LAO
70 YEARS OF SERVICE

December 20, 2012

Hon. Luis Alejo, Chair
Assembly Environmental Safety and Toxic Materials Committee
Room 2117, State Capitol
Sacramento, CA 95814

Dear Assembly Member Alejo:

Following an e-mail and a subsequent meeting with your staff on December 4, 2012, we were requested to evaluate the administration and performance of the Safe Drinking Water State Revolving Fund (SDWSRF), as administered by the Drinking Water Program within the Department of Public Health (DPH). We suggested that this evaluation be completed by comparing the SDWSRF to a similar financing program operated by a different agency—the Clean Water State Revolving Fund (CWSRF) as administered by the State Water Resources Control Board (SWRCB). Your staff indicated that you would also be interested in a comparison of DPH's rulemaking processes specific to the SDWSRF with the SWRCB's rulemaking processes specific to the CWSRF. This comparison would serve to evaluate the perceptions that rulemaking processes take overly long in DPH while SWRCB is more timely and efficient, and to determine what is driving any such differences between the two agencies.

Your staff further requested that we address the topic of transferring the administration of the SDWSRF from DPH to the SWRCB. We were asked to determine whether such a transfer is allowed under federal law, and what the potential trade-offs of such a transfer would be. We have addressed these additional issues to the best of our abilities given the limited time provided.

LAO Bottom Line. In evaluating the performance and administration of the state's two SRFs, we largely relied on metrics developed by the United States Environmental Protection Agency (U.S. EPA) for use in their annual program evaluations of the two SRFs in California. These metrics include ones that measure the utilization of the fund, the efficiency of fund disbursements, and the return on federal investment. While the performance of the SDWSRF on these metrics has improved in recent years, it still generally performs less well than the CWSRF and significantly below the national average of the performance of other states' SDWSRFs.

In evaluating the differences in rulemaking between the two SRFs, we found that SDWSRF rulemaking is subject to the Administrative Procedures Act (APA) processes while CWSRF rulemaking is not. This is a key factor that we have identified that may contribute to the differences in the length of time that rulemaking takes for each SRF.

This difference in performance between the state's two SRFs may be partially explained by differences in the level of administrative resources, the extent to which SRF resources are leveraged, organizational structure, and the prioritization of projects. For example, we found that

SWRCB charges a service fee on SRF funding agreements, which serves to augment their administrative budget beyond the federally allowed administrative set-aside of SRF resources and may improve their ability to allocate funding. Additionally, the SWRCB has leveraged its SRF resources in the past by issuing revenue bonds, thereby generating additional resources for CWSRF projects and resulting in a higher return on the federal investment of capitalization funds. While DPH and SWRCB are organized differently (department versus board structure), it is difficult to assess the extent to which this impacts the performance of the respective SRFs. Finally, the U.S. EPA has stated that the focus of DPH's SDWSRF on serving small communities may also negatively affect SDWSRF performance on certain metrics.

Several potential solutions to improve the performance of DPH's SDWSRF have been suggested by the U.S. EPA and other stakeholders. These solutions include enhancing administrative resources for SDWSRF through charging a loan servicing fee, the use of leveraging to provide more funds, administering the two SRFs jointly, and increasing the focus of the SDWSRF on "shovel-ready" projects. We have described these solutions below, but have not evaluated them fully. These solutions warrant further evaluation.

In evaluating the potential transfer of the SDWSRF to the SWRCB, we found that such a transfer is allowed under federal law (subject to a change in state statute), reflecting the fact that federal law provides states with considerable flexibility in terms of who administers the two SRFs. We further found that several administrative models for the SRFs exist in different states. The U.S. EPA and other program stakeholders have also indicated that there could be administrative benefits to administering the two SRFs in a single agency. However, such reorganization would increase the need for communication between SWRCB and DPH as the administration of the SDWSRF would be in a different agency than that which administers the core drinking water regulatory program that the SDWSRF is tied to. In the time provided, we were unable to fully evaluate the trade-offs of such reorganization, but this concept warrants further evaluation.

BACKGROUND

Below, we provide background information on the two SRFs and their administration by the respective agencies.

The SRFs Were Established by Federal and State Law

There are two main federal environmental protection regulatory statutes that address water quality issues—the Safe Drinking Water Act (SDWA) and the Clean Water Act (CWA). The SDWA was enacted in 1974 to protect public health by regulating drinking water. The SDWA regulates public water systems, which may be government or privately owned. The CWA was originally enacted in 1948 and significantly reorganized and expanded in 1972. It was enacted to regulate the discharge of pollutants into water and protect surface water quality.

The U.S. EPA enforces both the SDWA and the CWA. Most states have been granted "primacy" by the U.S. EPA, giving them the authority to implement and enforce the two acts. The states with primacy must adopt standards that are at least as stringent as those adopted by the U.S. EPA and ensure that those standards are met. The DPH is the primacy agency for the

SDWA and the SWRCB is the primacy agency for the CWA. California has enacted its own safe drinking and clean water acts to implement the federal law and establish state standards.

The SRFs—intended to advance the objectives of the SDWA and CWA—were established through amendments to SDWA and CWA. The SDWSRF was established nationally in 1996, and in California by the California Safe Drinking Water State Revolving Fund law (Health and Safety Code section 116760 et seq.) with the enactment of Chapter 737, Statutes of 1997 (SB 1307, Costa). The CWSRF was established nationally in 1987 and in California Water Code sections 13475 et seq. in the same year.

States May Choose Between Different SRF Administrative Models

Federal law provides states with the flexibility to administer the SRFs in several different ways. For example, the two SRFs might be administered jointly or separately. A SDWSRF might be administered by a public health agency or by a resources agency. In practice, the administrative model for the SRFs varies nationally. For example, in Arizona, a financing authority jointly administers both SRFs, while the SDWA primacy agency administers other drinking water programs. In Delaware, the two SRFs were previously administered separately. However, as Delaware's SDWSRF program faced difficulty in efficiently utilizing its funds, the administration of the fund was recently transferred to the agency that administers Delaware's CWSRF. In California, state law provides for the separate administration of the SDWSRF and the CWSRF by DPH and SWRCB, respectively. Below, we briefly discuss the structure of these two agencies as it pertains to the SRF programs.

The SDWSRF Is Administered by DPH. The SDWSRF is administered by DPH through the Drinking Water Program. The DPH drinking water field operations district offices and regional funding coordinators rank potential projects on a Project Priority List and oversee the individual projects. The DPH Technical Programs Branch provides statewide consistency. The DPH also contracts with the Department of Water Resources to provide certain administrative services relating to the SDWSRF, including conducting a completeness review of applications, evaluating the applicant's ability to repay the loan, and recommending the amount of loan subsidy and the terms and conditions of the loan.

The CWSRF Is Administered by SWRCB. The SWRCB regulates water quality and administers water rights in the state. The SWRCB consists of a state board in Sacramento (composed of five members representing differing areas of expertise) and nine regional boards (each composed of seven members). The state board sets the policy direction for the regional boards and acts as an appellate body for regional board decisions. Within the SWRCB, the Division of Financial Assistance administers the CWSRF. The SWRCB also contracts with several entities to complete CWSRF tasks, including an independent accountant firm to provide annual CWSRF audits, outside legal counsel to provide tax advice, outside contractors to perform credit analyses of CWSRF applicants, and an external financial advisor.

The SRFs Support Projects That Further the Goals of SDWA and CWA

The SDWSRF provides funding for projects that support the goals of SDWA, and CWSRF provides funding to projects that support the goals of CWA. In general, the SRFs provide

financial assistance for the capital costs associated with water quality infrastructure projects, but not for ongoing operations and maintenance costs. As the two SRFs have differing objectives, the type of projects funded and the eligibility of applicants differ, as discussed below.

The SDWSRF Provides Funding to Meet Drinking Water Standards. The SDWSRF provides funding for projects that bring public water systems into compliance with drinking water standards; to assess or protect source water; and improve the technical, managerial, and financial capacity of public water systems. The main type of public water system eligible for SDWSRF assistance is a "community" water system—either publicly or privately owned—that serves at least 15 service connections (such as a home or business) or that regularly serves at least 25 people who reside in an area. Essentially, a community water system serves a community of people that can be expected to consume that water continuously throughout the year.

Examples of eligible projects include consolidating water systems, providing water treatment, replacing aging infrastructure, or improving water conservation and security. The majority of SDWSRF funds are allocated to construction projects. Funding is also available for planning and feasibility studies for certain eligible applicants.

The CWSRF Primarily Provides Funding for Public Agencies to Address Wastewater Treatment. The CWSRF funds projects addressing wastewater treatment, nonpoint sources of pollution, and estuary water quality protection. Public agencies—such as cities, towns, districts, and management agencies (as designated under section 208 of CWA)—eligible nonprofit and private entities, and Native American tribal organizations with jurisdiction over the disposal of sewage or other waste may apply for financial assistance from the CWSRF program. The SWRCB states that, over the life of the CWSRF program, 70 percent of the CWSRF funds were awarded to wastewater treatment and water recycling projects. Nearly one-quarter of the funds were awarded for wastewater collection system projects and 6 percent of funds were awarded to non-point source pollution or estuary protection projects.

Funding of the Two SRFs Is Similar

Both of the SRFs are funded by annual federal capitalization grants from the U.S. EPA and require a 20 percent match from the state (that is, the state provides $1 for every $5 of federal funds). The federal and state funds are then used to provide financial assistance, including below-market loans for water infrastructure projects. The proceeds from these loans are then paid back, with interest, into the SRF in later years, providing funding for new loans in the future (the revolving nature of the SRFs).

Federal Capitalization Grants for SDWSRF Are Currently Slightly Less Than for CWSRF. In federal fiscal year (FFY) 2011-12, the US EPA provided California with an $84 million capitalization grant for the SDWSRF and a $105.6 million capitalization grant for the CWSRF.

State Match May Come From Several Sources. In recent years, the state match for the SDWSRF has been generated through revenues from two state General Obligation (GO) bond measures, Proposition 50 (2002) and Proposition 84 (2006). The SDWSRF state match for FFY

2011-12 was $17 million. In recent years, the state match for the CWSRF has been provided through a combination of revenues from GO bond measures (Propositions 84 and 13 [2000]) and funds contributed by applicants. (Some SRF loan applicants were previously allowed to put up the state match portion of the funding in return for more favorable loan interest rates.) The CWSRF was not required to contribute any funds towards a state match in FFY 2011-12 because the state had already exceeded the state match (which is measured cumulatively since the beginning of the SRF). States may issue revenue bonds to meet the state match requirements for both SRFs. (We discuss the leveraging of these revenue bonds to increase SRF resources in further detail later.)

SRF Loan Repayments Also Fund SRFs. In the FFY 2011-12 Intended Use Plan (a required planning document submitted to the U.S. EPA), the SWRCB stated that principal repayment and interest on outstanding loans currently generates $221 million annually. These funds are deposited in the CWSRF and used to make new loans and provide other financial assistance. The DPH expects to receive $38.8 million in principal repayment and interest on outstanding loans for the SDWSRF in 2012-13.

Several Forms of Financial Assistance Are Offered

The two SRFs offer several forms of financial assistance, including low-interest loans, zero-interest loans, debt refinancing, principal forgiveness, and grants. When an interest rate is charged, it is generally set at one-half of the state's GO bond interest rate. (The current interest rate is about 2.5 percent.) Zero-interest loans, principal forgiveness, and grants are also available to certain agencies and communities. (Historically, CWSRF did not offer grants; however, federal and state law was modified in 2009 to allow for grants and principal forgiveness for eligible applicants.)

The Allowable Loan Term Is Generally the Same Under Both SRFs. Loans for construction projects in both SRFs generally have a term of 20 years, or the useful life of the project (whichever is shorter). Disadvantaged communities may be given up to 30 years to repay the loan. (A community is considered disadvantaged if the median household income is below 80 percent of the statewide average.)

SRFs Have Different Maximum Funding Amounts Per Recipient Per Year. The maximum funding allocated per recipient per year is generally $30 million from SDWSRF and $50 million from CWSRF. Additionally, the SDWSRF will generally allocate only up to $20 million per construction project per year.

EVALUATING THE PERFORMANCE OF THE TWO SRFS

The U.S. EPA uses several metrics to evaluate the timely and expeditious use of SRF funds. Such measures include a fund utilization rate, the percent of unliquidated obligations, the return on federal investment, and the ability to meet a federal requirement to commit the SRF funds within a year of receipt of the federal grants. (We describe each of these metrics in more detail below.) The SDWSRF generally performs less well than California's CWSRF and the national average of other states' SDWSRF programs on these federal metrics. Prior to discussing the performance of the state's two SRFs on these metrics, we provide some basic background

information on the potential demand for SRF funding in the state, and on the number and value of funding agreements executed annually by each SRF in recent years.

Demand for SRF Funds and Funding Agreements Executed

Demand for SRF Funding. The U.S. EPA regularly assesses the capital investment needs of public water systems and other water infrastructure (such as wastewater treatment plants) to comply with federal and state water quality standards. These infrastructure needs drive demand for SRF funding. In 2007, the U.S. EPA found that California had $39 billion in drinking water infrastructure needs (in 2007 dollars) over a 20-year period. In 2008, the U.S. EPA found that California had $30 billion of wastewater infrastructure needs (in 2008 dollars) over a 20-year period. As shown below, these needs (annualized) far exceed the average total amount of funding agreements entered into annually under each SRF.

Number and Value of Funding Agreements. In general, CWSRF has executed more funding agreements each year and disbursed more funds than the SDWSRF. The total yearly number of executed funding agreements and total value of those agreements from 2007-08 through 2011-12 can be seen in Figure 1. In 2011-12, the CWSRF program executed 48 agreements with a total value of $784 million, while the SDWSRF program executed 30 agreements with a total value of $269 million. From 2007-08 through 2011-12, the CWSRF has executed 266 agreements with a total value of $2.6 billion, while the SDWSRF has executed 104 agreements with a total value of $695 million.

Figure 1

Number and Value of Funding Agreements Executed in SDWSRF and CWSRF

	SDWSRF			CWSRF		
Fiscal Year	Number of Agreements	Value of Agreements	Average Value of Agreement	Number of Agreements	Value of Agreements	Average Value of Agreement
2007-08	15	$11,299,653	$753,310	34	$394,145,664	$11,592,520
2008-09	12	22,852,839	1,904,403	46	402,271,617	8,745,035
2009-10	20	156,869,574	7,843,479	105	578,035,388	5,505,099
2010-11	27	235,894,308	8,736,826	33	399,769,941	12,114,241
2011-12	30	268,696,175	8,956,539	48	784,407,987	16,341,833
Totals	**104**	**695,612,549**	—	**266**	**2,558,630,597**	—
Annual Averages	21	139,122,510	6,688,582[a]	53	511,726,119	9,618,912[a]

[a] Reflects average value weighted by number of agreements.
SDWSRF = Safe Drinking Water State Revolving Fund and CWSRF = Clean Water State Revolving Fund.

The Average Value of CWSRF Agreements Is Greater Than SDWSRF Agreements. The average value of CWSRF agreements from 2007-08 through 2011-12 is somewhat greater than the average value of SDWSRF agreements over the same time. Smaller funding agreements may be more labor intensive than larger funding agreements because smaller projects are often completed by smaller water systems that may need more assistance in preparing funding applications.

SDWSRF Does Not Meet Federal Requirement to Make Binding Commitments

The federal government requires that states receiving SRF grants make binding commitments to fund projects within one year of the receipt of the federal grants. The binding commitments must be in an amount that is cumulatively greater than or equal to the grant payments and the state match.

The SDWSRF Does Not Meet Federal Requirements to Make Binding Commitments. The U.S. EPA found that the SDWSRF frequently fails to meet the federal requirement to make binding commitments that are cumulatively greater than or equal to grant payments and the state match within one year of receipt of payment. Over the history of the SDWSRF program, the U.S. EPA found that the DPH only met this requirement in FFY 1999-00 and FFY 2010-11.

The CWSRF Generally Meets Federal Requirements to Make Binding Commitments. The U.S. EPA has found that, in general, CWSRF has successfully met the binding commitment requirement.

The SDWSRF Fund Utilization Rate Is Lower Than CWSRF's Rate

The fund utilization rate is the cumulative fund assistance provided as a percent of the cumulative SRF funds available for projects. The fund utilization rate is one indication of how expeditiously a state is utilizing SRF funds. The U.S. EPA states that the acceptable fund utilization rate is within 5 percentage points of the national average for each SRF. The SDWSRF's fund utilization rate is below the national average, while the CWSRF's fund utilization rate is above the national average.

The SDWSRF Fund Utilization Rate Has Increased, but Is Still Below National Average. While California's SDWSRF fund utilization rate has improved over the last three years, it is still below the national average. For the period ending on June 30, 2009, California's fund utilization rate was 55 percent and the national average fund utilization rate was 80.5 percent (see Figure 2, next page). The U.S. EPA found that California's fund utilization rate increased to 73 percent by June 2011, still less than the national average of 86.6 percent as of that year. (The DPH reported a 2011 fund utilization rate of 78 percent but the U.S. EPA found discrepancies in the dollar values reported for executed loans and available funds.) In its 2012-13 SDWSRF Intended Use Plan, DPH stated that the fund utilization rate increased to 88 percent as of June 30, 2012. The DPH intends to increase the fund utilization rate to 95 percent by June 30, 2013.

The CWSRF Fund Utilization Rate Is Above the National Average. California's CWSRF fund utilization rate in 2011 was 107 percent, above the national average of 99 percent.

The SDWSRF Has Higher Unliquidated Obligations Than CWSRF

The unliquidated obligations are capitalization grant funds that the U.S. EPA has awarded to California but that the state has not yet drawn from the U.S. Treasury. The U.S. EPA considers this to be an important metric in measuring fund performance.

Figure 2
Average SDWSRF Utilization Rate
Including ARRA Funds

As of June 30	National Average	SDWSRF Rate[a]
2009	80.5%	55.0%
2010	89.7	72.0
2011	86.6	73.0

[a] California fund utilization rate given as determined by the U.S. Environmental Protection Agency (U.S. EPA) in their federal fiscal year 2011 Performance Evaluation Report. These numbers may differ from numbers given in the Department of Public Health's annual reports due to discrepancies identified by the U.S. EPA.
SDWSRF = Safe Drinking Water State Revolving Fund and ARRA = American Recovery and Reinvestment Act.

SDWSRF Has the Highest Rate of Unliquidated Obligations in the Nation. In a review of the SDWSRF program in FFY 2010-11, the U.S. EPA stated that California's SDWSRF had the highest amount and rate of unliquidated obligations in the nation. As of April 20, 2012, DPH had $462.3 million in unspent federal funds (including American Recovery and Reinvestment Act [ARRA] funds) out of $724.6 million in open capitalization grants—making SDWSRF's unliquidated obligations rate 64 percent. (Open capitalization grants are grants that are still considered active by the federal government.) The DPH has taken several steps over the course of the past year to reduce the unliquidated obligations, including training funding recipients in how to prepare and submit reimbursement claims, requiring them to submit those claims quarterly, and providing hands-on assistance in resolving any questions regarding claims. As a result of these changes, DPH expects to disburse $138 million in federal funds between April and December 2012.

CWSRF's Unliquidated Obligation Rate Was Deemed Appropriate by U.S. EPA. As of June 2011, SWRCB had $170 million in unspent federal funds out of $840 million in open capitalization grants—making CWSRF's unliquidated obligation rate 20 percent. This includes ARRA funds disbursed in 2009. This unliquidated obligation rate was deemed appropriate by the U.S. EPA.

SDWSRF's Return on Federal Investment Is Substantially Less Than CWSRF's Return

The U.S. EPA uses a metric, the "return on federal investment," to capture how many dollars of financial assistance were disbursed for each dollar of federal aid spent. Since states put up a 20 percent match, most states with a direct loan program should expect to have a return on federal investment of about 120 percent. (States that leverage SRF monies—as discussed later—can potentially achieve a return higher than this amount.)

The SDWSRF has a return on federal investment of 100.6 percent, meaning that only a little over a dollar of investments were created for every federal dollar spent. The CWSRF return on federal investment was 212 percent as of August 30, 2011.

WHAT FACTORS COULD EXPLAIN THE DIFFERENCE IN SRF PERFORMANCE?

We found that the difference in the performance of the two SRFs may be partially explained by differences in the level of administrative resources, the extent of leveraging of SRF resources, organizational structure, and the prioritization of projects. We discuss each of these potential factors driving the differences below.

The CWSRF Has Greater Administrative Resources Than SDWSRF

As shown in Figure 3, from 2007-08 through 2011-12, the CWSRF has consistently had a higher administrative budget than the SDWSRF. For example, in 2011-12, the SDWSRF administrative budget was $5.4 million and the CWSRF administrative budget was $7.3 million. In addition to the personnel years (PYs) that support the CWSRF within the SWRCB, the SWRCB also contracts with separate entities to provide some CWSRF administrative services. In FFY 2011-12, the value of those contract services was about $1.2 million. As discussed below, one reason that SWRCB has greater resources to administer its SRF is because it has chosen to exercise its authority to levy a fee to augment its SRF resources available for administrative purposes.

Figure 3
Administrative Budget and Personnel Years in SDWSRF and CWSRF

	SDWSRF				CWSRF	
		Personnel Years (PYs)				PYs
Fiscal Year	Administrative Budget	DPH[a]	DWR	Totals	Administrative Budget	SWRCB[a]
2007-08	$2,928,000	28	8	36	$4,795,451	32.2
2008-09	2,967,000	28	8	36	5,372,248	29.9
2009-10	4,904,000	43	8	51	9,699,533	55.6
2010-11	5,840,000	41	6	47	7,977,951	48.6
2011-12	5,437,000	32	4	36	7,295,394	47.8
2012-13[b]	5,108,000	27	4	31	9,260,410	47.8

[a] The Department of Public Health's (DPH's) personnel years and SWRCB personnel years include personnel years added as a result of the American Recovery and Reinvestment Act (ARRA) funds distributed in 2009. The ARRA positions will be phased out after fiscal year 2013-14.
[b] 2012-13 expenditures and personnel years are projected.
SDWSRF = Safe Drinking Water State Revolving Fund; CWSRF = Clean Water State Revolving Fund; and SWRCB = State Water Resources Control Board.

The SDWSRF Administration Solely Funded Through SRF Set-Aside. The U.S. EPA allows up to 4 percent of the SRF federal capitalization grants and the one-time funds awarded under ARRA under both SRF programs to be set aside for SRF administrative costs. This spending includes developing project priority lists, reviewing and processing applications, managing and overseeing projects, managing contracts with other state agencies, and meeting federal fiscal and financial requirements. The DPH funds the cost of administering the SDWSRF entirely through full use of this administrative set-aside. The DPH has stated that it has the authority to bill water systems for the costs associated with processing SRF applications (Health and Safety Code Section 116565), but that it does not currently do so.

The SWRCB Charges a Fee to Augment the Administrative Set-Aside. In addition to using the full amount provided by the 4 percent administrative set-aside, the SWRCB charges a fee to cover administrative costs of the CWSRF. The fee is structured as an annual service charge on the CWSRF financing agreements (not to exceed 1 percent of the outstanding balance of the financing agreement). The SWRCB was given the authority to charge this fee in California Water Code Section 13477.5 (c) (1), enacted by Chapter 6.5, Statutes of 1987. Revenues from this annual service charge are deposited in the State Water Pollution Control Revolving Fund Administrative Fund and can only be used for administrative purposes. In addition to providing more administrative resources, this also allows some of the administrative set-aside from the federal capitalization grant to be used for financial assistance.

In Summary. The greater level of budgetary and staffing resources available to SWRCB to administer the CWSRF may contribute to the CWSRF's greater ability to execute funding agreements. We note that in a 2011 performance evaluation review of the SDWSRF, the U.S. EPA found that DPH needed to strengthen the administrative support provided to the SDWSRF. We discuss addressing this issue later in the "Potential Solutions" section of this memo.

Use of Leveraging Partially Explains Differences In Level of Financial Assistance Provided

State and federal laws allow both SWRCB and DPH to expand, or "leverage," their loan programs through a financing agency—the California Infrastructure and Economic Development Bank (I-Bank). Under this process, the I-Bank sells revenue bonds on behalf of a department. Payments to the SRF for loans previously issued by the department create the revenue stream to repay those bonds. States that issue revenue bonds increase the ratio of state to federal dollars and should expect to have a return on federal investment that is above 120 percent. The DPH does not leverage its SRF funds, but SWRCB has, to limited extent. In 2002, the I-Bank sold $300 million in revenue bonds on behalf of the board, and an additional $300 million have been authorized but not sold. Approval from the U.S. EPA is required the first time that a state issues revenue bonds to leverage the SRF funds. The U.S. EPA has advised us that leveraging is only fiscally beneficial to the state if there is a greater current demand for SRF funds than can be satisfied by the current resources available.

Structural and Process Differences May Contribute to Differences in Performance on Federal Metrics

Impact of Broad Structural Differences Between DPH and SWRCB Difficult to Assess. It is difficult to assess the extent to which the differences in the history, culture, or organizational structure (for example, the board-versus-department difference) between DPH and SWRCB contribute to the CWSRF's better performance on federal measurements of timely and expeditious use of the SRF funds. In the time permitted, we were unable to reach any conclusions regarding these differences. Accordingly, in this section, we focus on differences in the SRF-related rulemaking processes of the two agencies, which aligns with your expressed interest in your request.

Rulemaking Processes Are Very Different Between DPH and SWRCB; DPH's Process Takes Longer. Changes to state and federal legislation necessitate ongoing rulemaking in both SRF programs. We found that the SDWSRF rulemaking process under DPH does take longer to complete than the comparable process for the CWSRF under SWRCB. We explain below a key factor that is driving this difference. It is less clear the extent to which these differences in rulemaking process are contributing to the different performance on federal metrics.

The SDWSRF Rulemaking Is Conducted in Accordance With the APA. The SDWSRF rulemaking is completed in accordance with the APA, which is found in the California Government Code Section 11340 et seq. The state's APA provides for a formal rulemaking process for state departments, including opportunities for the public to provide comments on proposed rules. In general, to complete the rulemaking process within the DPH, an interdisciplinary Rulemaking Project Team is formed. This team generally includes program matter experts as well as representatives from the Office of Legal Services, the Office of Regulations, and DPH's budget office. A stakeholder input coordinator may also be included in the Rulemaking Project Team. Enclosure 1 contains a flow chart detailing the DPH's rulemaking processes.

Once the Rulemaking Project Team is formed, it develops the rulemaking documents in accordance with APA standards. Those documents are reviewed by the deputy of the Center for Environmental Health, the DPH Director, the California Health and Human Services Agency, and the Department of Finance. Once approved by those agencies, the regulation package then enters the public participation process. The DPH has stated that it generally takes 15 months from the formation of the Rulemaking Project Team to the beginning of the public participation process. Once the public participation process has begun, the Office of Regulations organizes the regulatory package into a rulemaking file, submits it to the Director of DPH for final approval and then to the Office of Administrative Law for review and approval. If approved, the regulations then go into effect. The DPH has stated that it may take another 15 months from the point at which the regulations begin the public participation process to the point at which they go into effect. In general, DPH has stated that it takes two to three years to complete a regulatory package; however, a complex regulation may take significantly longer to complete.

The DPH has also stated that the cost to develop a regulation package varies depending on the complexity; however, the average is generally $300,000 over two fiscal years. State law governs what costs to the drinking water program are recoverable through fees levied on public water systems. The DPH has not historically considered the cost of developing drinking water program regulations as falling within the categories outlined in state law; therefore, these costs have not been charged to public water systems.

The DPH does not have any positions that are specifically dedicated to SDWSRF rulemaking. There are 2 PYs responsible for promulgating all drinking water related regulations. The last regulation related to the SDWSRF was promulgated in 2009.

The CWSRF Rulemaking Is Not Subject to APA. As authorized by current law, the CWSRF rulemaking is *not* subject to the APA. Instead, the SWRCB utilizes a "policy handbook" to enact rules and policy changes to the CWSRF. This policy handbook is updated through a public

process and approved at board meetings. The process to complete policy changes includes gathering input from internal divisions within the SWRCB and stakeholders, providing public notice of the changes, briefing board members, and posting the policy for public review. Any comments from the public are incorporated or responded to and the policy is adopted through a board resolution in an open board meeting. The entire process generally takes around one year. Enclosure 2, created by SWRCB, details the SWRCB's most recent schedule for amending the CWSRF policy (that is, policy amendments that SWRCB is currently working on). The SWRCB stated that although they do not have a staff person specifically devoted to policy updates, the updates may take approximately 1 PY of time per policy amendment.

The SDWSRF's Focus on Assisting Small Water Systems Affects SRF Performance

After conducting an indepth performance review of California's SDWSRF, the U.S. EPA stated that the pressure to fund small and disadvantaged communities placed an enormous strain on the SDWSRF program and staff resources and limited DPH's ability to fully utilize SDWSRF funds. As of June 30, 2011, assistance to small communities made up 62 percent of the total number of SDWSRF agreements and 16 percent of the total value of assistance provided. The U.S. EPA found that the focus on small disadvantaged communities with serious public health risks has lead community systems that are ready to proceed on projects but have less pressing drinking water problems to pursue funding elsewhere. The loss of these projects, which would have potentially required less staff time to manage and generated an income through interest on loans, may hurt SDWSRF performance as measured by U.S. EPA's metrics.

POTENTIAL SOLUTIONS TO IMPROVE SDWSRF PERFORMANCE

Several potential solutions to improve the performance of the SDWSRF have been suggested by the U.S. EPA and other stakeholders. These solutions include enhancing administrative resources for SDWSRF through charging a loan servicing fee, the use of leveraging to provide more loan funds, administering the two SRFs jointly, and increasing the focus on shovel-ready projects within the SDWSRF. We have described these solutions below, but have not evaluated them fully. Further analysis is needed to determine whether these potential solutions could improve SDWSRF performance.

Administrative Resources in SDWSRF Could Be Enhanced. The loan-servicing fee that the SWRCB charges fund recipients provides an additional source of revenue to support administration of the CWSRF. The U.S. EPA has recommended that DPH explore charging a similar fee on SDWSRF funding agreements. These resources could be targeted to address high priority administrative needs, such as getting dollars out the door faster, strengthening accounting and financial management support of the SDWSRF, or increasing support to small or disadvantaged communities.

The Potential for Leveraging Should Be Evaluated Carefully. Leveraging has been used by California's CWSRF and by SDWSRFs in other states to effectively increase the total funds available to the programs and increase their return on federal investment. However, the use of leveraging for the SDWSRF should be carefully considered. For example, it would be necessary

to ensure that DPH has the administrative capacity to utilize any additional funds that would be generated through leveraging before issuing revenue bonds. Leveraging is only fiscally beneficial if there is much greater *current* demand for high-need projects than currently available funding. In other circumstances, leveraging could actually be fiscally detrimental to the state. As mentioned previously, U.S. EPA approval is required before a state initiates the leveraging of its SRF resources.

Alternative Administrative Models Could Be Evaluated. You asked that we evaluate whether the SDWSRF could legally be administered by the SWRCB. We found that such a transfer would be allowed under federal law (but would require a change in state statute). As mentioned earlier, we found that several administrative models for the SRFs exist in different states. Each model has its potential disadvantages and trade-offs. In 2005, the U.S. EPA's Environmental Financial Advisory Board (EFAB) evaluated the potential benefits of any state combining the administration of its two SRFs. The EFAB found that combining operations could result in administrative efficiencies and financial benefits. Additionally, the EFAB report stated that consolidating the administration of the SRF programs would complement the U.S. EPA's efforts to approach water pollution control in an integrated manner. While administering the SRFs jointly in a single agency may yield administrative advantages, it may also result in increased need for coordination. If the SDWSRF were administered by the SWRCB, such reorganization would increase the need for communication between SWRCB and DPH as the administration of the SDWSRF would be in a different agency than that which administers the core drinking water regulatory program that the SDWSRF is tied to.

Given the limited timeframe, we were not able to fully evaluate the advantages and disadvantages of transferring the administration of SDWSRF to SWRCB (or another agency). We think, though, that such a proposal warrants further evaluation and legislative consideration.

Focusing on Shovel-Ready Projects May Improve SDWSRF Fund Performance. In a management review of the SDWSRF completed in September 2012, the U.S. EPA stated that public health goals could be best served when SDWSRFs are fully utilized to support a diverse portfolio of projects, including projects that have less pressing public health needs but are ready to proceed with construction. (Even lower-priority projects must still serve to bring water systems into compliance with state and federal drinking water standards.) Funding shovel-ready projects would help ensure that the SDWSRF resources are more fully utilized. Additionally, the future loan repayments from these projects help sustain the SDWSRF. The U.S. EPA has stated that loaning funds to these larger communities tends not to decrease the funding available to disadvantaged communities, as those communities are often relying on the portion of the SRF available as grant funding.

The U.S. EPA recommends that states develop an outreach plan to increase awareness and assist in diversifying the SDWSRF program. Additionally, the U.S. EPA has noted states that have implemented multidepartment outreach teams that assist communities identify the appropriate source of funding for their water quality infrastructure requirements and work with them to develop applications.

If you have questions or require additional information, please do not hesitate to contact my staff—either Janne Olson-Morgan at (916) 319-8327 (Janne.Olson-Morgan@lao.ca.gov) or Mark Newton at (916) 319-8323 (Mark.Newton@lao.ca.gov). Janne is responsible for public health issues and Mark is responsible for health and human services issues overall and has a background in natural resources and environmental protection issues.

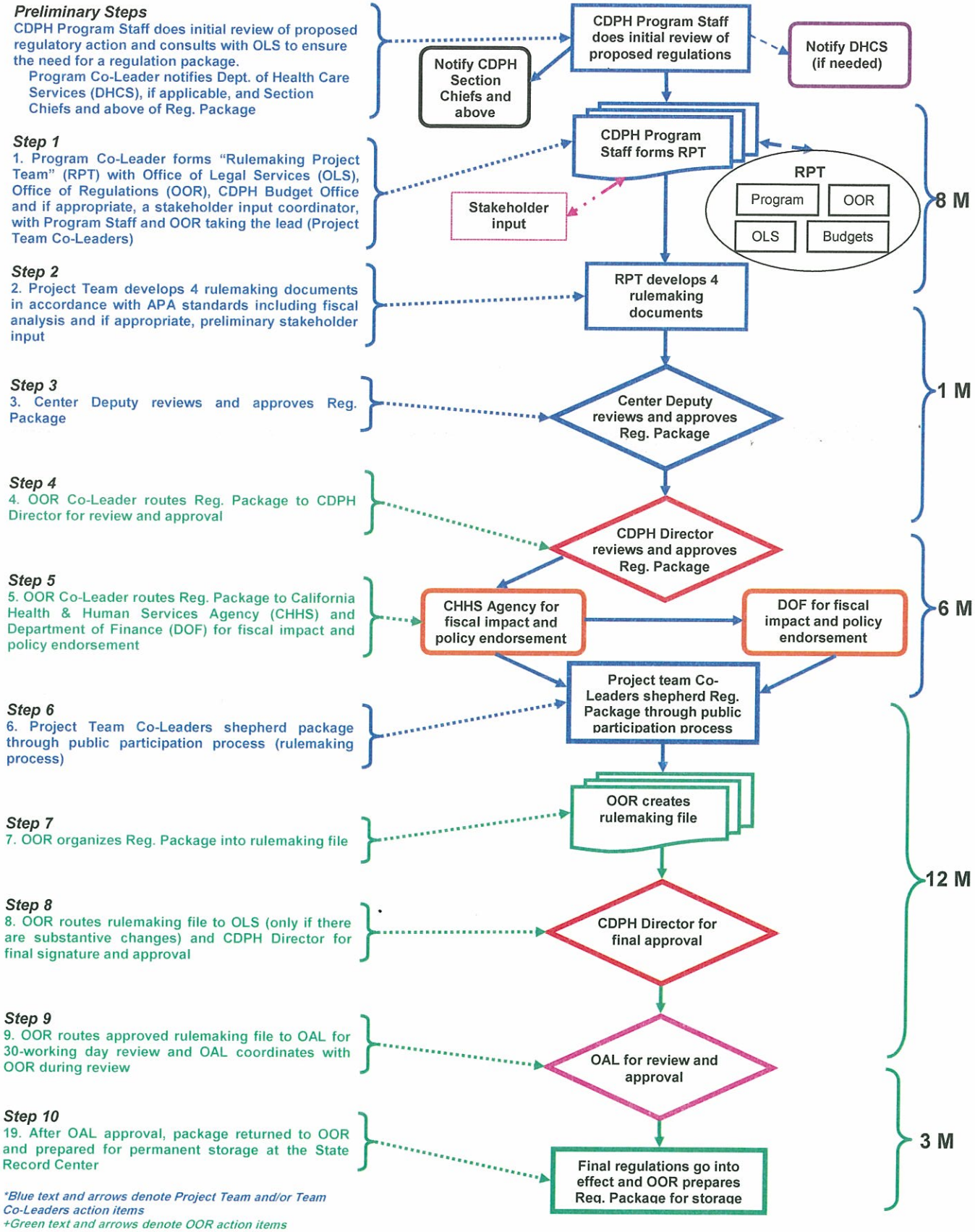
Sincerely,

Mac Taylor
Legislative Analyst

Enclosures

ENCLOSURE 1

CDPH RULEMAKING PROCESS MAP FLOWCHART



**Blue text and arrows denote Project Team and/or Team Co-Leaders action items*
+Green text and arrows denote OOR action items

ENCLOSURE 2

State Water Resources Control Board's Most Recent Schedule to Amend The Policy for Implementing The Clean Water State Revolving Fund

Event	Dates
Get input from Expanded Use Program	Completed May 1st (2012)
Give sections to WR, Credit and Environmental Units for editing	Completed May 18th
Collect and collate all comments from Expanded Use, Credit Review, Environmental and WR groups	Completed June 6th
Complete all changes to Policy	Completed July 17th
Give Copy to Bob and Christopher to Review	Completed July 20th
Incorporate Comments and revise Policy	Completed August 3rd
Senior/Supervisor/Legal Review of Draft Policy	Completed October 17th
Incorporate Comments	Completed November 14th
Develop New CWSRF Application	Completed December 12th (Begun in May)
Route Policy and Appendices for Final Comments	Begun December 17th End January 4th (2013)
Incorporate Comments into Policy	January 11th
Finalize Public Notice	January 11th
Brief Board Members	January 7-11th
Post Policy for Public Review	January 14th – February 14th
Incorporate Comments from Public Review	February 18-March 1st
Agenda Item Due	March 19th
Additional Board Briefing	April 15th – 19th
Adopt Policy	April 23rd (2013)