail to cross reference and identify the work and amount funded by the DWSRF. EPA finds it inadvisable for DWSRF assistance recipients to use a broadly written project consulting agreement to avoid potential incorrect and unrelated charges from being billed.

Recommended Follow-up: EPA recommends that the State Water Board develop written guidelines that will require CA DWSRF planning and design assistance recipients and their consultants to follow a budget and scope of work protocol for design and facility planning work funded by the CA DWSRF. A planning and design consulting agreement similar to the one developed between the City of Westmorland and their consultant appears to illustrate this best practice.

2. Set-aside Activity

- a. DWSRF Withholding Determinations:** EPA is authorized to withhold up to 40% of each year's capitalization grant if it determines that a state is not adequately implementing an operator certification program (20%) or capacity development program (20%).

EPA's review of these programs finds that the State Water Board is implementing approvable capacity development and operator certification programs between the Division of Drinking Water (DDW), which implements the Public Water System Supervision (PWSS) program, and the Division of Financial Assistance (DFA), which implements the DWSRF. EPA's determination is largely based on reports submitted by the State Water Board for the two programs annually and on more comprehensive program reviews that EPA conducts periodically. Ongoing management discussions between State Water Board and EPA confirm that California is meeting the intent set forth in the Safe Drinking Water Act.

EPA is, however, concerned about the timeliness of submission and thoroughness of content of annual and triennial reports for the capacity development and operator certification programs required by the PWSS grant workplan as well as the newly-aligned 10% set aside workplan. For multiple years, EPA has requested that the number of Public Water Systems (PWSs) that do not have a properly credentialed operator and the number of enforcement actions taken when this circumstance occurs be reported in the annual operator certification submittal, but this information has not been included. In addition, the September 2015 capacity development annual report failed to include the enforcement targeting tool (ETT) score of new PWSs that have violated national primary drinking water regulations, as required. Also, the capacity development annual report was delivered well past the deadline established in the grant workplan, so late, in fact, that EPA was preparing a recommendation to withhold 20% of the SRF award. Further, the Triennial Report to the Governor for Capacity Development is two years over-due.

Recommended Follow-up:

EPA recommends that California prioritize development and submission of complete reports in a timely manner (i.e., by August 15 of each year) that allows sufficient time for EPA review to help ensure full award of the SRF capitalization grant.

- b. Coordination between the DWSRF and PWSS Programs regarding Capacity Development and Operator Certification:** Since the transition to the State Water Board, the capacity development and operator certification programs have been separated from the PWSS program and placed with DWSRF. This change has created new communication and coordination challenges both within State Water Board as well as to EPA Region 9. In last year's PER, EPA recommended, among other things, that California update its capacity development strategy to: (1) include the new activities that are being conducted by the PWSS and DWSRF programs to support the capacity development program, and (2) improve communication, coordination, and management of expectations between the PWSS and DWSRF programs. The State Water Board had asked to hold off on revising the strategy to allow the reorganization to settle in and to see if pending legislative initiatives became law.

Recommended Follow-up:

1. EPA recommends that the State Water Board revise its capacity development strategy by June 2017 to reflect changes to the capacity development program that it has implemented in recent years. Updating the strategy may also make improving the capacity development annual report easier.
2. EPA recommends that the State Water Board consider establishing an MOU or developing an SOP to clarify expectations, support ongoing coordination between the DWSRF and PWSS programs and ensure mutually reinforcing program operation.

- c. Coordination between the DWSRF and PWSS Programs regarding Enforcement:** During the past year, the DFA and DDW held regular meetings and participated in several workgroups with EPA, such as a workgroup that monitors systems that exceed the MCL for arsenic. DFA and DDW staff worked together on a system to ensure that project-specific compliance milestones and end dates were met.

Recommended Follow-up:

EPA requests that the State Water Board provide EPA with a list of DWSRF-funded infrastructure projects that are expected to achieve project milestones (especially return-to-compliance) prior to September 30, 2017.

3. Status of CAP

In response to the EPA's Notice of Noncompliance, CDPH submitted its CAP to EPA on June 24, 2013, which, after subsequent revisions requested by EPA, was approved by EPA on July 23, 2013. The CAP identified the actions needed to address each of the

required elements in the notice of non-compliance, and included a schedule of deliverables and their due dates.

On May 17, 2016, EPA sent a letter to the State Water Board finding that the state was in full compliance with the financial requirements of the DWSRF program and officially closing the CAP.

Required Follow-up: None. EPA will continue to meet with the State Water Board periodically to discuss financial performance and other aspects of DWSRF program implementation.

B. Financial Management

1. 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 costs, the allowable draw proportion, and amount drawn is considered an improper payment. As part of EPA’s oversight of the DWSRF program, EPA reviews 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 DWSRF funded transactions annually.

EPA tested a total of ten CA DWSRF cash transactions as described in Table I, which were selected through statistical sampling.

Table I. CA DWDRF SFY 2015 Cash Transactions Tested

Number of Transactions Tested			Dollar Amount of Tested Transactions		
Total	Improper	Proper	Total	Improper	Proper
10	2	8	\$35,101,998.71	\$78.68	\$35,101,920.03

EPA reviewed all of the invoices or accounting records associated with each cash draw. This effort was conducted on February 1-5, 2016. 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 I, EPA identified a total of \$78.68 in improper payments that occurred during SFY 2015:

- The State Water Board miscalculated and underpaid a claim to the Montara Water and Sanitary District by \$0.72. The cash draw of \$1,743,130.51 is linked to this improper payment.
- Review of contracts funded under the 15% local assistance set-aside revealed that a contractor expense was calculated, invoiced and paid incorrectly. Contract back-up documents could not support \$77.96 of claimed costs. The cash draw of \$1,172,764.85 is linked to this improper payment.

The transaction testing worksheets for each cash draw tested can be found in Attachment B.

Required Follow-up: The CA DWSRF program is required to remedy these improper payment amounts totaling \$78.68. EPA asks that the State Water Board provide EPA by September 30, 2016, either evidence of satisfactorily correcting these improper payments or a schedule for when these two improper payments will be remedied and by all accounts corrected by December 30, 2016. EPA acknowledges the progress and improvements the CA DWSRF program has made in reducing improper payments. The installment of new internal controls and operational modifications have greatly improved the overall financial administration and operations of the program thereby reducing the occurrence of improper payments.

2. 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(1).

On April 19, 2013, EPA found the CA DWSRF 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. In response, CDPH submitted the CAP to EPA.

The CA DWSRF performed well in SFY 2014/2015 and exceeded the binding commitment goal set in the CAP by over \$8 million. On May 17, 2016, EPA sent a letter to the State Water Board finding that the state was in full compliance with the financial requirements of the DWSRF program and officially closing the CAP.

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 2014/2015 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 CA DWSRF remains below the national averages for several of the performance indicators.

Table II. Performance Measures California CA DWSRF

DWSRF Performance Measures - Cumulative	June 2014		June 2015	
	National Average	California Average	National Average	California Average
Fund Utilization Rate	92.0%	109.0%	93.1%	107.5%
Disbursements as % of Assistance Provided	79.6%	64.5%	82.1%	71.1%
Set-aside Spending Rate	85.5%	83.8%	87.3%	87.2%
Return on Federal Investment	126.6%	107.5%	130.6%	111.6%
Unliquidated Obligations (ULO) as a % of Federal Cap Grants – Annual (federal only)	8.5%	16.6%	6.4%	10.8%

- 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.

In accordance with the CAP, the CA DWSRF has taken steps to improve its commitment and utilization of funds. It executed over \$123 million in assistance agreements by June 30, 2015, exceeding the CAP requirement of \$115 million. In addition, the NIMS report showed that the State Water Board increased its CA DWSRF fund utilization rate progressively and substantially over the past couple of years. EPA commends the CA DWSRF for improving its financial performance.

Required Follow-up: None. On May 17, 2016, EPA sent a letter to the State Water Board finding that the state was in full compliance with the financial requirements of the DWSRF program and officially closing the CAP. EPA will continue to meet with the State Water Board periodically to discuss financial performance and other aspects of DWSRF program implementation.

- b. Unliquidated Obligations (ULO) – Use of Federal and Non-federal Funds:** 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. As of April 14, 2014, EPA has established a new national strategy to reduce ULO under the DWSRF. The strategy focus on two key objectives: (1) liquidation of past years' grant funds, and (2) maintenance of lower levels of ULO in future years.

As of the date of this PER, the CA DWSRF anticipates liquidating funds from previous DWSRF grants (FY 2013 and prior years' funds) by the end of September 2016 as prescribed by the DWSRF ULO reduction strategy.

To maintain lower levels of ULO in future years, the strategy calls for states to completely draw down funds from future grants within two years of grant award. There is an exception within this objective with respect to set aside funds. Some states may face challenges that could constrain their efforts to completely draw down all funds within two years, particularly with regard to set aside funds. In such instances, a state may request additional time to use set aside funds (up to twelve months) from EPA.

The CA DWSRF expects to liquidate grants within two years from the date of grant award with the exception of some FY 2014 set aside funds. On July 26, 2016, EPA reviewed and approved the State Water Board's July 20, 2016, request for additional time to use set aside funds from the federal fiscal year 2014 DWSRF capitalization grant. The CA DWSRF plans to use these set aside funds to support the State Water Board's new capacity development strategy. As such, EPA approved their request for an extension to liquidate these set asides by September 30, 2017.

While EPA 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.

During implementation of the CAP, the CA DWSRF program made substantial progress in its effort to quickly and efficiently expend funds and close-out federal capitalization grants. EPA believes the State Water Board's ongoing efforts to implement progressive program improvements and cash management strategies will help it maintain a low rate of unspent federal and non-federal funds.

Required Follow-up: In support of EPA's DWSRF ULO reduction strategy, the CA DWSRF is required to liquidate all funds from the FY 2014 DWSRF capitalization grant, FS 98934914, by September 30, 2017.

- c. Disbursements as a Percentage of DWSRF Assistance – Based on Cumulative Activity:** While the fund utilization indicator reflects how quickly the CA DWSRF

commits funds to projects by signing assistance agreements, the disbursement rate reflects how quickly the CA DWSRF disburses funds to systems. In SFY 2014/2015, the CA DWSRF disbursement ratio was 71.1%, which is significantly above its previous year's value of 64.5%. Disbursements increased in part due to the large number of assistance agreements executed in prior years. However, many of the new projects have not reached the stage of construction where disbursements occur quickly. The State's performance may lag the national average of 82.1% in part for this reason, but the high number of new assistance agreements will ensure continued improvement in the rate CA DWSRF funds are disbursed to systems.

Recommended Follow-up: None.

- 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 CA DWSRF, the 2015 NIMs report shows a ratio of 87.2%, which is on par with the national average of 87.3%, and an improvement over the previous year's value of 83.8%. The spending rate improvement is in part a result of the State Water Board's efforts to hire skilled staff to reconcile and manage these accounts.

Recommended Follow-up: None.

- 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 in environmental investment have been generated for every federal dollar spent through the program. States with a direct loan program may have a value of between 80% and 120% during the early stages of the program. This value is dependent on the amount of set-asides taken by the state. This percentage amount, however, increases overtime as repayments are generated and become available relative to the amount of federal and state match funding.

The CA DWSRF program had a cumulative return on federal investment of 111.6%, in SFY 2014/2015, which means that for every federal dollar spent by the CA DWSRF, \$1.12 of environmental investments were created. The percentage is an improvement from the previous year of 107.5%.

The State Water Board's use of federal dollars to resolve drinking water problems and improve infrastructure is below the national average for non-leveraged states of 130.6%. The program's performance suggests that a low amount of non-federal CA DWSRF dollars were disbursed to eligible borrowers. However, EPA anticipates that the CA DWSRF program will come more in line with the national average in the next one to two years as newly funded projects start to disburse funds rapidly.

Recommended Follow-up: None.

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 Attachment C.

- **City of Westmorland; Assistance Amount \$500,000; Project #1310008-003; contract #2014P304** – CA DWSRF funding was used to pay for a planning/feasibility study to correct the city's disinfection by-products (DBP) levels which exceed the maximum contaminated level (MCL). The study would identify a number of improvements that could assist in lowering the DBP levels and improve the water system for this disadvantaged community. These improvements are anticipated to involve processes such as storage tanks, associated pump stations, mechanical mixers for reduction of stagnation, improvement in the condition of the filters, etc.
- **Tuolumne Utilities District - San Diego Ditch Constructed Conveyance to connect to Columbia WTP, Project no. 5510013-009 C; Assistance Amount \$225,955** - CA DWSRF funding was used to construct approximately 1700 feet of new water main and eight new connections that will extend from an existing water main supplied from the Tuolumne Utilities District's Columbia Water System.

IV. Conclusion

EPA conducted an annual review of the CA DWSRF program 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 require follow-up and are to be addressed in the SFY 2015/2016 CA DWSRF Annual Report:

- **Rules of Cash Draw and Improper Payments** –*The CA DWSRF program is required to remedy these improper payment amounts totaling \$78.68. EPA asks that the State Water Board provide EPA by September 30, 2016, either evidence of satisfactorily correcting these improper payments or a schedule for when these two improper payments will be remedied and by all accounts corrected by December 30, 2016.*
- **Unliquidated Obligations (ULO)** - *In support of EPA's DWSRF ULO reduction strategy, the CA DWSRF is required to liquidate all funds from the FY 2014 DWSRF capitalization grant, grant # FS 98934914, by September 30, 2017.*

- **Set-Asides** – *(1) EPA recommends that California prioritize development and submission of the capacity development and operator certification reports in a timely manner, i.e., by August 15 of each year; (2) EPA recommends that California update its capacity development strategy by June 2017, and consider establishing a Memorandum of Understanding or developing Standard Operating Procedures to support ongoing coordination between the DWSRF and PWSS programs; and (3) EPA asks that the State Water Board provide a list to EPA of DWSRF funded infrastructure projects that are expected to achieve project milestones (especially return-to-compliance) prior to September 30, 2017.*

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

Attachment B - Transaction Testing Worksheets

Attachment C - EPA Project File Reviews