U.S. ENVIRONMENTAL PROTECTION AGENCY

OFFICE OF INSPECTOR GENERAL

Unliquidated Obligations Resulted in Missed Opportunities to Improve Drinking Water Infrastructure

Report No. 14-P-0318 **July 16, 2014**

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Abbreviations

CFR	Code of Federal Regulations
DWSRF	Drinking Water State Revolving Fund
EPA	U.S. Environmental Protection Agency
GAO	U.S. Government Accountability Office
IUP	Intended Use Plan
OIG	Office of Inspector General
SFY	State Fiscal Year

Cover photo: A wastewater treatment plant in Stratford, Connecticut. (EPA photo)

U.S. Environmental Protection Agency
Office of Inspector General

14-P-0318
July 16, 2014

At a Glance

Why We Did This Review

We performed this audit to determine whether the U.S. Environmental Protection Agency (EPA) has been effective in identifying and deobligating unneeded Drinking Water State Revolving Fund (DWSRF) assistance agreement funds and preventing unwarranted accumulations of unliquidated obligations. Our objectives were to determine whether (1) EPA and state actions taken to address large balances of DWSRF unliquidated obligations reduced such obligations, and (2) state lists of projects to be funded by capitalization grants realistically reflect the projects that may be funded.

This report addresses the following EPA goals and cross-agency strategies:

- *Working to make a visible difference in communities.*
- *Protecting America's waters.*

For further information, contact our public affairs office at (202) 566-2391.

The full report is at:
www.epa.gov/oig/reports/2014/20140716-14-P-0318.pdf

Unliquidated Obligations Resulted in Missed Opportunities to Improve Drinking Water Infrastructure

What We Found

When hundreds of millions of DWSRF dollars remain idle, states miss opportunities to improve the health of their communities' drinking water infrastructure and the opportunity to infuse funds into the economy and create jobs.

We found that the EPA and the five states we reviewed took many actions to reduce DWSRF unliquidated balances, but those actions have not reduced DWSRF unliquidated balances to the goal of below 13 percent of the cumulative federal capitalization grants awarded. For the period we examined the five states reviewed—California, Connecticut, Hawaii, Missouri and New Mexico—executed small numbers of loans each year and did not maximize the use of all DWSRF resources, including capitalization grant awards. State programs reviewed were not adequately projecting the DWSRF resources that would be available in the future to enable the states to anticipate the amount of projects needed to be ready for loan execution in a given year. As a result, $231 million of capitalization grant funds remained idle, loans were not issued, and communities were not able to implement needed drinking water improvements.

We also noted that states' project lists included in the capitalization grant application—called fundable lists—did not reflect projects that would be funded in the current year and overestimated the number of projects that will receive funding. Less than one-third of the projects on the fundable lists we reviewed resulted in executed DWSRF loans during the current grant year. We found that, generally, these states did not have a consistent "ready-to-proceed" definition. When projects are not ready to proceed, expected environmental benefits are delayed. Because states use the fundable lists to justify their annual capitalization grants, the fundable lists should communicate to the EPA and the public the projects that will be funded with taxpayer money.

Recommendations and Planned Corrective Actions

We recommend that the Assistant Administrator for Water require states with unliquidated obligations that exceed the Office of Water's 13-percent-cutoff goal to project future cash flows to ensure funds are expended as efficiently as possible. We also recommend that the Assistant Administrator develop guidance for states on what projects are to be included on the fundable lists and require regions, when reviewing capitalization grant applications, to ensure states are complying with the guidance. The EPA agreed to take sufficient corrective actions on most of the recommendations. The EPA still needs to take steps to ensure states have adopted the EPA's guidance on the definition of "ready to proceed."

UNITED STATES ENVIRONMENTAL PROTECTION AGENCY
WASHINGTON, D.C. 20460

THE INSPECTOR GENERAL

July 14, 2014

MEMORANDUM

SUBJECT: Unliquidated Obligations Resulted in Missed Opportunities to Improve Drinking Water Infrastructure
Report No. 14-P-0318

FROM: Arthur A. Elkins Jr.

TO: Nancy K. Stoner, Acting Assistant Administrator
Office of Water

This is our report on the subject audit conducted by the Office of Inspector General (OIG) of the U.S. Environmental Protection Agency (EPA). This report contains findings that describe the problems the OIG has identified and corrective actions the OIG recommends. This report represents the opinion of the OIG and does not necessarily represent the final EPA position. EPA managers, in accordance with established audit resolution procedures, will make final determinations on matters in this report.

The office responsible for implementing the audit recommendations is the Office of Water's Office of Ground Water and Drinking Water.

Action Required

Recommendation 3 and a portion of recommendation 1 are open and unresolved. In accordance with EPA Manual 2750, the resolution process begins immediately with the issuance of this report. We are requesting a meeting within 30 days between the Office of Water's Director, Office of Ground Water and Drinking Water, and the OIG's Assistant Inspector General for Audit. If resolution is still not reached, the Office of Water's Director, Office of Ground Water and Drinking Water, is required to complete and submit the dispute resolution request to the Chief Financial Officer to continue resolution.

We will post this report to our website at http://www.epa.gov/oig.

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Chapter 1
Introduction

Purpose

The purpose of this audit was to determine whether the U.S. Environmental Protection Agency (EPA) has been effective in identifying and deobligating unneeded Drinking Water State Revolving Fund (DWSRF) assistance agreement funds and preventing unwarranted accumulations of unliquidated obligations. An unliquidated obligation is the unexpended balance remaining from the amount of federal funds that the EPA has obligated to an agreement. Our objectives were to determine whether:

- EPA and state actions taken to address large balances of DWSRF unliquidated obligations reduced such obligations.
- State lists of projects to be funded by capitalization grants realistically reflect the projects that may be funded.

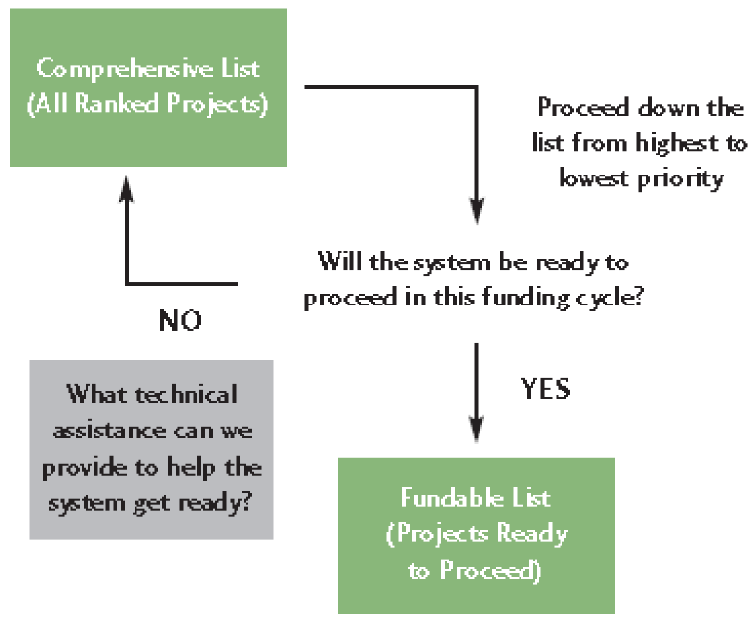
Background

The Safe Drinking Water Act Amendments of 1996 established the DWSRF to provide states with a financing mechanism for ensuring safe drinking water to the public. Since the program's inception in 1996 through March 1, 2013, the EPA awarded over $15.5 billion in DWSRF capitalization grants to states. Of that amount, $2 billion has remained unliquidated. An Office of Water manager indicated that 17 of the 50 states and Puerto Rico, or 34 percent, have unliquidated obligations that exceed 13 percent. The Office of Water's current focus is states with unliquidated obligation balances that approximately equal 2 years' worth of grants being open, which is roughly the national average of total unliquidated obligations to federal capitalization grants awarded, or 13 percent. Prior Office of Inspector General (OIG) audits identified that the EPA's internal controls have not always been effective in preventing unwarranted accumulations of unliquidated obligations.

The Safe Drinking Water Act Amendments of 1996 provided the EPA with the authority to enter into capitalization grant agreements with eligible states to further health protection and promote the efficient use of fund resources. Annually, capitalization grants are made available to each state and Puerto Rico for the purpose of providing loans to individual drinking water systems for infrastructure improvements. While states operate their own DWSRF programs, the EPA is responsible for oversight to ensure state programs are complying with applicable federal requirements throughout the project and close-out processes.

The EPA allots federal DWSRF funds to the states according to a formula that reflects their proportional share of needs identified in the most recent Drinking Water Infrastructure Needs Survey. In order for a state to receive the DWSRF funds allotted to it, the state must submit a complete capitalization grant application. Capitalization grant applications must include an annual Intended Use Plan (IUP) that contains the state's Comprehensive List and a subset of that list—the fundable list—as shown in figure 1.

Figure 1: General DWSRF priority setting process



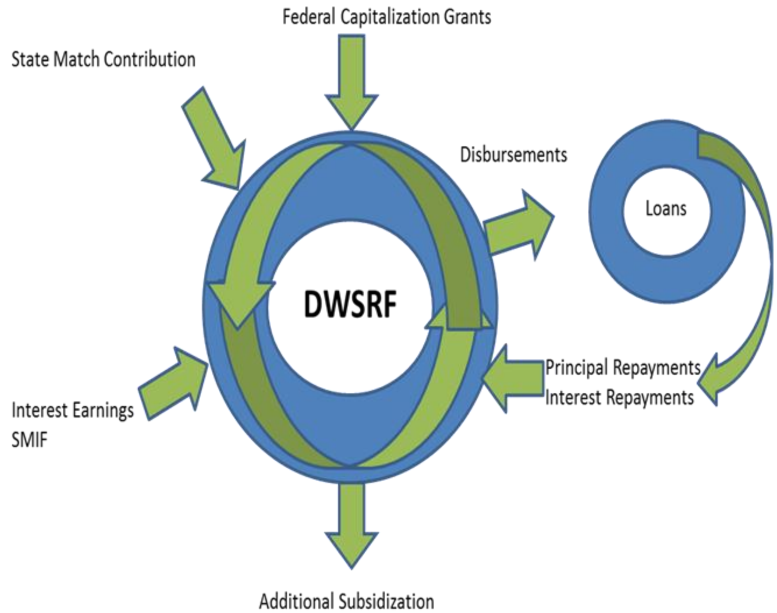
Source: DWSRF Program Operations Manual (Provisional Edition).

The fundable list includes projects expected to receive assistance in the next year. The DWSRF Program Operation Manual states that the IUP is the focal point of the capitalization grant application and agreement. It describes how the DWSRF program intends to allocate all of its available funds, including federal capitalization grants, state matching funds, loan repayment, fund interest earning, loan fees and bond proceeds. States must use all funds in accordance with an approved IUP.

The Safe Drinking Water Act Amendments of 1996 require the state revolving fund to be available in perpetuity for providing financial assistance to water systems as shown in figure 2. A 20 percent match to the capitalization grant is required. Funds are transferred to the state on a reimbursement basis after assistance recipients have billed the state for work completed and the state requests a transfer. In general, the recipients are required to repay the loan with interest. However, a state can also provide additional loan subsidies to disadvantaged communities that include negative interest rates. Interest earnings from the state's

DWSRF fund account can also accrue and increase the balance of the state's revolving fund.

Figure 2: Sources and uses of states' DWSRF



Source: EPA Region 9 presentation dated September 25, 2012.

The EPA Office of Water and EPA Regions 1, 6, 7 and 9 have been working with states that have high unliquidated obligation balances to identify the reasons more loans have not been executed and reduced unliquidated obligation balances.

Responsible Offices

The Office of Water's Office of Ground Water and Drinking Water is the EPA office with primary responsibility for the issues covered by this report.

Scope and Methodology

We conducted this audit from March 2013 through March 2014, in accordance with generally accepted government auditing standards. Those standards require 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.

Our primary contact for this audit was the Office of Ground Water and Drinking Water. We also judgmentally selected four EPA regions (Regions 1, 6, 7 and 9) that had the highest percentage of capitalization grant unliquidated obligations. From those regions, we judgmentally selected the following five states with high unliquidated obligations for detailed review: California, Connecticut, Hawaii, Missouri and New Mexico. We performed site visits and conducted interviews at each of the sampled state's DWSRF program offices except for Hawaii. We conducted all interviews for Hawaii via teleconference. We interviewed EPA Office of Water headquarters staff; and Regions 1, 6, 7 and 9 staff. We also reviewed:

- The Safe Drinking Water Act Amendments of 1996.
- The Code of Federal Regulations.
- EPA regulations and guidance.
- Guidance and documentation, IUPs, annual reviews, and the comprehensive priority lists and fundable lists for the five states reviewed.
- EPA performance evaluation plans and the EPA's communications with the states.

To determine whether the EPA and state actions taken to address large balances of DWSRF unliquidated obligations reduced such obligations, we interviewed key EPA and state staff and analyzed DWSRF program documentation for state fiscal years (SFYs) 2010 through 2013. We determined the procedures used by the EPA Office of Water and the selected states, and tested key procedures. We also analyzed SFYs 2010 through 2013 DWSRF unliquidated obligation balances to determine whether balances have been reduced.

To determine whether state projects to be funded by capitalization grants reflect the projects that may be funded, we compared state fundable lists of projects from SFYs 2010 through 2013 to projects funded for each respective year. We also determined when projects listed on fundable lists were actually funded.

Prior Audit Coverage

We researched prior EPA OIG and U.S. Government Accountability Office (GAO) reports related to EPA's DWSRF program. We noted one EPA OIG report and one GAO report that were pertinent to the program.

Table 1: Prior reports related to the DWSRF program

Report No./Date	Title	Description
EPA OIG 12-P-0102 December 1, 2011	Enhanced Coordination Needed to Ensure Drinking Water State Revolving Funds Are Used to Help Communicate Not Meeting Standards	This report stated that the DWSRF may never reach some communities with the highest number of health-based drinking water violations because: (a) these communities have no contact with the state DWSRF office and are not aware of the program; (b) they do not have technical, managerial or financial capacity; or (c) they cannot afford a loan.
GAO-02-125 January 24, 2002	Key Aspects of EPA's Revolving Fund Program Needed to be Strengthened	This report concluded that the EPA is not taking full advantage of the oversight tools currently available to monitor states' implementation of the DWSRF program.

Source: EPA OIG generated from Web search.

Chapter 2
Unused Funds Resulted in Missed Opportunities to Improve Drinking Water Infrastructure

Actions taken by the EPA, four EPA regions and the five states we reviewed did not reduce DWSRF unliquidated obligation balances below 13 percent of the cumulative federal capitalization grants awarded. As of September 30, 2013, the states we reviewed exceeded 13 percent of unliquidated obligations by $231 million. The Safe Drinking Water Act requires that the Administrator create provisions to ensure that each state commits and expends funds allotted to the state as efficiently as possible. Until SFY 2013, the five states reviewed—California, Connecticut, Hawaii, Missouri and New Mexico—had executed small numbers of loans each year and had not maximized the use of all DWSRF resources, including the capitalization grant awards. Three of the five states reviewed did not use financial tools to assist in projecting future DWSRF funds and predict the number and value of projects needed to be ready for loan execution in any given year. When loans are not issued, intended drinking water improvements may not be implemented and states lose opportunities to infuse funds into their economy and create jobs.

Efficient Use of Funds Required

The Safe Drinking Water Act requires that the Administrator create provisions to ensure that each state commits and expends funds allotted to the state as efficiently as possible. In turn, the DWSRF program final guidelines are codified in the Code of Federal Regulations (CFR) at 40 CFR Part 35 Subpart L, and require states to agree to commit and expend all funds as efficiently as possible and in an expeditious and timely manner.

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The EPA's State Revolving Fund Management Handbook presents DWSRF management concepts and good financial managerial practices. It demonstrates that the EPA is aware of the importance of financial management and the importance of cash flow projections for revolving loan funds. The handbook indicates that fund management must be considered across the dimension of time to balance what can be accomplished in the present versus the future. Cash flow modeling is the principal technique for analyzing the financial impact of decisions over time given the financial complexities of revolving loan funds. While the handbook does not require that states perform cash projections of all DWSRF funds to determine the program loan capabilities, it is considered to be good financial management practice.

Unliquidated Obligations Remain High

As of September 30, 2013, the DWSRF unliquidated balances for all five states reviewed remain high. In four of the five states, the unliquidated obligation balances increased from 2010. The five states reviewed had cumulative unliquidated balances of over $533 million, as shown in table 2:

Table 2: Cumulative unliquidated obligation balances as of September 30, 2013

States	2010	2011	2012	2013	Percent change in balance from 2010 to 2013
	(Dollars stated in thousands)				
California	$605,757	$557,557	$445,877	$357,523	-41%
Connecticut	26,044	26,412	39,384	34,736	33%
Hawaii	30,867	34,523	38,104	38,137	24%
Missouri	58,268	60,615	60,876	59,745	3%
New Mexico	30,746	33,680	43,551	43,195	40%
Total	**$751,682**	**$712,787**	**$627,792**	**$533,336**	

Source: National Information Management System database and OIG analysis.

The EPA Office of Water focused on an unliquidated obligation balance for each state of 2 years for a state's grant award, which is approximately equal to 13 percent of the cumulative federal capitalization grants awarded. Any state with a balance above this level is considered to have a high unliquidated obligation balance. The five states reviewed exceeded the level by more than $200 million, as shown in table 3.

Table 3: Amount of states' September 30, 2013 unliquidated obligation balance exceeding 13 percent of cumulative federal capitalization grants awarded

State	Cumulative federal grants	Unliquidated obligations	Amount exceeding 13 percent
	(Dollars stated in the thousands)		
California	$1,539,666	$357,523	$157,367
Connecticut	176,732	34,736	11,761
Hawaii	159,377	38,137	17,418
Missouri	289,028	59,745	22,171
New Mexico	163,623	43,195	21,924
Total	**$2,328,426**	**$533,336**	**$230,641**

Source: National Information Management System database and OIG analysis.

Actions to Reduce Unliquidated Obligations

We found that the Office of Water, the four EPA regions and five states reviewed were all focused on reducing unliquidated obligations and have taken various actions to reduce unliquidated balances in the DWSRF program.

California, which has the highest DWSRF unliquidated balance of all the states, decreased its balance by 41 percent between September 30, 2010, and September 30, 2013. Over the past 4 years, California's Department of Public Health has taken a number of steps that have resulted in a reduction of the unliquidated obligation balance, including:

- Cease the practice of committing funds to projects not ready to proceed.
- Implement new terms and conditions in loan agreements to require no less than quarterly the submission of claims on costs incurred.
- Provide higher priority rankings for larger communities that absorb smaller communities. This allows a small community that could not meet technical and managerial requirements of the DWSRF program the ability to meet requirements and be funded.
- Increase staffing.
- Separate planning and construction phases into two loans.
- Use contractors to increase outreach and working with small and disadvantaged communities with the application process and providing technical assistance.
- Improving pace of expenditures by awarding total funding agreements that have exceeded annual cap grants over the last 3 years
- The EPA's Region 9 aided the California Department of Public Health in developing a cash flow model to project future loan capabilities. The model is being used to determine how the Department of Public Health will reach the 120 percent commitment rate goal that the EPA has set for its program.

Other states have also taken action to reduce unliquidated obligation balances. Connecticut developed a pipeline of projects, restructured its organization and revised its project ranking procedures to allow ready-to-proceed projects to be more readily funded. Hawaii conducted workshops called "road shows" to educate potential recipients about the benefits of the DWSRF program and encourage large systems to take loans. Missouri offered to pay for the initial engineering report, plans and specifications, as well as phase one reports to assist communities in using the DWSRF program. New Mexico changed the annual fundable list process to a quarterly process that requires loans be issued within 3 months for projects on the fundable list. They also recently developed a cash flow model to anticipate resources available for loans and estimate the value of projects that need to be in the pipeline.

The actions taken have enabled states to increase their number of annually executed loans. However, unliquidated obligation balances only decrease when loan recipients begin projects and request payments. Therefore, unliquidated obligations will not be reduced until payment requests are submitted against these loans.

Financial Projections of DWSRF Resources Needed to Maximize Fund Utilization

The reasons for the low numbers of loans executed vary from state to state because of unique challenges faced by each state. Challenges can include staffing shortages, lack of focus on the DWSRF program and more attractive funding sources. However, three of the five states reviewed did not use cash flow models to assist in projecting the amount of DWSRF funds that would be available in the future to aid those states in anticipating the number and value of projects needed to be ready for loan execution in any given year. The other two states have only recently begun to implement and use cash flow models.

To aid in decreasing DWSRF unliquidated obligation balances, state programs need to project their present fund inflows and outflows of cash into the future. The EPA's State Revolving Fund Management Handbook[1] states "cash flow modeling/financial planning is the principal technique for analyzing the financial impact of decisions over time, given the financial complexity of revolving loan funds." Cash flow modeling would help states confidently forecast the amount of DWSRF dollars available so that they can anticipate the value of ready-to-proceed projects needed each year and aid them in addressing high unliquidated balances. We found the following:

- Hawaii determines the number of loans it can commit using all DWSRF fund sources, but does not have the projects ready to proceed; therefore, it only executed a small portion of the projects on its fundable lists.
- Connecticut's Department of Public Health recently began to project the amount of funds expected to be drawn down on projects and the respective amount of DWSRF grant balances, but has not taken into account repayments of principal, interest and retained earnings to project future inflows.
- Missouri does not perform financial projections to predict the amount of all DWSRF funds that would be available in the future to finance projects.
- California and New Mexico recently began to implement and use cash flow models.

On April 19, 2013, the EPA issued California a notice of noncompliance which determined that the state's Department of Public Health had not timely and efficiently committed and expended its DWSRF funds. While there were several contributing factors to the state's noncompliance, the EPA cited that the Department of Public Health had not applied the modeling tools needed to integrate financial and project activities and had not accurately accounted for loan repayments into the fund. The EPA also stated that as a result the unexpended funds lost millions of dollars of purchasing power for public health purposes because of inflation, and the unspent funds do not support the revolving nature of

[1] EPA 832-B-01-003 April 2001.

the fund. Region 9 aided California's Department of Public Health in the creation of a cash flow model to project future program loan fund balances, which has provided a better way of ensuring that the DWSRF program sources are efficiently used. California staff told us that implementation of the cash flow model has helped them understand the value of the resources available.

Idle Funds Cause Diminished Results and Missed Opportunities

Without financial projections to determine the amount of loans that can be executed with all DWSRF fund sources, $230,640,728 has not been committed and expended as efficiently as possible in the five states we reviewed. When loans are not issued and capitalization grant funds remain idle, the value of money is diminished, needed drinking water improvements are not implemented, communities do not receive the intended health benefits, and states miss opportunities to infuse funds into the state's economy and create jobs. As a result, we consider the $230,640,728 as funds that could be put to better use based on implementation of the recommendations.

Recommendation

We recommend that the Assistant Administrator for Water:

1. Reduce unliquidated obligations by:

   a. Working with states with high unliquidated obligations to use financial tools to project future cash flows to aid in liquidating balances by using those projections in planning for expending funds in a timely and efficient manner.

   b. Quarterly providing to the regions a summary of states that have attended the cash flow analysis training and compare that with states not achieving the goals of the 2014 strategy to identify states that may need additional assistance.

Agency Comments and OIG Evaluation

While the EPA disagreed with recommendation 1a, it described actions it had recently taken to address the issue of unliquidated obligations. On April 14, 2014, the Director, Office of Ground Water and Drinking Water, issued a strategy for reducing unliquidated obligations. The goals of the strategy are (a) to fully use funds from previous DWSRF grants (fiscal year 2013 and prior) by the end of September 2016 and (b) complete draw down of funds from future years' grants within 2 years of the date of the award. The strategy includes a section on forecasting financing capacity through use of cash flow or similar analysis**.** The strategy states:

> Cash flow modelling allows a state to determine the amount of assistance its program can prudently provide in a given year and can help a state assess the impacts of current year financing decisions on future years' financing capacity. Particularly when used in conjunction with a robust list of fundable projects that are ready to proceed, cash flow analysis can help states to maximize the pace of project funding where supported by sound financial management principles.

In the 2014 strategy, the Director asked the regional water directors to encourage states not using cash flow analysis to participate in training offered. The EPA stated in the response that it believed this approach, framed within the expectation that states will work toward operating their DWSRFs to have unliquidated obligations at the lowest practical level while recognizing that state circumstances vary, will promote appropriate focus on grant fund liquidation.

In response to recommendation 1, the Office of Ground Water and Drinking Water suggested we retain the spirit of the recommendation but rephrase as "Work with states" rather than "Require." The EPA stated it started working with states on this initiative in the second quarter of fiscal year 2014 and that it is an ongoing activity.

The 2014 strategy addresses the issue identified in our report—mainly, the reduction of prior-year DWSRF obligations. However, we are concerned that revising the recommendation to only ask the EPA to "work with states" to use financial tools to project future cash flows does not reflect a commitment to a specific action(s). As an alternative, we have revised the first recommendation to reflect the wording the EPA suggested and added an additional action to monitor states involvement in the cash flow analysis training. The OIG considers the April 2014 strategy as responsive to recommendation 1a; however, they agency will need to provide a response, with corrective action dates, for recommendation 1b. The EPA should ensure that the 2014 strategy is implemented.

Appendix A provides the agency's full response to the recommendations. Appendix B provides the agency's April 14, 2014, strategy for reducing unliquidated obligations issued to regional water division directors.

Chapter 3
More Ready-to-Proceed Projects Would Improve Drinking Water Infrastructure

States' fundable lists included in the intended use plan (IUP) of the capitalization grant application overestimate the number of projects that will receive loans during the current funding cycle. Less than one third of the projects on the fundable lists reviewed resulted in executed DWSRF loans within the time period covered by the current IUP. Federal regulations say the IUP must contain a fundable list of projects that are expected to receive assistance from available funds designated for use in the current IUP. Reasons why states execute a fraction of loans for the projects on their fundable lists varied, but we found that, generally, these states do not have a consistent "ready-to-proceed" definition. When projects are not funded and high unliquidated obligation balances occur, needed environmental improvements are delayed.

Fundable Lists Should Contain Projects Expected to Be Executed Within 1 Year

According to 40 CFR §35.3555, a state must prepare an annual IUP that describes how it intends to use the DWSRF capitalization grant to support the overall goals of the program. The Safe Drinking Water Act Amendments of 1996 requires states to annually submit an IUP that includes a list of projects to be assisted in the first fiscal year that begins after the date of the plan. Title 40 CFR Part 35 states that the IUP must contain a comprehensive list of projects and a fundable list of projects. The EPA's DWSRF Program Operations Manual, dated October 2006, presents DWSRF management concepts and good financial managerial practices. It states that two lists of priority projects are included in the annual IUP: the comprehensive list and the fundable project list. From the comprehensive list, programs develop a fundable list of projects that are expected to receive assistance in the upcoming year. The fundable list of projects is developed based on projects that are ready to proceed during the current funding cycle.

On December 2, 2011, the EPA Administrator sent a letter to all states providing them with steps that could be taken to expedite the flow of State Revolving Fund dollars into the state's economy, including:

- Draft assistance agreements for projects being funded through federal capitalization so that they are ready to be signed upon award of the capitalization grant.
- Work closely with communities to build a pipeline of projects that are ready to proceed so that contracts can be awarded and construction can begin upon the award of assistance agreements.

States Overestimate Projects That Will Receive Funding

Based on our review and comparison of the represented states' SFY 2011 through 2013 fundable lists and annual reports, fundable lists do not realistically represent those projects expected to receive DWSRF assistance in the corresponding SFYs. Only a fraction of the projects on the fundable lists result in executed DWSRF loans within the current IUP year, and generally, the value of the awards made is significantly less than the value of the projects on the states' fundable lists. The regions we reviewed did not expect all of the projects listed on the fundable list to result in an executed loan agreement during that year. Fundable lists intentionally exceed the value of the grant to allow for unforeseen problems with projects that do not move forward as expected. However, for SFY 2011 through SFY 2013, the number of loans executed equal less than one-third of the projects listed. Hawaii executed loans equal to 7.9 percent of the number of projects listed; California executed the highest percentage, executing 31.1 percent of the number of projects listed on the fundable list. Table 4 compares the number and value of projects on states' fundable lists to the number of loans actually made for SFYs 2011 through 2013.

Table 4: **Number and value of projects on fundable lists and loans made by SFY**

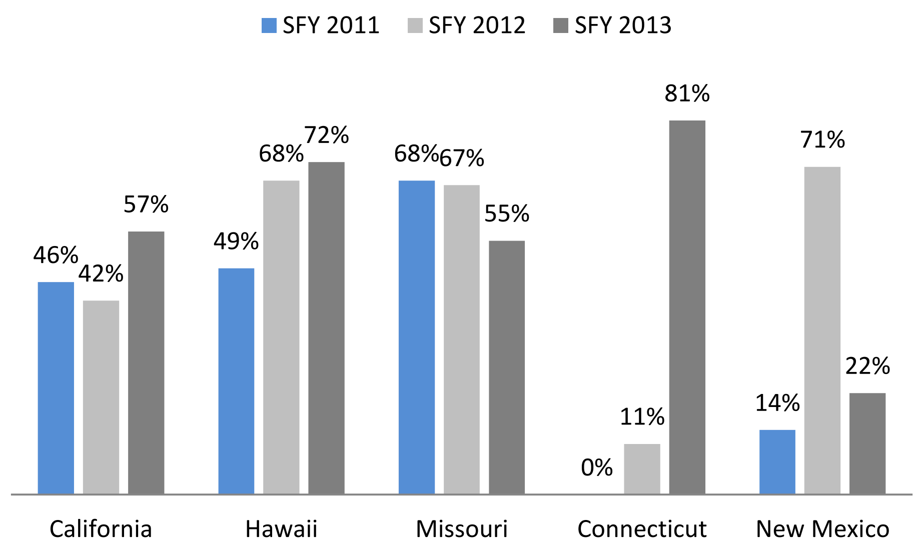
		Total number of:		Value of:	
SFY	**State**	**Projects on fundable list**	**Final loan agreements**	**Projects on fundable list**	**Final loan agreements**
2011	California	145	27	$245,332,554	$235,315,624
	Connecticut [a]	0	2	0	1,841,000
	Hawaii	69	3	242,415,608	5,178,581
	Missouri	22	5	38,990,258	2,974,900
	New Mexico	21	5	27,815,000	2,640,035
2012	California	83	30	174,199,656	268,696,175
	Connecticut	88	5	63,374,606	3,288,663
	Hawaii	76	5	255,499,500	5,856,911
	Missouri	27	6	41,626,606	14,826,684
	New Mexico	29	0	31,113,020	0
2013	California	77	38	235,534,658	265,239,107
	Connecticut	102	39	124,319,917	34,170,363
	Hawaii	83	10	267,649,500	27,632,906
	Missouri	20	9	55,906,704	13,552,333
	New Mexico	22	16	37,779,934	25,526,002

Source: EPA OIG analysis of state data.

Note: [a] Connecticut indicated it did not create a fundable list in SFY 2011 due to the heavy workload created by the American Recovery and Reinvestment Act.

Due to the generally low number of loans made relative to projects on the states' fundable lists, subsequent states' fundable lists contain a high percentage of projects that carried over from prior years. Figure 3 shows the percent of projects included on the fundable list that were repeated from previous fundable lists.

Figure 3: **Percentage of projects on state fundable lists that carried over from prior years**



Source: EPA OIG analysis of state data.

Note: [a] Connecticut indicated it did not create a fundable list in SFY 2011 due to the heavy workload created by the American Recovery and Reinvestment Act.

Federal regulations state that projects on fundable lists should be projects that are expected to receive assistance from available funds designated for use in the current intended use plan. However, we found that many projects are listed on state fundable lists for several years before they are finally awarded funds. Table 5 shows the year a project was first listed on the fundable list for the loans executed in SFY 2013:

Table 5: Projects first appeared on state fundable lists

State	Number of loans made in SFY 2013	Project originated on respective fundable lists			
		SFY 2010	SFY 2011	SFY 2012	SFY 2013
California	[a]38	15	8	2	9
Hawaii	10	3	5	2	0
Missouri	9	3	2	3	1
Connecticut	39	4	[b]N/A	35	0
New Mexico	[a]16	2	7	0	4

Source: EPA OIG analysis of state data.

Notes: [a] Four California and three New Mexico projects were not identified by auditors on the SFY 2010–2013 state fundable lists.
[b] Connecticut indicated it did not create a fundable list in SFY 2011 due to the heavy workload created by the American Recovery and Reinvestment Act.

Projects on Fundable Lists Not Ready to Proceed to Construction

The states we reviewed executed loans for a fraction of the projects on their fundable lists for a variety of reasons. Generally, we found that these states do not have a consistent definition of "ready to proceed." According to the EPA's DWSRF Program Operations Manual dated October 2006, projects on the fundable list should be ready to proceed. However, EPA has not defined "ready to proceed" in its regulations, although EPA best practices suggest that projects are ready to proceed when a signed construction contract is in place. States, however, do not have a consistent definition of "ready to proceed."

- Missouri places projects on the fundable list once an applicant has submitted a complete facility plan for approval and has established an acceptable debt instrument for their proposal. This is the state's definition of "ready to proceed." According to Missouri staff, when projects are initially placed on the fundable list, they are not necessarily construction ready, and in most cases it takes anywhere from 18 to 24 months for a project to proceed through the state's approval process. Therefore, "readiness to proceed" can be interpreted as ready to proceed with the state review process rather than with construction.

- The Hawaii fundable list contained projects that had construction start dates that were not within the current fiscal year, and contained projects that had unrealistic start dates. Hawaii staff informed the OIG that although there is no definition for "ready to proceed," the state deems projects ready to proceed in terms of how soon they may start construction or, at the very least, how soon they may issue a "notice to proceed" to a contractor.

- California changed the definition of its fundable list in the 2010–2011 IUP because it did not represent the list of projects that would be awarded funds within the current fiscal year. Prior to this, California's fundable list was synonymous to its Invited Project List—or those projects that were invited to submit a full application for funding from available funds. California staff told us that the term "ready to proceed" is not explicitly defined by the state, but the state views projects that are ready to proceed as those projected to be ready to enter into a funding agreement.

- New Mexico recently added "ready to proceed" to its criteria for including projects on the fundable list. New Mexico adopted the definition of "ready to proceed" as any project that will be funded within the next 3 months. Prior to 2013, whether a project was ready to proceed was not a consideration for including projects on New Mexico's fundable list.

- Connecticut also recently added "ready to proceed" to its project-ranking criteria. The state has a 2-year project-ranking process for projects that are ready to proceed with the activities as explained in the projects' workplan within the next 2 years. The projects that are deemed ready to proceed in the first year are ranked and placed on the first year's list. Those projects that were ready to proceed in the second year would be placed in the second year's list.

Staff at all five states indicated that, in the past, they had difficulty getting projects ready to proceed. Some states are still having difficulty getting enough projects ready for loan execution to reduce the unliquidated obligation balance to the value of 2 years of grants. Without a process to develop project capacity so that there is a succession or pipeline of projects ready to proceed, it will be difficult to reduce unliquidated obligation balances.

EPA regional offices need to improve their review of state fundable lists. States submit their IUPs in anticipation of their annual capitalization grant. EPA staff from one regional office told us that their review is not generally focused on the fundable list. Staff from another regional office informed us that projects on one state's fundable list are not necessarily ready to proceed, despite the fact that federal regulations required such projects to be funded within the time period covered by the IUP (which is typically 1 year). Staff from another regional office told us that the spirit of the fundable list is to identify projects ready to proceed, but did not know why the projects on the fundable list did not always receive funding.

Environmental Improvements Are Delayed

Since states use the fundable lists to justify their annual capitalization grants, the fundable lists should communicate to the EPA and the public a practical list of projects that will be funded with taxpayer money. When projects are not ready to proceed, expected environmental benefits are delayed. The EPA's priority is to move DWSRF funds as quickly as possible, to carry out projects on the ground to deliver improved environmental and public health protection. To accomplish this, states need to work with their communities to ensure fundable lists' projects are ready to proceed with construction so that project loans can be executed and construction can begin upon the receipt of annual capitalization grants. It is this pipeline of ready-to-proceed-with-construction projects that should comprise states' annual fundable lists. Doing so will ensure that states award a high percentage of these projects, resulting in improved environmental and health protection, and reducing unliquidated obligations.

Recommendations

We recommend that the Assistant Administrator for Water:

2. Develop guidance for states on what projects are to be included on the fundable list, including a definition for "ready to proceed."

3. Require that EPA regions, when reviewing the capitalization grant application for states with high unliquidated obligation balances, ensure states have adopted the EPA's guidance on the definition of "ready to proceed" and use that definition in developing the fundable list.

4. Communicate to states having high unliquidated obligation balances that they should adopt the best management practice of having a well-organized process to ensure that projects on the fundable list are ready to proceed to loan execution within the current IUP year.

Agency Comments and OIG Evaluation

The EPA disagreed with recommendations 2 and 3 and agreed with recommendation 4.

In response to recommendation 2, the Office of Ground Water and Drinking Water agreed that it is important to assist states in developing a common understanding of what "ready to proceed" means in the context of unliquidated obligation reduction. This issue is highlighted in the April 2014 strategy, which emphasizes the need for projects to be ready to proceed in that states should plan to award funding for projects that are ready to begin construction. Projects on the fundable list should be immediately ready, or be poised to be ready, to enter into assistance agreements. The Office of Ground Water and Drinking Water indicated it will be working with regions to assist states in reflecting this approach in their fundable lists.

The Office of Ground Water and Drinking Water recommended dropping recommendation 2 because it is closely related to recommendation 3. The OIG does not agree that the recommendation should be dropped. However, we believe the agency's action as detailed in the April 2014 strategy should address recommendation 2. Therefore, we consider recommendation 2 closed.

In response to recommendation 3, the Office of Ground Water and Drinking Water said, "EPA's Regions are expected to work with states to implement the strategy and to ensure that appropriate thought and care have been taken in developing states' fundable lists." During our exit conference, the Drinking Water Infrastructure Branch chief explained that the IUP review process is designed to ensure the strategy will be implemented. However, the Office of Ground Water and Drinking Water did not provide any instruction, such as an updated standard operating procedure, or a memorandum that requires regions to consider states' incorporation of the strategy in their review of the states' IUP. The OIG believes the agency needs to provide an action, or future action, and a corrective action date to address the recommendation. The audit resolution process will be used to resolve the recommendation

In response to recommendation 4, the Office of Ground Water and Drinking Water agreed with the recommendation. The practices outlined in the April 2014 strategy memo focus on projects that are ready to proceed to construction upon financing and advises that assistance for planning and design be awarded separately if projects are not expected to proceed to construction in the near term or project year. The strategy also calls for state adoption of project bypass procedures, recognizing that some projects on the fundable list may, for unanticipated reasons, not be ready to proceed as originally envisioned; and for the development of fundable lists that are sufficiently robust to facilitate the use of bypass procedures if needed. The EPA issued the strategy to the regional water division directors on April 14, 2014, and the strategy has been shared with the states. We consider this recommendation to be closed.

Appendix A provides the agency's full response to the recommendations. Appendix B provides the agency's April 14, 2014, strategy for reducing unliquidated obligations issued to regional water division directors.

Status of Recommendations and Potential Monetary Benefits

RECOMMENDATIONS						POTENTIAL MONETARY BENEFITS (in $000s)	
Rec. No.	Page No.	Subject	Status[1]	Action Official	Planned Completion Date	Claimed Amount	Agreed-To Amount
1	9	Reduce unliquidated obligations by:					
		a. Working with states with high unliquidated obligations to use financial tools to project future cash flows to aid in liquidating balances by using those projections in planning for expending funds in a timely and efficient manner.	C	Assistant Administrator for Water	4/14/14	230,641	
		b. Quarterly providing to the regions a summary of states that have attended the cash flow analysis training and compare that with states not achieving the goals of the 2014 strategy to identify states that may need additional assistance.	U	Assistant Administrator for Water			
2	16	Develop guidance for states on what projects are to be included on the fundable list, including a definition for "ready to proceed.	C	Assistant Administrator for Water	4/14/14		
3	16	Require that EPA regions, when reviewing the capitalization grant application for states with high unliquidated obligation balances, ensure states have adopted the EPA's guidance on the definition of "ready to proceed" and use that definition in developing the fundable list.	U	Assistant Administrator for Water			
4	16	Communicate to states having high unliquidated obligation balances that they should adopt the best management practice of having a well-organized process to ensure that projects on the fundable list are ready to proceed to loan execution within the current IUP year.	C	Assistant Administrator for Water	4/14/14		

[1] O = recommendation is open with agreed-to corrective actions pending
C = recommendation is closed with all agreed-to actions completed
U = recommendation is unresolved with resolution efforts in progress

Agency Response to Draft Report

(Received April 25, 2014)

MEMORANDUM

SUBJECT: Response to the Office of Inspector General Draft Project No. OA-FY13-0214, "Unliquidated Obligations Resulted in Missed Opportunities to Improve Drinking Water Infrastructure," dated March 12, 2014

FROM: Nancy K. Stoner
Acting Assistant Administrator

TO: Arthur A. Elkins, Jr.
Inspector General

Thank you for the opportunity to respond to the issues and recommendations in the subject audit report. The following is a summary of the agency's overall position, along with its position on each of the report recommendations. For those report recommendations with which the agency agrees, we have provided either high-level intended corrective actions and estimated completion dates to the extent we can or reasons why we are unable to provide high-level intended corrective actions and estimated completion dates at this time. For those report recommendations with which the agency does not agree, we have explained our position.

<u>AGENCY'S OVERALL POSITION</u>

The EPA agrees that the timely expenditure of federal funds for infrastructure is needed to ensure maximum use of resources and advance investment in the reliable delivery of safe drinking water. We welcome the IG's recommendations on potential improvements to this program in an effort to enhance the EPA's Drinking Water State Revolving Fund program. The EPA would like to acknowledge the role the primacy states have in this program. This might pose a programmatic challenge when determining how the EPA can adopt some of the corrective actions cited in the IG's report.

AGENCY'S RESPONSE TO REPORT RECOMMENDATIONS

No.	Recommendation	High-Level Intended Corrective Actions	Estimated Completion by Quarter and FY
4	Communicate to States having high unliquidated obligation balances that they should adopt the best management practice of having a well-organized process to ensure that projects on the fundable list are ready to proceed to loan execution within the current IUP year.	The practices outlined in the DWSRF ULO Reduction Strategy memo focus on projects that are ready to proceed to construction upon financing and advises that assistance for planning and design be awarded separately if projects are not expected to proceed to construction in the near term or project year. The Strategy also calls for state adoption of project bypass procedures, recognizing that some projects on the fundable list may, for unanticipated reasons, not be ready to proceed as originally envisioned; and for the development of fundable lists that are sufficiently robust to facilitate the use of bypass procedures if needed. Bypass procedures will enable a state to efficiently reach a ready-to-proceed project further down the list if needed. OGWDW also suggests that the IG's report reflect that it is appropriate for states' fundable lists to contain projects (immediately ready-to-proceed or poised to be so) of cumulative value that sufficiently exceeds the amount a state expects to provide in assistance in the period covered by the IUP.	OGWDW's DWSRF ULO Reduction Strategy was released on April 14, 2014; progress will be regularly tracked and reinforcement of the Strategy's messages will be ongoing.

Disagreements:

No.	Recommendation	Agency Explanation/Response	Proposed Alternative
1	Require States with high unliquidated obligations to use financial tools to project future cash flows to aid in liquidating balances by using those projections in planning for expending funds in a timely and efficient manner.	The draft report repeatedly asserts that OGWDW has established a ULO target of less than 13 percent of the cumulative federal capitalization grants awarded. This is a mischaracterization. During the time the OIG was conducting research for this report, OGWDW was developing a strategy to address ULO in the long term. Metrics under consideration included a metric based on states holding no more than two years-worth of capitalization grants as ULO at any given time. At the time of initial discussion, two years-worth of capitalization grants would have been approximately 13% of the cumulative federal capitalization grants awarded. OGWDW has since adopted a metric based on pace of funds liquidation as an appropriate indicator that conveys an understanding of assistance agreements being awarded and projects being initiated in a timely fashion (independent of percentage, which can mask liquidation status due to the accumulation of appropriations over time). On April 14, 2014, the Office Director emailed the Strategy to the Regional Water Division Directors. The Strategy includes objectives targeted towards spend-down of legacy ULO by the end of FY16 and management of future ULO based on liquidation of federal grant funds 24 months from the date of a state's capitalization grant award, respecting that there will be differences among states. OGWDW believes that this	Retain the spirit of the recommendation but re-phrase as "Work with States" rather than "Require." Started working with states on this initiative in 2QFY14; it's an ongoing activity.

		approach, framed within the expectation that states will work towards operating their DWSRFs to have ULO at the lowest practical level while recognizing that state circumstances vary, will promote appropriate focus on grant funds liquidation. OGWDW requests that the memorandum be included as an appendix to the IG's report.	
2	Develop guidance for States on what projects are to be included on fundable list, including a definition for "ready to proceed".	OGWDW agrees that it is important to assist states in developing a common understanding of what "ready to proceed" means in the context of ULO reduction. This issue is highlighted in the Strategy which emphasizes the need for projects to be ready to proceed in that states should plan to award funding for projects that are ready to begin construction; and should generally separate assistance for planning and design from assistance for construction. We will be working with Regions to assist states in reflecting this approach in their fundable lists.	This recommendation is closely related to Recommendation 3. OGWDW recommends dropping Recommendation 2 and modifying Recommendation 3 as suggested next.
3	Require that EPA Regions, when reviewing the capitalization grant application for States with high unliquidated obligation balances, ensure State have adopted the EPA's guidance on the definition of "ready to proceed" and use the definition in developing the fundable list.	EPA's Regions are expected to work with states to implement the Strategy and to ensure that appropriate thought and care have been taken in developing states' fundable lists. The Strategy also highlights the potential for states to use DWSRF loan or set aside funds to assist water systems with project conception, planning and design leading to readiness to proceed to construction.	OGWDW recommends modifying Recommendation 3 to "Regions should work with States to improve processes for accessing project readiness to proceed to construction, or to plan/design as appropriate.

Contact Information:

If you have any questions regarding this response, please contact Peter Grevatt, Director of the Office of Ground Water and Drinking Water on 202-564-3750 or Elizabeth Corr at 202-564-3798.

Attachments:
Drinking Water State Revolving Funds Unliquidated Obligations Reduction Strategy
National Priorities for the Drinking Water State Revolving Fund Program
Maximizing the Benefits of the Drinking Water State Revolving Fund through Efficient Federal Funds Management Practices
Letter to Don Chapman, Director of California Department of Public Health

Cc:
Mike Shapiro
Peter Grevatt
Michael Mason
Marilyn Ramos

Appendix B

April 14, 2014 Office of Water's Strategy

(Received April 25, 2014)

MEMORANDUM

SUBJECT: Drinking Water State Revolving Fund (DWSRF) Unliquidated Obligations (ULO) Reduction Strategy

FROM: Peter Grevatt, Director
Office of Ground Water and Drinking Water

TO: Water Division Directors
Regions I-X

This memorandum presents a national strategy to reduce unliquidated obligations (ULO) under the Drinking Water State Revolving Fund (DWSRF). DWSRF ULO are unspent funds from grants provided to states by the Environmental Protection Agency to assist drinking water systems in financing needed infrastructure improvements. States may also use a portion of their DWSRF grant funds as set asides for other important public health protection purposes including helping water systems, particularly small systems, strengthen their technical, managerial and financial capacity; implementing state Public Water System Supervision (PWSS) programs; and providing support for source water protection. The DWSRF ULO reduction strategy is directed to the timely expenditure of federal funds for these activities and supports our broader collective goal of maximizing the use of all DWSRF resources to advance investment in the reliable delivery of safe drinking water to the American people.

The strategy focuses on two key objectives: 1) liquidation of past years' grant funds and 2) maintenance of lower levels of ULO in future years. These objectives are framed within the expectation that states will work towards operating their DWSRFs to have ULO at the lowest practical level while recognizing the varying institutional and financial circumstances of each state. The objectives are accompanied by a set of practices to assist states and to encourage them to operate the best infrastructure financing programs they are able within their respective institutional frameworks. These objectives and practices are described in further detail below. The strategy's overall approach is further reinforced by the "best practices" identified by both the Council of Infrastructure Financing Authorities (CIFA) and the Association of State Drinking Water Administrators (ASDWA).

The strategy evolved from a series of consultations with states, CIFA, ASDWA, and you and your Regional DWSRF and PWSS staffs. The strategy's objectives and practices have received positive feedback from CIFA's and ASDWA's boards of directors, reflecting the continuing strong emphasis that these organizations place on sound DWSRF funds management. I appreciate your thoughtful input and perspectives and your acknowledgement of the multiple aspects of DWSRF funds utilization that need to be addressed collaboratively now and into the future of the program to ensure timely, expeditious and efficient use of these federal dollars. The strategy also builds on my memorandum to you of September 12, 2013, which describes flexibilities that states have under DWSRF regulations to help in addressing certain aspects of ULO, including use of federal funds on a first-in first-out (FIFO) basis; bypass procedures for projects not yet ready to proceed; funds use equivalence for additional subsidy and green projects; and funds reserve authority for DWSRF set asides. These flexibilities are already used by many states and will enable others to accelerate their efforts to spend their DWSRF grant funds.

I want to express my appreciation for your support and that of your staffs in the development and early implementation of key aspects of this strategy. An important step that all Regions took working with states in 2013 was to award all DWSRF state grants in the fiscal year of appropriation. The state associations have also endorsed this step. We will need to continue on this foundation of prompt grant awards in 2014 and future years. Your continued engagement on these issues will be essential to assure the full, timely use of these funds to address high priority public health protection needs of water systems within each state.

Strategic Objectives

The strategy aims to reduce DWSRF ULO for both loan and set aside funds to lower yet practical levels, targeted to occur within financially manageable timeframes as indicated by the experience of states with low ULO, while respecting that there will be differences among states. This aim is reflected in the strategy's objectives:

(1) Full utilization of funds from previous DWSRF grants (FY 2013 and prior years' funds) by the end of September 2016.

    These grant funds may be referred to as "legacy ULO" as they will have been available for a significant period of time by the end of fiscal year 2016. These loan and set aside funds are a focus of immediate concern and attention. I encourage you to focus most intensively on states with higher ULO while ensuring that others remain on their paths to meet or continue to stay within this objective.

(2) Complete draw down of funds from future years' grants within two years from the date of grant award.

    This objective addresses the maintenance of lower ULO in the future to support timely, expeditious and efficient use of DWSRF grant funds for both loan and set aside assistance. The purpose is to prevent accumulation of grant funds and minimize the number of open grants. States that are meeting or exceeding this objective are encouraged to continue to do so. Regions are asked to work closely with all other states to reduce carriage of ULO and manage within the objective.[1]

Practices

The strategy focuses on fundamental DWSRF program management practices, with heightened emphasis on approaches that can help reduce ULO. Many states are already successfully using these "best practices" to support sound funds management and timely public health protection. I am asking you to join me in working with states to adopt the following practices, directed toward the strategic objectives, where needed:

(1) **Focus on Ready-To-Proceed Projects**. Proactive efforts by states to help get projects ready to proceed to financing and to ensure that construction of funded projects is initiated on schedule represent an investment in protecting the health of our communities. States have options available through the use of either DWSRF loan funds or set aside funds, or both, to work with water systems at each phase, from project conception through planning and design, to ensure that priority infrastructure projects are ready to proceed to construction. State financial assistance for project planning and design can offer opportunities for water systems, especially small systems, in preparing projects for construction. States are strongly advised to ensure that construction funding for projects on the fundable list is not awarded until projects are ready to begin construction. If DWSRF funds are provided up front for planning and design, those funds should be awarded separately from funds for construction, unless the project is assured to proceed to construction within the near term; for example, in the same program year.

(2) **Develop a Robust List of Fundable Projects.** A robust fundable list contains projects of cumulative value that sufficiently exceeds the amount a state expects to provide in assistance in the period covered by its Intended Use Plan (IUP). Projects on the fundable list should be immediately ready, or be poised to be ready, to enter into assistance agreements. A well-developed fundable list affords a state the option to bypass projects not ready for financing due to unanticipated issues. Incorporation of bypass procedures into IUPs enables states to efficiently advance ready projects, while appropriate use of these procedures facilitates project timeliness and expeditious funds use for responding to priority public health needs. Solicitations by states of water system projects needing capital investment to protect public health underpin the development of the comprehensive project lists from which fundable lists are drawn and are an important

[1] Some states, particularly with respect to set aside funds, may face challenges that could constrain their efforts. In such instances, states in collaboration with Regions should carefully consider, wherever possible, alternative approaches for using the funds in the timeliest manner possible to achieve their intended public health protection purposes. Additional time to use set aside funds is envisioned not to extend beyond twelve months.

early step; states' efforts to ensure that water systems within their jurisdictions are well-informed of the financing opportunities available through the DWSRF are key to support this process.

(3) **Forecast Financing Capacity through Use of Cash Flow or Similar Analysis.** Understanding the relationships between future incoming funds, projected disbursements and future project needs is a powerful tool that states can use to optimize the productivity of all of their DWSRF funds. Incoming funds include the federal capitalization grant and state match, as well as principal and interest payments on loans, leveraged bond proceeds and fees. Cash flow modelling allows a state to determine the amount of assistance its program can prudently provide in a given year and can help a state assess the impacts of current year financing decisions on future years' financing capacity. Particularly when used in conjunction with a robust list of fundable projects that are ready to proceed, cash flow analysis can help states to maximize the pace of project funding where supported by sound financial management principles. It can also assist states in moving funds more quickly to reimburse project expenditures, supporting expeditious draw on federal and other sources of funds. I ask that you encourage states not using cash flow analysis to participate in training offered by my office to facilitate their understanding of the techniques and conditions that support this approach and that you work with them to determine how its use might enhance their ability to finance needed drinking water infrastructure.

(4) **Manage Set Aside Accounts to Reflect the Pace of Funds Use.** Set aside funds are a hallmark of state flexibility under the DWSRF program and are taken by states for a variety of purposes, such as technical assistance, PWSS program management and source water protection, as well as for planning and design grants for project readiness. In taking set asides, states have options that they can exercise to support effective use of these funds while minimizing ULO. States that have long-term projects funded with set aside funds can reserve the authority to take funds from a future grant, in lieu of the current grant, to support these multi-year projects. States may reserve the authority for the two percent, four percent and ten percent set asides. Once authority has been reserved it does not expire and may be exercised by the state against any future capitalization grant. Other approaches that may be useful to a state in managing set aside accounts include adjusting the amounts taken from one year to the next to reflect actual pace of spending; and transferring accumulated unused set aside funds to the loan fund.

(5) **Draw Down Federal Funds and State Match First.** States have several sources within their drinking water revolving funds from which to draw funds for reimbursement of project expenditures. Please encourage states to draw federal capitalization grant funds and state match funds before using other funds, to the extent possible, to cover these

reimbursements and reduce ULO. This approach of prioritizing federal and state match draw down can be informed and facilitated by cash flow analysis.

(6) **Accelerate Federal Cash Draws through Prompt Invoicing.** To help manage ULO, please encourage states to work with assistance recipients to achieve submission of invoices as promptly as possible (such as monthly, as indicated by national association "best practices") and to expedite review of project payment requests to effect timely cash draws of federal capitalization grant funds.

These practices are dynamic and interactive. My staff will continue to work with staff in the Regions and states and state associations to promote these practices, drawing on the experience of states in reducing and maintaining low ULO as well as ongoing efforts by CIFA and ASDWA to advance cash flow approaches and set-aside management.

Strategy Implementation

This strategy is for immediate implementation. I advocate that you confer closely with states in your Region to put these practices in place as needed to support ULO reductions and to position states as much as possible to achieve the strategy's objectives, recognizing that states present a wide range of circumstances and starting points relative to the objectives and in utilizing the supporting practices. For states that currently meet or exceed the objectives, it will be important to ensure that these achievements are maintained. For others, your dedicated efforts to assist in developing a sound and sustainable path to meet the objectives will be critical. For those states understand any factors that may impede meeting the objectives, while working to attain the lowest ULO balances possible.

To further assist you, I will make my staff available to consult with your staff and any state officials that you identify as needing information or technical assistance. My staff has been tracking ULO and will continue to provide this information to your staff on a monthly basis to facilitate your frequent evaluation of each state's progress and assist you in identifying where further assistance to states is needed. I will continue to evaluate our collective efforts and will seek your input should we need to reinforce this strategy to achieve its purpose of significantly lowering ULO levels.

My office is committed to support you and the states. My staff recently conducted a webinar in collaboration with state and regional presenters on cash flow analysis as a recommended tool to support timely, expeditious and efficient use of funds. Additional webinars and materials are planned that will further address this and other financial management aspects of the DWSRF program. As you work in consultation with states to understand their individual circumstances, you may identify other needs and opportunities for overcoming hurdles to reducing ULO. I am available upon your request to discuss ways in which my office might be able to assist. There may also be opportunities for states to support each other through transfer of knowledge from direct experience and use of best practices. I would be happy to communicate with states' national organizations to assist in brokering these kinds of state-to-state relationships.

Programmatic mechanisms are also available to you and may be useful in working with states to attain ULO reductions. These include specifying state DWSRF grant budget and performance periods, and grant conditions, if needed; state changes in Intended Use Plans; and, if appropriate, state modifications to DWSRF operating agreements which might be useful in documenting state-administered financial processes. While EPA's grants policy allows up to seven years for full expenditure of open grants, the DWSRF regulations call for the expenditure of all funds as efficiently as possible, in an expeditious and timely manner. Implementation of this strategy across the national DWSRF program will promote a focus on expeditious liquidation of grant funds to ensure that appropriated dollars are being used to address critical public health needs in a timely manner.

You may also find it helpful to track the pace of states' implementation of the above-described strategic objectives, as well as use of the practices, as you evaluate whether the strategy's objectives are being achieved in your Region. I will be doing so on a regular basis to support collaboration with you on achieving progress in ULO reduction. Together we need to carefully evaluate the efforts of each state in ULO reduction. I look to you to actively ascertain that a state is making or has made sufficient progress towards sound management of its DWSRF funds and, if warranted, to take appropriate action to ensure proper and timely funds use.

I want to thank each of you and also convey my appreciation to CIFA, ASDWA and their respective board members for sharing insights and expertise in the development of this strategy. I look forward to working with you and the states to ensure the timely use of DWSRF funds for public health protection. Please contact me or have your staff contact Chuck Job, Chief, Infrastructure Branch, at (202) 564-3941 or job.charles@epa.gov at any time with questions or to share ideas to advance this important initiative.

Distribution

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