

**Management Discussion of the California Safe Drinking Water State
Revolving Fund Program
Prepared by U.S. EPA, Region 9
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Background

Since inception, the California Safe Drinking Water State Revolving Fund (SDWSRF) Program has been operated by the California Department of Public Health (CDPH) with contract support from the California Department of Water Resources (DWR) and various independent contractors, including Self-Help Enterprises, University of California-Davis, and the California Rural Water Association. Within CDPH, the SDWSRF Program is operated through a decentralized arrangement that assigns different aspects of loan processing, financial management and project management to CDPH Technical Programs Branch, engineers and funding coordinators in the CDPH district offices, and CDPH Financial Management Branch.

With 294 executed assistance agreements totaling over \$1.2 billion¹, the SDWSRF has made significant contributions to ensuring safe drinking water to California communities of all sizes. In addition, California has instituted two state bond programs in recent years, Propositions 50 and 84, which have provided millions of dollars in grants for water infrastructure projects. The SDWSRF Program goals focus on addressing public health risks and helping small disadvantaged communities (serving 10,000 or less) to achieve compliance with drinking water standards. This focus has resulted in small systems receiving 62% of the total SDWSRF assistance agreements and 16% of the total dollars provided in assistance funding.²

In recent years, CDPH has sought to improve the effectiveness of its SDWSRF Program to meet its yearly funding commitment goals. However, the amount of SDWSRF funds committed to projects, as a percentage of available funds (i.e., fund utilization or pace of the program) continues to be below the level sought by EPA and CDPH. Similarly, the percentage rate of “unliquidated obligations” (ULOs)³ is the highest of any state thereby heavily impacting the national performance of the Drinking Water State Revolving Fund (DWSRF) program. At the time of the EPA 2011 Annual Review, the SDWSRF had \$462.3 million in ULOs, including ARRA funds. The amount of open capitalization grants to CDPH totaled approximately \$724.6 million (including ARRA). Thus, as a percentage of open capitalization grants, CDPH had a ULO rate of about 64%. Expressed as a percentage of total capitalization grants since inception, CDPH had a

¹ /Reporting year ending June 30, 2011; U.S. EPA National Information Management System (NIMS)

² / Information summarized in Table I, Attachment 1 as reported from U.S. EPA NIMS, year ending June 30, 2011

³ /The definition of an “unliquidated obligation” is the unexpended balance remaining from the amount of federal funds EPA obligated to an agreement under 31 USC 1501(a) (5). For the SDWSRF program, this is the total amount of EPA capitalization grants that CDPH has not “drawn down” whether formally committed to projects through a funding agreement or not.

ULO rate of about 32%.⁴ Because of SDWSRF's high rate of ULOs and its slow rate of financing DWSRF eligible projects, a detailed on-site program review was conducted as part of EPA's 2011 annual review.

The objective of this review was to help EPA understand the interactions among the different processes and organizations involved in the annual SDWSRF financial assistance cycle, and to identify ways to streamline or otherwise improve the SDWSRF operations to increase the pace of the program and reduce ULOs. The review was comprised of on-site or telephone interviews with CDPH staff in the district offices of Richmond, Santa Rosa, and Los Angeles and in the headquarters offices, staff from the Department of Water Resources, and telephone interviews with third party contract providers, non-governmental organizations, and SDWSRF recipients. In addition, EPA interviewed staff from DWSRF programs in other states to identify best practices. EPA's observations and recommendations are summarized in the remaining sections of this report.

Key Observations and Recommendations

EPA found the SDWSRF Program to be operated and staffed by capable and attentive individuals that are committed to the success of the program and to achieving compliance with Safe Drinking Water (SDWA) requirements, protecting human health and assisting small and disadvantaged communities. However, notwithstanding steps taken by CDPH to improve the effectiveness of its SDWSRF, the program continues to experience delays in finalizing assistance agreements and disbursing funds. Therefore, EPA is identifying possible actions to help streamline or otherwise improve SDWSRF operations and the program's ability to efficiently commit and expand all funds in an expeditious and timely manner, while maintaining the program's commitment to public health.

EPA has identified the following key concerns/issues that need to be addressed regarding the funding of projects by the SDWSRF:

- Need to establish a more comprehensive SDWSRF Program planning process that will efficiently and effectively bring viable projects into the SDWSRF and will increase the financial and public health benefits of the program.
- Lack of an internal and external outreach or marketing plan.
- Need to develop partnerships with other State or Federal financing entities and community stakeholders.
- Barriers to financial management, planning and modeling.
- Inefficiencies in claims processing/accounting support.
- Need for a proactive project development plan and selection process.
- Organizational inefficiencies.

⁴ /As reported by U.S. EPA, HQ, ULO calculations current as of May 30, 2012 and include all grants from 1997 through 2011 (does not include the unawarded 2012 grant).

I. Improve Customer Base, Program Performance and Project Eligibility Through Outreach

Observations

- 1) Internal and external pressure to fund small and disadvantaged communities with serious drinking water problems has placed enormous strain and demand on the SDWSRF Program and staff resources, limiting CDPH's ability to fully utilize SDWSRF funds. A number of small disadvantaged communities in California have public water supplies that do not meet SDWA requirements and pose a threat to public health. These threats are among the most severe faced by California public water supplies, and thus they are a top priority for CDPH to address through the SDWSRF Program. There is also strong political pressure on CDPH to address the drinking water needs of these communities, who struggle both financially and with the complexities of the federal and state DWSRF requirements. Environmental justice and stakeholder groups lobby heavily for CDPH to provide additional support to small systems. In response to the needs of the small communities and the associated political pressure, CDPH devotes a large portion of their effort to addressing needs of small systems with serious drinking water problems. This focus on small communities with the most serious health problems plays a part in CDPH's inability to fully utilize the funding in the SDWSRF, resulting in high ULOs and low pace.
- 2) SDWSRF application requirements tend to be more onerous for small borrowers to complete. SDWSRF staff spends a disproportionate amount of time helping these borrowers through the application process. Many small or disadvantaged communities with high priority risk ranking are not ready to proceed when they are placed on the SDWSRF project priority list (PPL). The focus on and time needed to assist small or disadvantaged borrowers can often stretch on for several years after the initial project application, which over time has contributed to SDWSRF's under performance in converting SDWSRF funds into eligible assistance agreements. Improved planning, marketing, contact and communication with potential borrowers may be needed to ensure projects are ready to be funded.
- 3) CDPH's efforts to address the needs of small disadvantaged communities have not been widely recognized. As of June 2011, over half (62%; 181 out of 294) of cumulative SDWSRF assistance agreements have been made to small communities (i.e., communities with a population of 10,000 or less), and the percentage of cumulative SDWSRF dollars provided to small communities represents 16% (i.e., \$230 million out of \$1.4 billion). However, the perception among some small communities and stakeholders is that CDPH is not directing sufficient SDWSRF funds to the serious drinking water needs of small and disadvantaged communities. Improved outreach, contact and communication with potential borrowers and stakeholders may be needed to highlight program successes.

- 4) Although CDPH and their external stakeholders share similar environmental and public health goals aimed at serving small and disadvantaged communities, these goals are not productively aligned. The relationship between CDPH and certain stakeholders is strained, in part, because of opposing views concerning project eligibility. Also, some stakeholders seem to believe that providing SDWSRF loans to larger, communities diminishes the amount of funding available to disadvantaged communities. They do not recognize that, since disadvantaged communities typically cannot afford to pay even low rates of interest and must rely on grants or their equivalent, providing loans to more communities does not diminish the limited amount of subsidized funding available to disadvantaged communities. This breach between CDPH and some stakeholders may exist for several reasons, including a lack of understanding of the SDWSRF funding process, poor communication and interaction between parties, lack of consensus building, and failure to compromise and embrace change.
- 5) The public health infrastructure needs of small and disadvantaged communities can be served without compromising the ability of the program to grow and sustain the SDWSRF in the long term. The purpose of the SDWSRF Project Priority Ranking System is to establish a list of eligible projects to be funded such that the most serious public health risks are given the highest priority (categories A-G to be high priority, categories H-K to be medium priority, and categories L-O to be low priority). Since the entities listed highest on the PPL have traditionally been small or disadvantaged communities, many communities or systems with medium or low ranking priorities have sought funding elsewhere. The outcome is a customer base that is not well diversified. Many successful state DWSRF programs seek and deliver assistance to projects that are of a lower priority but ready to proceed to construction, which reduces idle funds, manages demand, and sustains the fund in the long term. The public health interest needs of all communities can be best served when the DWSRF is fully utilized with a robust and diversified portfolio of projects and customers.

Recommendations

Establishing a balanced and diverse portfolio of projects on the priority list that are ready to proceed to planning or construction within the next year will help improve financial planning, get more projects funded more quickly, and close out the capitalization grants more rapidly. SDWSRF can enhance its portfolio of projects without jeopardizing assistance to small and disadvantaged communities by expanding outreach efforts and improving community awareness and stakeholders' relations with CDPH. EPA recommends that SDWSRF consider the following options:

- a) Develop an outreach plan. Improving the role marketing and outreach play in raising the awareness about the DWSRF program to communities, stakeholders, and consultants has proven to heighten the success of many DWSRF programs. Having a broad spectrum of stakeholders has a direct, positive impact on the core DWSRF. DWSRF programs that engage their stakeholders effectively are more

successful in shaping that relationship to the greatest advantage. Outreach, education, training and technical assistance can help foster meaningful relationships within the program and transform stakeholder fear and/or animosity into understanding, productivity and a positive program strategy. Outreach can have the dual purpose of making community and state leaders more aware of the benefits of the DWSRF and of developing projects so they are ready by the time they get on the project priority list. States who have implemented outreach programs or established a dedicated marketing team indicated that improving outreach and reaching projects at the earliest planning stages resulted in:

- increased pace of assistance,
- improved quality of projects, and
- improved attainment of planning goals.

The state could use a portion of their 4% administration set aside to fund field engineers to conduct outreach and marketing activities. Training will be required to increase the engineers' understanding of the financial component of the program and to learn their new additional duty. California has multiple funding mechanisms, which stem from different funding sources (Federal and State) and that have different requirements, benefits and focuses. The engineers could provide guidance to recipients as to which funding source might be most appropriate, enhancing the relationship between SDWSRF and recipients and making subsequent application processing more efficient. Using the engineer in this manner would also increase the role of the funding coordinators, as they would be expected to oversee this aspect of the engineers' activities.

- b) Conduct and participate in workshops. In states around the country, community decision-makers have said that workshops are one of the most effective outreach tools. Conducting DWSRF workshops throughout the state geared towards communities and consultants, such as engineers, can inform them of the opportunities of the DWSRF and how they can minimize the application burden. The main objectives of these workshops are to increase transparency by creating an expanded awareness of financing options, needs, and project eligibilities, and an added benefit is to build trust in the SDWSRF Program.

Florida has had great success with its annual SRF workshops, which it conducts in cooperation with the Florida Engineering Society. The two-day workshop targets both communities and consulting engineers, who receive continuing education credits for their participation. Training engineers on the requirements of the DWSRF can be beneficial to communities.⁵

- c) Expand the role of CDPH District Staff or Third Party Providers. CDPH has a strong field presence by having Funding Coordinators and district engineers in each of the 5 CDPH Regional Offices. The Funding Coordinators serve as

⁵ As stated in the Texas Clean Water and Drinking Water State Revolving Fund Loan Process Management and Marketing Initiative Final Report, Prepared by Northbridge Environmental Management Consultants, July 10, 2009

SDWSRF liaisons with HQ, District staff, and the local public water systems. EPA recommends that CDPH consider expanding the role of the Funding Coordinators to include outreach. They could travel around their district on a regular basis to maximize their communication with communities and discuss the SDWSRF. This would allow them to work closely with communities to develop projects and work through the application process. This type of personal outreach has worked well in states such as Georgia and Arizona. New York has a 6-person team funded out of its 4% administrative set-aside that works directly with small communities throughout the state and assists them in developing projects and preparing applications. This team of circuit riders does not limit their assistance to DWSRF financing, but helps the communities come up with the best financing package (“one-stop shops” as described below in paragraph f), “Coordinate with other funding sources”). Pennsylvania has a team of 4 with similar responsibilities, and New Mexico has added state engineers who work closely with small communities on developing their preliminary engineering reports. This helps ensure that the projects are well-developed when placed on the project priority list, and that they will be ready to advance to the funding agreement relatively quickly.

To maximize resources and support to small water utilities and systems, the California State Water Resources Control Board Clean Water SRF and the SDWSRF may consider jointly co-funding, through a third-party contract, a “SRF Circuit Rider Team” to expand the quality and level of technical assistance provided from both SRF programs. This Team could follow-up with communities on the priority list whose projects have not been progressing to determine what the problems are and how the SRF program staff may help. Many third-party providers like Rural Communities Assistance Corporation are qualified and equipped to serve as liaisons with communities, by providing technical assistance, generating interest in the DWSRF, and providing support for workshops.

- d) Hire staff to conduct outreach for the SDWSRF. EPA recommends that the SDWSRF Program considering establishing a dedicated outreach or marketing team that supports HQ and the District Funding Coordinators, supervises and coordinates the third-party assistance providers, conducts workshops, develops and implements outreach tools (such as publications, brochures, websites, and award programs), and coordinates events and a “one-stop shop” program (as described in paragraph f) “Coordinate with Other Funding Sources”).
- e) Develop a SDWSRF strategic program plan. In the SDWSRF Program, the main focus areas are on complying with the SDWA requirements, public health and cost effectiveness. CDPH is grappling with balancing these focus areas with the drinking water priorities of the state as well as with the federal expectations of timely and expeditious use of the funds. Effort should be made by the SDWSRF program to conduct research to gain a strong understanding of the drinking water needs and priorities of the State so to help shape and create a productive and thriving program. By CDPH establishing a strategic SDWSRF plan, priority

funding areas can be identified and targeted for technical and financial support. Ideally, improved marketing, outreach and strategic program planning efforts would result in the development of a pipeline of projects and better management of the demand for assistance. The concepts of pipeline and demand management focus on two factors:

- Proactively finding the projects that will have the greatest benefits on public health and affordability; and
- Working closely with communities and knowing in advance which projects are likely to seek SDWSRF financing in the next two to five years.

These factors will help stabilize demand within the state, allowing it to engage in better financial planning, and ensure that funds go to where they are most needed.

- f) Coordinate with other funding sources. EPA recommends that CDPH consider forming a “One Stop Shop” similar to Arizona’s Rural Water Infrastructure Committee (RWIC). Funding coordination through one-stop shops, such as Arizona’s RWIC or with non-profit organizations, can assist with maximizing contact with communities and potential borrowers. Lending authorities or providers work with communities to come up with a funding package that works for them and is affordable. CDPH currently participates in the California Financing Coordinating Committee funding fairs, which serve to provide general information (by way of an information booth) about the SDWSRF Program. In contrast, one-stop shop programs are more “hands-on”, where the various state and federal funding agencies collectively discuss a particular community’s needs and possible funding options with that community.

For example, the Arizona RWIC serves as a "One Stop" funding entity for communities and small water systems in need of assistance, which generally have more difficulty securing funding. The RWIC hosts meetings around the state throughout the year where community leaders can present their projects to the committee; in turn, the RWIC comes up with a funding plan for the community, which often includes multiple funding sources in concert. The committee is composed of representatives from various infrastructure loan and grant programs, federal and state lending authorities, and technical assistance providers. It assists small drinking water and wastewater systems navigate the federal, state and local financial and technical assistance programs.

Likewise, the New York State Water and Sewer Infrastructure Co-funding Initiative was established to help communities find single or multiple sources of government funding available to them. With the help of an interactive website, <http://www.nycofunding.org>, communities:

- Learn about the government funding programs
- Determine which funding programs a project may be eligible for
- Understand the application process
- Obtain the optimum funding package for their project
- Streamline the funding process

Obtain funding more quickly.

The Initiative is staffed with a Co-funding Coordinator. Communities interested in project co-funding from participating state and federal agencies (i.e., USDA - Rural Development) can call the Co-funding Coordinator for an initial consultation. The community fills out a questionnaire about their project and provides it to the Coordinator. The information gathered from the initial consultation will be entered into a co-funding database and shared with the participating funding agencies. They will use it to assess the extent to which a project has been developed and to preliminarily determine whether a project is a good candidate for their respective funding programs.

- g) Explore charging an administrative fee on loan assistance agreements and using these fees to provide additional financial assistance for projects to small and disadvantaged communities and administrative support to the SDWSRF. CDPH could use some of the administrative fee income collected to establish a grant or low interest loan program specifically targeted to small or disadvantaged communities for engineering and design or construction projects. Since these funds are generated from fees and can be kept outside the DWSRF, a selection of federal requirements may not apply thereby expediting the funding process. In addition, a portion of the fee income can be used to supplement program administration (e.g., staffing, outreach, training, etc.) and technical assistance as discussed in section I.c.

II. Improve Financial Management Policies, Planning and Practices

Observations

- 1) Assistance recipients do not consistently provide sufficient financial project information to enable adequate financial planning and oversight. CDPH uses a conservative financial planning process that has kept the SDWSRF free of defaults for over 15 years. However, a number of factors have influenced the ability of the program to engage in effective financial planning, including lack of cash-flow projections and readiness-to-proceed issues. When essential project budget information is missing or insufficient, it is difficult to plan when draws or disbursements will occur and, therefore, forecast the financial status of the fund. Similarly, at a project level, the lack of financial information can result in an imbalance between the financial and engineering review processes, resulting in wasted effort (see observation 6 below).
- 2) CDPH has had difficulty in receiving timely and regular claim requests from assistance recipients, which slows the rate of funds disbursed and makes it more challenging to engage in cash management. To help ensure funds are disbursed in a timely and predictable pace, CDPH stipulates in the assistance agreement that claims must be submitted quarterly. However, the assistance agreement does not stipulate that the recipient submit a minimum dollar amount for each quarterly

claim request nor are there penalties or consequences imposed on the recipient for failing to submit a quarterly claim. The recipient should be held to a minimum claim amount based on its quarterly budget or estimate of construction costs. Delays in submitting claims make it more challenging to practice effective cash management. In addition, the District or field staff indicated that they were unclear about the financial structure of the program and the financial issues facing the program. This was often indicated by an expressed frustration over the funding delays and the ability to initiate project construction. Without a field staff that is well acquainted with the financial framework of the program, an opportunity to effectively work with communities may be missed.

- 3) The accounting support provided to the SDWSRF Program needs improvement. To receive a capitalization grant, the State agreed to operate the program in accordance with EPA regulations by retaining the necessary managerial, financial and technical skills. EPA assessed the accounting support situation within CDPH during the 2011 annual review and concluded that the support provided by the Financial Management Branch should be improved. The Financial Management Branch does not have dedicated accounting staff familiar with the basic requirements of the SDWSRF Program. Illustrating this point was the transaction test conducted on a SDWSRF set aside draw as part of the 2011 EPA annual review. Unlike the program draws, which are primarily processed by the Administration & Financial Section of the Technical Programs Branch and submitted to the Financial Management Branch for execution, the set aside draws rely on the Financial Management Branch for payroll and cost allocation. EPA determined that the selected draw was an erroneous payment because the Financial Management Branch was unable to provide adequate back up documentation to justify the draw. In addition to not being able to provide adequate documentation, the time and staff required to produce what the Financial Management Branch was able to produce was of concern. After four months of inquiry and EPA receiving portions of the information from the State, the Financial Management Branch was never able to walk EPA staff from beginning (expense origination) to the end (federal draw) of the process. That CDPH was unable to produce supporting documents to justify the set-aside draw calls into question the adequacy of CDPH's accounting records and procedures. The Federal DWSRF program requires that the State establish fiscal and accounting controls to allow for proper measurement of expenses incurred by the DWSRF. A program the size and complexity of the SDWSRF necessitates dedicated accounting staff with the necessary skills and abilities to establish fiscal controls and accounting systems that are sufficient to account for and report SDWSRF Program activities.
- 4) CDPH has not managed the program historically to accommodate repayment funds. When setting funding targets, CDPH has not taken into account the anticipated amount of repayments to the SDWSRF that will occur during the year. States are expected to commit fund repayments and other funds to projects within

a year of receipt. If all available funds are not committed to projects, then the IUP must contain a plan which details how and when the funds will be used.

- 5) The role of the Department of Water Resources (DWR) in implementing the financial aspects of the program has become an organizational hindrance.⁶ In the early years, DWR financial assistance to a technical agency like CDPH was practical. However, over time DWR has become an organizational hindrance rather than a help. Although it performs critical functions in the process, it does so in an inefficient decentralized manner. For example, DWR currently prepares the legal agreement (Notice of Application Acceptance or NOAA and Funding Agreements) for the SRF. So whenever an original agreement or an amendment to an agreement needs to be prepared it is first crafted by SDWSRF staff, sent to DWR staff for review and preparation, reviewed by DWR legal staff, returned to the SDWSRF staff for review and comments, returned to DWR as needed for corrections, distributed for final review and then distributed to the water system for execution. Similar back and forth occurs for performing financial reviews of assistance recipients, processing payment claims, change orders, etc.
- 6) Financial review of potential assistance recipients may not proceed concurrent with the engineering process. Interviews conducted by EPA with SDWSRF Regional engineers, District engineers, field engineers and funding coordinators revealed hardworking dedicated staff, knowledgeable on technical issues related to their respective projects, but engineering staff expressed considerable frustration. Engineering staff noted that often they would spend considerable time developing the engineering aspects of a project, only to have the project halted due to a lack of financial capacity. In these cases, engineering staff may have to repeat engineering studies and redo other work. This has led to numerous cases of inefficiency.

Recommendations

- a) Use financial modeling to anticipate the needs of the program and measure the financial impact of policy decisions and program changes. Nationally, many DWSRF programs use financial modeling to measure the financial impact of policy decisions and program changes. SDWSRF should use financial modeling to assess the impacts of policy decisions such as changing interest rates, portfolio diversification, funding timeline, transfer of funds, or over-commitment strategies. To be able to do this, CDPH needs to commit SDWSRF resources and develop a strategy that builds the technical expertise internally as well as the data components. The Loans and Grants Tracking System can serve as the tool, but CDPH needs to commit time and SDWSRF staff to develop the expertise and knowledge to properly use this tool. (Please refer to Section IV on LGTS in this report.)

⁶ /The organizational efficiencies concerning DWR were originally discussed in the *California Safe Drinking Water State Revolving Fund Process Review* prepared by Northbridge Environmental Consultants, July 2, 2008 for US EPA, Region 9.

- b) Use of cash flow modeling and construction cost tracking tools for financial planning should be a high priority. Cash flow modeling is an integral part of DWSRF financial planning. It is a projected budgeting of expected cash outflows versus cash inflows and monetary resources on hand. It also accounts for the element of time. Committing to a regular process that forecasts or models the cash flow of the SDWSRF could be a significant step in addressing the high unliquidated balances of the SDWSRF, both in the capitalization grants as well as in the loan repayment account. Cash flow modeling would help CDPH confidently forecast the SDWSRF dollars available to commit, in a timely manner, to new assistance agreements. Understanding the sensitivity of the SDWSRF to variables that affect cash flow conditions (such as interest rates, disbursement rates, income, etc.) could greatly help CDPH monitor the program's performance and develop short-term and long-term strategies for managing its cash flow (including ULOs) and executing assistance agreements. A solid cash flow model also serves to identify the operating factors that have the greatest value in improving program performance and is an excellent early warning system to help take corrective action and manage the financial health of a program. EPA Region 9 is currently developing a cash flow modeling spreadsheet that the SDWSRF Program will be able to use and update beginning in October 2012. It will be designed in such a way that when LGTS data is scrubbed and updated, accurately representing project and financial information in real time and is entered across all functional areas (including accounting), reports can be run to simply populate the cash flow model. The SDWSRF Program should consider training a minimum of 2 staff persons to develop the expertise to understand, update and offer sound financial advice on the outputs of the cash flow model. This expertise could also be obtained through contract support or by requesting an Inter-personnel Agreement with EPA, allowing CDPH to retain temporary staff with the expertise to support the implementation of the SDWSRF cash flow model.

To develop the data resources necessary for the above recommendation the SDWSRF Program should:

1. require recipients to provide a budget of construction costs with a schedule (i.e., dates and amounts) of projected claim requests for all costs upon execution of the funding agreement;
 2. require an updated claim schedule with each payment request, which is submitted quarterly as a term of the loan agreement; and,
 3. collect and update amortization schedules for each project and enter them into LGTS.
- c) Explore alternative loan or assistance mechanisms to achieve funding goals. CDPH should review the feasibility and need for other funding mechanisms such as refinancing, linked-deposit loans, and co-funding opportunities (as discussed in section I. e, "Coordinate with other funding sources"). Many SRF programs use linked-deposit loans with community banks, whereby the borrower is able to

obtain a lower interest rate without having to shoulder the administrative burden of the SRF. This can be helpful for small projects. Linked-deposit programs are “investments” rather than loans, so project sponsors are only required to undergo their local bank’s financial review process. CDPH may consider looking into this option for small projects.⁷

Another alternative is to offer communities or water systems with existing debt the opportunity to refinance. The SDWSRF may buy or refinance debt obligations of municipal, intermunicipal or interstate agencies where the initial debt was incurred and construction started after July 1, 1993. Refinancing could substantially reduce ULOs held by SDWSRF and initiate a repayment stream that could be used to fund future projects.

- d) Consider over commitment strategies to reduce ULOs. The over commitment of funds is the practice of committing more funds than are currently available, anticipating that additional funds will be forthcoming. Successful over commitment involves timing outlays to coincide with cash flows and repayments. Over committing allows a state to fund more projects and also helps reduce ULOs. For a state to effectively practice an over commitment strategy, precise financial planning and coordination is required to ensure expected future repayments meet or exceed requested disbursements. Thus, a good cash flow model would help SDWSRF implement an over commitment strategy. Oregon has been using an over commitment strategy since FY 2005 for its SRFs. This strategy has reduced unliquidated funds from around \$90 million to approximately \$2 million.⁸
- e) Hire a “point or control person” for the SDWSRF to improve the financial capacity and oversight of the program. The complexity of SDWSRF financing, and the desire by CDPH to target the needs of small and disadvantaged communities, supports dedicating a least one SDWSRF staff person to engage in financial and program planning full-time. To meet the financial capability requirements of the program and to coincide with CDPH’s plan to issue state match revenue bonds in the near future, CDPH should hire a SDWSRF “point or control person” with the necessary management, financial planning and forecasting skills to present funding options, program and financial plans to upper management. The role of this person would be critical in working and coordinating with the District Funding Coordinators and engineers, and looking for ways to efficiently and effectively assess funding options and viable projects.

7/ As stated in examples reported in the Texas Clean Water and Drinking Water State Revolving Fund Loan Process Management and Marketing Initiative Final Report, Prepared by Northbridge Environmental Management Consultants, July 10, 2009

8/ As stated in examples reported in the Texas Clean water and Drinking Water State Revolving Fund *Loan* Process Management and Marketing Initiative Final Report, Prepared by Northbridge Environmental Management Consultants, July 10, 2009

- f) Consider transferring funds from the SDWSRF to the CWSRF as a form of fund management. Under 119 STAT. 530 PUBLIC LAW 109–54, the U.S. Congress maintained in effect the authority to allow states to transfer as much as 33% of their annual drinking water state revolving fund grant to the Clean Water Act (CWA) SRF, or an equivalent amount from the CWA SRF to the DWSRF. With proper planning, priority setting, and public disclosure, this provision can assist a State in maximizing its infrastructure funding programs by increasing the availability of funds where they are most needed, enhancing bond ratings, and lowering borrowing costs without increasing risks. In the case of CDPH, a transfer of SDWSRF capitalization grant dollars is a viable way to reduce ULOs while providing the California CWSRF additional funds without having to issue revenue bonds. The Governor of a State may reserve an amount equal to 33% of the DWSRF capitalization grant and transfer the funds to the CWSRF. Moneys may be transferred between the SRF programs on a net basis provided that the 33% ceiling is maintained. Once money has been transferred, even if the donor SRF reaches the 33% limit, it may still be transferred back to the donor SRF from the receiving SRF by a subsequent transfer.
- g) Move many of the financial functions performed by DWR for the SDWSRF in-house to CDPH. With the aid of a fully functional LGTS, the hiring of financial analysts, and a SDWSRF point person, CDPH should assume the responsibility for many if not all of the DWR SDWSRF functions.
- h) Train and educate the SDWSRF engineering and technical field staff on the financial aspects of the SDWSRF Program. By increasing the financial knowledge of field staff, CDPH could gain a higher level of insight on the funding issues surrounding potential recipients. Having a better understanding and exposing the staff to the “big picture” of the program could be useful in resolving future issues. This will be especially important to the extent SDWSRF modifies their priority ranking system to place greater emphasis on readiness to proceed.

III. Enhance Application Process and Project Priority List

Observations

- 1) During telephone interviews conducted by EPA staff, former or existing SDWSRF recipients indicated that the application process was challenging and lengthy. Because the time between the pre-application deadline and the priority list being finalized is long, it can take 6 months or more before a potential assistance recipient begins the full application process. The full application process from pre-application to executed funding agreement can range from 2.5 years to 5.4 years depending on the type of assistance and the need to satisfy water rate increase requirements. In addition, claims documentation from assistance recipients is sometimes incomplete thereby delaying on average from 2 to 6 months CDPH’s ability to begin the SDWSRF Program’s payment process.

Together, this may contribute significantly to the lack of movement in the expenditure of capitalization grants, the number of open older grants, and the large, uncommitted fund balance of roughly \$425 million identified during EPA's annual review site visit in April 2012.

- 2) Projects listed on DWSRF Project Priority List may be outdated and no longer viable for funding. As of January 2012, the cumulative SDWSRF project priority list (PPL) holds 4,575 projects. Each year, new projects are added to the PPL, but existing projects are not deleted unless they receive funding or request to be removed from the list. As a result, many of the projects on the list are either outdated or not ready to proceed and CDPH must invite far down the list to find viable projects to reach the annual funding obligation target. Based on their pre-application and PPL ranking in 2012, over 600 water systems or entities were invited to submit a full application for SDWSRF funding. However, only 80 of these applicants were eligible for ranking on the fundable list and are likely to receive a funding agreement by the end of June 2013. Although the priority rating process is simple and straight forward, the criteria do not accommodate the broad spectrum of funding needs and demand. The SDWSRF PPL is cumulative and projects are not placed in categories to allow priority ranking within a specific grouping of projects.
- 3) SDWSRF offers several types of financial assistance to eligible project applicants, but restrictions placed on the assistance may limit their appeal to communities. The first is construction or Tier I funding to non-disadvantaged community projects that are ready to proceed to construction within one year. This financing option is typically offered for 20 years at one-half the State general obligation bond rate, at a \$20 million maximum amount of funding for each project in a fiscal year and a maximum funding amount of \$30 million for any system per fiscal year. The second type is planning or Tier II funding for a maximum length of 5 years at one-half the State general obligation bond rate, and a maximum per project funding amount of \$500,000. Lastly, financing for disadvantaged community projects have similar terms as Tier I and Tier II with the exceptions that the length of the loan may extend beyond 20 years, interest rate may be zero percent, and financial subsidies are available. However, when EPA conducted interviews with non-profits, water systems, and third party providers, they indicated that the requirements associated with Tier II planning were limiting. In particular, they said the maximum funding cap of \$500,000 and the 18 month deadline to complete the Tier II funding application and execute a financial assistance agreement limited their interest in this type of assistance. Offering different types of assistance can prove beneficial, but it is important to properly assess and evaluate the needs of communities before establishing multiple funding options.
- 3) The decision points for selecting a viable and ready project are lengthy and should be reassessed and streamlined. Within the current SDWSRF process, it is plausible for projects selected for the fundable list not to be ready or viable for

funding. The fundable list is adopted prior to fully vetting the technical and financial viability and readiness of the project. The decision point for placing a project on the fundable list seems premature.

Recommendations

EPA encourages the SDWSRF Program to study the application review and project priority processes to look for potential areas for improvement and streamlining. Doing so could free up time to work with struggling communities and potentially handle additional loan volume. CDPH should review its “typical” SDWSRF project timeline from pre-application to project completion to determine where there are delays and why they happen.

EPA recognizes that many aspects of the SDWSRF application and PPL processes are specified in State statute or regulations, however, there may be opportunities to simplify processes with or without regulatory changes, including reducing the time it takes to review and rank pre-applications, creating a funding list of viable projects, and minimizing the time it takes to make a funding decision. EPA recommends that CDPH consider the following actions or information requests as ways to enhance the project selection process and ensure that projects are ready when they are placed on the priority list or submit their full application:

- a) Utilize more of the available Local Assistance and Other State Program Set-aside. Providing for technical assistance related to capacity development will ensure small systems are eligible for SDWSRF assistance before they are listed on the PPL. The state of Indiana Department of Environmental Management has a strong Capacity Development Program. The program encourages public water systems to assess their capacity to function in a “business-like” manner by providing them with a self-assessment tool. This tool, in the form of a questionnaire (Exhibit A), is intended to help a system identify major capital and operating costs that could arise in the operation of their system. This is the first step in building the technical, managerial and financial capacity to decide the funding alternatives and steps needed to support a viable system. CDPH should consider the feasibility of increasing technical assistance to small communities using the 15% set-aside.
- b) Require engineering and financial reports for project ranking on the fundable list. The SDWSRF Program should consider revising its project priority process to focus on projects that are ready to proceed to construction. As part of the screening process to qualify for placement on the fundable list, entities should submit approved engineering and financial reports, which indicate that the project is ready to proceed. The State of New York, which may be a good example, requires the applicant to submit an engineering report before they will rank the project on the fundable list.

The New York Department of Health (NY DOH) keeps a comprehensive, multi-year list that acts as a project pipeline. The Multi-Year List includes all eligible projects for which pre-application forms have been submitted and reviewed, including those projects on the preceding Multi-Year List. The NY DOH accepts pre-applications on a continuous basis. All eligible projects for which pre-application forms are submitted on or before September 3 of each year will be included on the Multi-Year List in the final IUP. In addition, each year a Project Readiness List is developed for the IUP that includes all projects for which an engineering report or plans and specifications are submitted to the NY DOH or for which construction is completed by a specified date. A project is deemed "ready" when all technical submittals have been received by the NY DOH. Projects that have submitted pre-application forms, but have not submitted sufficient technical documentation may be included on the Multi-Year List, but not the Project Readiness List. Also, the Project Readiness List includes a subsidized funding line. Projects listed above this subsidy funding line include all those projects expected to qualify for a subsidized interest rate or hardship financing within the current IUP period. Provisions are made in the Project Priority Ranking System to by-pass projects that may not progress as expected.

NY accepts applications to provide short term funding for any project that is on the readiness list. Projects above the subsidy line are eligible for subsidized rate or hardship financing and projects below the line are eligible for market rate financing. Once applications for funding are received for projects on the readiness list a "missing items letter" is sent and weekly or biweekly project loan staff meetings are conducted with their partners at NY State Environmental Finance Corporation to track missing items and discuss follow-up with the communities.

NY DOH's method of ranking produces several lists so that projects with different levels of priority and readiness can be efficiently organized and managed. These listings will display the status of all projects in the system and indicate the final list of projects that qualify for funding in the current IUP.⁹ This allows the state to provide full transparency to the public while producing a manageable list of ready projects.

- c) Include project ranking categories to allow ranking within a specific grouping of projects. Federal legislation requires that, on an annual basis, a minimum of 15% of DWSRF be distributed to water systems serving a population of 10,000 or less. These water systems that qualify for financial hardship have special conditions that require a separate category for these projects. By creating ranking categories, CDPH can track and monitor the funding levels provided to these categories, which can help highlight program achievements and generate source data for developing goals and objectives for the amount of SDWSRF funding that will be

⁹ Information taken from the New York State Drinking Water State Revolving Fund 2012 IUP website http://www.health.ny.gov/environmental/water/drinking/iup/2012/docs/final_2012_iup.pdf

aimed at small and disadvantaged communities. One example of using ranking categories is NY, which created three priority ranking categories:

1. **Category A List:** consists of projects for small systems serving less than 10,000 people from the Project Readiness List. This list includes a funding line and a line designating the SDWA minimum funding requirement (15% of the DWSRF) for small public water systems.
2. **The Category B List:** consists of projects for water systems serving greater than or equal to 10,000 people from the Project Readiness List.
3. **The Category C (Hardship) List:** includes all eligible projects that have received written confirmation that they qualify for financial hardship assistance.

Also, SDWSRF's loans and tracking system can be equipped to track project categories for generating useful project and funding status reports.

- d) Offer short-term and long-term financing to expand financing options and improve readiness to proceed. In 2010, CDPH implemented a program change that offered separate SDWSRF financing for project planning assistance. Planning assistance can be especially beneficial for small and disadvantaged communities that may not have sufficient funds to help develop projects on their own. Also, funds for planning usually can be drawn quickly after commitment, thereby reducing idle funds. These loans can be converted to construction loans, however, the conversion does not appear to shorten or expedite the contract for construction funding.

To enable all communities to better pursue SDWSRF financing and improve the timing and funding of projects, CDPH should consider developing short-term funding and long-term funding programs in lieu of its current funding programs, i.e., planning assistance and construction assistance agreements.

Short-term financing could offer assistance for planning and design and also construction of the project. This would enable the entity to go straight from planning and design to construction without the additional step of applying for a new construction loan. For example, the New York DWSRF Short-Term Financing Program can be used for both planning and construction and must be converted to long term financing or repaid after a 3 year maturity. NY DOH accepts applications for short term funding for any project on the readiness list within its priority ranking category. Projects above the subsidy line are eligible for subsidized rate or hardship financing and projects below the line are eligible for market rate financing. Loans may be converted to long term financing even if all planning is not yet complete, but funds will not be disbursed for construction activities until plans are approved by the NY DOH.

CDPH should study the feasibility of offering other financing mechanisms to communities to determine the impact on the project timeline, ULOs, and

procedures and time required to implement planning only assistance. Offering other funding mechanisms may provide tangible benefits to CDPH, communities and water systems by meeting funding needs quickly and with administrative ease.

- e) Include a project schedule section or timeline in the pre-application. Applicants can indicate in the pre-application the planning and design status of their projects based on milestones (e.g., is the detailed engineering complete?) and provide an estimate for a construction start date. Mississippi has communities note on the pre-application when they would be ready to receive funding – fiscal year 2012, 2013 or 2014. This helps the program develop a pipeline of projects and place a project on the priority list closer to when it will require funding, removing some of the guess work as to when projects will be ready to proceed.
- f) Allow for automatic ranking of the pre-applications. Arizona has an online pre-application process, where projects get loaded into the data management system and can be ranked quickly. CDPH should consider including an electronic project ranking system in their SDWSRF automated loan and grant tracking system to allow project submissions to be completed online and ranked electronically.
- g) Eliminate District Office ranking of pre-applications. CDPH HQ should consider being the primary reviewer of the pre-application and consulting with the District Offices if questions arise. This would shorten the pre-application ranking process by 30 days. New York's program has successfully taken this approach and convenes a scoring committee of two or three HQ and District Office engineers if project costs are questionable or project scope is unclear and there is need for clarification.
- h) Limit invitation to submit full application to projects that will be ready to close within one to two years. This can reduce the number of invitations to process, the number of applications to screen and the amount of staff time dedicated to reviewing full applications. As a result, staff time can be redirected to other SDWSRF priorities in need of support.

IV. Integrate Loans and Grants Tracking System (LGTS) into all aspects of SDWSRF loan program

Observations

- 1) LGTS is a management tool that offers multiple benefits both programmatically and financially, however, within the SDWSRF Program there has been a discontinuity of LGTS usage. For the systems benefits to be realized, LGTS must be fully utilized by SDWSRF staff and data entered accurately and timely. CDPH has adopted and partially integrated LGTS for the SDWSRF. It appears that staff is using it for some aspects of project development and programmatic management. However, there is a clear disconnect with the financial side of the program. Accounting SDWSRF staff are not trained and do not use LGTS. This

means that meaningful disbursement data is not getting associated with and tracked per loan. The SDWSRF should be tracking disbursements on a per loan basis, to allow for the retrieval of real time financial information, and the ability to analyze historical disbursement information to project and plan for the future. A second area of incomplete utilization is with SDWSRF field staff. As LGTS is not a web based tool there are challenges in getting field staff appropriate access to the data base to upload the information and data for which they are responsible.

- 2) Regional EPA staff has historically not been able to reconcile NIMS data with that provided by SDWSRF to EPA in annual reports. LGTS data is used to populate the National Information Management System (NIMS), the data system EPA uses for annual monitoring and reporting to Congress and other entities on SRF program and financial performance. As transparency and accuracy are paramount, NIMS should be accurate and reconcilable with information provided EPA in other forums.
- 3) LGTS is not being fully utilized to account for SDWSRF cash streams associated with disbursements, repayments, interest earnings, capitalization grants, etc. Combining this information with the disbursement data and more specifically projected disbursement data would enable the program to model cash flow. CDPH is not dedicating the SDWSRF staff resources and collecting the information necessary to use LGTS to support cash flow modeling.

Recommendations

- a) CDPH should bridge any internal divides, specifically with the accounting section within the Financial Management Branch, and bring LGTS up to full functionality within the SDWSRF Program. CDPH should continue to pursue working with their contractor to push LGTS functionality out to the District Offices and to the Financial Management Branch. This will enable District staff to be responsible for the LGTS data elements associated with funding coordination and project management (e.g., construction timelines, site inspections, and community served data). Likewise, by creating a fully functional system whereby the Financial Management Branch uses LGTS to track and record SDWSRF fund disbursements and repayments, the program can embark on a path to strategic planning. The Financial Management Branch should assign an accountant dedicated to the SDWSRF Program with a core job responsibility of integration and use of LGTS.

The DWSRF program is a financial vehicle whose purpose is to meet the goals of the Safe Drinking Water Act (SDWA). If it is not managed as a financial vehicle, its ability to meet these goals is reduced. LGTS is the tool that allows managers to pull in program data, financial data, and historical data to manage the program and project needs into the future.

- b) Use LGTS to track projects through the application process and in scoring potential assistance recipients. Commendably, the SDWSRF has begun using

LGTS to track projects through the application process in order to reduce processing time and eliminate funding delays. We encourage CDPH to continue evaluating ways of using LGTS to streamline the SDWSRF application process and eliminate cumbersome and circuitous procedures.