

California State Water Resources Control Board

Replacing, Removing, or Upgrading Underground Storage Tanks Program Program Evaluation

May 2012





May 17, 2012

Thomas Howard, Executive Director
California State Water Resources Control Board
1001 I Street
Sacramento, CA 95814

Dear Mr. Howard:

Enclosed is our report entitled 'Replacing, Removing, or Upgrading Underground Storage Tanks Program Evaluation.' This report was prepared on behalf of the California State Water Resources Control Board (Board) by Sjoberg Evashenk Consulting and includes our analysis and recommendations. As it relates to the Program, our report addresses the Board's compliance with statutes, regulations, policies, and procedures; efficiency and effectiveness of policies and procedures; and internal controls. A draft report was discussed with Program management on April 23, 2012 and management comments received were considered in drafting the final report.

Sjoberg Evashenk Consulting was pleased to work with the Board on this important project.

Respectfully submitted,

A handwritten signature in cursive script that reads 'Kurt R. Sjoberg'.

Kurt R. Sjoberg
Chairman

cc: Liz Haven, Deputy Director, Division of Financial Assistance
James Maughan, Assistant Deputy Director, Division of Financial Assistance
Doug Wilson, Administration Section Chief, Division of Financial Assistance

THE EQUATION FOR EXCELLENCE

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Executive Summary

Sjoberg Evashenk Consulting, working on behalf of the State Water Resources Control Board (Board), completed a performance audit of the Replacing, Removing, or Upgrading Underground Storage Tanks (RUST) Program. The objectives of the audit were to assess:

- The Board's compliance with statutes, regulations, policies, procedures, and processes at meeting program goals and objectives.
- Efficiency and effectiveness of the Board's policies, procedures, and processes at meeting program goals and objectives.
- Internal controls to prevent fraud and other activities incompatible with generally accepted accounting principles (GAAP), State Administrative Manual (SAM) guidelines, and sound fund management practices.

Initially established within the Technology, Trade, and Commerce Agency (TTCA), the responsibility of the RUST Program (Program) was transferred to the Board when the TTCA was eliminated in January 2004. The Program provides grants and loans to thousands of small businesses to repair, replace, remove, or upgrade their petroleum underground storage tanks, piping, and dispensers throughout California to satisfy federal and state regulatory requirements. The Program is intended to be largely a self sufficient program where revenues generated from principal and interest repayments on existing loan awards, late payment fees, application processing fees, and interest earnings on cash balances are used to fund new annual loan and grant awards and administrative activities.

When the Board took over the Program, the existing cash balance of about \$4.3 million was infused with \$8 million from the Board's Underground Storage Tank Cleanup Fund (USTCF) program to provide the Program with a sizable cash balance. Over the ensuing years, however, expenditures have continually outpaced revenues, resulting in an erosion of the Program's cash balances. Specifically, cash balances at the beginning of Fiscal Year 2005-2006 were \$20,370,297 and by June 30, 2011 cash balances were \$10,312,805¹—a decline of more than \$10 million. A significant reason revenue has fallen over the last several years is the demand for loans as well as interest rates have declined causing a corresponding decrease in the pool of monies available to fund grants from the principal and interest and loan repayments generated. Unfortunately, the Program is unable to determine future demand for loans and grants due to a lack of information on the number of petroleum underground storage tanks requiring repair.

The Program follows a funding allocation methodology that budgets the amount of annual grants to be awarded as a percentage of the Program's annual spending authority. As a result, the grant pool allotted is not directly aligned to the Program's revenue generation from loan repayments and interest earnings, and this approach impacts the Fund's overall sustainability. This occurred because the Program's spending authority has always exceeded its actual revenue each year. Our projections reveal that by following the Program's current funding allocation methodology will continue to diminish and likely exhaust all of the Program's funds in 2016, just after the Program's scheduled sunset date of January 1, 2016. To provide program services beyond the

¹ Combined balances from all subaccounts and includes unliquidated encumbrances.

sunset date, the Program must adjust its funding allocation model to link expenditures with revenue generating activities or infuse additional monies into the Program. If the Program adjusts its methodology to align grant awards with revenue generation activities, our projections indicate that it will likely have sufficient cash flow to operate through the end of 2018.

Moreover, since the transition of program responsibilities to the Board, staff has worked hard to rebuild the Program with structured and formal new policies and procedures as very little documentation, records, or historical data was transferred. However, despite these efforts, the Program's operational processes could be further improved through additional procedures ensuring:

- ✓ Applicants comply with loan and grant eligibility requirements,
- ✓ Project costs are effectively evaluated for eligibility and reasonableness, and
- ✓ Maximum revenue generation on loan activity is obtained.

The Program's management and staff readily acknowledge the opportunities for improvement in the financial and operational areas and are in the process of implementing initiatives that target the weaknesses noted in this report. According to Program management, they have already begun incorporating several proactive changes, such as developing a tracking spreadsheet for loan servicing activities, revising templates for grants and loans, updating eligibility checklists with summary information for historical documentation, and focusing additional efforts on accounts receivable activities.

To assist the Board and Program management to improve its operations, we offer the following recommendations:

1. Adjust funding allocation model to link expenditures with revenue generating activities, infuse additional monies into the Program, or allow the Program to sunset on January 1, 2016 as currently scheduled.
2. Develop a financial analysis management process to monitor current and project future cash flow in order to find the correct balance between the level of grant funding, loan disbursements, and principal and interest repayments. This should include receiving cash management reports from the Accounting department on a regular basis.
3. Work with the Board's other related UST programs and CAL EPA to determine a methodology for identifying the pool of potential eligible program participants and estimating future demand for RUST loans and grants.
4. Establish processes to require additional information on applications specifying the type of work that will be conducted to make it easier for Loan Analysts to determine the type of permits required, such as "Will project work involve above ground activities, Will project work involve removing a tank," etc.
5. Seek approval to adjust Program legislation to provide management with more flexibility to move monies between sub accounts within the Program's fund.
6. Consider implementing a permitting check list to facilitate the review process that lists all of the potential types of permits that could be required by rules and regulations. Prior to loan or grant approval and funds disbursement, this checklist should be completed with an

acknowledgement that active permits were obtained or a written explanation describing the reasons why a particular permit has not been obtained or is not required.

7. Ensure UCC filings are submitted timely and should search the UCC filing database prior to loan approval to identify the number of other lenders that have filed statements against the borrower's assets so the Program can effectively consider its security interest position.
8. Require loan applicants provide evidence that they were unable to obtain funding elsewhere.
9. Require grant applicants provide documentation demonstrating financial hardship and develop financial hardship criteria to ensure each applicant's financial position is evaluated consistently.
10. Develop processes to establish a grant priority list in the event that the number of grant applicants will exceed the available grant funding.
11. Implement qualification processes and criteria to evaluate the creditworthiness of potential loan applicants.
12. Develop and utilize cost guidelines that expand on what activities are eligible and describe the typical types of activities that would be expected along with a range of costs. Establish a risk-based process to seek technical assistance from the Leak Prevention Program when loans and grants meet certain criteria (high dollar value, submitted cost estimates or invoices fall outside of expected activities and costs outlined in the cost guidelines, etc.). If needed, the Program should consider seeking a statutory amendment to add reasonableness as a requirement.
13. Consider renegotiating the contract to pay the FDC for loan applications that meet eligibility qualifications.
14. Establish a specific and consistent point in the loan application process to set the interest rate, such as the day the loan is formally approved. Also, the Program should comply with statute and utilize the exact SMIF rate established by the SCO.
15. Formally determine when loan awards can be disbursed, such as 1-year after agreement execution per the current contract template or 2 years after agreement execution when all undisbursed monies are unencumbered. Once a determination is made regarding the time period allowed for borrowers have to request disbursements, enforce the stated policy.
16. Consider withholding a percentage of each loan disbursement request until the borrower provides a "Notice of completion/final inspection" report issued by the local regulator after a project is complete.
17. For all revised and new policies, update application notifications and the contract template between loan recipients and the Board.
18. Develop a trigger in the loan servicing process to ensure loans automatically enter repayment status at certain key intervals, such as when six months has elapsed since the last disbursement has been requested or 1-year after agreement execution. Also develop a process to manually enter borrowers into repayment status, such as when the borrower notifies the Program that the project is complete.
19. Report late and missed payments to the credit bureaus.

20. Continue efforts to utilize the LGTS for the RUST Program and/or work with the ABS Mortgage Office system vendor to determine if the system has additional options or modules that could provide the Program with the needed loan reporting and tracking functionality.

Introduction

Established at the Technology, Trade, and Commerce Agency (TTCA) in 1989, the Replacing, Removing, or Upgrading Underground Storage Tanks (RUST) program has provided grants and loans to thousands of small businesses to repair, replace, remove, or upgrade their petroleum underground storage tanks, piping, and dispensers throughout California to satisfy federal and state regulatory requirements. The intent of the RUST Program (Program) is to help qualified gasoline retailers pay the expenses associated with required UST upgrades and/or removal to comply with UST requirements to protect groundwater from contaminants, such as methyl tertiary-butyl ether (MTBE). According to RUST management, the Program helps:

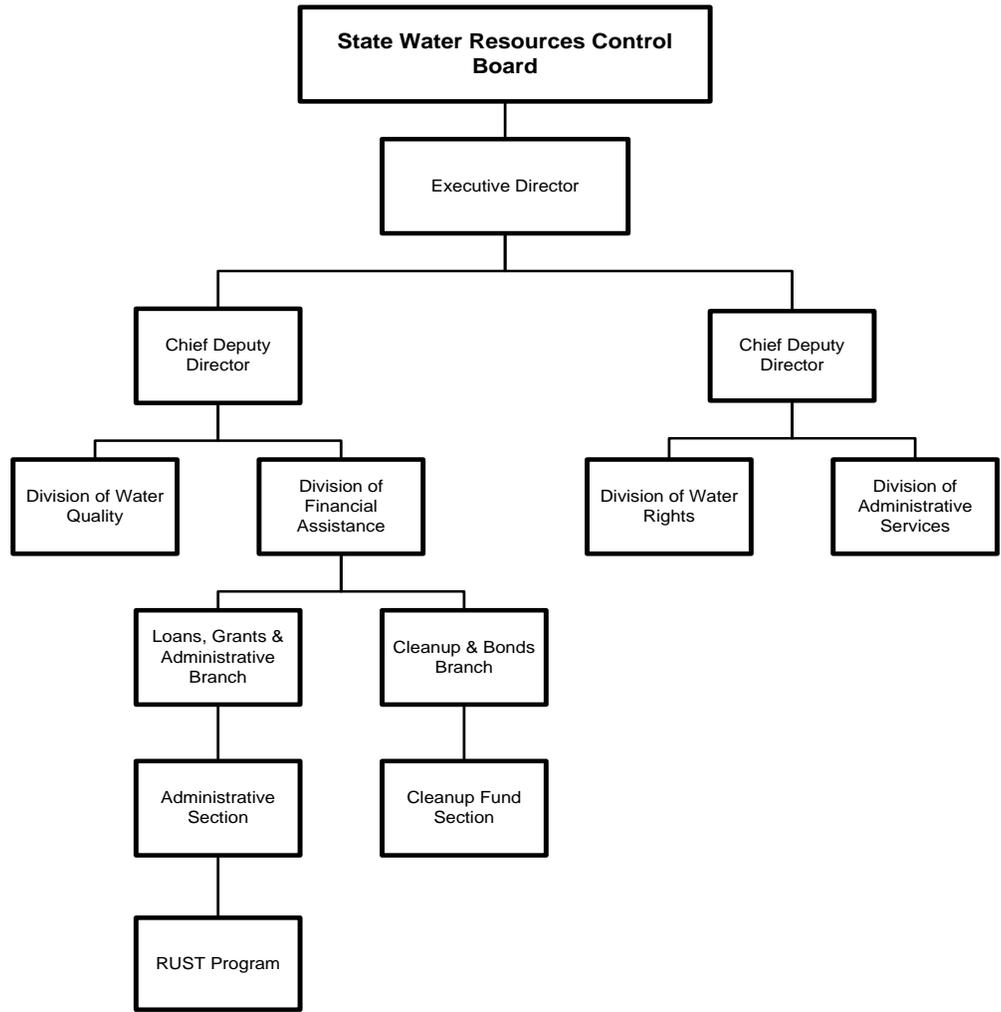
- Protect California's drinking water from contaminants.
- Protect California's air by assisting small gas station owners in complying with Enhanced Vapor Recovery (EVR) requirements.
- Ensure that necessary fuel supplies are properly maintained.

Since the elimination of the TTCA in January 2004, the California State Water Resources Control Board (Board)² has assumed responsibilities over the RUST Program. The responsibilities include determining applicant eligibility; processing and accounting for new and existing loans and grants; and collecting outstanding loans, pursuing delinquent borrowers, and enforcing contract provisions. The Program is administered within the Board's Division of Financial Assistance, as illustrated in Figure 1.

In addition to the Board, a number of regulatory agencies provide regulatory oversight of all underground storage tanks (UST), whether or not tank owners participate in the loan or grant program. Most USTs are regulated by either the Regional Water Board or local agencies.

² State Water Resources Control Board is a state agency that administers the RUST program and is under the oversight of a Board tasked with setting statewide water quality policy.

Figure 1. SWRCB Organization Chart (abbreviated)



RUST Program Highlights

Between 2005 through 2011, the Program has received approximately 161 loan and 766 grant applications, from which 120 loans and 484 grants have been awarded. Applicants must meet statutorily required financial and business operations criteria to be deemed eligible to participate in the Program. Program loans can range from \$10,000 to \$750,000 with terms from 10 to 20 years. Loans may be used to finance up to 100 percent of the costs necessary to upgrade, remove, or replace project tanks, including corrective actions, to meet applicable local, state, or federal standards. These actions may include, but not limited to, any design, construction, monitoring, operation, or maintenance requirements of the Health and Safety Code.

Program grants can range from \$3,000 to \$50,000 and may be used to finance up to 100 percent of the costs necessary to upgrade USTs by installing containment sumps, double-walled piping, dispensers, under-dispenser containment boxes/pans, electronic monitoring systems, and enhanced vapor recovery systems and conduct enhanced leak detection tests.

Objectives, Scope, and Methodology

Sjoberg Evashenk Consulting was hired by the State Water Resources Control Board (Board) to conduct a performance audit of the Replacing, Removing, or Upgrading Underground Storage Tanks (RUST) Program (Program). The objectives of the audit were to assess:

- The Board's compliance with statutes, regulations, policies, procedures, and processes at meeting program goals and objectives;
- Efficiency and effectiveness of the Board's policies, procedures, and processes at meeting program goals and objectives; and,
- Internal controls to prevent fraud and other activities incompatible with generally accepted accounting principles (GAAP), State Administrative Manual (SAM) guidelines, and sound fund management practices.

The period of our audit is focused on fiscal years 2004 through 2011. To answer the audit objectives, we specifically employed the following procedures during this audit:

- Reviewed California Health and Safety Code, program regulations, Legislative Annual Reports, Board decisions, and policies and procedures.
- Interviewed Program management and staff and Division of Administrative Services' Accounting Office to gain an understanding of the Program's overall environment;
- Analyzed financial data, including revenues, expenditures, fund balances, encumbrances, reimbursement payments, payment projections, etc.
- Projected revenues and expenditures for the next 10 years (through 2020-2021);
- Obtained, reviewed, and analyzed grant and loan files, including:
 - Loan and Grant Applications.
 - Financial documents, including, but not limited to: business and personal financial statements, tax returns, debt schedules, and Certifications of Financial Responsibility.
 - UST Operating and Construction Permits, including Underground Storage Tank permits, Permit to Operate, and Authority to Construct permits.
 - Contractor Proposals and Invoices.
- Ascertained whether the projected revenues are likely to be sufficient to support the Program's projected expenditures; and,
- Conducted physical walk-throughs of the Program's various operational processes.

We conducted this performance audit in accordance with generally accepted government auditing standards (GAGAS). Those standards required that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Chapter I: Current Funding Allocation Methodology Restricts Program's Sustainability

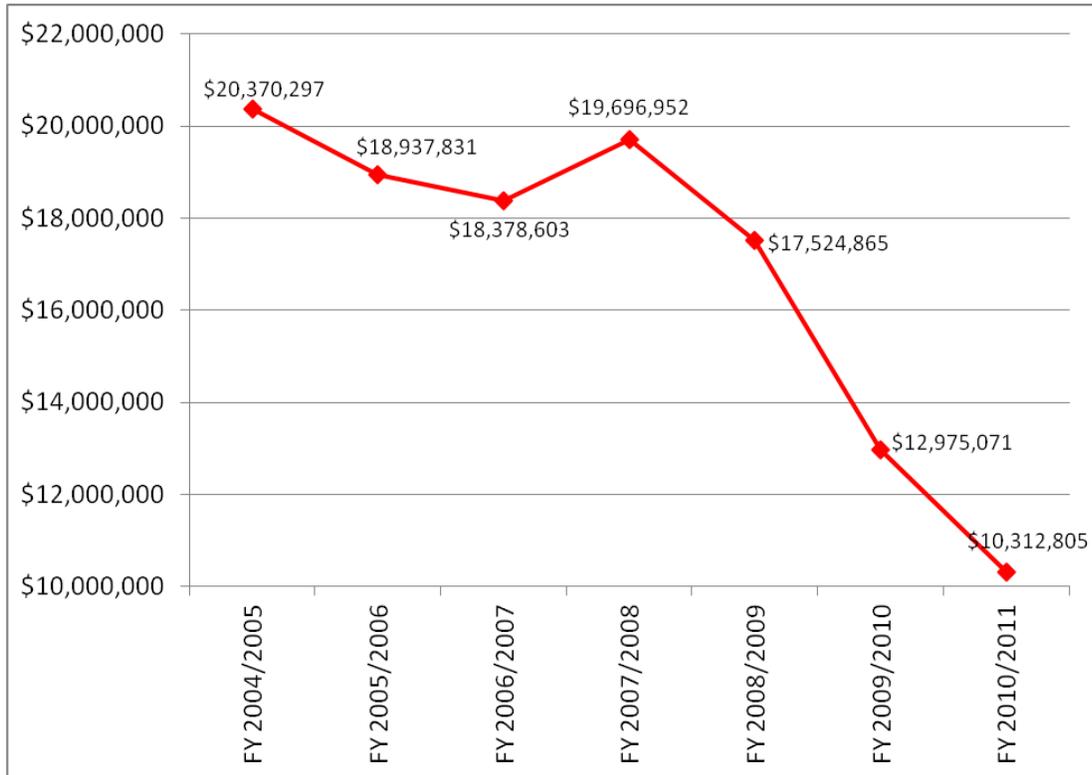
The Replacing, Removing, or Upgrading Underground Storage Tanks (RUST) Program (Program) provides grants and loans to small businesses to repair, replace, remove, or upgrade their petroleum underground storage tanks, piping, and dispensers throughout California to satisfy federal and state regulatory requirements. The Program is intended to be largely a self-sustaining enterprise where revenues generated from principal and interest repayments on existing loan awards, late payment fees, application processing fees, and interest earnings on cash balances are used to fund new annual loan and grant awards and pay for administrative activities.

Initially established within the Technology, Trade, and Commerce Agency (TTCA), the responsibility of the Program was transferred to the State Water Resources Control Board (Board) when the TTCA was eliminated in January 2004. When the Board took over the Program, the existing Program balance of about \$4.3 million was supplemented with \$8 million from the Board's Underground Storage Tank Cleanup Fund (USTCF) program to provide the Program with a sizable cash balance. Subsequently, program disbursements have outpaced revenues nearly every year, which has led to a sharp decline in the Program's cash balances. The Fund's on-going sustainability is at risk because the Program follows a policy of issuing grant awards at a certain level regardless of the amount of revenue that the Program generates through collections of loan repayments and interest earnings. Our projections reveal that following the Program's current funding allocation methodology will continue to erode the Program's cash balances and likely exhaust all funds by 2016, just after the Program's scheduled sunset date of January 1, 2016. According to statute, any remaining funds are to be transferred into the USTCF once the Program sunsets.

Program Cash Balances Have Diminished Over the Last Six Years As Expenditures Continually Exceed Revenues

In 1989, the Program was established as a loan assistance revolving fund relying on revenue generated through principal repayments, interest earnings, processing fees, and late payment charges to fund new loans and pay for administrative activities. In 1999, the Program was expanded to include grant awards. By design, revolving funds essentially recycle funding by replenishing outlays with repayments, and thus, retaining the original capital that established the fund. Under a revolving fund scenario, the Program would fund some small grants as well as lend larger amounts in the form of loans and rely on revenue generated through the repayment of loans and the related interest earnings rather than needing additional annual funding allocations. However, the Program's approach to funding its loans and grants has resulted in the continual erosion of the fund as it has not generated sufficient revenue to keep pace with its expenditure commitments. In fact, cash balances have diminished by almost half over the last six years, as shown in Figure 2. Specifically, cash balances at the beginning of Fiscal Year 2005-2006 were \$20,370,297 and by June 30, 2011 cash balances were \$10,312,805—a decline of more than \$10 million.

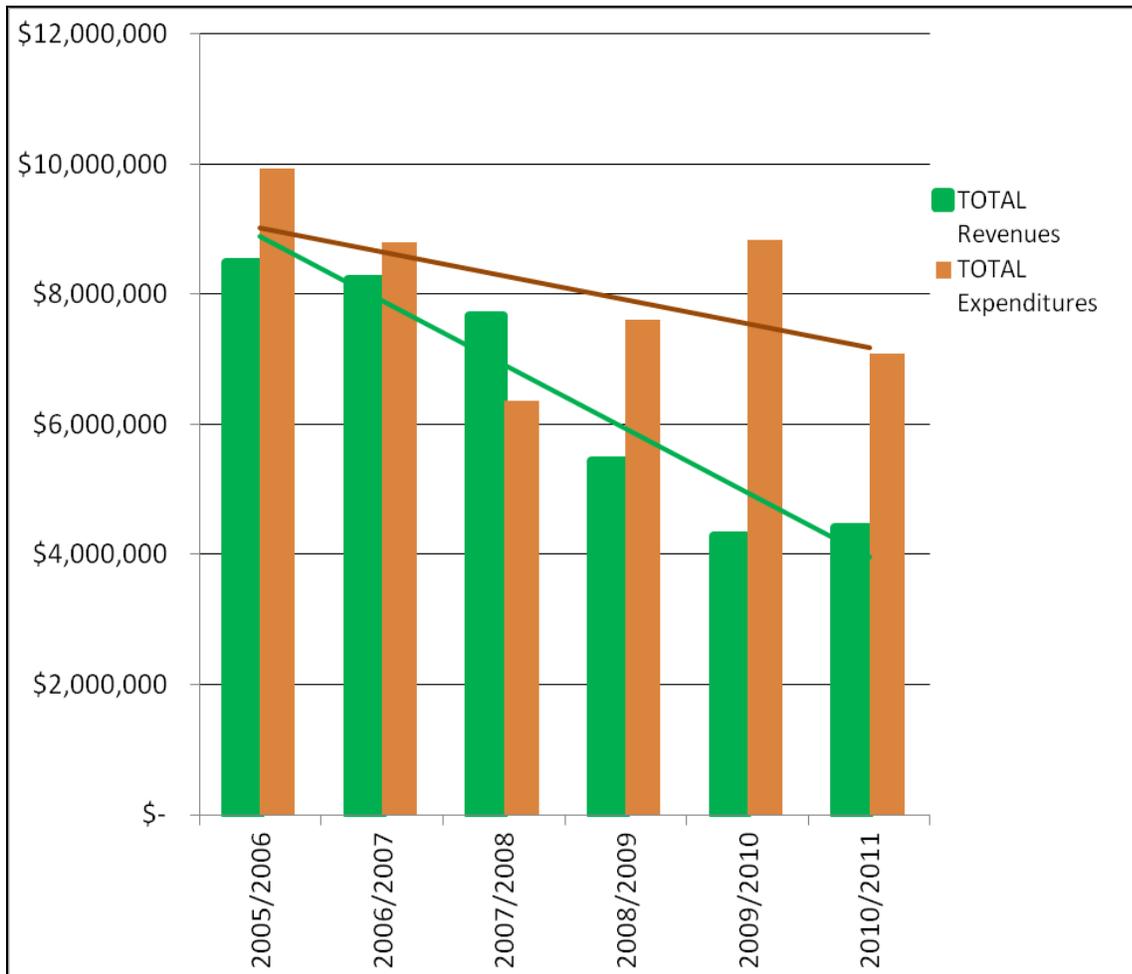
Figure 2. Cash Balances—2005-2011



The June 30, 2011 figure includes balances from all of the Fund’s subaccounts, which includes an administrative subaccount where monies are unable to be shifted to the main subaccount without legislation authorizing changes between subaccounts. The inability to shift excess monies in the administrative subaccounts to the Program’s main subaccount limits management’s ability to manage cash flow. Program management should seek adjustment to legislation that would provide more flexibility to move monies between the Program’s sub accounts.

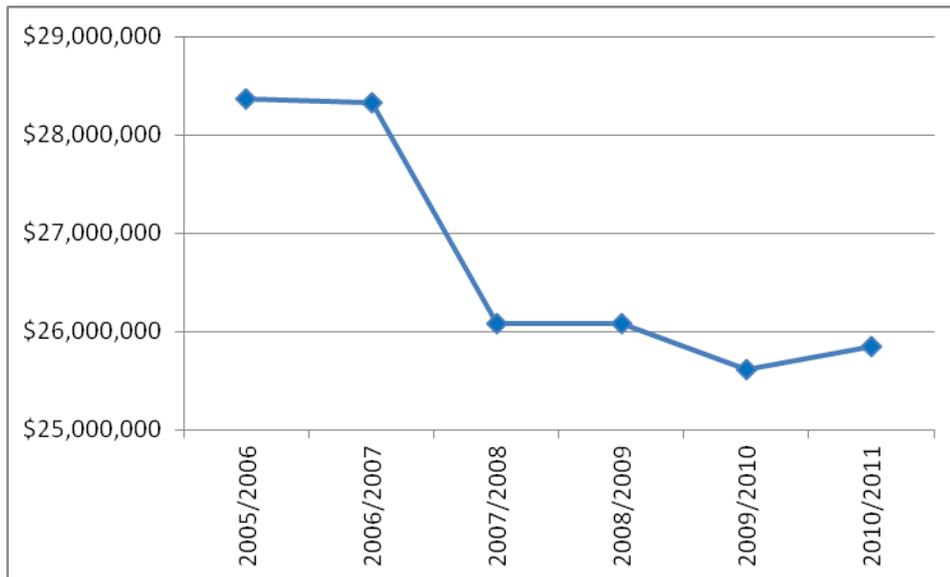
The Program’s cash balances have declined by more than \$10 million over the last several years because revenues have not been sufficient to pay for loans, grants, and program operations as expenditures have outpaced revenues nearly every year, as illustrated on Figure 3.

Figure 3. Annual Expenditures and Revenues—2006-2011



While the Program’s cash balances have declined over the last several years, its outstanding loans receivable balances owed to the Program have also decreased, but less dramatically, as reflected in Figure 4. Specifically, loan receivable balances outstanding were \$28.4 million at the end of Fiscal Year 2005-2006 and dropped to just under \$25.8 million at the end of Fiscal Year 2010-2011—indicating existing loan balances are being paid off faster than new loans are being issued.

Figure 4. Outstanding Loan Receivable Balances—2006-2011



Since Fiscal Year 2005-2006 (the first full fiscal year SWRCB administered the Program) through June 30, 2011, the Program generated \$38,541,232 in total revenue through the following sources to be utilized to pay for program expenditures:

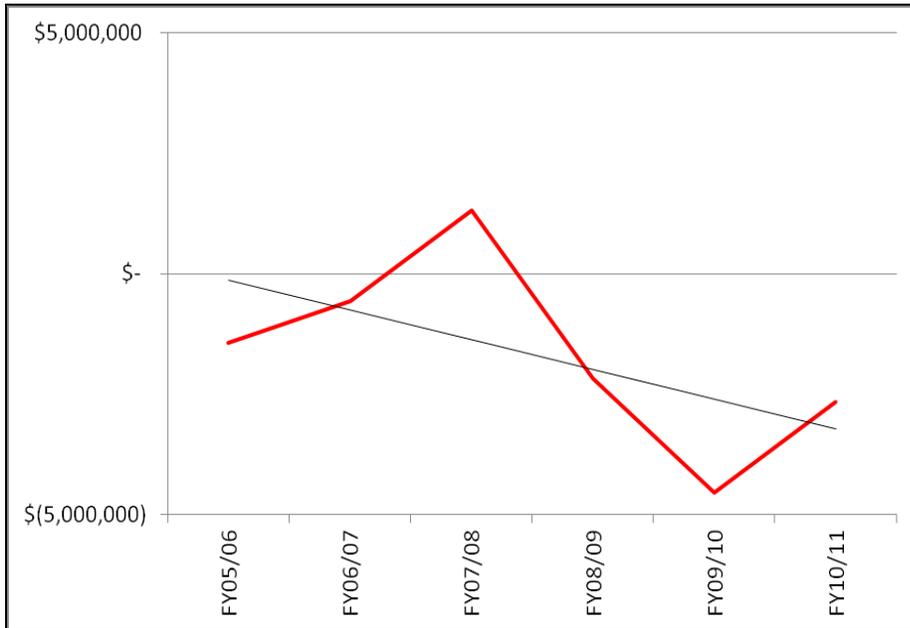
- Loan Principal Repayments—\$29,054,524
- Interest Earned on Loans—\$5,670,881
- SMIF Interest— \$3,307,386
- Late Payment Fees and Application Processing Fees— \$508,441

During the same time period, the Program incurred \$10 million more in expenditures than it generated in revenues—\$48,598,725 in expenditures through the following activities:

- Loan Disbursements—\$26,659,843
- Grant Disbursements—\$19,683,850
- Administrative Expenses—\$2,255,032

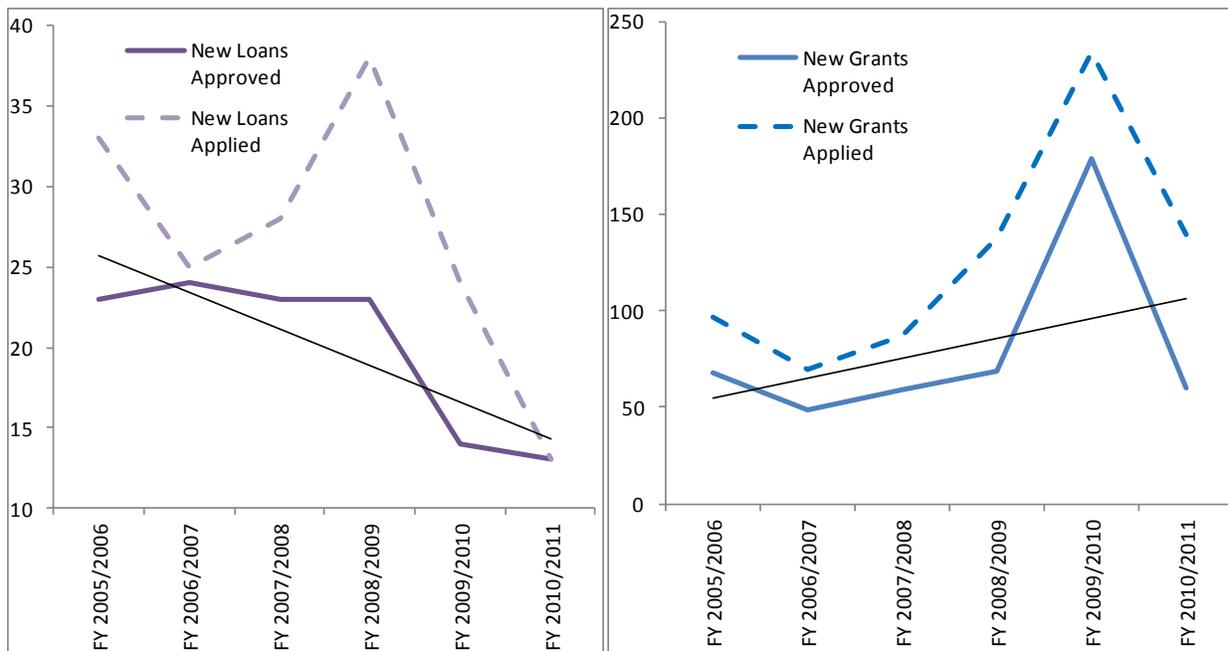
As shown on Figure 5, the imbalance between revenues and expenditures results in a negative cash flow position where the Program must utilize existing cash balances to fund activities, which includes the \$8 million transferred from the USTCF in 2004.

Figure 5. Annual Cash Flow—2006-2011



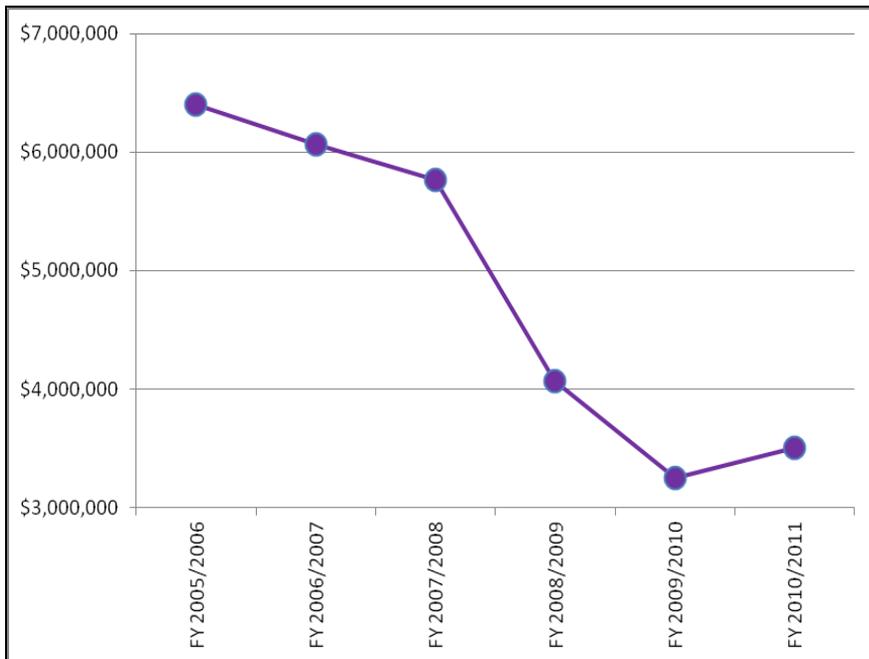
The primary reason revenue has fallen over the last several years is largely due to the number of new loans awarded has declined, but there has not been a comparable reduction in the number of grants awarded, as shown in Figure 6.

Figure 6. Number of Grant and Loans Applied and Approved—2006-2011



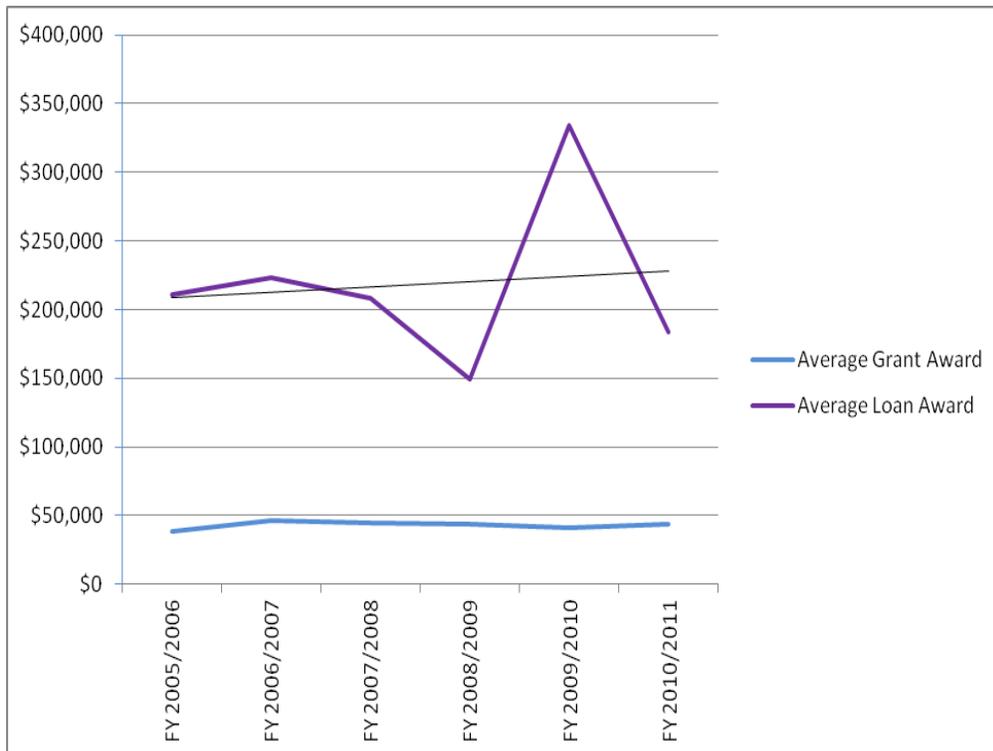
The reduced demand for loans caused a corresponding decrease in monies available to cover grant awards from principal loan repayments, as shown in Figure 7.

Figure 7. Principal Repayments on Loans—2006-2011



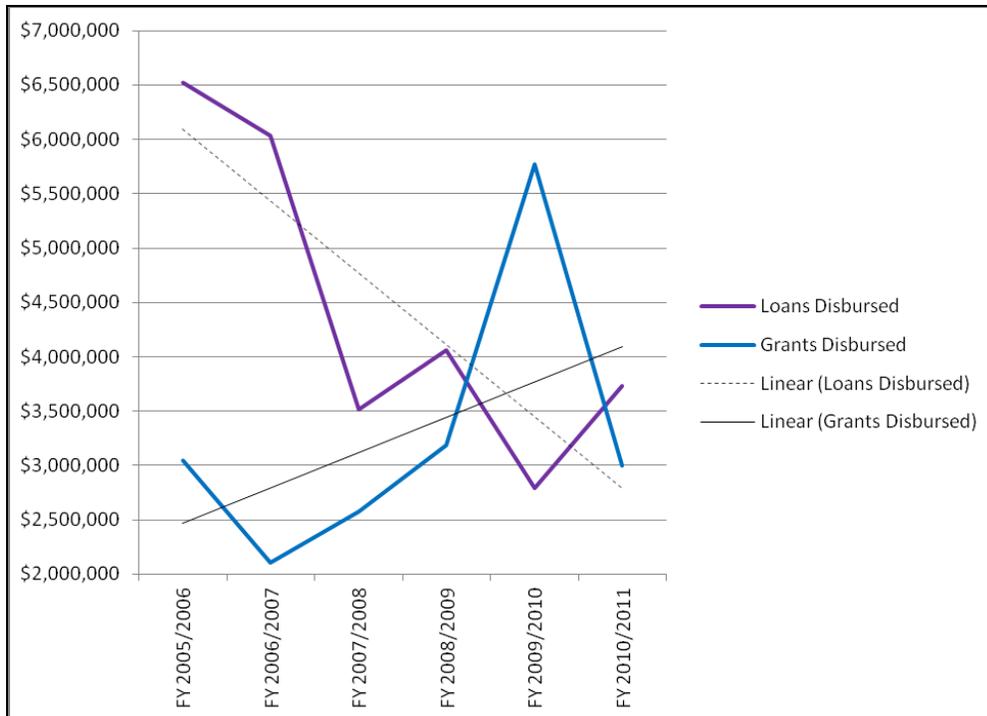
Additionally, the average individual loan and grant award has remained relatively consistent, as reflected in Table 8.

Figure 8. Average Grant and Loan Awards—2006-2011



Given the difference between the demand for loans and grant awards and the fact that average grant and loan awards have remained relatively stable over the course of the last several years, it is not unexpected that the amount of Program loan funding disbursed between FY 2005-2006 and 2010-11 fell while the amount of grants awarded increased during the same time period, as shown in Figure 9. According to the Program, demand was very high for grants and loans during the early years of the Program, but demand for loans has fallen in recent years due to economic factors.

Figure 9. Amount of Annual Loans and Grants Disbursed—2006-2011³

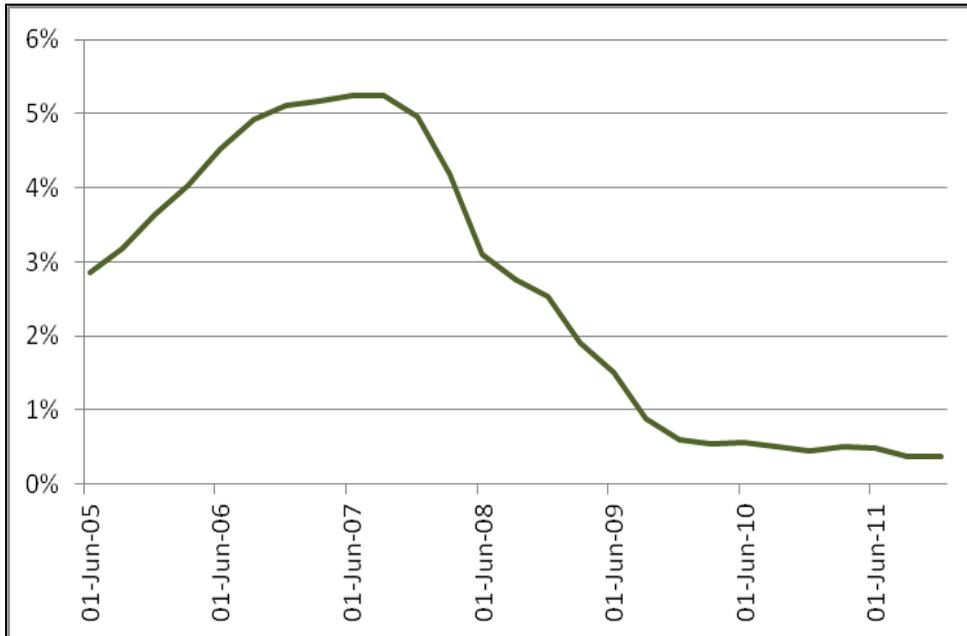


Although Interest Rates have Dropped, Revenue Generation not Materially Impacted

Another less significant reason annual revenues have fallen relates to the decrease in interest the Program has earned on loan repayments and on its cash balances. The Program was intended to fill the gap of affordable loans to encourage the tank replacement projects and protect groundwater. As such, under statute, interest rates charged on Program loans were set following the rates realized by state’s Pooled Money Investment Fund (SMIF). Since the Program’s move to the Board, SMIF rates charged have ranged from a high of 5.236 percent in 2007 to the current low rates of less than one half of one percent—.0378 percent in December 2011, as shown in Figure 10.

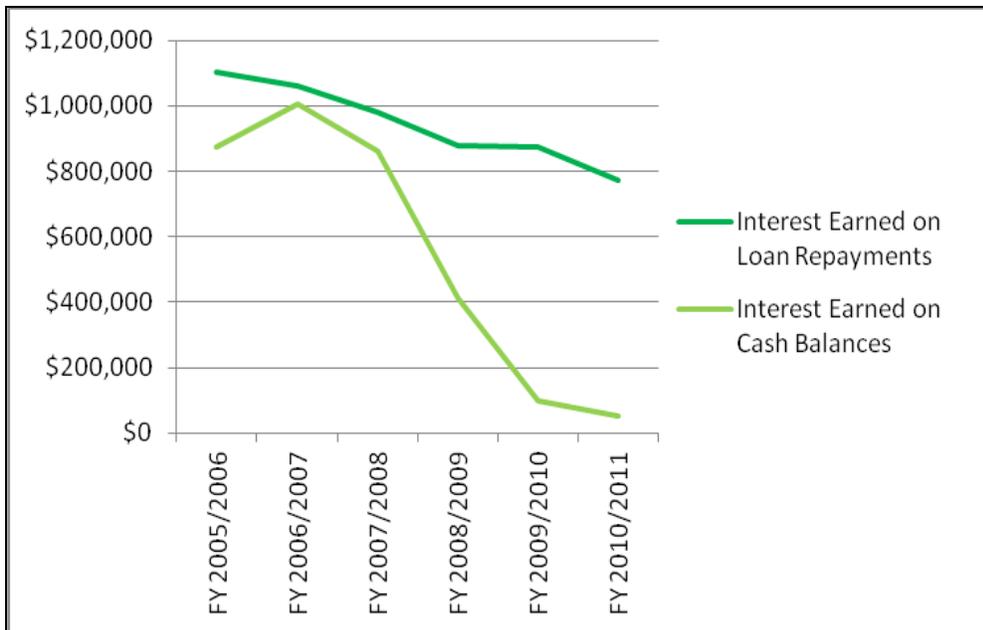
³ To bolster the program, an additional \$8 million (beyond the regular annual appropriation) was appropriated pursuant to AB 96 during Fiscal Year 2009-2010, which explains the spike in grants disbursed during this fiscal year.

Figure 10. SMIF Interest Rates—2005-2011



The fall in SMIF interest rates has impacted both money the Program earns on loan repayments and earnings on its fund balance that is invested in SMIF, shown in Figure 11.

Figure 11. Interest Earned on Loan Repayments and Cash Balances—2005-2011



The impact of the interest rate on Program interest earnings is modest, however. In fact as discussed in the next section, our projections suggest that an increase from .5 percent interest rate to 3 percent earned on future loans will only earn slightly over one million dollars in additional revenue between Fiscal Years 2011-2012 and 2016-2017.

The Program Lacks the Data to Project Future Demand

The RUST Program is unable to project future demand for loans and grants. According to Program management, they are unable to determine future demand for loans and grants due to a lack of information on the number of USTs requiring repairs. According to management within the SWRCB's Division of Water Quality, the Board's Geotracker System, a database that provides online access to environmental data related to USTs located near underground water wells, currently lacks information that would be necessary to estimate the future demand for repairs on USTs. Specifically, the database system lacks information regarding the age and construction of USTs and does not include data that relates to elements of program eligibility for tank owners, such as businesses size—businesses with fewer than 500 employees. However, the California Environmental Protection Agency (CAL EPA) is in the process of implementing a Centralized Environmental Reporting System (CERS) that will, among other things, provide comprehensive and centralized information on the number of USTs, date of installation, type of construction, etc. It is estimated that all local Unified Program Agencies (regulators) will be reporting into the system by January 2013. The Program should work with CAL EPA to utilize CERS to gather key data in order to project future demand, including estimating the number of tanks that will require repairs.

Program's Long Term Sustainability and Future Cash Position Uncertain

As described earlier, over the last six years, the Program's cash balances have declined significantly because revenues generated are insufficient to fund new loans and grants that are to be awarded annually and to support the Program's administrative costs. In addition to these current cash flow concerns, our projections indicate that the future viability of the Program beyond its scheduled sunset on January 1, 2016 is uncertain.

To analyze the Program's long-term sustainability and future cash position, we estimated the Program's cash position under the current and two adjusted funding allocation models. Each of the three scenarios was developed using the same assumptions related to demand for future loans, interest rates, loan late payment fee revenue, loan processing revenue, and administrative expenditures. The only key component that differs between the three scenarios is the level of the Program's funding dedicated to new loans and grant awards.

Our analysis reveals that if the current funding allocation model continues to be the basis for awarding grant monies, the Program will likely not have sufficient available resources to cover potential expenditures past the 2016 sunset date. However, if the Program adjusts its methodology to align grant awards with revenue generation, it will likely have sufficient cash flow through the end of 2018, not counting any additional infusion of cash.

As mentioned, our projections show that the Program is likely not sustainable past 2016 unless alternative funding allocations are adopted. As such, to provide program services beyond the sunset date, the Program must adjust its funding allocation model to link expenditures with revenue generating activities and refocus priorities related to grant awards, or infuse additional monies into the Program.

Current Funding Allocation Model Insufficient to Generate Enough Revenues to Cover Program Expenses or Maintain Cash Balances

The Program's current funding allocation model does not ensure sufficient revenues are generated to cover program expenditures, thus, steadily eroding the fund balance. Specifically, the current funding model budgets the amount available for funding grants each year as a percentage of the Program's annual spending authority rather than basing grant awards on levels of revenue generation from loan repayments and interest earnings. As mentioned earlier, the RUST Program is intended to be largely self-sustaining, where revenues generated by Program activities are utilized to fund annual loans and grants for replacing, removing, or upgrading petroleum underground storage tanks and for administrative activities. As such, aside from an infusion of \$8 million from a one-time transfer from the Underground Storage Tank Cleanup Fund (USTCF) when the Program moved to the Board in Fiscal Year 2004-2005, the Program does not receive additional fund appropriations and must generate sufficient revenues to support the Program and administrative expenses. The Program generates operating funds through the following sources:

- Loan Principal Repayments
- Interest Earned on Loans and Cash Balances
- Late Payment Fees and Application Processing Fees

The Program incurs expenses from:

- Loan Expenditures
- Grant Expenditures
- Administrative Activities

Annually, through the state's budget process, the Program receives an \$8 million spending authority appropriation that allows Program to spend monies from the Rust fund to issue loans and grants⁴. The California Health and Safety Code (HSC) restricts the amount of Program funds that can be utilized issuing grant awards. Specifically, HSC Section 25299.109 states that no more than 33 percent of annual available funds can be utilized awarding RUST grants with at least 67 percent (or more) to be utilized issuing loans. To comply with the funding restrictions, the Program has interpreted the provisions to not issue more than 33 percent, or \$2.64 million, of its \$8 million annual spending authority awarding grants. While the Program has the authority to spend \$8 million in total annually on loans and grants, the Program is ultimately limited in what it can expend to its available cash.

Although Program rules limit the total proportion of grants awarded annually in comparison to the loans approved, it could award a smaller percentage of its annual appropriation to grants in favor of loans. The purpose of limiting the amount of grants that can be awarded is to balance the funding to ensure that a sufficient amount of Program funds are utilized in issuing loans since

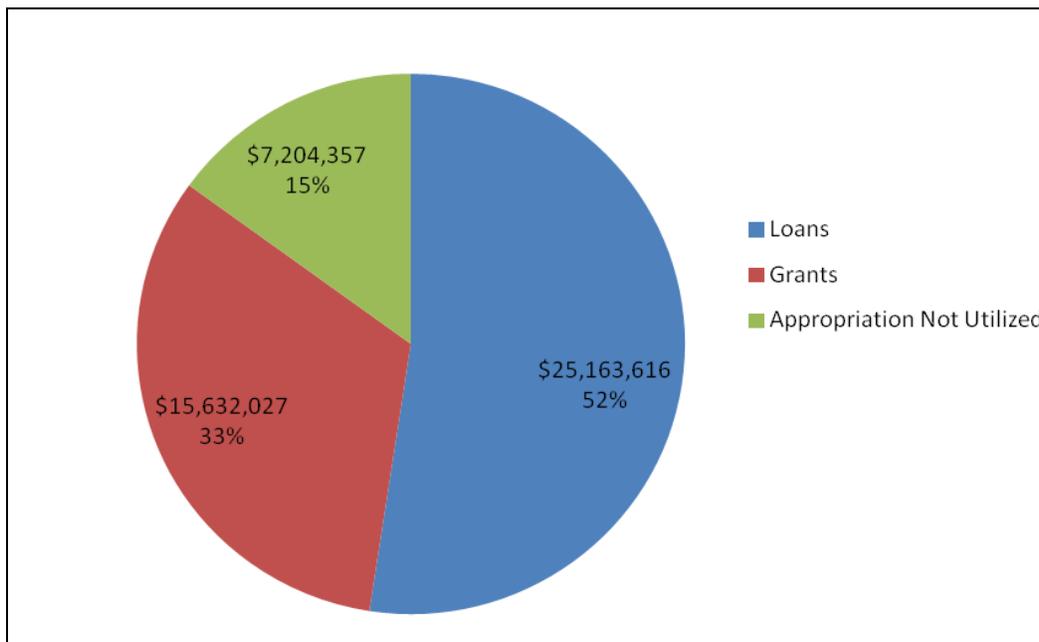
⁴ The Program also receives a separate annual allocation for administrative activities—about \$600,000 in 2010-2011.

loans that are repaid and on which interest is earned are significant drivers of the Program’s ability to generate revenue. Because loans are expected to be repaid and interest is paid on all outstanding balances, this revenue is essential to ensure the Program is sustainable. In other words, the Program must limit its grants as a proportion of loans to remain viable.

It is clear that the legislative intent in limiting the amount of grants to be awarded was to ensure that the majority of Program funds were to be utilized to issue loans and to maintain a sustainable revenue stream. The model that the Program adopted, however, is not viable in the longer term as it does not link grant expenditures to revenue generation activities. As a result, in the last six years the Program’s expenditures have outpaced the revenues and cash balances have declined.

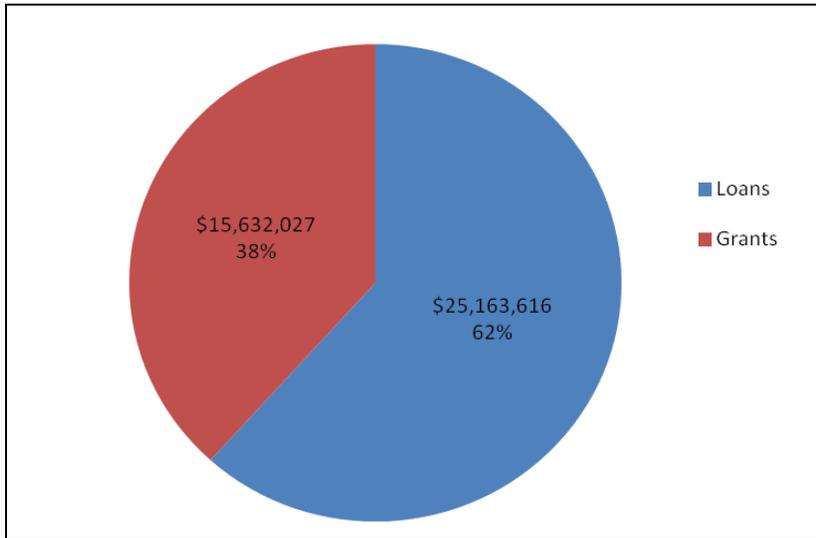
Over the six fiscal years through June 2011, the Program had the budgetary authority to spend \$48 million from the Rust fund; and it designated 33 percent of the \$48 million (the maximum amount allowed) to grant awards. As shown in Figure 12, while we found that the Program was in compliance with the requirement that no more than 33 percent of the \$48 million spent on grant awards, the remaining 67 percent of the appropriations was not utilized to issue revenue generating loans. In fact, only 52 percent of the available \$48 million in appropriations was used to issue loans and 15 percent was not utilized at all.

Figure 12. Regular Appropriation Spending Authority—2005-2011



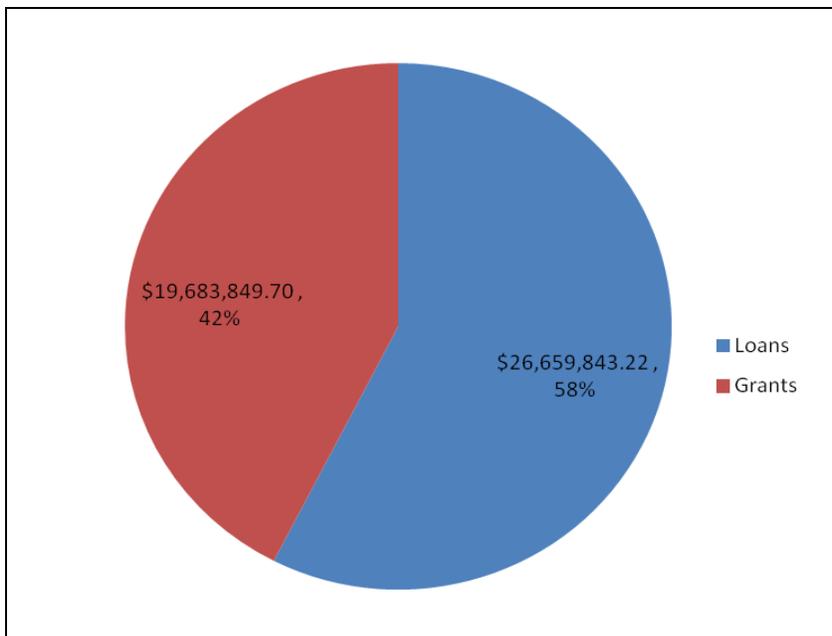
In total, only \$40.8 million of the \$48 million available spending authority was actually encumbered, or set aside when loans and grants are approved, because the Program had less demand for loans and did not need to utilize the entire spending authority. Of the \$40.8 million actually encumbered, grant awards comprised 38 percent of the spending authority consumed between Fiscal Years 2005-2006 and 2010-2011, as shown in Figure 13, which is more than the 33 percent intended.

Figure 13. Regular Appropriation Spending Authority Utilized—2005-2011



Moreover, while 38 percent of the spending authority was used for encumbering grant awards, 42 percent of the Program’s actual grant and loan *expenditures* were associated with grant awards, as shown on Figure 14. Grants make up a larger percentage of actual expenditures than annual appropriations because not all amounts set aside for a particular loan were expended as some projects do not require the entire awarded loan amount. To bolster the Program, an additional \$8 million (beyond the regular annual appropriation) was appropriated in Fiscal Year 2009-2010, of which only \$4.2 million was awarded—all of which went to funding grants and none to loans. This additional appropriation did not have restrictions similar to the regular funding that only 33 percent could be awarded to grant recipients.

Figure 14. Makeup of Loan and Grant Expenditures—2005-2011



As such, because grant and administrative expenditures are not tied to loan disbursements—the Program’s primary revenue generator—the Program cannot ensure its resources are utilized in the most effective manner to ensure sufficient revenues are generated by loan activities to cover grant awards.

Projections of Program’s Future Revenues and Cash Position under the Current and Adjusted Funding Appropriation Allocation Models

To analyze the Program’s long-term sustainability and future cash position, we estimated the Program’s cash position under the current and adjusted funding allocation models. We based our assumptions on changes to the ratio between future grant and loan expenditures as well as future payment projections and changes in interest rates. We created the following two models:

1. Grant Awards Not Tied to Revenue Generating Activities (Current Funding Appropriation Model)
2. Grant Awards Tied to a Percentage of Loan Expenditures

Both of the models were developed using the same assumptions related to projections of future loan expenditures, loan repayments, interest rates, loan late payment fees, loan processing fees, and administrative expenses. Specifically, for each of the two models, we based our projections on the following basic assumptions:

- Loan expenditures—since there is a lack of data to project potential future demand for loans, we estimated future loan expenditures to be comparable to the average over the last four years, \$3.70 million a year.
- Administrative expenditures—we estimated future administrative expenses to be the same as the last fiscal year of actual expenditure data—Fiscal Year 2009-2010. This assumption results in future annual administrative expenditures of \$350,000.
- Revenue generated via loan repayments:
 - Existing loans—we utilized annual payment and interest estimates data provided by Program management via their ABS system.
 - New future loans—we based future annual repayments on principal and interest calculated on \$3.70 million annual loan disbursements. We utilized the most recent interest rate established on loans of .5 percent.
- Loan late payment fee and loan processing fee revenue—we estimated future loan late payment and loan processing fee revenue to be the same as the last fiscal year of actual expenditure data—Fiscal Year 2009-2010. This assumption results in future annual loan late payment and loan process fee revenue of \$140,000.
- Interest rate revenue—as described in the previous section, interest rates have fallen over the last several years to about .5 percent where it has been since early 2010. Each of our three models takes a conservative approach by utilizing .5 percent as the rate the Program will earn on new loans issued. We found that even if we assume a more aggressive interest rate, the amount of additional revenue generated will not significantly alter the expected outcome of the models. For example, if we assume 3 percent interest rate will

be earned on future loans, about \$1.2 million dollars in additional revenue could be generated in total between Fiscal Years 2011-2012 and 2016-2017.

The key component in the two models relates to the Program’s grant awards. The first model utilizes the current funding allocation methodology and the second model utilizes adjusted funding allocation models where grant awards are tied to revenue generation activities rather than spending authority.

Projections under the Current Allocation Funding Model

Under our first model, we estimated the Program’s cash position under the current funding allocation model where grant expenditures are not linked to loans related proceeds, which is the Program’s key revenue generation activity. Under this model, we created two scenarios that both utilize the basic assumptions described earlier related to future loan repayments and other annual fee revenue as well as loan and administrative expenditures.

Under this model, we estimated that the Program would generate earnings on annual loans of about \$3.70 million, roughly the average amount of loans the Program has issued over the last several years with little marketing effort. As such, the Program could receive an additional \$24.2 million in annual principal and interest payments and other revenue between Fiscal Years 2011-2012 and 2015-2016, as shown in Table 1.

Table 1. Projections of Future Revenue Under Current Provisions

Fiscal Year	Annual Principal and Interest Payments on Existing Loans	Annual Principal and Interest Payments on Future Loans @ .5%	Annual Other Revenue (SMIF, Late Fees, & Processing Fees)	Grand Total
2011-2012	\$5,781,574	\$0.00 ⁵	\$140,000	\$5,921,574
2012-2013	\$4,060,852	\$379,404	\$140,000	\$4,580,256
2013-2014	\$3,876,380	\$758,808	\$140,000	\$4,775,188
2014-2015	\$3,095,660	\$1,138,212	\$140,000	\$4,373,872
2015-2016	\$2,893,418	\$1,517,617	\$140,000	\$4,551,035
Grand Total	\$19,707,884	\$3,794,041	\$700,000	\$24,201,925

Adding \$24.2 million in future estimated revenue to the Program’s cash balance of \$10.3 as of June 30, 2011, the Program will have approximately \$34.5 million in available cash from July 1, 2011 through Fiscal Year 2015-2016 to use for expenditures related to grant and loan disbursements and administrative activities.

We also assumed that future grant expenditures would continue to account for about 42 percent of grant and loan expenditures as has been the case since 2005 and illustrated in Figure 14. This

⁵ Projections were generated in March 2012 when Fiscal Year 2011-2012 was nearly over; thus, Fiscal Year 2011-2012 principal and interest payment projections included only payments on existing loans.

assumption results in future annual grant expenditures of about \$2.64 million, which is also the maximum portion (33 percent) of the Program’s annual spending authority that can be awarded to grant recipients. In total, the Program could incur expenditures of \$33.4 million, as shown on Table 2.

Table 2. Projections of Future Expenditures Under Current Provisions

Fiscal Year	Loan Expenditures	Grant Expenditures	Administrative Expenditures	Grand Total
2011-2012	\$3,700,000	\$2,640,000	\$350,000	\$6,690,000
2012-2013	\$3,700,000	\$2,640,000	\$350,000	\$6,690,000
2013-2014	\$3,700,000	\$2,640,000	\$350,000	\$6,690,000
2014-2015	\$3,700,000	\$2,640,000	\$350,000	\$6,690,000
2015-2016	\$3,700,000	\$2,640,000	\$350,000	\$6,690,000
Grand Total	\$18,500,000	\$13,200,000	\$1,750,000	\$33,450,000

Thus, under this model, the Program is projected to have approximately \$1.06 million in cash balance when it is scheduled to sunset in 2016. Extending the projections one additional year with the same assumptions, our projections indicate the Program’s cash balance will be in a negative position during Fiscal Year 2016-2017. Additionally, loan receivables outstanding will drop from about \$20.8 million in Fiscal Year 2011-2012 to about \$19.6 million during Fiscal Year 2016-2017.

Projections under an Adjusted Funding Model: Grant Expenditures are Linked to Loan Disbursement Estimates

To analyze the Program’s long-term sustainability and future cash position under various funding allocation models, our third model estimates the Program’s revenues and cash position under a funding allocation model where grant awards are linked to loan related proceeds, which is the Program’s key revenue generation activity. Similar to our first model, under this model we created two scenarios that utilize both the basic assumptions described earlier related to future loan repayments and other annual fee revenue as well as loan and administrative expenditures.

Scenario #1—Future Loan Disbursement Projections Based on Past Activity

Like the first model, we estimated that the Program would generate earnings on annual loans of about \$3.70 million and could receive an additional \$24.2 million in annual principal and interest payments and other revenue between Fiscal Years 2011-2012 and 2015-2016, as shown in Table 1. Adding \$24.2 million in future estimated revenue to the Program’s cash balance of \$10.3 as of June 30, 2011, the Program could have approximately \$34.5 million in available cash from July 1, 2011 through Fiscal Year 2015-2016 to use for expenditures related to grant and loan disbursements and administrative activities.

Under this model, future grant expenditures are tied directly to a percentage of projected loan disbursements—50 percent of the amount disbursed in loans is expended awarding grants. Since

this model assumes future loan disbursements of \$3.70 million annually, annual grant expenditures are then assumed to be about \$1.85 million. In total, the Program could incur expenditures of \$30.3 million, as shown in Table 3.

Table 3. Projections of Future Expenditures Grants Tied to Loans – Grant Awards are 50% of Loan Expenditures

Fiscal Year	Loan Expenditures	Grant Expenditures	Administrative Expenditures	Grand Total
2011-2012	\$3,700,000	\$2,640,000 ⁶	\$350,000	\$6,690,000
2012-2013	\$3,700,000	\$1,850,000	\$350,000	\$5,900,000
2013-2014	\$3,700,000	\$1,850,000	\$350,000	\$5,900,000
2014-2015	\$3,700,000	\$1,850,000	\$350,000	\$5,900,000
2015-2016	\$3,700,000	\$1,850,000	\$350,000	\$5,900,000
Grand Total	\$18,500,000	\$10,040,000	\$1,750,000	\$30,290,000

Thus, under this model, the Program is projected to have approximately \$4.3 million in cash balance when it is scheduled to sunset in 2016. Extending the projections several years with the same assumptions, our projections indicate the Program’s cash balance will not be in a negative position until Fiscal Year 2018-2019. Additionally, loan receivables outstanding will also be the same as the first model—dropping from about \$20.8 million at the end of Fiscal Year 2011-12 to about \$19.7 million during Fiscal Year 2015-2016. By Fiscal Year 2018-2019, loan receivables outstanding will be about \$19.4 million.

Scenario #2—Future Loan Disbursement Projections Based Increased Demand for Loans

We also created a second scenario under this model by estimating the impact on cash flow between FY 2011-2012 and 2015-2016 if more annual loans were issued as a result of increased marketing efforts for the loan program. For this scenario we utilized the same assumptions as the first scenario except that the Program would issue about \$5.36 million, or 67 percent of its annual appropriation, in future annual loans versus \$3.7 million given an increased effort to market the loan program and stimulate demand. We also continued our key assumption for this model that annual grant expenditures would be approximately 50 percent of annual loan expenditures, or about \$2.68 million, which also turns out to be the maximum portion (33 percent) of the Program’s annual allocation that can be awarded to grant recipients. Our projections reveal that while loans receivable outstanding will grow by about \$4 million under this scenario, the additional strain on cash flow from issuing additional loans will leave the Program with a cash balance of only about \$1.05 million by the end of Fiscal Year 2013-2014 and the Program will likely be in a negative cash position by Fiscal Year 2014-2015—four years earlier than the first scenario with a more conservative new loan disbursement projection. While the loan balance outstanding owed to the Program would be higher under this scenario than the first scenario, this latter approach creates more immediate cash flow problems since much more cash is going out in the short-term to fund the additional loans than is coming back into the

⁶ Projections were generated in March 2012 when Fiscal Year 2011-12 was nearly over; thus, Fiscal Year 2011-2012 grant expenditure projects were based more closely on actual figures.

Program in terms of repayments. As a result, it is clear that the Program must not only balance the strain on its immediate cash flow from awarding grants, but also from issuing loans.

The Program's historical funding model has provided enough funding to allow a "first-come-first-serve" approach to awarding grants and did not have a significant back log of grants that could not be filled within a reasonable amount of time, such as by the subsequent fiscal year appropriation. For either of the two scenarios under this model, the basic assumption is that the number of grants awarded need to be tied to loan expenditures, which will effectively reduce the number of grants that can be awarded annually—likely to a level where the demand from eligible grantees exceeds the funding available. As a result, the Program will have to develop a process to analyze the financial hardship of grantees based on predefined criteria and develop a priority list to rank grantees by financial hardship—which is a statutory requirement. Health and Safety Code Section 25299.105(c) provides that the priority list be based on financial hardship or the relative impact upon the local community.

Overall, the Program is likely not sustainable past 2016 under the current funding allocation model where grant monies are awarded at a certain level regardless of the amount of revenue that the Program generates through collections of loan repayments and interest earnings. As such, the Program must either adjust its funding allocation model to link expenditures with revenue generating activities, infuse additional monies into the Program, or allow the Program to sunset on January 1, 2016 as currently scheduled.

Recommendations:

To improve financial management practices and strategies in order to better manage the Program's cash flow, the Board and Program management should:

1. Adjust funding allocation model to link expenditures with revenue generating activities, infuse additional monies into the Program, or allow the Program to sunset on January 1, 2016 as currently scheduled.
2. Develop a financial analysis management process to monitor current and project future cash flow in order to find the correct balance between the level of grant funding, loan disbursements, and principal and interest repayments. This should include receiving cash management reports from the Accounting department on a regular basis.
3. Work with the Board's other related UST programs and CAL EPA to determine a methodology for identifying the pool of potential eligible program participants and estimating future demand for RUST loans and grants.
4. Seek approval to adjust Program legislation to provide management with more flexibility to move monies between sub accounts within the Program's fund.

Chapter II: While Program Administration Has Some Good Loan and Grant Processes in Place, Improvements are Needed

As mentioned in the previous chapter, the Board took over the Replacing, Removing, or Upgrading Underground Storage Tanks (RUST) Program (Program) from the Technology, Trade, and Commerce Agency (TTCA) when it was eliminated in 2004. Since the transition of responsibilities to the Board, staff has worked diligently to rebuild the Program developing new policies and procedures as very little documentation, records, or historical data was transferred. However, despite these efforts the Program could further be improved to ensure:

- ✓ Applicants comply with loan and grant eligibility requirements,
- ✓ Project costs are effectively evaluated for eligibility and reasonableness, and
- ✓ Maximum revenue generation on loan activity is obtained.

According to Program management, they have already begun incorporating several proactive changes, such as developing a tracking spreadsheet for loan servicing activities, revising templates for grants and loans, updating eligibility checklists with summary information for historical documentation, and focusing additional efforts on accounts receivable activities.

Program does not Always Ensure Applicants Comply with Loan and Grant Eligibility Requirements

According to Health and Safety Code Section 25299.102, to be deemed eligible for a loan, applicants must meet specific requirements, including:

- Be a small business domiciled in California that employs fewer than 500 employees and is independently owned and operated, and not dominant in its field of operation;
- Own or operate a project tank;
- Unable to obtain loan funding, upon reasonable terms, from private institutions, the California Pollution Control Financing Authority, or any other government board;
- Demonstrate the ability to repay the loan, and the availability of adequate collateral to secure the loan; and,
- Comply with hazardous substance storage and financial responsibility requirement laws, including possess valid operating permits.

Further, according to Health and Safety Code Section 25299.105, to be deemed eligible for a grant, applicants must meet specific requirements, including:

- Be a small business domiciled in California that employs fewer than 20 employees, is independently owned and operated, and not dominant in its field of operation;
- Legally able to conduct business and sell less than 900,000 gallons of gas annually for the previous two years;
- Comply with hazardous substance storage and vapor emissions laws including possess valid operating and construction permits;

- Conform with tank construction and monitoring regulatory requirements; and,
- Demonstrate that requested funding is only for the specific activity's leak prevention, detection, and monitoring, including being located near public drinking water wells.

Additionally, loan and grant applicants must submit an application along with specific financial and legal documentation to demonstrate the applicant's eligibility to participate in the Program and receive funding. For example, applicants must submit, where applicable, copies of required valid permits, environmental audits, cost proposals and budgets, corrective action plans, tax returns, employee tax forms, debt schedules, and insurance certificates.

While the Program reviews loan and grant applications for compliance with eligibility requirements and ensures that many conditions are met, we found instances where applicants did not comply with eligibility requirements described above. Specifically, the Program does not always ensure project tanks have an active operating permit; loans are secured prior to disbursement of funds; applicants demonstrate inability to obtain funding elsewhere or financial hardship; applicant creditworthiness is sufficiently analyzed; and applicants' number of employees does not exceed maximum allowed.

Project Tanks do not Always Have Active Operating Permits throughout the Life of Loan or Grant Agreement

Based on our review of rules and regulations as well as interviews with Program management, we determined that grant and loan recipients must have several types of permits in order to legally own and operate a petroleum underground storage tank and be eligible to participate in the Program. Those permits may include (when applicable):

- Underground Storage Tank (UST) permit issued by the local regulator when a business is deemed to be in compliance with relevant state and local rules and regulations.
- Permit to Operate (PTO) issued by the local Air Quality Management District to any facility that emits air pollutants (required as part of the RUST Program after August 2009 with the passage of AB 96).
- Tank Construction Permits—either 1) an Authority to Construct (ATC) permit issued by the local Air Quality Management District to any facility proposing to construct, modify, or operate a facility or equipment that may emit pollutants (required only when the project involves above ground work) or 2) other types of tank construction permits issued by various local regulators when projects involve removing or installing tanks.
- Notice of completion/final inspection issued by the local regulator after a project is complete.

Additionally, several sections of Program rules and regulations require that both loan and grant applicants have current permits issued by their local regulators at the time of application and throughout the life of the agreement. Specifically:

- Health & Safety Code Section 25284(a)(1) states that “no person may own or operate an underground storage tank unless a permit for its operation has been issued by the local agency to the owner or operator of the tank, or a unified program facility permit has been

issued by the local agency to the owner or operator of the unified program facility on which the tank is located.”

- California Code of Regulations (C.C.R.) Title 23, Section 3423 specifies that each loan agreement must maintain active permits and shall include “an affirmative covenant by the borrower that it shall continuously comply with any applicable federal, state, or local requirement, including requirements for operating tanks, throughout the term of the loan.”

Statutes provide some leeway regarding active operating permit requirements for loan recipients. Specifically, California Health and Safety Code Section 25299.103(b) states that “the department may not refuse to grant a loan to an applicant solely because the applicant has failed to obtain a permit to operate.” Provisions also stipulate that applicants provide an explanation of the reasons why the project tank is not in compliance with applicable local, state, or federal standards.

Our testing of 35 grants and 10 loans revealed that the loans and grants generally had the required PTOs, tank construction permits, and notice of completion/final inspections. However, our testing revealed that many required UST permits were either expired at the time of loan or grant agreement execution or at the time funds were disbursed. Specifically, we found three UST permits were expired at the time of grant agreement execution and four UST permits were expired at the time of loan agreement execution. Furthermore, grants and loans that may have had active UST permits at the time of agreement were expired at the time funds were disbursed. We found 13 grants and 8 loans had expired UST permits at the time of funds disbursement. While statutes provide some flexibility for permitting requirements related to loans, we did not find any evidence that the four loan applications with expired UST permits at the time of agreement execution provided the required detailed explanations. According to RUST Program management, the UST permits may have been current at the time of application, but expired by the time of agreement due to timing issues. Also, it has been the historical practice of the Program not to recheck UST permits for currency throughout life of the loan or grant; rather, UST permits are only checked at the time of grant or loan agreement execution.

The Program should develop procedures that will ensure borrowers and grantees possess the required active permits prior to execution of an agreement and throughout the term of the grant or loan. Processes in place should require staff review each required permit prior to the disbursement of Program funds to ensure permits are active and the recipient is in compliance with rules and regulations. The Program should consider inserting language in application instructions and contract agreements stipulating that recipients maintain valid permits throughout term of agreement and failure to do so will result in cancellation of the agreement and funding. When loan recipients are unable to obtain active UST permits prior to loan agreement, the Program should ensure that a proper explanation of the reasons why the project tank is not in compliance with applicable local, state, or federal standards.

Although the loans we reviewed generally had tank construction permits in the file, because the Program only requires tank construction permits at the time of disbursement and does not require applicants provide project work dates when submitting invoice reimbursement requests, Program records were insufficient to determine if the tank construction permits were active at the time

project worked was conducted. As discussed later in this chapter, the Program should require applicants to provide estimated work dates on their grant and loan application and provide actual work dates on their reimbursement requests to demonstrate that funding is used for eligible activities occurring after agreement execution and that tank construction permits were valid when work was conducted.

Further, because of the lack of information available within the loan files and the complexity and diversity of permitting requirements of local regulators, we were unable to consistently determine if required construction permits for removal and installation of tanks were obtained. Specifically, the type of permit required depends largely on the type of work to be performed. For example, if the work to be performed involves removing an underground storage tank then a tank construction removal permit may be required by either the local Air Quality District or another local agency and the Program. However, we noted that only vague scope of work descriptions were typically provided by applicants in project proposals, which lack sufficient detail for the Program's Loan Analyst to determine what types of permits may be necessary. Additionally, there are a multitude of local regulators and agencies across the state responsible for permitting underground storage tanks (UST operating permits) that are also responsible for authorizing the removal or installation of tanks and issuing corresponding construction permits. While all underground storage tanks must have operating permits issued by the local regulators, not all regulators have the same permitting requirements for construction work related to removing and installing tanks—some local regulators may require permits for all associated work or just parts of projects while other regulators may not require any permits. As a result, the Program's Loan Analyst must research the related provisions as well as contact applicants and various local regulators to get clarification on the work to be performed and determine the types of permits required based on the scope of work and local rules. Also, the loan files we reviewed did not contain notations regarding why regular construction permits for removal and installation were not required (i.e. local regulator did not require such permits)—thus, we were unable to determine if required construction permits were always obtained.

Program does not Always Secure Loans Prior to Loan Disbursement of Funds

The RUST Program provides loans ranging between \$10,000 and \$750,000 to qualified borrowers with terms of either 10 or 20-years—with 10-year loans being most common. In order to safeguard the Program's assets, borrowers must provide collateral to secure the loan. According to the Health & Safety Code Section 25299.103, a complete loan application is to include, among other items, "financial and legal documents necessary to demonstrate the applicant's ability to repay and provide collateral for the loan." Collateral includes a deed on real property (20-year loans) or a lien on business assets through a UCC filing with the County clerk where the project is located and the California Secretary of State (10-year loans).

Although the Program obtains a deed of trust at the time of loan execution on 20-year loans, Program practice has been to wait until after a 10-year loan is approved and executed before filing the UCC statement with the appropriate entities. According to Program staff, the UCC filing time frame is not specified in statute and Program practice has been to file the UCC form after the loan agreement has been executed, but before the first loan disbursement is made. According to Program staff, the practice began to prevent having to withdraw the UCC filing if the loan agreement was not executed. While Program staff indicate that it is practice to file UCC

statements soon after loan execution, our testing of 10 loans found four instances in which the UCC filing statement was completed after the initial loan disbursement and another instance in which the statement was never filed with the County. The missing UCC filing was filed during the audit when brought to the attention of Program staff.

Additionally, it has not been the practice of the Program to perform a lien search to identify how many other lenders have filed statements against the potential borrower's assets before executing a loan agreement or disbursing funds. According to staff, the Program has not considered its security interest position in the past other than in cases where subordinations are requested and the Program ensures the State's equity position would not be harmed by granting a subordination request. Failing to secure the loan before disbursement places the Program at risk of significant financial loss as the Program would have no claim on the borrower's assets in case of default.

Program Does Not Require Applicants to Demonstrate Inability to Obtain Funds Elsewhere or Financial Hardship

As part of the loan eligibility criteria, Health and Safety Code Section 25299.102(c) requires that applicants demonstrate that "loan funds are not obtainable, upon reasonable terms, from private institutions, the California Pollution Control Financing Authority, or any other government board." For grants, Section 25299.106(b) requires that the Program collect "financial and legal documents necessary to demonstrate the applicant's financial hardship" as part of the application process.

We found that the Program does not evaluate whether loan applicants were denied funding by other sources when applying for a RUST loan and does not require grant applicants to provide evidence of financial hardship. Currently, loans and grants issued to otherwise eligible applicants on a "first-come, first-served" basis until funds are exhausted each year regardless of whether they have a verified financial hardship or have been unable to secure funding from other sources. According to Program staff, providing evidence of financial denial or hardship has not been the practice or part of the eligibility and application process. Rather than issuing grants to only those applicants that demonstrate a financial hardship, SWRCB legal staff has interpreted the statute to only require Program staff to request documentation and analyze the financial hardship of grantees if there are more requests for funding than available and a priority ranking system was needed. [sentence deleted]

Although the RUST Program Analyzes Potential Borrowers' Ability to Pay, Analysis of Credit Worthiness is Lacking

While the Program is highly dependent on the revenue generated by borrowers repaying loans, the Program does not have formal guidelines to evaluate the creditworthiness of borrowers. According to Health and Safety Code, the Board shall make loan funds available to applicants that meet certain eligibility requirements, including the demonstrated ability to repay the loan through necessary financial and legal documentation [H&S Code Section 25299.102(d) and 25299.103(a)(3)]. Additionally, California Code of Regulations Title 23, Section 3426(a)(3) states the Board is to require that the applicant meets a set of requirements, including demonstrating that "the business is creditworthy."

When the Financial Development Corporation (FDC), an independent contractor that provides the Program with loan packaging services, submits the loan application of a potential borrower, it includes a calculation of the borrower's Times Fixed Charges Ratio (TFCR), which measures the borrower's ability to pay fixed expenses, such as rent and interest. A TFCR of "1" or greater is standard in the financial industry demonstrates that a company is able to pay its fixed charges. The information from the FDC also includes a copy of the borrower's credit report along with the FDC staff member's opinion related to the borrower's creditworthiness.

While the Program guidelines include specifics on evaluating a borrower's ability to pay, the Program does not have any policies that guide RUST Program staff in assessing a borrower's creditworthiness or likelihood of repaying the loan. Specifically, Program guidelines detail how to calculate the TFCR ratio and provide that a measure of "1" meets the Program's minimum financial standard for the ability to repay the loan without resorting to more debt. However, Program staff do not have formal guidelines for analyzing credit reports, and creditworthiness, of a borrower or have related measures to quantitatively accept or reject an applicant. While the TFCR may be an effective tool to determine whether a borrower can repay the loan, it is not an effective indicator for whether or not the borrower will repay the loan.

Grantees' Number of Employees does not Always Meet Statutory Maximum Requirements

According to Health and Safety Code requirements, grant applicants must "employ fewer than 20 full-time and part-time employees" and loan applicants must "employ fewer than 500 full-time and part-time employees" [H&S 25299.105(a)(1)(B) and H&S 25299.102(a)]. While our testing of 35 grants and 10 loans revealed that the Program generally approved loans and grants where applicants provided employee information consistent with statutory requirements, we noted one instance where an applicant exceeded the allowable number of employees. Specifically, statute specifies grantees can have a maximum of 20 employees, but the grant application indicated that the applicant had 26 employees. Without a careful and thorough review of grant application documents and assurance that the applicant meets eligibility criteria, Program staff cannot ensure that grant funds are appropriately issued in compliance with statute.

Overall, the Program must incorporate additional processes and procedures to ensure applicants comply with all grant and loan eligibility requirements. Improvements should include ensuring project tanks have an active operating permit; loans are secured prior to disbursement of funds; applicants demonstrate inability to obtain funding elsewhere or financial hardship; applicant creditworthiness is sufficiently analyzed; and applicants' number of employees does not exceed maximum allowed.

Program Lacks Necessary Cost Information to Effectively Evaluate Costs for Eligibility and Reasonableness

According to statute, up to \$50,000 can be granted and up to \$750,000 can be loaned to eligible applicants to pay for up to 100 percent of costs associated with upgrading, removing, or replacing underground storage tanks in order for tanks to meet the regulatory requirements of various underground storage tanks laws. To obtain funding, loan and grant recipients provide cost proposals at the time of application and then submit invoices for reimbursement of actual project costs throughout the term of the agreement.

While the Program has detailed administrative guidelines for gathering the necessary eligibility documentation when processing grants and loans applications, the Program lacks cost guidelines that detail the types of eligible activities for receiving funding and establishing corresponding reasonable cost ranges. Rather, staff must rely on personal knowledge and interpretation of the very broad wording in statute to determine if activities are eligible, allowable, reasonable, and necessary. Not only does the lack of cost guidelines increase the risk of inconsistencies between approved and denied costs, the risk also increases that Program funds can be utilized for ineligible or unnecessary activities. While our audit did not include performing detailed testing of approved cost proposals and invoices, we noted a lack of documentation provided by recipients. However, in our file review, we happened upon one approved invoice that appeared to have included an ineligible item—a cashier console. Although the cashier console does not appear to be a costly item, it represents the risk that ineligible expenses can be paid for with Program funds. The Program should work with the Board’s technical experts in the Leak Prevention Program within the Division of Water Quality to develop cost guidelines that expand on what activities are eligible and describe the typical types of activities that would be expected along with a range of costs.

In addition to the lack of cost guidelines, loan and grant cost proposals submitted by recipients generally lack cost detail required by statute. According to rules and regulations, loan and grant applications must contain detailed cost estimates of the tasks that are required to be completed. However, our review of 35 grants and 10 loans revealed that there is a general lack of detailed support for work proposed as well as charges actually invoiced. Rather, proposals often have a lump sum description of the work with a single line item cost associated. The lack of detailed documentation and support for costs in proposals and invoices limits the ability of staff to accurately evaluate and approve costs submitted for reasonableness prior to reimbursement. As such, in conjunction with newly developed cost guidelines, the Program should require applicants and contractors provide detailed cost estimates with line item activities and expenses sufficient enough for the Program to effectively evaluate the proposed project activities and costs for reasonableness and necessity.

According to the Program’s interpretation of Health and Safety Code Sections 25299.107 and 25299.104, loan and grant funds are limited to eligible costs that are incurred after agreement execution with the Board. However, through our testing of grants and loans between 2005 and 2011, we were unable to determine dates when project work began to ensure activity occurred after the grant or loan agreement was executed and that tank construction permits were valid when work was conducted because recipients are not required to provide date information with cost reimbursement requests. As a result, RUST staff cannot be assured that work performed was completed after grant agreement execution and could conceivably reimburse contractors or UST owners for work completed prior to loan or grant agreement execution. According to Program staff, while it does not require date information be provided, when it is clear that work was completed before loan agreement execution the costs are denied. Going forward, the Program should require applicants to provide estimated work dates on their application and provide actual work dates on their reimbursement requests to ensure funding is utilized for eligible activities that occurred after agreement execution and that tank construction permits were valid when work was conducted.

Moreover, we found that Program staff—employees that manage key administrative processes involved in processing and approving loans and grants—are not technically trained for determining the reasonableness or necessity of project costs. This lack of technical expertise combined with the lack of cost guidelines make it difficult for Program staff to assess whether activities proposed are necessary and whether associated costs are reasonable.

SWRCB legal counsel stated that under the current law, the RUST Program cannot deny costs because the costs are unreasonable. However, we believe good business practices and fiduciary responsibility require the Program to review costs for reasonableness. While it may be true that loan recipients have cause to ensure project costs are kept to a minimum as monies have to be repaid, the same cannot be said for grant recipients as those monies do not have to be repaid. Additionally, as the loan and grant recipients are small business owners—typically “mom and pop” stores—they likely do not have the expertise or sophistication to ensure costs are reasonable and necessary.

Overall, without adequate cost guidelines and technical review of costs and activities, the risk that Program funds are used to reimburse recipients for ineligible activities or unreasonable or unnecessary costs is increased. As such, we believe the Program would benefit from utilizing developed cost guidelines and seeking technical assistance from the Leak Prevention Program when submitted cost estimates or invoices fall outside of expected activities and costs outlined in the cost guidelines. If needed, the Program should consider seeking a statutory amendment to add reasonableness as a requirement.

Certain Loan Processes Require Improvement to Ensure Maximum Revenue Generation

Certain loan processes require consideration or improvement to ensure the maximum amount of revenue is generated, such as:

- ✓ Reconsidering paying loan packaging fees for applications that do not meet basic eligibility requirements;
- ✓ Formalizing processes for setting loan interest rates;
- ✓ Ensuring loan repayments begin timely and late payments are reported to credit bureaus; and,
- ✓ Utilizing a more robust loan tracking and servicing system.

Program Should Reconsider Paying Loan Packaging Fees for Applications that do not Meet Basic Eligibility Requirements

For assistance with loan packaging and marketing services, the Program utilizes the Financial Development Corporation (FDC) to locate small businesses that may be eligible for loans. As part of the agreement between the Board and FDC, the Program pays the FDC \$1,000 for each completed application submitted to the Program for funding consideration. Also, the loan applicants are charged a loan origination fee of two percent of the requested loan amount—one percent is paid directly to the FDC and one percent is paid to the Program. As loan packagers, the FDC’s role is meant to simplify the application process by making it easy for applicants to visit a field office and receive assistance in applying for a loan. According to the contract, FDC shall provide the following loan packaging services:

- Respond to inquiries and provide information on the RUST Loan Program.
- Review each loan package received to insure that all required financial and technical documents for the application are present, including but not limited to, current operating permits; insurance certificates and tax returns, etc.
- Analyze financial statements of potential borrowers and write credit analysis and prepare recommendation for each qualified loan package submitted to the State Water Board for funding consideration.
- Complete and forward loan packages to the State Water Board within 30 days of receipt of a complete loan application.

Each completed loan package includes a recommendation by the FDC to the Program to either approve or deny the loan applications, or conduct further cash flow analysis. The Program's Loan Analyst then conducts further analysis and provides recommendations to the Program's Loan Committee to approve or deny loans.

Currently, the Program pays the FDC \$1,000 for every loan application submitted, even if applicants are denied loans due to clearly not meeting eligibility requirements. In fact, the most recent loan application submitted by the FDC and denied by the Program involved work on an aboveground storage tank, which appears to be clearly ineligible since the Program is for work on underground storage tanks only. Although we could not determine the exact number of application denials due to the lack of data available, 42 loan applications submitted between 2005-2006 and 2010-2011 were ultimately rejected. While rejected loan applicants were not charged the two percent loan origination fee because they were denied, the Program likely paid the FDC \$42,000 in loan packaging fees on these applications that did not meet eligibility requirements. While the contract between the FDC and the Program does not explicitly state that the FDC must evaluate loan applicants against eligibility criteria to ensure applications submitted to the Program meet eligibility requirements, the Program may wish to consider renegotiating the contract to pay the FDC for loan applications that meet eligibility qualifications.

Program Should Formalize Processes for Setting Loan Interest Rates

According to Health and Safety Code Section 25299.104(b), the "interest rate for loans shall be set at the rate earned by the Surplus Money Investment Fund at the time of loan commitment." However, our testing of 10 loans revealed that the interest rates on the loans did not always match the SMIF interest rate, which is adjusted by the California State Controller on a quarterly basis, in place at the time of loan execution. Based on interviews with Program staff, interest rates are rounded up or down to the next half percentage point and are established during the process to prepare loan documents, but there is not a specific point in the process that triggers setting the interest rate. Also, because of delays that may occur when requesting and receiving required documents from the borrower, the loan agreement may not be executed until a significant amount of time after the interest rate is set. However, neither statute or policies and procedures mention utilizing a rounded SMIF rate. Going forward, the Program should establish a specific and consistent point in the loan application process to set the interest rate, such as the day the loan is formally approved. Also, the Program should comply with statute and utilize the exact SMIF rate established by the SCO.

Program Should Develop Processes to Ensure Loan Repayments Begin Timely and Late Payments are Reported to Credit Bureaus

After loan agreements have been fully executed, the Program does not have processes in place to ensure loan repayments begin on time. Specifically, upon execution of a loan, recipients can request disbursements up to the amount of the loan award for actual costs of upgrading, repairing, or replacing underground storage tanks. A borrower enters repayment status and begins making principal and interest payments on loans either when an entire loan award has been disbursed or when the borrower notifies the Program that the project is complete and no additional disbursements will be requested. Before borrowers enter repayment status, they are required to make monthly interest only payments on loan disbursement amounts received to date. Once a loan is fully disbursed and enters repayment status, the loan is entered into the Program's "ABS Mortgage Office" system, which generates amortization schedules, payment coupons, billing statements, and late notices.

Contracts between recipients and the Board have a provision that requires all cost reimbursements be obtained within a year of agreement execution in an effort to ensure projects are completed timely. Specifically, contracts state: "borrowers must submit invoices to the State Water Board for the entire loan amount within (12) months after the effective date of the Agreement." Borrowers can also formally request a time extension in writing. However, the Program does not regularly enforce this aspect of the contract and informally allows loan disbursements to occur up to two years after agreement execution without formal written extension requests by the borrower. According to Program staff, loans disbursements are informally allowed to occur up to two years after agreement execution to coincide with the Board's encumbering rules—after two years all undisbursed project award monies must be disencumbered.

Additionally, while the Program withholds 10 percent of each grant disbursement request until the borrower provides a "Notice of completion/final inspection" report issued by the local regulator after a project is complete, the Program does not have a similar requirement for loan borrowers even though loan agreements indicate the Board's option to withhold a retainer. Retaining a percentage of loan disbursement requests encourages borrowers and contractors to meet their contractual obligations and help assure completion of the construction according to plans and specifications. The Program should consider incorporating a retainer process within the loan program similar to the one utilized with the grant program—particularly since the funding involved with projects associated with the loan program is far more significant than the grant program.

Further, the Program does not currently have a mechanism to automatically place borrowers in repayment status to begin principal and interest payments on loan disbursements. Rather, the Program places borrowers in repayment status when:

- Borrower's disbursement request exhausts the entire loan award, or
- Borrower notifies the Program that the project is complete and any remaining loan award monies will not be requested.

However, if a borrower finishes their project for less than the entire award amount and does not notify the Program that the project is complete, the Program lacks a trigger to prompt the start of the repayment process. According to Program staff, borrowers are contacted if one year elapses without a disbursement request and additional funding is available on the loan award to determine if the project is complete and repayment should begin. While our testing of 10 loans revealed that most loans are placed in repayment status within one year of last disbursement, we found that two loans were not placed in loan repayment status within one year of the last disbursement and could find no evidence of follow up in the loan file. Specifically, in this instance the loan reflected that the last disbursement was made more than two years before the borrower was placed in repayment status. We noted that the most recent disbursement was made in October 2009 and records did not show any documented follow-up; however, the borrower was placed in repayment status in March 2012 as a result of our audit bringing the issue to the attention of Program staff. In a second instance, the loan reflected that the last disbursement was made in March 2009 and the loan was placed in repayment status in July 2011—we also could not find evidence of follow-up for this loan. According to the Program, calls were probably made to follow-up with the borrowers, but not documented.

In September 2011, the Program staff developed a manual tracking spreadsheet in Excel with information related to disbursement amounts and dates and remaining award funds available for all loans awarded, but not in repayment status. This spreadsheet will be utilized to track disbursements to ensure borrowers enter repayment status once all funds have been disbursed or to contact borrowers when disbursements have not been requested timely.

Moreover, once loans enter repayment status, the Program has procedures in place to collect payments from delinquent borrowers, but does not report late payment activity to the credit bureaus—even in situations where a borrower stops loan payments altogether. Specifically, all loan repayments are due on the first day of each month. If payments are not received by the 15th day of the month, the Program sends a late notice to the borrower and attaches a late payment to the account. After four late notices are issued in a row, a final demand letter is sent and the loan file is turned over to SWRCB legal staff who attempt to establish payment arrangements with the borrower. According to Program staff, a final demand letter has only been issued a handful of times since the Board took over the Program in 2004. While final demands may not be common, our testing of 10 loans revealed that three of the loans had several instances of late notices sent to the borrower. However, the Program does not have a process in place to report late payment activity to credit bureaus, which could help limit occurrences of late payments if borrowers are aware that making late payments could negatively affect their credit score. In order to best protect the Program's assets and provide greater accountability for borrowers, the Program should begin reporting late and missed payments to the credit bureaus. According to the Program, they will need to conduct a cost/benefit analysis related to implementing a credit bureau reporting procedure.

Program Could Benefit From a More Robust Loan Tracking and Servicing System

One issue facing the Program's loan services is the lack of a robust loan tracking and servicing system. The Program utilizes the ABS Mortgage Office system to generate amortization schedules, payment coupons, billing statements, and late notices. However, the Program does not utilize this system for project reporting and tracking capabilities, such as the ability to create

automatic triggers when a loan recipient has not requested a disbursement within a certain period of time or to use historical data for trending purposes, such as rate of late payments and defaults. It is unclear if the system has the needed functionality or if the Program has only been provided a limited segment of the system's full range of options available. In an attempt to address the lack of a loan tracking and servicing system, Program staff had recently proactively developed a manual loan tracking system in Excel, as previously described—however, a manual system will only be able to provide some limited additional benefit and would not be sufficient to provide the tracking and reporting data the Program needs.

The Board's Clean Water State Revolving Fund (CWSRF) utilizes the Loan and Grant Tracking System (LGTS), which is a database that allows the CWSRF program to efficiently track program and financial information. LGTS program staff enter information about individual projects and aggregate the data into program-wide reports for management and stakeholders. The LGTS system can provide a wide variety of tracking reports, such as whether applicants are requesting disbursement in a timely manner and automatically generates reminders if applicants appear to be falling behind with their projected disbursements.

Overall, there are additional operational improvements that could be implemented to strengthen controls and maximize the amount of revenue the Program generates, such as paying loan packaging fees on applications that meet eligibility requirements and formalizing processes to set interest rates. To insert more accountability into the process, the Program should develop processes to ensure loan repayments begin timely and establish a requirement that a retainer is held until projects are complete and late payments will be reported to the credit bureaus. Additionally, while Program management indicated that past attempts to transition the RUST program onto the LGTS, they may wish to continue with such efforts to utilize the seemingly more robust LGTS for the RUST Program.

Recommendations:

To improve the Program's operational processes and procedures to ensure effective utilization of Fund resources and improve accountability, the Board and Program management should:

5. Establish processes to require additional information on applications specifying the type of work that will be conducted to make it easier for Loan Analysts to determine the type of permits required, such as "Will project work involve above ground activities, Will project work involve removing a tank", etc.
6. Consider implementing a permitting check list to facilitate the review process that lists all of the potential types of permits that could be required by rules and regulations. Prior to loan or grant approval and funds disbursement, this checklist should be completed with an acknowledgement that active permits were obtained or a written explanation describing the reasons why a particular permit has not been obtained or is not required.
7. Ensure UCC filings are submitted timely and should search the UCC filing database prior to loan approval to identify the number of other lenders that have filed statements against the borrower's assets so the Program can effectively consider its security interest position.

8. Require loan applicants provide evidence that they were unable to obtain funding elsewhere.
9. Require grant applicants provide documentation demonstrating financial hardship and develop financial hardship criteria to ensure each applicant's financial position is evaluated consistently.
10. Develop processes to establish a grant priority list in the event that the number of grant applicants will exceed the available grant funding.
11. Implement qualification processes and criteria to evaluate the creditworthiness of potential loan applicants.
12. Develop and utilize cost guidelines that expand on what activities are eligible and describe the typical types of activities that would be expected along with a range of costs. Establish a risk-based process to seek technical assistance from the Leak Prevention Program when loans and grants meet certain criteria (high dollar value, submitted cost estimates or invoices fall outside of expected activities and costs outlined in the cost guidelines, etc.). If needed, the Program should consider seeking a statutory amendment to add reasonableness as a requirement.
13. Consider renegotiating the contract to pay the FDC for loan applications that meet eligibility qualifications.
14. Establish a specific and consistent point in the loan application process to set the interest rate, such as the day the loan is formally approved. Also, the Program should comply with statute and utilize the exact SMIF rate established by the SCO.
15. Formally determine when loan awards can be disbursed, such as 1-year after agreement execution per the current contract template or 2 years after agreement execution when all undisbursed monies are unencumbered. Once a determination is made regarding the time period allowed for borrowers have to request disbursements, enforce the stated policy.
16. Consider withholding a percentage of each loan disbursement request until the borrower provides a "Notice of completion/final inspection" report issued by the local regulator after a project is complete.
17. For all revised and new policies, update application notifications and the contract template between loan recipients and the Board.
18. Develop a trigger in the loan servicing process to ensure loans automatically enter repayment status at certain key intervals, such as when six months has elapsed since the last disbursement has been requested or 1 year after agreement execution. Also develop a process to manually enter borrowers into repayment status, such as when the borrower notifies the Program that the project is complete.
19. Report late and missed payments to the credit bureaus.
20. Continue efforts to utilize the LGTS for the RUST Program and/or work with the ABS Mortgage Office system vendor to determine if the system has additional options or modules that could provide the Program with the needed loan reporting and tracking functionality.

State Water Resources Control Board's Response to the Audit

State Water Resources Control Board

MAY 16 2012

Ms. Lynda McCallum
Sjoberg Evashenk Consulting, Inc.
455 Capitol Mall, Suite 700
Sacramento, California 95814

Dear Ms. McCallum:

RESPONSE TO THE DRAFT REPLACING, REMOVING, OR UPGRADING UNDERGROUND STORAGE TANKS PROGRAM EVALUATION REPORT

The State Water Resources Control Board (State Water Board) staff has reviewed the draft report for the above entitled audit and finds it to be a thorough analysis of the Replacing, Removing, or Upgrading Underground Storage Tanks (RUST) Program. State Water Board staff has also reviewed the 20 recommendations in the areas of funding allocation methodology and program administration and finds them to be well thought out and constructive. As noted in the report, the Program has already begun implementing initiatives that target the weaknesses noted in your draft report. Implementation of the recommendations will require careful consideration and coordination to ensure that the State Water Board achieves the desired results of a more efficient program and maximizes the amount of revenue the Program generates through loan repayments. Also, as noted in the report, implementation of some of the recommendations may require legislative action. Following receipt of the final report, State Water Board staff will develop an action plan to implement the recommendations with consideration of priority, feasibility, and authority.

Thank you for your work on this project; we believe the effort will be instrumental in improving the administration of the RUST Program in both the financial and operational areas.

Sincerely,



Thomas Howard
Executive Director