Report to Management
Audit of the Cash Inflows from Outlays

April 14, 2010

Texas Water Development Board

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KEY POINTS OF REPORT

Overall Conclusion

TWDB responded quickly and appropriately to increase the amount of funding drawn from the federal government starting at the beginning of state fiscal year (SFY) 2007 in September 2006. Federal fiscal year (FFY) 2007 (that began October 1, 2006) and FFY 2008 showed record draws of federal funding and success in reaching "stretch" goals and reducing unliquidated obligations (ULO).

These successes were accomplished due to a visionary marketing plan, effective outlay processing, and a general awareness by staff concerning progress on projects. However, processes to automate tracking the progress of projects were not able to be completed, and suggestions from consultants were not fully implemented.

At the beginning of FFY 2009, the American Recovery and Reinvestment Act (ARRA) became a top priority for Environmental Protection Agency (EPA). Both EPA and TWDB were required to expend an inordinate amount of resources to timely complete ARRA requirements during FFY 2009 and the first third of FFY 2010.

The records for FFY 2009 and the first one-third of 2010 indicate that the funds drawn in these two recent years has declined from the record amounts drawn in FFY 2007 and 2008. The ULOs will likely become a concern to EPA in the near future and may prevent TWDB from utilizing funding that could be made available.

Key Facts and Observations

TWDB exceeded EPA "stretch" goals for the Drinking Water (DW) Program in 2007 and 2008, but draws of DW State Revolving Fund (SRF) federal funding decreased in 2009 and 2010.

TWDB needs to improve management of individual DW projects after the loan commitment is made.

TWDB drew CW funding expeditiously in 2007 and 2008, but fell behind during 2009 and 2010.

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A. Management Summary

1. Purpose

The purpose of this report is to present the conclusion, observations, recommended action plans, and management responses from the audit of cash inflows from outlays. This audit was conducted in accordance with the *International Standards for the Professional Practice of Internal Auditing* and generally accepted government auditing standards.

The government standards require that the audit is planned and performed to obtain sufficient, appropriate evidence to provide a reasonable basis for observations and conclusions based on the selected audit objectives. The evidence obtained provides a reasonable basis for the observations and conclusions based on these objectives.

2. Background

TWDB receives grants each federal fiscal year (FFY) to conduct the Drinking Water (DW) State Revolving Fund (SRF) and the Clean Water (CW) SRF Programs. The grant money is made available to TWDB by the Environmental Protection Agency (EPA) within two years after the award is made.

The funds remain in possession of the federal government until outlay reports containing invoices for valid expenditures are received from the loan and grant recipients. Once these outlays are processed, TWDB draws the funds from the federal government and deposits them in the SRFs.

For CW, all loans are initially funded with state funds. All of the funding is put in escrow and released to the loan recipients upon approval of review engineers. Federal funds are drawn after the fact from outlays sent in upon TWDB request. For DW, loan recipients must send in outlays prior to receiving funds. These outlays are processed as the projects proceed.

In 2006, EPA became concerned about the large amount of funding that had not been drawn from the CW and DW grants. They began to refer to these amounts as unliquidated obligations (ULO) and established “stretch” goals for drawing these funds more expeditiously.

During the course of this audit, over twenty staff members throughout various parts of the agency were consulted including staff from Executive Administration, Operations and Administration, Finance, Project Finance, and Construction Assistance.

3. Scope and Objectives

The scope of this audit encompassed the examination and evaluation of the adequacy and effectiveness of the internal controls and quality of performance in carrying out assigned responsibilities for cash inflows from outlays. The scope included specific program steps designed to assess:

- Accomplishment of goals and objectives,

- Effectiveness and efficiency of operations, and
- Safeguarding of assets.

The objectives included the following determinations:

- Status of "stretch" goals for drawing the ULOs in the federal grants for the DWSRF,
- Effectiveness of managing individual DW projects after the loan commitment is made, and
- Timeliness of drawing funds for the CWSRF.

4. Conclusion

TWDB responded quickly and appropriately to increase the amount of funding drawn from the federal government starting at the beginning of state fiscal year (SFY) 2007 in September 2006. Federal fiscal year (FFY) 2007 (that began October 1, 2006) and FFY 2008 showed record draws of federal funding and success in reaching "stretch" goals and reducing ULOs.

These successes were accomplished due to a visionary marketing plan, effective outlay processing, and a general awareness by staff concerning progress on projects. However, processes to automate tracking the progress of projects were not able to be completed, and suggestions from consultants were not fully implemented.

At the beginning of FFY 2009, the American Recovery and Reinvestment Act (ARRA) became a top priority for EPA. Both EPA and TWDB were required to expend an inordinate amount of resources to timely complete ARRA requirements during FFY 2009 and the first third of FFY 2010.

The records for FFY 2009 and the first one-third of 2010 indicate that the funds drawn in these two recent years has declined from the record amounts drawn in FFY 2007 and 2008. The ULOs will likely become a concern to EPA in the near future and may prevent TWDB from utilizing funding that could be made available.

5. Action Plans

The following steps are recommended:

- **Management should determine whether additional efforts to ensure entities are progressing with their projects and remitting outlays timely would increase the amount of funds drawn for the DWSRF.**

  Management should review and consider whether to further implement suggestions from the Northbridge report.

- **Management should develop and implement a process to identify and follow up on DW commitments that may not be viable and may not close and determine the necessary steps to remove them as active commitments from all databases and applicable reports.**

Management should consider how to automate the tracking of DW projects during the planning and design phase. Management should determine if staff could be assigned to work with each entity during the planning and design phase to encourage faster progress on projects and to ensure outlays are submitted promptly.

- **Management should determine if it would be expeditious to draw as much of the funding as possible from the 2008 CW grant by using Tier III projects and if it would be possible to have more Tier III projects on future IUPs. Meanwhile management should work with EPA to obtain clarification on drawing for Tier II projects that have not followed federal rules.**

B. Detailed Observations

1. TWDB Exceeded EPA "Stretch" Goals for the DW Program in 2007 and 2008, but Draws of DWSRF Federal Funding Fell Behind in 2009 and 2010

Amid concerns about large ULOs in the DW Program, the EPA wrote a letter on November 29, 2006, expressing the need to use DW resources as wisely and expeditiously as possible. In the letter EPA asked TWDB to assume a "stretch" goal of drawing at least $55.9 million from the DW grant awards for construction and $9.3 million from the cumulative set-asides by the end of FFY 2007. (Two of the drinking water set-asides are the responsibility of the Texas Commission on Environmental Quality (TCEQ) and reflect 12% of the DW grants. The other set-aside is the four percent reserved for TWDB administration of the program.)

At the time of this request, TWDB had a relatively low demand for DWSRF funding, so an aggressive marketing program was established. As a result the 2007 IUP reported the largest number of submissions of Projects Information Forms ever received in any fiscal year and the draft IUP for 2008 showed prospects for another record breaking year. By October 15, 2009, the total project costs on the IUP priority list had increased from about $272 million for the 2006 IUP to about $451 million for the 2009 IUP. Including ARRA, the total projects costs increased to about $4.7 billion for the 2010 IUP.

TWDB also assembled a project oversight team and an outlay team to ensure entities were closing loans expeditiously, continuing to make progress on projects, and sending in outlay reports. Projects were tracked manually and plans were made to upgrade automated systems with the Texas Water Information System Expansion (TxWISE).

Draws for FFY 2007 were about $59.7 million for construction and about $11 million for set-asides, exceeding the "stretch" goals by about $5.5 million. The EPA complimented TWDB in October 2007 and said they looked forward to "even more programmatic success" in FFY 2008.

For FFY 2008, EPA set total "stretch" goals to $78.3 million. Draws for FFY 2008 were about $79.6 million for construction and about $13 million for set-asides totaling about $92.6 million and exceeding the "stretch" goals by about $14.3 million.

In December 2008, TWDB contacted EPA to ask about the "stretch" goals for FFY 2009. At that time, EPA was concerned about the potential impact of Infrastructure Stimulus Bill later called the American Reinvest and Recovery Act (ARRA) and determined not to establish FFY 2009 "stretch" goals at that time. Due to ARRA, no "stretch" goals were established for TWDB for either FFY 2009 or FFY 2010.

TWDB submitted the last report to EPA on ULOs on October 31, 2008. In that report TWDB predicted drawing over $92 million in FFY 09 and almost $120 million in FFY 10 for construction. During FFY 09 TWDB actually drew only about $56 million for construction. During the first third of FFY 10, TWDB has drawn only about $15.5 million for construction. If construction funding continues to be drawn at the same rate through the remainder of FFY 10, TWDB would draw only about $46.5 million.

During FFY 2009 and through January 31, 2010, EPA and TWDB have been working to implement ARRA. Although marketing efforts and IUP submissions are still at record levels and efforts have continued to ensure entities are closing loans, efforts to ensure entities are progressing on their projects and sending in their outlays have diminished.

Many obstacles in the DW Program tend to deter rapid progress on projects. One problem has been the lack of an automated tracking system for projects during the planning and design phase to make a better determination if the project is making timely progress. Another difficulty is the environmental review process the entities must undertake. Many other agencies must approve the environmental reviews and TWDB has little control of the amount of time it takes to complete this process.

In July 2009, Northbridge Environmental Management Consultants issued a report entitled the *Texas Clean and Drinking Water State Revolving Fund Loan Process Management and Marketing Initiative Final Report*. In that report, several other obstacles to moving projects more quickly were pointed out that at this time have not been fully overcome including:

- Projects on the IUP list that are not ready to proceed,
- Lack of incentive for entities to submit regular loan outlays, and
- Need for enhanced training and updated procedures.

Now that the commitment and initial closing phase of ARRA has been completed, EPA may refocus on the regular DW Program and may again express concerns about the ULOs.

Recommended Action Plan 1: Management should determine whether additional efforts to ensure entities are progressing with their projects and remitting outlays timely would increase the amount of funds drawn for the DWSRF.

Management should review and consider whether to further implement suggestions from the Northbridge report.

Management Response 1: Management agrees with the recommendation as actions to improve project tracking were previously underway.

Implementation of Phase 1 for TxWISE, a project tracking software system, which will assist in improved project oversight, has been completed. Project data is currently being populated and staff trained. In addition, an improved automated Outlay process, which was first utilized and proven effective for ARRA projects is also underway. Additional project oversight functions have also been implemented (Project Leads and Review Engineers). SRF program changes meant to address a project's ready-to-proceed status are being drafted for presentation at the Board's next meeting. These program changes should assist in the pace of project draws.

Management will continue to evaluate whether additional efforts are needed to ensure DWSRF projects are progressing sufficiently and outlays are being submitted timely.

Management has reviewed the Northbridge report and is currently working on implementation of several of the report's suggestions. In addition, TWDB staff and TCEQ staff have been meeting monthly to discuss implementation of applicable suggestions in the report.

Responsible parties: DEAs of Construction Assistance, Operations and Administration, and Project Finance.
Estimated completion date: September 2010

2. <u>TWDB Needs to Improve Management of Individual DW Projects After the Loan Commitment is Made</u>

When DW loans are initially closed, generally a small amount of funding (5-10% of the commitment) is able to be invoiced and released. This usually includes some upfront costs such as the loan origination fee, bond issuance expenses, preliminary engineering planning, and preliminary engineering fees. Additional funds are released as the project proceeds and outlay reports are received.

As of the end of February 2010, about $86 million in DW commitments had not had an initial installment closing. For three of these loans totaling about $5.5 million, the projected closing date had elapsed over two months previously and TWDB staff believed the commitments would never close. One loan for about $65 million had been extended by the Board in February because the commitment would have expired. For another commitment of $.6 million, the projected closing date had passed and had to be changed. The other eight loans totaling about $14.9 million had anticipated closing dates between March and December 2010.

As of the beginning of February 2010, approximately $290 million in DW commitments were closed and pending subsequent installment closings. A large number of these projects, 44.8%, had not completed a subsequent installment closing for over a year. Commitments having an installment closing within the prior year, but not within the last three months, totaled 10.6%. A total of 44.6% of these commitments had a subsequent installment closing within the prior three months.

An example is one commitment for about $49.6 million that completed the initial installment closing in November 2007 for $1.8 million. The second installment, approximately $5 million, did not occur until the middle of February 2010. Meanwhile, the project's debt repayment schedule was such that all of the first closing amount and $2 million of the second installment was repaid by March 2010. This entity signed a large contract in July 2009 for $47,044,014 to construct a water treatment plant and was given the notice to proceed the first part of August 2009.

Entities receive a commitment that allows two years to close the first loan installment. Project Finance has a system to track entities from the time a commitment is made and to update closing dates as the commitment period progresses. There are commitments outstanding that may not be viable and may not close which need to be evaluated as they continue to be included in TWDB databases and reports. A process has not been implemented that will identify these projects as soon as possible and determine the necessary steps to remove them as active commitments from all databases and applicable reports.

After the first closing, projects normally move into the engineering and design phase during which there is no automated tracking of the projects. No TWDB staff is currently assigned to encourage entities to complete these phases. Because the amount of time between the original commitment and the completion of construction can be lengthy, the money for committed projects often remains in the DW grants for four or five years.

At the end of SFY 2006, TWDB had grant funding ranging back to the 1999 grant and a total balance in all the DW grants of about $283 million. TWDB reduced the combined grant balances by nearly $4 million in FFY 2007, by nearly $25 million more in FFY 2008, and by another $3 million in FFY 2009. This left a balance of about $251 million in the 2004 through 2008 grants.

However, at the end of January 2010, the grant balances for the 2004 through 2009 grants had increased to nearly $301 million. If the trend for draws continues for the rest of FFY 2010, the grant balance by the end of FFY 2010 will exceed the FFY 2009 level by about $2 million.

TWDB has a large demand for DW funding. Staff should be able to either encourage entities to take the money more quickly or make the funding available to other entities. TWDB needs to know the up-to-date status of each project with committed funding.

Recommended Action Plan 2: Management should develop and implement a process to identify and follow up on DW commitments that may not be viable and may not close and determine the necessary steps to remove them as active commitments from all databases and applicable reports.

Management should consider how to automate the tracking of DW projects during the planning and design phase. Management should determine if staff could be assigned to work with each entity during the planning and design phase to encourage faster progress on projects and to ensure outlays are submitted promptly.

Management Response 2: Management agrees with the recommendation.

Action is already underway to evaluate projects that currently appear stalled. Going forward a formal procedure will be drafted and implemented to identify and address potentially stalled projects on a routine basis. TxWISE and program enhancements discussed earlier will also assist in this task.

Management is working on enhancing the TxWISE program to specifically track milestones associated with the planning and design phase. Current staff assigned to each project/entity will utilize existing methods, the TxWISE tool, and the improved Outlay process to assist entities with constant progress and to ensure regular outlays are being submitted.

Responsible parties: DEAs of Construction Assistance and Project Finance
Estimated completion date: January 2011

3. TWDB Drew CW Funding Expeditiously in 2007 and 2008, but Fell Behind During 2009 and 2010

In the summer of 2006, EPA was also concerned about ULOs in the CW Program and established a "stretch" goal of drawing $58.2 million in FFY 2007. The ULO balances for CW were much smaller than the DW ULO balances. At that time TWDB was able to draw CW funds for all projects on all IUP years and was able to find completed projects with documentation available to quickly draw the funds.

TWDB has two types of CW projects: (1) Tier II projects that are funded completely with recycled money and must only follow state rules, and (2) Tier III projects that are funded with the federal grant and state match and must follow the federal rules. TWDB has always drawn federal funds from outlays on projects funded through both Tiers with the concurrence of EPA staff.

During FFY 2007, TWDB drew about $111 million leaving a ULO balance of about $17 million. During FFY 2008, TWDB drew about $63 million leaving a ULO balance of about $2 million. To accomplish these feats TWDB had assembled an outlay team and had an outlay coordinator that identified appropriate clients and encouraged them to send in outlays. They also drew most of the funding from Tier II projects.

At some point during this timeframe, TWDB determined that an outlay coordinator was no longer needed and that CW could only be drawn from the correct IUP year. During 2009 TWDB drew about $13.6 million in construction funding leaving a ULO balance of about $24.5 million.

During the audit of SFY 2009, KPMG, a contractor working for the State Auditor's Office (SAO), contacted the EPA Office of the Inspector General (OIG) regarding the ability of TWDB to draw on Tier II projects that do not follow the federal requirements. Although EPA had provided guidance that drawing on Tier II projects was allowable, EPA OIG determined it was not, and the SAO issued findings on February 22, 2010. An issue concerning the use of a specific list of Tier II projects to draw from must also be resolved. TWDB is working with the EPA to get consistent clarification on the rules, but in the meantime the only

draws that would be sanctioned by EPA OIG (and thus SAO) would be draws from Tier III project lists for the 2008 and the 2009 grant years.

During the first four months of FFY 2010 TWDB drew about $1.3 million for construction from the 2008 grant that will leave a ULO balance of about $23.2 million for construction in the 2008 grant by the end of FFY 2010. If construction funding continues to be drawn at the same rate through the remainder of FFY 10, TWDB would draw less than $4 million.

The Tier III project list for IUP year 2008 has three projects for a total of about $40 million. One of these projects for about $5 million is about 91% complete and another for about $15 million is about 100% complete. For 2008 CW, TWDB can draw 80% of the project costs from the CW grant. If TWDB could request and process outlay reports from these two projects, about $15 million could be drawn. Construction has not started on the other 2008 Tier III project with a commitment for $20 million, so it is not likely that many outlays from this project would be available to draw funding during FFY 2010.

The 2009 grant currently has about $14.1 million available for construction. As of March 15, 2010, no construction funding had been drawn from the 2009 grant. During the last two quarters of FFY 2010, about $14.1 million more will be added to the grant balance for construction. By the end of FFY 2010, if nothing is drawn, the 2009 construction grant balance will be about $28.2 million.

The Tier III project list for IUP year 2009 has six projects for a total of about $38.6 million. For 2009 CW projects, TWDB can draw 82% of the projects costs from the CW grant. Thus about $34.4 million of the $38.6 million would have to be spent and documentation sent to TWDB by the loan and grant recipients before this grant could be drawn from Tier III projects. Thus, for the 2009 grant, it would not be as easy to draw all the money using the Tier III project costs.

The larger the number of Tier III projects on the IUP, the easier it would be to draw all of the funds from them if decisions are made that cause drawing funds from Tier III projects to be a requirement. If agreements are made that the funds can also be drawn for Tier II project costs, an additional decision must be made whether a specific list of projects should be designated.

Recommended Action Plan 3: Management should determine if it would be expeditious to draw as much of the funding as possible from the 2008 CW grant by using Tier III projects and if it would be possible to have more Tier III projects on future IUPs. Meanwhile management should work with EPA to obtain clarification on drawing for Tier II projects that have not followed federal rules.

Management Response 3: Management agrees with the recommendation to draw as much 2008 CWSRF funds from Tier III projects as possible. Currently all eligible funds from 2008 and 2009 tier II and III projects that have closed and incurred costs are in the process of preparing Outlays for draws. As of 04/09/10, $16,092,671.06 has been drawn since 09/01/09.

Management has determined that it is not possible to increase the amount of Tier III projects on future IUPs as this could negatively impact the CWSRF capacity model. Better alternatives for increasing the pace of draws exist that

would not decrease the program's capacity, such as the program enhancements discussed above.

Management agrees and will continue to work with EPA regarding clarification of drawing for Tier II projects.

Responsible parties: DEA of Project Finance and Chief Financial Officer
Estimated completion date: January 2011

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