



UNITED STATES ENVIRONMENTAL PROTECTION AGENCY
REGION IX
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JUN 28 2017

Ms. Leslie Laudon
Deputy Director, Division of Financial Assistance
California State Water Resources Control Board
P.O. Box 100
Sacramento, CA 95812-0100

Dear Ms. Laudon:

I am pleased to present you with the EPA Region 9 Program Evaluation Report (PER) for the California Drinking Water State Revolving Fund (DWSRF) and Clean Water State Revolving Fund (CWSRF) programs for state fiscal year 2015/2016. The PER is based on the California State Water Resources Control Board's (State Water Board's) *DWSRF and CWSRF Annual Reports for Fiscal Year 2015/2016*, both dated October 31, 2016, audited financial information and additional information gathered in conjunction with EPA's site visits to the State Water Board in January and February 2017.

The PER addresses California's performance and compliance with the requirements of the DWSRF and CWSRF programs and the capitalization grant agreements. The PER provides EPA's observations and recommended or required follow-up actions for improving the program. The following main required follow-up actions are described in more detail in the PER:

- **Unliquidated Obligations (ULO)** - *In support of EPA's DWSRF ULO reduction strategy, the California DWSRF is required to liquidate all funds from the FY 2014 DWSRF capitalization grant, grant # FS-98934914, by September 30, 2017.*
- **Compliance with Reporting Requirements** - *EPA asks that the California DWSRF program ensure that the project and health benefit information for the projects listed in Table I of the PER is correct and entered in the Project and Benefits Reporting System (PBR) by September 30, 2017.*

We wish to acknowledge the positive action California has taken to reduce DWSRF unliquidated obligations (ULO), increase fund utilization and maintain strong financial performance. The California DWSRF executed over \$322 million in new assistance agreements during the period under review. The projects funded by these new assistance agreements have improved the California DWSRF program's rate of fund utilization, which surpassed the national program

average rate, and will help reduce ULO as they proceed to construction. EPA commends the State Water Board for these accomplishments, and we look forward to continuing our combined outreach efforts to bring public attention to the infrastructure successes being funded by both SRF programs.

EPA thanks the Division of Financial Assistance (DFA) for the progress and improvements they have made in reducing improper payments. The installment of new internal controls and operational modifications have greatly improved the overall financial administration and operations of the program thereby reducing the occurrence of improper payments.

EPA also commends California for being committed to the shared goal of supporting small systems and disadvantaged communities. On May 18, 2016, the DFA's Office of Sustainable Water Solutions presented information to the State Water Board and the public about a new combined three-year strategy for small and/or disadvantaged communities wastewater and drinking water capacity development. This strategy functionally aligns with EPA Region 9's fiscal year 2017 *Small Public Drinking Water System Action Plan* and goal to develop sufficient capacity to assure consistent compliance with the Safe Drinking Water Act as well as the goals of the Clean Water Act through the implementation of the CWSRF.

I would like to express my appreciation for the assistance that your staff provided during the review. We are committed to working with you to address the concerns identified in the PER and to discussing with you further refinements in the California DWSRF and CWSRF programs. If you have questions about the PER, please call me at 415-972-3420.

Sincerely,

A handwritten signature in blue ink, appearing to read "Douglas E. Eberhardt", with a long horizontal flourish extending to the right.

Douglas E. Eberhardt
Manager, Infrastructure Section

Enclosures

cc (electronic w/o encls):
Jim Maughan, DFA
Darrin Polhemus, DDW
Lance Reese, DFA
Josh Ziese, DFA
Kelly Valine, DFA
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PROGRAM EVALUATION REPORT
California Drinking Water and Clean Water State Revolving Fund Programs
Based on the State Fiscal Year 2016 California Annual Reports
On-site Reviews Conducted January 9-13 and February 15-16, 2017

I. Introduction

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

To provide EPA with timely information on the progress and many accomplishments of the California DWSRF program for the review period ending June 30, 2016, the State Water Board submitted to EPA a draft of the California DWSRF Annual Report on October 31, 2016. A final version of the California DWSRF Annual Report was dated and submitted on February 1, 2017, and a final report of the California CWSRF Annual Report was submitted to EPA on October 31, 2016.

During January 9-13 and February 15-16, 2017, EPA conducted its annual on-site reviews of the two California SRF programs. Staff from EPA visited the State offices to review selected project files and cash draws, and to talk with state staff about various aspects of the California SRF programs. To ensure that the annual review addressed all the major elements for the SRF programs, EPA staff completed the *SRF Annual Program, Project and Financial Review Checklist* for each SRF program, Attachment 1.

Based on the California annual reports for SFY 2015/2016, evaluation conducted at EPA's office and the on-site visits, EPA has prepared this program evaluation report (PER) documenting the results of this year's annual review. The PER covers all program activities from the program inception to the present, with major emphasis on the activities performed during SFY 2015/2016. The PER evaluates the State's ability to achieve the intent of the DWSRF and CWSRF program and comply with grant agreements. The PER contains findings and observations from the review and identifies follow-up actions to be addressed in SFY 2016/2017, referencing EPA's Notice of Non-compliance and California's Corrective Action Plan for the DWSRF program, as appropriate.

II. Background and Scope

The California DWSRF uses federal capitalization grants, state match funds, loan repayments, and interest earnings to make loans for construction of drinking water treatment facilities and support several

Safe Drinking Water Act programs. Since the program began in 1998 through June 30, 2016, the California DWSRF has executed 402 loans totaling approximately \$2.58 billion¹.

The California CWSRF uses federal capitalization grants, state match funds, loan repayments, bond proceeds and interest earnings to make loans for construction of wastewater treatment facilities, the implementation of nonpoint source water quality control projects, and the development and implementation of estuary enhancement type projects. Since the program began in 1988 through June 30, 2016, SWRCB has executed 747 loans totaling approximately \$9.15 billion¹.

The California DWSRF and CWSRF programs are required to maintain the following program and financial elements, which EPA assessed during its review. Elements noted with an * are discussed in Sections III and IV of this report. The other elements were found to be acceptable and do not require further discussion.

Required Program Elements

- Annual/Biennial Report
- Funding Eligibility*
- Compliance with DBE Requirements
- Compliance with Federal Requirements and Grant Conditions: i.e., Cross-Cutting Authorities, American Iron and Steel, Davis-Bacon, Additional Subsidy, and Green Projects, Reporting*
- Compliance with Environmental Review Requirements
- Operating Agreement
- Staff Capacity
- Set-aside Activity* (DWSRF only)
- Status of Corrective Action Plan* (DWSRF only)

Required Financial Elements

- State Match
- Binding Commitment Requirements
- Rules of Cash Draw (including improper payments) *
- Timely and Expeditious Use of Funds*
- Compliance with Audit Requirements
- Assistance Terms
- Use of Fees
- Assessment of Financial Capability and Loan Security
- Financial Management

The scope of the annual review includes consideration of the legal, managerial, technical, financial and operational capabilities of the State Water Board to manage the California SRF programs.

EPA Region 9 used the SRF Annual Review Guidance, SRF Annual Program Review Checklist, Project File Review Checklist, Transaction Testing Checklist, and data collected in the National Information

¹ As of June 30, 2016, and as reported in the National Information Management System (NIMs)

Management System for SRFs to ensure that all major elements of the program were reviewed and discussed with the California DWSRF and CWSRF management and staff.

In response to the Improper Payments Elimination and Recovery Act of 2012 the Office of Management and Budget through the EPA Office of the Chief Financial Officer directed that the State Revolving Funds be subject to testing of a random selection of SRF transactions to develop a national estimate of improper payments from these programs. Therefore, for this review, eleven DWSRF and four CWSRF program cash transactions totaling over \$45 million were selected for testing by the Office of the Chief Financial Officer.

III. California DWSRF Program: Observations and Follow-up Actions

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

A. Program Management

1. Funding Eligibility - Extended Term Financing (ETF) for Public Water Systems serving Non-Disadvantaged Communities

On October 26, 2016, the State Water Board sent a letter to EPA Region 9 requesting a waiver from criterion #5 of the EPA DWSRF ETF Memorandum dated April 14, 2014. Criterion #5 requires that state DWSRF programs demonstrate that the future lending capacity of the fund is not significantly impacted by offering ETF to public water systems serving non-disadvantaged communities. This memorandum requires a state to demonstrate that expected repayments from the fundable list on which these ETF projects are listed does not decrease by more than 10% annually over the next 5 years, as compared to the condition under which those projects would have received 20-year term loans at a comparable rate.

EPA agrees that the California DWSRF should not be restricted by the no more than 10% reduction in repayments criterion. EPA agrees that the letter from the State Water Board amply justifies allowing California's DWSRF to reasonably modify the percentage decrease in expected repayments over a 5-year period per criterion #5.

The State Water Board's letter proposed several steps for the California DWSRF to follow to closely monitor the management of the DWSRF as it relates to the amount of ETF provided on an annual basis and its fiscal impact on the DWSRF. EPA has reviewed these steps and believes they, as modified below, are appropriate and will safeguard the future lending capacity of the fund, improve the affordability of projects for program participants, and potentially increase the lending activity of the California DWSRF.

Recommended Follow-up: EPA recommends that the State Water Board adhere to the following steps when evaluating plans to offer ETF to public water systems serving non-disadvantaged communities:

1. The State Water Board's Division of Financial Assistance (DFA) will include in its proposed Intended Use Plans the long-term impact (i.e., over a 5-year period) on the DWSRF resulting from proposed ETF amounts in that SFY.
2. The proposed annualized ETF amounts and resulting fiscal impact will be made available publicly as part of the State Water Board's consideration of future DWSRF Intended Use Plans.
3. USEPA will be notified and will be able to review the proposed ETF amounts and the resulting fiscal impact and provide comments/concerns as part of the State Water Board's consideration and adoption of future DWSRF Intended Use Plans.
4. DFA will also include in its annual DWSRF reports to USEPA the actual amounts of ETF provided and the resulting fiscal impact on the DWSRF.

EPA appreciates the opportunity to be involved in the future review and approval process of the California DWSRF program's ETF initiatives.

2. DWSRF Set-aside Activity

- a. DWSRF Withholding Determinations:** EPA's review of State's operator certification and capacity development programs finds that the State Water Board has approvable programs and continues to make incremental improvements to meet the needs of their respective communities. EPA's determination is largely based on reports submitted by the State Water Board for the two programs annually and on more comprehensive program reviews that EPA conducts periodically. Ongoing management discussions between State Water Board and EPA confirm that California is meeting the intent set forth in the Safe Drinking Water Act.

EPA is, however, concerned about the timeliness of submission and thoroughness of content of annual and triennial reports for the capacity development and operator certification programs required by the PWSS grant work plan as well as the newly-aligned 10% set-aside work plan. For several years, EPA has requested that the number of public water systems (PWSs) that do not have a properly credentialed operator, and the number of enforcement actions taken when this circumstance occurs, be reported in the annual operator certification submittal, but this information has not been included.

Recommended Follow-up: EPA recommends that California prioritize development and submission of complete reports in a timely manner (i.e., by August 15 of each year) that allows sufficient time for EPA review to help ensure full award of the SRF capitalization grant. EPA also suggests that steps be taken to optimize these programs such that measurable improvement in respective community performance can be demonstrated.

- b. Coordination between the DWSRF and PWSS Programs regarding Capacity Development and Operator Certification:** Since the transition to the State Water Board, the capacity development and operator certification programs have been separated from the PWSS program and placed with the DWSRF. This change has created new communication

and coordination challenges both within State Water Board as well as to EPA Region 9. In last year's PER, EPA recommended, among other things, that California update its capacity development strategy to (1) include the new activities that are being conducted by the PWSS and DWSRF programs to support the capacity development program, and (2) improve communication, coordination, and management of expectations between the PWSS and DWSRF programs. In response, the State Water Board had asked to hold off on revising the strategy to allow the reorganization to settle in and to see if pending legislative initiatives became law.

Recommended Follow-up: EPA recommends that the State Water Board revise its capacity development strategy by December 30, 2017, to reflect changes to the capacity development program that it has implemented in recent years. Updating the strategy may also make improving the capacity development annual report easier.

3. Status of Correction Action Plan (CAP)

In response to the EPA's April 19, 2013, Notice of Noncompliance, CDPH submitted its CAP to EPA on June 24, 2013, which EPA approved on July 23, 2013. The CAP identified the actions needed to address each of the required elements in the notice of non-compliance, and included a schedule of deliverables and their due dates.

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

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

4. Compliance with Federal Requirements and Grant Conditions

a. Project and Benefits Reporting

On December 22, 2014, Ronald Bergman, Acting Director, Drinking Water Protection Division issued an EPA memorandum addressing the need for more complete data on the public health benefits of DWSRF projects and on project status as reported in the Project and Benefits Reporting System (PBR).

This emphasis on data completeness for PBR arose in response to an EPA Office of Inspector General internal audit that found missing data in critical fields that contribute to determining public health outcomes.

In reviewing the California's PBR for completeness, EPA found that it had no missing data in critical fields. However, our review did find a couple of inconsistencies between the project information reported in the California DWSRF Annual Report versus PBR. For example, there are cases where projects listed in the Annual Report are missing in PBR, and there are also project dollar amounts reported in the Annual Report that differ from the

amounts reported in PBR. Table I lists the projects that are either missing from PBR or showing conflicting financial information:

Table I. – PBR Discrepancies

| DWSRF Project Name | Dollar Discrepancy | Missing in PBR |
|---|---------------------------|-----------------------|
| 1. Las Deltas Mutual Water System | X | |
| 2. Firebaugh, City of - Las Deltas Mutual Water Company | X | |
| 3. Donner Summit Public Utility District – Big Bend Water Users Association (planning assistance) | | X |
| 4. City of Colusa - Del Oro Water Co. Walnut Ranch (planning assistance) | | X |

Required Follow-up: EPA asks that the California DWSRF program review and correct the information in PBR for the projects listed in Table I, by September 30, 2017. EPA appreciates the State Water Board’s support in improving the Agency’s ability to report on the public health benefits of the DWSRF projects.

b. American Iron and Steel

During EPA’s project file review of the City of Livingston, a copy of the AIS certification was not in the project file. The California DWSRF project manager requested a copy directly from the recipient, and EPA was then able to verify compliance with the AIS requirements for this DWSRF project.

The California DWSRF is responsible for collecting or reviewing certifications of compliance with the American Iron and Steel requirements from assistance recipients. This review occurs during the on-site inspection by the project manager. The assistance recipient is required, as part of the financing agreement, to keep AIS documentation on file. Typically, the California DWSRF does not keep a copy of the certification in its project file to help minimize the number of files that need to be stored.

Recommendation: To ensure proper and accessible file documentation of a project’s AIS status, EPA recommends that the final project inspection checklist, which is completed by the project manager, be modified to include an entry that addresses AIS compliance. In doing so, documentation of the project’s AIS status will be available in the project file without encumbering the file with any new forms or documents.

B. Financial Management

1. Rules of Cash Draw and Improper Payments

Cash draws from the federal treasury for DWSRF expenses must be based on eligible incurred project or set-aside costs. Any inconsistency between the eligible incurred costs, the allowable

draw proportion, and amount drawn is considered an improper payment. As part of EPA’s oversight of the DWSRF program, EPA reviews state cash draws to protect against waste, fraud and abuse, and to minimize and document improper payments.

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

EPA tested a total of eleven California DWSRF cash transactions as described in Table II, which were selected through statistical sampling.

Table II. California DWDRF SFY 2016 Cash Transactions Tested

| Number of Transactions Tested | | | Dollar Amount of Tested Transactions | | |
|-------------------------------|----------|--------|--------------------------------------|----------|-----------------|
| Total | Improper | Proper | Total | Improper | Proper |
| 11 | 1 | 10 | \$38,738,975.65 | \$0.30 | \$38,738,975.35 |

EPA reviewed all the invoices or accounting records associated with each cash draw. This effort was conducted on January 9-13, 2017. In addition, the state provided additional back-up documentation via email in the following weeks to clarify any outstanding questions.

As noted in Table I, EPA identified a total of \$0.30 in improper payments that occurred during SFY 2016:

- The State Water Board miscalculated and underpaid a claim to the Los Angeles Department of Water and Power (LADWP) by \$0.30. The cash draw of \$1,301,009.51 is linked to this improper payment.

A function of EPA’s transaction testing is to also review the suitability of incurred project costs. EPA found that the DFA does an excellent and thorough job of scrutinizing the eligibility of DWSRF project construction, engineering/design, and administrative costs submitted for reimbursement, but that this review is not always well documented. In reviewing the claims from some of the large dollar DWSRF projects, EPA found several of the calculations and notations documenting cost adjustments and reimbursements to be confusing and difficult to authenticate. The reason(s) for and dollar amount of the claim adjustments were unclear and not easily tracked. In addition, the level of thoroughness and detail for each project claim adjustment varied from project to project. It was through the on-site discussions with the DWSRF disbursement analysts that EPA confirmed that the project claim adjustments were justified.

The transaction testing worksheets for each cash draw tested for the DWSRF can be found in Attachment 2.

Required Follow-up: None. On May 9, 2017, Lance Reese with the DFA notified EPA by email that the DWSRF contract #2012CX105 to LADWP had been fully disbursed. The full disbursement of this contract rectifies the \$0.30 improper payment related to the cash draw of \$1,301,009.51 and identified during EPA's annual review.

Recommended Follow-up: The size and complexity of the projects funded by the California DWSRF underscore a need for careful documentation of claims and project cost eligibility determinations. EPA recommends that DFA develop a standardized written format and protocol that displays the calculations and reasons for a project claim modification. By doing so, a clear representation and history of the project claim adjustment and payment will be available to anyone reviewing a project claim file.

2. Timely and Expeditious Use of Funds

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

On April 19, 2013, EPA found the California DWSRF in non-compliance with the federal regulation and the terms and conditions of the capitalization grant agreement governing expeditious and timely use of the DWSRF funds. In response, CDPH submitted the CAP to EPA.

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

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

The DWSRF financial indicators for states that have not leveraged, such as California, show that California's SFY 2015/2016 DWSRF performance varies, see Table III. California made significant improvements over its previous year's performance, and now exceeds the national average for pace or fund utilization rate. However, when compared to the national averages for non-leveraged states, the California DWSRF remains below the national averages for a couple of the performance indicators.

Table III. California DWSRF Performance Indicators from NIMS

| As of 30 June | DWSRF 2015 | | DWSRF 2016 | |
|--|-------------------------|-------------------|-------------------------|-------------------|
| DWSRF Performance Measures - Cumulative | National Average | California | National Average | California |
| Fund Utilization Rate (line 419) | 93.1% | 107.5% | 93.1% | 113.1% |
| Disbursements as % of Assistance Provided (line 420) | 82.1% | 71.1% | 82.6% | 69.9% |
| Set-aside Spending Rate (line 424) | 87.3% | 87.2% | 88.9% | 92.0% |
| Return on Federal Investment (line 418) | 130.6% | 111.6% | 131.2% | 113.8% |
| Unliquidated Obligations (ULO) as a % of Federal Cap Grants (source of data from EPA Compass Data Warehouse) | 6.4% | 10.8% | 3.9% | 5.3% |

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

In accordance with the CAP, the California DWSRF has taken steps to improve its commitment and utilization of funds. It executed over \$322.7 million in assistance agreements in SFY 2015/2016, a substantial increase from the previous fiscal year of \$104.6 million. The NIMS report showed that the State Water Board increased its California DWSRF fund utilization rate progressively and substantially over the past several years. EPA commends the California DWSRF for improving its financial performance.

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

- b. Use of Federal and Non-federal Funds:** Funds that EPA has awarded to a state in a capitalization grant, but that the state has not yet drawn from the U.S. Treasury, are considered unliquidated obligations (ULO). As of April 14, 2014, EPA has established a new national strategy to reduce ULO under the DWSRF. The strategy focuses on two key objectives: (1) liquidation of past years’ grant funds, and (2) maintenance of lower levels of ULO in future years.

As of the date of this PER, the California DWSRF liquidated all funds from previous DWSRF grants, i.e., FY 2013 and prior years' funds, by the end of September 2016 as prescribed by the DWSRF ULO reduction strategy.

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

The California DWSRF expects to liquidate grants within two years from the date of grant award except for some FY 2014 set-aside funds. On July 26, 2016, EPA reviewed and approved the State Water Board's July 20, 2016, request for additional time to use set-aside funds from the federal fiscal year 2014 DWSRF capitalization grant. The California DWSRF plans to use these set-aside funds to support the State Water Board's new capacity development strategy. As such, EPA approved their request for an extension to liquidate these set-asides by September 30, 2017. As of March 14, 2017, \$1,800,923.91 in unliquidated set-aside funds remain.

During implementation of the CAP, the California DWSRF program made substantial progress in its effort to quickly and efficiently expend funds and close-out federal capitalization grants. Table IV illustrates the timely and expeditious use of federal funds and shows that the California DWSRF ULO as a percentage of the federal capitalization grants is at 5.3%, which is close to the national average of 3.9%.

Table IV. California DWSRF ULO as of 07/01/2016

| State | All Funds (Project & SA) | | | Project Funds Only | | | Set Aside Funds Only | | |
|-------|----------------------------|-------------------|-----------------------------------|-----------------------|-------------------|--------------------------------------|----------------------|------------|---------------------------|
| | Federal Cap Grants Awarded | Project & SA ULOs | ULOs as a % of Federal Cap Grants | Project Funds Awarded | Project Fund ULOs | ULOs as a % of Project Funds Awarded | SA Awarded | SA ULOs | ULOs as a % of SA Awarded |
| CA | 1,704,446,058 | 89,847,928 | 5.3% | 1,493,663,346 | 71,067,260 | 4.8% | 210,782,712 | 18,780,668 | 8.9% |

While EPA is paying attention to ULO, the requirement to expend funds in an efficient and timely manner applies to state match, repayments, interest, and other non-federal funds as well. EPA believes the State Water Board's ongoing efforts to implement progressive program improvements and cash management strategies will help it maintain a low rate of unspent federal and non-federal funds.

Required Follow-up: In support of EPA's DWSRF ULO reduction strategy, the California DWSRF is required to liquidate the remaining funds from the FY 2014 DWSRF

capitalization grant, FS-98934914, by September 30, 2017. DFA should notify EPA upon liquidation of these funds.

c. Disbursements as a Percentage of DWSRF Assistance – Based on Cumulative Activity:

While the fund utilization indicator reflects how quickly the California DWSRF commits funds to projects by signing assistance agreements, the disbursement rate reflects how quickly the California DWSRF disburses funds (i.e., federal cap grants, state match, and repayments) to systems. In SFY 2015/2016, the California DWSRF disbursement ratio was 69.9%, which is slightly below its previous year's value of 71.1%. The State's performance also lags the national average of 82.6%. EPA will, in the coming year, focus on the successful use of the whole fund and the importance of not having large undrawn cash balances.

Recommended Follow-up: EPA would like to better understand why the disbursement rate for the California DWSRF is below the national average. Perhaps there are workload or resource constraints, or other underlying reasons within the claims and disbursement process that effect the rate DWSRF funds are disbursed to systems. California's performance may also lag the national average because many of the new projects have not reached the stage of construction where disbursements occur quickly. EPA recommends that the State Water Board explain in the 2016/2017 Annual Report the reason for California DWSRF's low rate of disbursement and what steps may be taken to optimize the rate of disbursements.

d. Set-aside Spending Rate – Based on Cumulative Activity: Expressed as a percentage, this indicator reflects the rate at which set-aside funds are disbursed to assist state and local activities. For the California DWSRF, the 2016 NIMs report shows a ratio of 92.0%, which is well above the national average of 88.9%, and an improvement over its previous year's value of 87.2%. The spending rate improvement is in part a result of the State Water Board's efforts to hire skilled staff to reconcile and manage these accounts, and budget coordination between the Division of Drinking Water Public Water System Supervision (PWSS) grant work plans and the DFA DWSRF set-aside work plans.

Recommended Follow-up: None.

e. Return on Federal Investment: This indicator represents the cumulative assistance disbursed as a percentage of cumulative federal cash draws. This indicator is designed to show how many dollars in environmental investment have been generated for every federal dollar spent through the program. States with a direct loan program may have a value of between 80% and 120% during the early stages of the program. This value is dependent on the amount of set-aside funding taken by the state. This percentage, however, increases over time as repayments are generated and become available relative to the amount of federal and state match funding.

The California DWSRF program had a cumulative return on federal investment of 113.8%, in SFY 2015/2016. This means that for every federal dollar given to the California DWSRF, \$1.14 of environmental investments were created. This is an improvement from the previous year, when the return on federal investment was 111.6%.

The State Water Board's use of federal dollars to resolve drinking water problems and improve infrastructure is below the national average for non-leveraged states of 131.2%. The program's performance suggests that a low cumulative amount of non-federal California DWSRF dollars were disbursed to eligible borrowers. However, EPA anticipates that the California DWSRF program will come more in line with the national average in the next one to two years as newly funded projects start to disburse funds rapidly.

Recommended Follow-up: None.

C. Project File Review

EPA's review of DWSRF project files found the projects to be eligible and in compliance with the program requirements. The project file review checklists for each of the projects listed below can be found in **Attachment 3**.

- **City of Livingston; Assistance Amount \$1,513,836; Project #2410004-002C**
California DWSRF funding was used to meet a compliance order requiring the City to correct high arsenic concentrations. To solve the problem, the City is constructing an arsenic filtration system which consists of a coagulation/filtration system and sand media to treat the water.
- **Gordon Acres Water Company Inc.; Assistance Amount \$468,000; Project 3600297-005P**
California DWSRF funding was used to develop a public water system improvement plan to deal with a current well that shows repeated occurrences of contamination. This involves the development of a feasibility study involving the following deliverables: well investigation; engineering report; environmental documents; land survey, mapping and geotechnical investigation; plans and specs development; and test drilling.

D. Follow-Up from Prior Years PER

In the prior PER, EPA required that the California DWSRF correct two improper payments totaling \$78.68, identified during the testing of cash transactions. The SWRCB conducted a review of the transactions in question and found no evidence of errors to support improper payments. In their September 20, 2016, letter to EPA, the SWRCB clarified the perceived errors and adequately justified why the amount was not improper. EPA accepts the SWRCB's explanation and acknowledges that there were no improper payments.

The PER also required the CA DWSRF to liquidate all set aside funds from the FY 2014 DWSRF capitalization grant, grant #FS98934914, by September 30, 2017. In this same letter to EPA, the SWRCB stated that it continues to target the 2014 DWSRF capitalization grant for full liquidation by September 30, 2017.

IV. California CWSRF: Observations and Follow-up Actions

A. Financial Management

1. Transaction Testing and Improper Payments

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

EPA tested 4 CWSRF cash transactions selected through statistical sampling with a total draw of \$6.7 million from the federal treasury between October 2015 and June 2016. Our review of these program financial transactions did not find any improper payments. The details for each cash draw tested can be found in **Attachment 2**.

Recommended follow-up: None

2. Timely and Expeditious Use of Funds

California's performance for the major CWSRF program financial indicators is above or within an acceptable range of the national average, as described in Table V. California also appears to be in full compliance with the CWSRF requirements for efficient, timely and expeditious expenditure of funds. The State is maximizing the use and effectiveness of CWSRF assets.

Table V. California CWSRF Performance Indicators from NIMS

| As of June, 30 | CWSRF 2016 | | CWSRF 2015 | |
|---|-------------------|------------------|-------------------|------------------|
| Performance Measures - Cumulative | California | National Average | California | National Average |
| Fund Utilization (line 285) | 113% | 98% | 116% | 98% |
| Cumulative disbursements as a percent of CWSRF assistance (Line 297). | 80% | 87% | 83% | 88% |
| Return on Federal Investment (line 307) | 237% | 263% | 224% | 258% |
| Retained Earnings (line 320) | 22.3% | 19.5% | 22.4% | 19.1% |

- a. **Fund Utilization Rate:** Fund utilization rate or pace of the program represents the cumulative assistance provided as a percent of cumulative SRF funds available for projects. It is one indicator of how quickly CWSRF funds are made available to finance projects. Table I shows that California has done an excellent job in quickly converting CWSRF funds to loans for projects and exceeds the national average.

Recommended follow-up: None

- b. Use of Federal and Non-federal Funds:** Table VI. shows the status of unspent capitalization grant funds as of June 30, 2016. The SWRCB has a history of successfully obligating all federal funds during the fiscal year in which they are appropriated. As of June 30, 2016, the SWRCB had one capitalization grant open with a total of \$46 million in unspent federal funds, which is 1.52% of total federal funds awarded to the state.

Table VI. California CWSRF ULOs as of 06/30/2016

| State | All Funds | | | State |
|-------|----------------------------|------------|-----------------------------------|-------|
| | Federal Cap Grants Awarded | ULOs | ULOs as a % of Federal Cap Grants | |
| CA | 3,052,583,918 | 46,364,869 | 1.52% | CA |

The level of ULO is exceptional, as \$46 million is less than one capitalization grant. This indicates that the California CWSRF is anticipating federal grant awards and awarding assistance agreements such that when federal funds become available there is an immediate demand for them.

With respect to the utilization of non-federal dollars in the program, states are required to make timely loans using all available CWSRF funds for eligible projects. As stated in EPA Policy Memoranda, SRF 99-05 and SRF 99-09, one year is a reasonable time frame for expecting states to commit repayments and other available funds to CWSRF projects. The memoranda further clarify that in the event the state does not have sufficient projects ready to receive commitments, it must identify in its Intended Use Plan how and when the funds will be used. In the case of the California CWSRF program, the NIMs report shows that SWRCB has satisfactorily committed all available program funds to CWSRF projects within a year.

Federal, recycled and other non-federal funds need to be disbursed as soon as possible to avoid the appearance of fund underutilization. EPA uses cumulative disbursements as a percent of CWSRF assistance to determine whether a state is having trouble with the timely disbursement of their federal and non-federal funds. As described in Table V the California CWSRF shows a ratio of 80%, slightly below the national average of 87%.

However, the sum of federal funds, cash and cash equivalents is approximately one year's worth of disbursements, indicating that the California CWSRF is disbursing all sources of funds in a timely and expeditious manner.

Recommended follow-up:

EPA would like to better understand why the disbursement rate for the California CWSRF is below the national average. Perhaps California's performance may lag the national average because of an increase in new large projects and the new projects have not reached the stage of construction where disbursements occur quickly. EPA recommends that the State Water

Board explain in the 2016/2017 Annual Report the reason for California CWSRF's low rate of disbursement and what steps may be taken to optimize the rate of disbursements.

- c. Return on Federal Investment:** Return on federal investment represents the cumulative assistance disbursed as a percentage of cumulative federal cash draws. This indicator is designed to show how many dollars of assistance were disbursed to eligible borrowers for each federal dollar spent. States with a direct loan program should have an expected value for this indicator of 120%, which reflects the 20% state match of federal capitalization grants. States that leverage should have a higher value than 120% because they have more funds available relative to the amount of federal funding than non-leveraged states. In California's case, the State CWSRF has exceeded the standard level of performance, i.e., 120%. The 237% return on investment is in part attributed to availability of more funds due to leveraging as well as loan repayments, interest and investment income being loaned out.

Recommended follow-up: None

- d. Sustainability (Retained Earnings) Excluding Subsidy:** This indicator seeks to gauge how well the CWSRFs are maintaining their invested or contributed capital, without adjusting for loss of purchasing power due to inflation. For purposes of this indicator only, contributed capital is defined as the federal capitalization grant less the 4 percent allowed for administrative expenses, plus the required 20 percent state match regardless of the source (i.e., borrowed, appropriated, etc.). For those States that do not borrow for state match, like California, if the retained earnings of a CWSRF is greater than or equal to zero, then the CWSRF is deemed to be maintaining its contributed capital and the sustainability of the fund. The California CWSRF is exceeding the national average with a retained earnings calculation of 22.3%, thus indicating that the financial health of the fund is sustainable.

Recommended follow-up: None

B. Project File Review

EPA's review of CWSRF project files found the projects to be eligible and in compliance with the program requirements. The project file review checklists for both projects listed below can be found in **Attachment 3**.

- **Hi Desert Water District; Assistance Amount \$142,349,314; Project #5295-110**
The Basin Plan for the Colorado River Basin was amended on May 19, 2011, to prohibit septic tank discharges in the Town of Yucca Valley (Town). Sewer collection and treatment facilities will be constructed in three phases. The District will construct Phase 1 of the project, which includes installation of a sewer collection system, a wastewater treatment facility (WWTF), and water reclamation recharge ponds. Approximately 77 miles of sewer pipeline will be constructed in the central portion of the Town to convey an annual average flow of one million gallons per day of wastewater to the proposed WWTF. This phase of the project will provide the core infrastructure for expansion of the collection, treatment, and disposal system needed for future Phases 2 and 3.

- **Clear Creek CSD; Assistance Amount \$933,143; Project #8130-110**

The project will include booster pump station with two end-suction centrifugal pumps; variable frequency drives; SCADA improvements; and two interconnections with existing facilities.

C. Follow-Up from Prior Years PER

In the prior PER, EPA recommended the California CWSRF include the Fish and Wildlife Coordination Act as part of the cross-cutter review checklist that the loan recipients fill out. As EPA is researching further which crosscutters should be reviewed in the loan application process, no further action is required from either the California DW or CW SRFs.

V. Conclusions

EPA conducted an annual review of the California DWSRF and CWSRF programs in accordance with EPA's SRF Annual Review Guidance. Based upon the file reviews, on-site project file reviews and interviews, EPA concludes that the State of California met all program requirements for the review period. The following key exceptions, which require follow-up, should be addressed in the SFY 2016/2017 California DWSRF Annual Report:

- **Unliquidated Obligations (ULO)** - *In support of EPA's DWSRF ULO reduction strategy, the California DWSRF is required to liquidate all funds from the FY 2014 DWSRF capitalization grant, grant # FS-98934914, by September 30, 2017.*
- **Compliance with Reporting Requirements** - *EPA asks that the California DWSRF program ensure that the project and health benefit information for the projects listed in Table I of the PER is correct and completely entered in the Project and Benefits Reporting System (PBR) by September 30, 2017.*

VI. Attachments

Attachment 1 EPA Annual Report Program, Financial and Set-aside Review Checklist

Attachment 2 Transaction Testing Worksheets

Attachment 3 EPA Project File Reviews

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Attachment 2 Transaction Testing Worksheets

Attachment 3 EPA Project File Reviews