PROGRAM EVALUATION REPORT

WEST VIRGINIA

Drinking Water Treatment Revolving Fund

STATE FISCAL YEAR 2004

FINAL

June 2005

U.S. Environmental Protection Agency
Region III
Philadelphia, PA

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PROGRAM EVALUATION REPORT

West Virginia

Drinking Water Treatment Revolving Fund

State Fiscal Year 2004

EXECUTIVE SUMMARY

This Program Evaluation Report (PER) is the U.S. Environmental Protection Agency (EPA) evaluation of the West Virginia Bureau of Public Health's (BPH) Drinking Water Treatment Revolving Fund (DWTRF) program. This report identifies strengths and areas for improvement in the program. The review covers the period July 1, 2003 through June 30, 2004. EPA conducted its on-site review from March 8 to 10, 2005.

The process included the submittal of the BPH Biennial Report, EPA's evaluation of the program, and EPA's issuance of this PER.

The scope of this year's program review was established in accordance with EPA's Interim Final Annual Review Guidance and the national State Revolving Fund (SRF) Checklist to ensure a detailed review of all program components.

BPH is managing the DWTRF program effectively and efficiently. The program is exhibiting good financial strength. The State met the binding commitment (BC) requirement during FY 2004. BPH does an excellent job of meeting the needs of small communities.

The PER identifies several action items for BPH including: (1) considering process changes to improve pace by reducing project bypasses and accelerating loan applications and closings, (2) preparing a plan for assuring compliance with the six affirmative steps to encourage participation of Disadvantaged Business Enterprises in procurement of services, equipment, supplies, and construction, (3) preparing financial statements for set-aside activities, (4) preparing a report which identifies factors impacting the pace of loan execution and the fund utilization rate and recommendations for improvement, (5) reviewing payroll and other charges and assure that costs are properly allocated to accounts, (6) reconciling financial information, (7) drawing Federal

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funds based upon actual incurred costs, and (8) submitting quarterly reports of closed loans and binding commitments.

INTRODUCTION

This PER is the EPA evaluation of West Virginia's DWTRF program. A PER documents the annual review process, as required by the Safe Drinking Water Act (SDWA).

The purpose of an annual review is to assess the State's management of the program, including:

- Performance in achieving goals and objectives identified in the Intended Use Plan (IUP) and Biennial Report;
- Compliance with the terms of the capitalization grant agreement, operating agreement, and regulations;
- Financial status and performance of the Funds and set-aside accounts;
- Status of resolution of prior year PER action items;
- Correction of audit findings and recommendations; and
- Discussion of future program directions and initiatives.

This PER identifies strengths and areas for improvement in the program. The annual review covered the period July 1, 2003, through June 30, 2004. EPA conducted its on-site review from March 8 to 10, 2005.

The annual review process included BPH's submittal of the Biennial Report, EPA's evaluation of the State's program, and the issuance of this PER.

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BACKGROUND

The SDWA Amendments of 1996 authorized funding for states to establish a Drinking Water State Revolving Fund (DWSRF) program to assist systems to finance the cost of infrastructure needed to achieve or maintain compliance with SDWA requirements and to protect public health. The DWSRF program includes both construction funds and set-aside funds for support of state-wide drinking water program support activities.

Under Title 64 of the West Virginia Code, BPH is responsible for implementing and managing the DWTRF in accordance with the requirements and objectives of SDWA. The program resides in the Department of Health and Human Resources (DHHR), which provides management for SRF financial matters, including grants management and disbursement of funds. Additional coordination with offices of the state treasurer and the state auditor ensure inter- and intra-agency coordination, management, oversight, and integrity of the program.

In addition to the DWTRF construction fund, BPH administers several set-aside, or non-project accounts, used for: (1) administration of the loan program, (2) small system technical assistance, (3) state program management, and (4) local assistance and other state activities.

Some of the goals of the DWTRF include:

- Provide financial assistance to eligible drinking water systems to eliminate drinking water problems and improve drinking water quality in the State;
- Continue implementation of the Source Water Protection Plan through community and non-community ground and surface water assessments;
- Continue implementation of the Capacity Development Strategy, assisting existing and newly created public water supplies in acquiring and maintaining capacity to comply with SDWA: and
- Market and develop the DWTRF to ensure the long term health of the fund.

BPH manages both the construction fund and the set-aside accounts effectively and efficiently. The programs exhibit sound financial strength, including:

- Strong accounting and financial structure;

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- Good financial capability review and loan monitoring processes;
- Annual independent and periodic internal financial and compliance audits; and
- Prudent investment policies.

BPH complied with the BC requirement for FY 2004. EPA commends BPH for taking steps to increase program pace and for making DWTRF loans to small systems and disadvantaged communities.

As of June 30, 2004, total capitalization for the DWTRF project fund and set-aside program activities is $60,891,000, which consists of Federal grant funds and state match. During FY 2004, BPH closed two loans for a total of $3,130,623.

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SCOPE

The FY 2004 annual review of West Virginia's DWTRF program was conducted in accordance with EPA's SRF Interim Final Annual Review Guidance to ensure a detailed review of all program components.

The programmatic review included the following topics:

- Public health benefits,
- Program pace,
- Funding to small and disadvantaged communities,
- IUP goals,
- Cross-cutter compliance,
- Operating agreement,
- Disadvantaged Business Enterprises (DBE) requirements, and
- Sustainability/asset management.

The grant compliance review included the following requirements:

- Acceptance of payments,
- State match,
- Binding commitments,
- Financial Status Reports,
- Federal Cash Transaction Reports,
- Administrative costs,
- Data management, and
- Biennial Report.

The financial review included the following matters:

- Perpetuity,
- Financial health of the Fund,
- Modeling,
- Financial indicators,
- Audits,
- Program income,
- Loan monitoring,
- Collections on loans receivable,
- Financial management policies, and
- Capability assessment system.

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To accomplish the review, EPA:

- Held discussions with State staff
- Reviewed BPH's Biennial Report, IUPs and Project Priority Lists
- Reviewed the following:
  - S Data in the Drinking Water National Information, Management System (DWNIMS) database,
  - S Financial Status Reports,
  - S Federal Cash Transaction Reports, and
  - S EPA grants payment records,
- Reviewed the following project files for programmatic compliance:
  - S Town of Franklin,
  - S Cowen Public Service District (PSD), and
  - S Mason County-Camp Conley
  - · Reviewed the following project files for compliance with MBE/WBE requirements:
    - S Cowen PSD and
    - S Town of Wayne
  - · Reviewed the following project files for compliance with financial requirements:
    - S Mason County PSD and
    - S Town of Franklin

EPA conducts separate reviews of the technical aspects of the drinking water program activities undertaken with set-aside funds in conjunction with its review of the Public Water Systems Supervision (PWSS) program. The current review examined the administrative and financial aspects of the set-aside activities.

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OBSERVATIONS
PROGRAMMATIC AREAS REVIEWED

PUBLIC HEALTH BENEFITS

The State briefly describes the expected public health benefits of drinking water projects in its IUPs and Annual Reports. The State featured two projects in its FY 2004 Annual Report which addressed a variety of drinking water problems.

The Town of Bath (Berkeley Springs Water Department), is famed for its warm medicinal springs, Berkeley Springs, which are now owned by the State. The springs, which were also the source water for the Town's drinking water as well as for bottled water for many surrounding areas, were determined to be under the direct influence of surface water. BPH issued the utility an administrative order to install filter units and monitoring equipment in order to comply with SDWA requirements. The town utilized a DWTRF $1.1 million loan to upgrade the water treatment plant. The project included the installation of two 10-foot gravity dual media filters, piping, static mixer, chemical feeders, turbidity analyzers, filter effluent pumps, and backwash pumps. The project also included the installation of a backwash retention decant tank and an upgrade of a raw water pump station. The project has resulted in treated water which now meets SDWA requirements and has reduced the potential for contamination of the drinking water supply, which serves a population of 2,440.

The Corporation of Shepherdstown, in the eastern panhandle of West Virginia, has a population of 800 with a small college of approximately 4,800 students located on its outskirts. The Town's water system serves approximately 1,230 residential and commercial customers. BPH determined that the facility was out of compliance with the SDWA disinfection requirements. Infrastructure improvements will be required to maintain compliance. The existing system also has low water pressure in the east end of the Town. Residents of the neighborhood, which is composed of 31 single-family homes and a day care center, requested improvements. This area is considered financially disadvantaged. The facility upgrade included modification of the clear well, installation of a new chlorine scale, replacement of existing raw water pumps, and addition of equipment to handle waste material from the treatment filters (which reduces the risk of illness from microbial pathogens). Funding for the project included two loans: a loan for $1,300,541 at 3% interest for 20 years and a loan for $699,459 at 1% interest for 30 years.

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PROGRAM PACE

BPH closed two drinking water loans totaling $3.1 million during the year ending June 30, 2004, and met the BC requirement. Compliance with the BC requirement is one measure of the State's ability to commit DWTRF funds in a timely and expeditious manner. EPA also measures the rate at which states convert BCs to closed loans, which is called the fund utilization rate. BPH's fund utilization rate of 63% is lower than the national average (83%). (See further discussion of program pace on page and of BCs on page .)

The State made efforts to improve program pace in FY 2004. BPH offers loans to cover design costs and has received two requests for this assistance. BPH is working with Northbridge Environmental Management, EPA's national program support consultant, on a project tracking system. Completion and implementation of this system is expected by March 2006. The project tracking system will be an important program management tool because it will allow BPH to identify delays in all phases of project management (including the time between issuance of BC letters and loan closings) and to implement measures to move projects through the process more quickly.

The State's program pace (ability to close loans) is affected by staffing level, the length of the BC period, the number of bypassed projects, and the project priority list development process.

Staffing

At the time of the review, the State had a vacancy for an assistant manager to oversee DWTRF projects. This vacancy did not directly affect the State's ability to manage projects during the review period covered by this report. The vacancy could, however, affect the State's program pace in FY 2005 because the position was vacant for several months. Subsequent to the review, DHHR filled the position.

BC Time Period

The length of time from BC letter to closed DWTRF loan also affects program pace. In West Virginia, it typically takes about 18 months for a BC to become a closed loan. The BC process includes at least six months for design completion and nine months for the Public Service Commission (PSC) review. BPH has worked with the PSC to reduce this review period in many cases. Applicants also need time to acquire property rights and rights-of-way and to obtain legal and accounting services prior to loan closing. BPH provides many loans to small and disadvantaged communities. These loans often take a long time to complete the closing process. EPA recommends that the State continue to identify process improvements to shorten this time period.

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Project Bypasses and Priority List Management

The State's Annual Report notes that 23 projects were bypassed in FY 2004; the total value of these bypasses was approximately $70 million. Of these, 16 received funding from other sources and no longer needed DWTRF assistance. The remaining seven projects were bypassed because applicants had not received approval from other co-funding agencies. Ten of the bypassed projects had a dollar value of less than $2 million each and most had received or were seeking grant funds from other sources. There is a concern that high priority projects may not be moving forward.

The number of projects bypassed for lack of funding suggests a need to make projects more affordable. The State may wish to consider providing full or partial principal forgiveness for select projects. Such assistance could make projects more affordable for disadvantaged communities and reduce competition from other funding agencies.

BPH screens all water projects for the Infrastructure and Jobs Development Council (IJDC), the State's funding clearinghouse. BPH uses the IJDC's loan applications to identify and rank potential DWTRF loan applicants and does not require a separate application to develop the DWTRF project priority list. Consequently, projects may appear on the DWTRF priority list before all necessary funding is in place; many projects are bypassed as a result.

BPH acknowledged that changing the manner and timing of priority list development could reduce the number of bypassed projects and accelerate the readiness of projects to proceed to loan closing and construction. EPA encourages the State to reevaluate this process.

Action Items: BPH should continue to identify ways to accelerate the loan application and closing process.

BPH will consider approaches to reduce project bypasses including: (1) revising its process for developing the DWTRF project priority, (2) improving the readiness of projects to proceed (e.g., additional technical assistance, streamlining co-funding approval procedures) and (3) addressing project affordability.

In its Annual Report, BPH shall more clearly describe the status of bypassed projects and the efforts the State is making to assist the projects move forward.

At the request of BPH, EPA will provide sample guidelines and criteria regarding principal forgiveness and assist the State in understanding the potential impact of using the additional subsidy on the long-term financial viability of the Fund.

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SMALL AND DISADVANTAGED ASSISTANCE

BPH has done an excellent job of meeting the needs of small and disadvantaged drinking water systems and has exceeded the SDWA minimum requirement to provide 15% of available funding to small systems (less than 10,000 population). As of June 30, 2004, the State provided 21 DWTRF loans in the amount of $23,152,908 to small communities, or 70% of total loan dollars. BPH also provided 16 loans in the amount of $18,571,867 to disadvantaged systems, representing 56% of total loan dollars.

REPORTS

Although the State's Operating Agreement (OA) with EPA requires Biennial Reports, the State has been submitting Annual Reports. The State submitted the Annual Report with the required information and appropriate level of detail on November 8, 2004, after EPA approved BPH's request for a time extension. BPH has committed to submitting future Annual Reports by September 30. The Annual Reports facilitate discussion during the on-site review. EPA commends BPH for reporting more frequently than is required.

The State met the due date for submitting data to DWNIMS. There were no data quality problems. EPA commends BPH for its continued submission of accurate DWNIMS data in a timely manner.

OPERATING AGREEMENT

BPH prepared proposed amendments to the Operating Agreement and provided them to EPA during the annual review.

Action Item: EPA will review BPH's proposed amendments to the OA.

DISADVANTAGED BUSINESS ENTERPRISES

The State must comply with the DBE requirements, which include:

- Negotiating fair share goals;
- Ensuring that recipients of Federal funds apply the six affirmative steps so that qualifying DBE firms have an opportunity to compete for contracts and sub-contracts; and
- Providing quarterly reports to EPA indicating utilization of disadvantaged businesses.

The DBE program encompasses six affirmative steps to promote the fair-share

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objective:

(1) Inclusion of qualified DBE firms on solicitation lists;
(1) Assurance that DBE firms are solicited whenever they are potential sources;
(1) Division of total requirements, when economically feasible, into smaller tasks or quantities to permit maximum participation of DBEs;
(1) Establishment of delivery schedules which encourage participation by DBE firms;
(1) Utilization of DBE listings, such as those of the Small Business Administration and the Minority Business Development Agency (both in the U.S. Department of Commerce); and
(1) Requirement that prime contractors take the previous five affirmative steps if they subcontract work.

BPH is responsible for ensuring that loan recipients apply the six affirmative steps to each of the four categories of procurement activity: services (such as legal, planning, design, engineering, and project management), equipment, supplies, and construction. This requirement applies to projects designated as funded with an amount equal to the Federal DWSRF grants.

BPH successfully negotiated new DBE fair share goals for each of the four procurement categories during the summer of 2003. In addition, BPH submitted its quarterly DBE reports on time.

EPA reviewed DBE documentation from two drinking water project files: Cowen PSD and Town of Wayne. There was no documentation in either file to show that the six affirmative steps had been applied during the selection process for services, such as planning and design, for these projects. Services for the Town of Wayne project, however, were paid with non-SRF funding.

Documentation in the files indicated that efforts to apply the six affirmative steps had been made by the loan recipients when selecting prime contractors for project construction. These consisted of placing advertisements for construction bids in local newspapers soliciting contractors and the utilization of DBE databases for identifying DBE firms. The file documentation did not indicate whether any of the procurement actions were related to equipment or supplies.

EPA is currently reviewing implementation options with respect to the six affirmative steps, particularly regarding procurement for services. EPA will provide additional guidance to states regarding these options. After receiving the EPA guidance, BPH should prepare a revised DBE compliance plan. The revised plan should include a summary of what DWTRF borrowers must do and document to ensure that they comply with DBE requirements for prime contracts as well as subcontracts.

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The plan should cover procurement for all four categories (construction, services, supplies, and equipment). It should clarify whether the requirements differ when different sources of funds are used.

The DBE plan should include early additional communication by BPH with potential loan applicants. Such communication may assist borrowers to develop a better understanding of DBE requirements and opportunities to successfully implement the affirmative steps. Outreach activities might include development of a brochure, question and answer sheet, or letter which describes the DBE program and the six affirmative steps, a website containing DBE information, and DBE training for potential applicants. Through these means, BPH could more effectively communicate the need to comply with the DBE provisions, including documentation of the affirmative steps and the possible consequences of noncompliance.

Action Items: EPA will provide guidance to BPH regarding options for complying with the DBE six affirmative steps.

BPH should provide EPA a plan to ensure compliance with the six affirm ative steps, particu larly with respec t to applyi ng these steps to the procur ement of servic es. This plan should be submit ted to EPA within 60

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days of receipt of EPA's DBE guidance.

EPA will, if requested, work with BPH to develop possible solutions to the DBE compliance issue.

ENVIRONMENTAL REVIEW

EPA reviewed the State's files for the Cowen, Town of Wayne, Town of Franklin, and Mason County-Camp Conley projects and found documentation of compliance with the State's environmental review process. BPH appropriately issued Findings of No Significant Impact for the Cowen treatment plant upgrade and waterline extension, the Town of Wayne treatment plant upgrade, and the Town of Franklin water line installation projects. BPH appropriately issued a categorical exclusion for the Mason County-Camp Conley waterline replacement project.

SET-ASIDE ACTIVITIES

The State's rate of set-aside obligations and expenditures continued to increase during FY 2004. The following table shows the State's progress in obligating and expending funds on a cumulative basis for each set-aside category for grants awarded from FYs 1998 through 2004. Nationally, the average rate of state set-aside expenditures was 60.9% for Technical Assistance, 67.7% for Program Management, and 58.5% for Local Assistance (cumulative as of June 30, 2004). The table below shows that BPH's cumulative expenditure rate is higher than the national average for each set-aside category. BPH provides a cash match for the Program Management set-aside. While the expenditure rate for Program Management shown below (100%) reflects full utilization of Federal funds, BPH has also expended state match funds so that the State has actually expended 134.4% of Federal funds, nearly twice than national average (67.7%). Overall, BPH's expenditure rate for Federally provided set-aside funds is 81.1%, exceeding the national average of 62.4%.

Further analysis of the State's progress in expending set-aside funds will be conducted as part of EPA's PWSS oversight process.

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SET-ASIDE UTILIZATION CUMULATIVE ALL GRANTS As of June 30, 2004				
	Technical Assistance	Program Management	Local Assistance	Total
CUMULATIVE AWARDED	$1,002,571	$4,314,892	$5,369,676	$10,687,139
CUMULATIVE OBLIGATED	$1,002,571	$4,314,892	$3,445,657	$8,763,120
% OBLIGATED	100.0%	100.0%	64.2%	82.0%
*EXPENDED	$911,645	$4,314,892	$3,445,657	$8,672,194
% EXPENDED	90.9%	100.0%	64.2%	81.1%
% EXPENDED U.S. Average	60.9%	67.7%	58.5%	62.4%

*Source: DWNIMS
Note: BPH provides its Program Management match in cash. On a cumulative basis, BPH has obligated $5,807,131 for Program Management activities, which exceeds the Federal funds provided for this set-aside by $1,492,239. The amount above the Federal funds reflects obligation of a portion of the available state match. Likewise, BPH has expended $5,800,736 (as reported in DWNIMS), which exceeds the Federal funds provided by $1,485,844.

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OBSERVATIONS
FINANCIAL AREAS REVIEWED

HEALTH OF THE FUND

Capitalization grants and state match earmarked for the DWTRF as of June 30, 2004 totaled $60,891,000. The overall financial growth of the DWTRF has been good due to the continuation of EPA grants and state match funding. As of June 30, 2004, net assets were approximately $34,926,745, not counting $18,537,146 in unexpended Federal capitalization grant funds. That is 14 percent over FY 2003 net assets of $30,545,450. Net assets include $2,897,453 in loan principal and interest repayments and $919,552 in investment earnings. Most of the growth was from the EPA grants and state match received during the year.

The financial health of the West Virginia DWTRF program is good. All loans are secured by system revenues and reserves pledged by the borrowing entities. The DWTRF fund account has a strong cash flow. Financial management is sound, the State's internal controls are in place, there is no debt, and there have been no loan defaults. A summary of the financial status of the DWTRF program is shown in the table below:

Financial Health Summary As of June 30, 2004	
Cumulative Federal Grants & State Match	$60,891,000
Net Assets	$34,926,745
Loan Repayments	$2,897,453
Investment Earnings	$919,552
Loan Disbursements	$29,038,148

DWTRF funds are invested by the State Treasurer in the Cash Liquidity and Government Money Market Pools managed by the West Virginia Investment Management Board (IMB). These pools were established by the State to provide for the investment of state and local government funds. The types of securities in which IMB invests include U.S. Government obligations, repurchase agreements, highly-rated corporate bonds, and commercial paper. These securities are considered to be among the safest available. U.S. Government obligations are secured by the full faith and

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credit of the U.S. government. The corporate bonds and other securities achieve their high ratings because they are not likely to default.

Return on Equity (ROE) is a measure of the growth of capital within the DWTRF. The ROE for the DWTRF was 1.05% for FY 2004, which is slightly less than ROE for FY 2003 (1.10%). The reason for a slight decrease in ROE is that net assets increased more than income in FY 2004. Although a 1.05% ROE is not unexpected for a subsidized lending program that has a weighted loan interest rate of 0.380%, it will not maintain purchasing power if, over the long-term, the rate of inflation is higher.

One way for BPH to determine the effect of inflation on the DWTRF would be to prepare long-term financial projections for the DWTRF based upon current financial policies (e.g., interest rates, term of loans, construction period interest). These projections should be compared to the same parameters discounted by the anticipated rate of inflation over the same time period. If requested by BPH, EPA will provide assistance in using the EPA Financial Planning Model.

In addition, the relatively low 1.05% ROE also indicates that the DWTRF is not sufficiently accumulating capital from its lending and investing activities to achieve significant financial growth. This provides further evidence that most of the financial growth in the DWTRF is due to EPA grants and state match. (See the discussion of "Net Return on Contributed Capital" below.)

DWTRF FINANCIAL INDICATORS

All of the indicators generally demonstrate that the DWTRF program's financial performance is fair. The State maintains lending capacity to provide financial assistance into perpetuity. The rate of growth above initial Federal and State contributions is very small. Funds are not being committed to loans commensurate with EPA expectations. Note that each of the indicators reflects calculations on a cumulative basis.

NIMS Financial Indicator for DWSRF

Indicator	2002	2003	2004	National Average
Program Pace (Loans as a % of Funds Available)	66%	68%	63%	83%
Return on Federal Investment	$1.31	$1.34	$1.32	$1.67
Disbursements as a % of Assistance	95%	87%	88%	72%
Net Return After Forgiving Principal	$846,531	$1,157,110	$1,461,176	—
Net Return on Contributed Capital	3.6%	4.3%	4.7%	—

Program Pace (Loans as a % of Funds Available)

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The Loans to Funds Available indicator represents the percent of money available in the DWTRF program which has been lent. The Loans to Funds Available indicator reflects executed loans. Over the last year, the State's performance reflected by this indicator has decreased. (See discussion of pace on page .) It is far below the national EPA benchmark of 83%. EPA's Strategic Plan includes a program activity measure on "Fund Utilization" which is comparable to the program pace indicator reported in DWNIMS. The 2005 Strategic Plan included a national target of 81% and a Region 3 commitment of 79%. The Agency's 2006 National Water Program Guidance, which implements and updates the Strategic Plan, includes an FY 2008 national target of 86%. Region 3 is developing its related 2008 target for this measure. Continued improvement by BPH on the pace of loan execution is essential.

Action Item: BPH shall prepare a brief report which: (1) analyzes the factors which impact the pace of loan execution and the fund utilization rate and (2) identifies recommendations for how to improve performance. If desired, BPH may request assistance from EPA.

Return on Federal Investment

The Return on Federal Investment indicator shows the amount of financial assistance or loans disbursed for each dollar of Federal cash draws made on a cumulative basis. The national average for this indicator is $1.67. The national average for this indicator for states which have leveraged is $2.02; for non-leveraged states it is $1.28. The national average for non-leveraged states for this indicator was $1.21 is of June 30, 2002, and $1.26 as of June 30, 2003. For the period covered by this review, the State's performance ($1.32) was higher than the national average of non-leveraged states and, therefore, is acceptable.

Disbursements as a Percentage of Assistance

Loan Disbursements as a Percentage of Assistance Provided shows the speed at which funds are disbursed to closed loans. It is calculated by dividing cumulative loan disbursements by cumulative assistance provided. The value of the indicator ranges from 0% to no more than 100%. BPH (88%) is above the national average (72%). This shows that, although BPH is not closing loans at the expected pace, when it closes loans, BPH is very timely in disbursing funds and completing projects.

Net Return after Forgiving Principal

Net Return after Forgiving Principal, also called Net Return, shows the net earnings of the DWTRF after loan principal has been forgiven. The operating earnings are calculated first by subtracting the net bond interest expenses. Then match bond principal and loan principal forgiven are subtracted from these earnings to yield the net return to the DWTRF. (West Virginia does not issue bonds to generate its match, nor

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does it provide loan principal forgiveness.) The Net Return indicator shows how well the DWTRF is maintaining invested or contributed capital. Note that performance is expected to be a net positive return. The net return increased by almost 37% from 2002 to 2003 and over 26% from 2003 to 2004.

Net Return on Contributed Capital

Net Return on Contributed Capital gives context to the Net Return indicator by comparing the net return of the DWTRF to the dollar amount of contributed capital. It is calculated by dividing the Net Return by cumulative contributed capital and expressed as a percentage. Contributed capital is equal to total Federal cash draws less set-aside expenses plus state match deposited into the DWTRF. BPH has a net return on contributed capital that is above 0%. This indicates that the DWTRF is accumulating capital on the initial EPA and State contributions, although the current rate of this growth is low.

AUDITS OF THE FUND

On July 28, 2004, the independent certified public accountants (CPAs) issued their opinion on the DWTRF audited financial statements which includes the State construction loan portion of the BPH DWTRF. The auditors expressed an unqualified opinion on these financial statements, indicating that they are fairly presented and conform to generally accepted accounting principles (GAAP).

As part of their audit, the CPAs performed a Single Program Audit of the State's Federal financial assistance in accordance with generally accepted governmental auditing standards and Office of Management and Budget (OMB) Circular A-133 and issued that report on the same date as the financial statements. There were no notes or disclosures indicating any deficiencies in the State's accounting system or internal controls. The audit, however, contained one finding of non-compliance with Federal regulations:

2004-1 Sub-recipient Monitoring

FYE June 30, 2003: 2 required Single Audits from sub-recipients were not received as of the date of the audit report.

FYE June 30, 2001: 1 required Single Audit from a sub-recipient was not received as of the date of the audit report.

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The CPAs recommended that the State continue to monitor the status of these required audit reports and provide technical assistance to ensure that management and the governing body of the borrowers understand the importance of filing timely audit reports. No costs were questioned by the CPAs as a result of this finding.

During the on-site review, EPA reviewed the State's procedures and actions taken to address these findings. EPA is satisfied that the State's actions have improved sub-recipient audit compliance overall, and will continue to improve compliance with the OMB A-133 sub-recipient audit requirements.

The FY 2004 DWTRF set-aside costs were not included in any FY 2004 audit. At the time of the on-site review, the WV FY 2004 Statewide Single Audit had not yet been issued; however, BPH officials informed EPA that the DWTRF was not covered in the FY 2004 Single Audit. In addition, BPH did not have a separate, independent audit performed on the set-asides for FY 2004 (as in prior years).

SET-ASIDE ACCOUNTING AND INTERNAL CONTROLS

During the annual review, EPA assessed BPH's accounting and reporting of set-aside costs incurred under DWTRF grants. BPH has established separate fund accounts for each set-aside activity (as well as for the loan projects).

As noted above, BPH did not have an audit performed on the FY 2004 set-aside costs incurred. In addition, BPH did not provide EPA with unaudited financial statements for these costs. As a result, EPA was not able to determine the costs of each set-aside by cost category (e.g., payroll, fringe, other direct costs).

In FY 2000, DHHR and BPH agreed to provide an annual audit of the set-asides to fulfill the DWSRF accounting requirements of the SDWA. In the absence of an audit and any un-audited financial statements, EPA cannot determine whether the set-asides were properly recorded in accordance with GAAP.

EPA tested a small sample of DWTRF payroll and related charges for two BPH staff members for January 2004 totaling $11,805.16. The January 2004 monthly timesheet for one of the selected staff members indicated that time was charged to the DWTRF set-asides and the EPA Earmark Oversight grant (the 3% grant) during that time period. The percentage of time charged to the 3% grant was 3.37% of the total amount of time charged for the month ($211.23). BPH did not allocate this amount to the 3% grant. The entire amount of the staff member's time for the sampled month was charged to and reimbursed by the capitalization grant.

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OMB Circular A-87 requires that all payroll charges be supported by adequate timekeeping distributions and other appropriate documentation, and be allocated to the correct funding source in a timely manner. BPH did not do this for the selected time charges. No DWTRF staff time was allocated to other Federal grants or other state-funded activities based upon time recorded on BPH staff timesheets.

BPH claimed that it has designed and implemented a system to calculate the correct time charges for all of its employees and allocate these to the proper funding sources based upon the data on the timesheets. However, BPH has not yet trained its staff to use this system.

BPH agreed to calculate and process the appropriate time allocations as soon as possible.

Action Items: BPH will prepare FY 2004 financial statements for the set-asides and certify that the amounts reported for each set-aside agree with the amounts reported in the statewide FY 2004 audited financial statements.

BPH will determine the correct payroll and related costs based upon time charges on staff timesheets and allocate all charges to the correct funding sources as soon as possible. BPH will continue to perform timely allocations of these charges.

FINANCIAL CAPABILITY AND LOAN MONITORING

As of June 30, 2004, the State had closed 23 DWTRF loans totaling $33,100,758, of which $27,127,444 was outstanding as loans receivable. EPA assessed the State's procedures for performing credit analyses of the borrowers prior to loan closing. In addition, EPA assessed the State's system for monitoring the continued financial strength of municipal borrowers during the loan term to assure continual repayment.

EPA reviewed the State's procedures and how they were applied to the following two projects totaling $3,130,623: Town of Franklin ($2,528,623) and Mason County PSD ($602,000).

EPA found that the State has an effective system for performing initial credit analysis and assessing loan security proposed by loan applicants. It addresses all of the factors that affect the applicant's ability and willingness to repay its debts. Of particular interest are the State's requirements that most projects receiving assistance from the State be reviewed by, and receive a certificate of convenience and necessity from, the PSC. In addition, the State uses the Municipal Bond Commission (MBC) as the collection agent on all loans. The MBC's rate coverage and debt service reserve

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requirements reduce the likelihood of delinquencies or loan defaults.

EPA reviewed the State's loan compliance monitoring program procedures and found that it has an effective system. It is a multi-faceted approach involving a review of the MBC collection reports on each of BPH's loans. BPH also requires and reviews annual financial statement audits for all borrowers. In addition, required Single Audits are reviewed and any findings and recommendations are resolved.

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OBSERVATIONS
GRANT COMPLIANCE AREAS REVIEWED

PAYMENTS

Consistent with the payment schedules in the grant agreements, during FY 2004, EPA released and the State accepted Federal payments totaling $3,717,025 from the Automated Standard Application for Payments (ASAP) account. Of this amount, $1,239,845 was for projects and $2,477,180 was for set-asides. Cumulative payments as of June 30, 2004, totaled $44,602,470: $32,768,401 for projects and $11,834,069 for set-asides.

STATE MATCH

BPH met the 20% state match requirement for projects. Based on cumulative Federal payments as of June 30, 2004, the required match was $8,538,000. As of June 30, 2004, the State had deposited $10,148,500 into the Fund, as shown in the State's FY 2004 Annual Report. This agrees with the amount reported in DWNIMS.

Under the Program Management set-aside, BPH was required to provide $1,560,354 in state match funds based on disbursements made during FY 2004. The State provided $1,560,354 as shown in the State's FY 2004 Annual Report. This agrees with the amount reported in DWNIMS.

ADMINISTRATIVE COSTS

BPH disbursed $359,505 in administrative expenses against the capitalization grants during FY 2004. Cumulative administrative costs expended as of June 30, 2004 total $1,340,027, representing 2.28% of the total grants awarded to BPH. This is within the 4% ceiling set by the SDWA.

FINANCIAL STATUS REPORTS (FSRs)

Federal outlays reported on the FSRs did not agree with the disbursements reported on the Federal Cash Transaction Reports (FCTRs). The State reported net disbursements of $4,516,707.84 on the FCTRs, and $4,499,725.49 on the FSRs, a difference of $16,982.41. Because the expenditures being claimed on the FSRs and

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the FCTRs are on a cash basis, there should be no differences.

Action Item: BPH must reconcile amounts reported on the FCTRs with amounts reported on the FSRs.

FEDERAL CASH TRANSACTION REPORTS (FCTRs)

The State reported capitalization grant receipts of $4,835,570.51 on the FCTRs. This amount reconciles to EPA's grant payment records. BPH also reported net disbursements of $4,516,707.84, as stated above. However, this amount does not agree with the expenditures reported in the FSRs, the Annual Report, or DWNIMS.

The FCTRs as of June 30, 2004, also showed that $71,226.06 was overdrawn from the Federal grants. The DHHR accountant provided EPA with reports showing that the overdrawn amount was offset by corresponding expenditures as of March 7, 2005. At that point, Federal receipts and expenditures were in balance.

DHHR draws Federal cash from ASAP on the basis of the negative balance of each grant account. The negative balance represents the total expenditures charged to the grant but not yet reimbursed by EPA. DHHR does not draw cash based on specific invoiced expenditures. EPA believes the method used by DHHR to draw cash from ASAP caused the overdraw. This method represents an internal control weakness as evidenced by the $71,226.96 overdraw of EPA grant funds.

Action Items: BPH must reconcile information in the FCTRs with its FSRs, DWNIMS, and the State's Annual Report

DHHR must draw Federal funds from ASAP based upon actual expenditures incurred and invoiced by BPH. In addition, DHHR must reconcile the cash balances in ASAP to official State accounting records monthly, and provide this reconciliation to BPH.

BINDING COMMITMENTS

Total BCs required as of June 30, 2004 were $41,306,401 based on Federal grant payments of $31,528,555 and state match of $8,178,625. Actual BCs as of June 30, 2004 were $42,831,758. The difference between the required and actual amount is $1,525,357. EPA commends the State for making great strides in continuing to meet the BC compliance requirement.

EPA discussed the need for the State to report BC status quarterly. In prior years, BPH agreed to report loan closings and BCs to EPA on a quarterly basis, but did not do so consistently in FY 2004. EPA was, therefore, unable to determine whether the State complied quarterly with the BC requirement. However, during the annual

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review process, EPA was able to determine that the State had complied quarterly with the BC requirement.

Action Item: The State will report closed loans and BCs to EPA on a quarterly basis.

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RECOMMENDATIONS

ACTION ITEMS FOR BPH

The following is a list of items identified throughout the report for State action:

1. BPH should continue to identify ways to accelerate the loan application and closing process. (Page)

1. BPH will consider approaches to reduce project bypasses including: (1)revising its process for developing the DWTRF project priority, (2) improving the readiness of projects to proceed (e.g., additional technical assistance, streamlining co-funding approval procedures) and (3) addressing project affordability. (Page)

1. In its Annual Report, BPH shall more clearly describe the status of bypassed projects and the efforts the State is making to assist the projects move forward. (Page)

1. BPH should provide EPA a plan to ensure compliance with the six affirmative steps, particularly with respect to applying these steps to the procurement of services. This plan should be submitted to EPA within 60 days of receipt of EPA's DBE guidance. (Page)

1. BPH shall prepare a brief report which: (1) analyzes the factors which impact the pace of loan execution and the fund utilization rate and (2) identifies recommendations for how to improve performance. If desired, BPH may request assistance from EPA. (Page)

1. BPH will prepare FY 2004 financial statements for the set-asides and certify that the amounts reported for each set-aside agree with the amounts reported in the statewide FY 2004 audited financial statements. (Page)

1. BPH will determine the correct payroll and related costs based upon time charges on staff timesheets and allocate all charges to the correct funding sources as soon as possible. BPH will continue to perform timely allocations of these charges. (Page)

1. BPH must reconcile amounts reported on the FCTRs with amounts reported on the FSRs. (Page)

1. BPH must reconcile information in the FCTRs with its FSRs, DWNIMS, and the

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State's Annual Report. (Page)

1. DHHR must draw Federal funds from ASAP based upon actual expenditures incurred and invoiced by BPH. In addition, DHHR must reconcile the cash balances in ASAP to official State accounting records monthly, and provide this reconciliation to BPH. (Page)

1. The State will report closed loans and BCs to EPA on a quarterly basis. (Page)

ACTION ITEMS FOR EPA

The following is a list of items identified throughout the report for EPA action:

1. At the request of BPH, EPA will provide sample guidelines and criteria regarding principal forgiveness and assist the State in understanding the potential impact on using the additional subsidy on the long-term financial viability of the Fund. (Page)

1. EPA will review BPH's proposed amendments to the OA. (Page)

1. EPA will provide guidance to BPH regarding options for complying with the DBE six affirmative steps. (Page)

1. EPA will, if requested, work with BPH to develop possible solutions to the DBE compliance issue. (Page)

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PRIOR YEAR ACTION ITEMS

The following is a list of items identified in the FY 2003 PER for BPH or EPA action and actions which have been taken:

1. BPH should include success stories in future DWTRF Biennial Reports.
   Resolved

1. BPH is asked to provide two sample success stories within 30 days of receipt of the final PER.
   Resolved

1. BPH should continue to identify ways to accelerate the loan application and closing process and to address reasons for project delays.
   Ongoing

1. BPH should initiate use of the DBE checklist for inclusion in the project files to document borrowers' compliance with the six affirmative steps.
   Resolved

1. BPH will provide cumulative set-aside obligation amounts within 30 days of receipt of the final PER and in future Annual or Biennial Reports.
   Resolved

1. The State will report closed loans and BCs to EPA quarterly.
   Ongoing

1. BPH must adjust its FCTRs to show the correct amount of Federal disbursements consistent with the FSRs.
   BPH is working to resolve this problem.

1. BPH must reconcile information in the FCTRs with its FSRs, DWNIMS, and the State's Annual Report.
   BPH is working to resolve this problem.

ACTION ITEMS FOR EPA

1. EPA will review BPH's proposed amendments to the OA.
   Ongoing

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