



U.S. Department of Agriculture
Office of Inspector General
Great Plains Region
Audit Report

Rural Utilities Service
Water and Waste Program
Grant Eligibility



**Report No.
09601-6-KC
September 2003**



UNITED STATES DEPARTMENT OF AGRICULTURE

OFFICE OF INSPECTOR GENERAL

Washington D.C. 20250



DATE: September 8, 2003

REPLY TO
ATTN OF: 09601-6-KC

SUBJECT: Water and Waste Program Grant Eligibility

TO: Hilda Gay Legg
Administrator
Rural Utilities Service

THROUGH: John Purcell
Director
Financial Management Division

This report presents the results of our audit of the Rural Utilities Service's water and waste grant eligibility determination process. The agency's written response to the official draft report, dated July 24, 2003, is included in the report as exhibit E. Excerpts from the response and the Office of Inspector General's position are also incorporated into the Findings and Recommendations section of the report. Based on the written response, we accept your management decision for Recommendation No. 3. As described in the report, additional information is required before management decisions can be achieved for Recommendations Nos. 1, 2, and 4.

In accordance with Departmental Regulation 1720-1, please furnish a reply within 60 days describing corrective actions taken or planned and the timeframes for implementation for those recommendations where management decisions have not been reached. Please note that the regulation requires management decisions to be reached on all findings and recommendations within 6 months after report issuance. You should follow your internal agency procedures in forwarding final action correspondence to the Office of the Chief Financial Officer for the cited recommendation where management decision has been achieved.

We appreciate the cooperation and assistance extended by Rural Utilities Service managers and employees.

/s/

RICHARD D. LONG
Assistant Inspector General
for Audit

EXECUTIVE SUMMARY

RURAL UTILITIES SERVICE WATER AND WASTE PROGRAM GRANT ELIGIBILITY WASHINGTON, D.C.

REPORT NO. 09601-6-KC

RESULTS IN BRIEF

This report presents the results of our audit of the Rural Utilities Service (RUS) grant eligibility determination process. The primary objective of our review was to determine

whether RUS grant funds were used only to benefit applicants unable to viably fund their water and waste projects without the use of grants. Depending on RUS' determination of the applicants' need for grants, some water and waste projects are funded entirely with loans and some are funded with a combination of grants and loans. We reviewed no water and waste projects funded entirely with loans. However, for RUS grants made concurrently with RUS loans, we reviewed the RUS loan eligibility determinations, as well as the grant eligibility determinations.

Limited RUS grant and loan funds were not appropriately leveraged for maximum benefit to proposed water and waste projects in rural America, and commercial investment lenders were not given the opportunity to evaluate each application to determine if they would be interested in participating, in whole or in part, in financing the projects. While servicing requirements implemented in response to recommendations made in our prior audits improved identification of interested investment lenders, it was RUS practice to not contact interested commercial lenders to determine their interest in financing projects involving requests for grant funding. As a result, using statistical sampling techniques, we estimated that about \$85.5 million of limited grant funds were provided unnecessarily to 97 projects in our universe of 905 grant recipients. Concurrently in funding these projects, RUS made them loans that could have been replaced with financing from loans from commercial lending sources totaling a statistically estimated \$97.9 million to these projects which received unnecessary grants. We also statistically estimated commercial lenders could have provided loan financing totaling another \$163.3 million to 169 projects that did need grants as part of their funding, if given the opportunity.

We also found Rural Development Strategic and Annual Performance Plans did not include specific goals, objectives, or performance measures for leveraging limited grant or loan funds through successful referrals of eligible applicants to commercial lenders.

We further found RUS did not always complete required tests for other credit properly for the statistically selected grant recipients reviewed. Grant applicant and servicing officials often did not obtain project evaluations from interested investment lenders or other sources of commercial credit. In other cases, RUS accepted declination letters from local lenders who did not normally make loans for water and waste projects. Also, RUS did not require applicants to provide project evaluations from their existing commercial lenders who had financed their other projects. We statistically estimated there were inadequate tests for other credit for 286 projects receiving grants totaling about \$325.4 million.

Exhibit A presents a summary of the monetary results of the audit.

KEY RECOMMENDATIONS

We recommended RUS (1) discontinue current practice of making grants contingent on RUS loans being used to finance the balance of project cost and emphasize the need to work with interested commercial lenders in order to maximize leverage of limited RUS funds, (2) revise current policy to require evaluations from interested investment lenders be solicited and analyzed before each future grant award is considered, and (3) establish Government Performance Results Act specific goals and performance measures for successful referrals of grant applicants to commercial credit and/or participation in joint financing with the private sector.

AGENCY RESPONSE

On July 24, 2003, RUS officials expressed general concurrence with the audit recommendations in their written response to the official draft report (see exhibit E for the response). RUS plans to publish a directive supporting the concept of maximizing utilization of grant funding before January 1, 2004. The directive will clearly state that RUS does not have a policy of awarding grant funds contingent on RUS loans being used to finance the balance of project cost. RUS plans for the directive to include specific requirements for documenting analysis of grant and loan applications and guidelines for referral of applicants to interested investment lenders. Also, RUS plans to modify the agency tracking system to capture information on referrals to other credit and establish specific goals and performance measures for successful referrals of grant and loan applicants to commercial credit.

In the written response to the official draft report, RUS officials stated the agency defined reasonable user rates as those rates that were comparable to the rates of communities with similar economic conditions and the same type of established system. Also, RUS officials stated the commercial lender who evaluated the sample grants considered reasonable user rates to be those in the \$40 to \$50 range per month or comparable to the average cable television bill for all systems nationwide.

OIG POSITION

The written response to the official draft report indicates RUS officials plan to take positive actions to correct the conditions cited in this report. However, we noted that RUS officials did not correctly understand the definition of reasonable user rates used by the investment lender that evaluated the sample projects. The investment lender stated that, in some cases, communities receiving RUS water and waste grants and loans also received cable television service with monthly rates in the \$40 per month range. The investment lender defined reasonable user rates as those that were, in his experience, similar to those for communities with the same type of established systems, including both communities receiving RUS grant and loan assistance, and those with commercial financing. The investment lender noted user rates for systems with commercial financing could not exceed the rates system users could afford. Otherwise, the community would default on the loan obligation. Also, we noted the communities selected by servicing officials as having similar systems were normally other communities already receiving RUS grant and/or loan assistance. During audit fieldwork, RUS officials stated the planned improvements to the agency's automated tracking system would include maintaining comprehensive records of user rates and improving servicing officials' ability to compare the rates of similar systems.

We were able to accept the management decision for Recommendation No. 3. RUS will need to provide additional information before we can achieve management decisions on Recommendations Nos. 1, 2, and 4.

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INTRODUCTION

BACKGROUND

The Rural Utilities Service (RUS) is one of three major program areas operating under the United States Department of Agriculture (USDA) mission area Rural Development (RD). RUS was established by Public Law 103-354, the Federal Crop Insurance Reform and Department of Agriculture Reorganization Act of 1994. RUS administers the water and waste programs of the former Farmers Home Administration (FmHA) that provide funding to water and sewer projects for rural communities.

RUS is authorized to provide direct loans, guaranteed loans, and grant assistance to public entities for water and waste disposal facilities in rural areas and towns with populations up to 10,000 people. The type of assistance (either loan funds or a combination of loan and grant funds) provided is governed by each community's financial situation. Program regulations stipulate that RUS loans and grants are to be used for water and waste disposal projects serving the most financially needy communities. RUS Instruction 1780.35(c) provides user charges should be reasonable. RUS determines the grant amount based on equivalent dwelling unit costs that are not below similar system user costs. RUS grants are made to public entities, nonprofit associations, and certain Indian tribes. Water and waste disposal grants are authorized under the Consolidated Farm and Rural Development Act, as amended (Title 7 United States Code (U.S.C.) 1926). The Consolidated Farm and Rural Development Act, as amended, requires applicants to certify in writing and the Secretary to determine and document that the applicant is unable to finance the proposed project from their own resources or through commercial credit at reasonable rates and terms (7 U.S.C. 1983).

In addition, the Secretary is required to prepare a comprehensive rural development strategy which is designed to achieve the most effective combinations of Federal, State, and local resources to meet the needs of rural areas for orderly growth and development. The Secretary is required, in part, to improve credit availability and accessibility and delivery of commercial and public financial resources in the maintenance and creation of jobs in rural areas (7 U.S.C. 2204(b)).

RUS administers its water and waste disposal program by allocating grant and loan funds to the State offices (SO). Each State's allocation is determined by a formula established by regulation. The SO's then make

the funds available to their area offices (AO) to support rural water and sewer projects proposed by local communities.

RUS SO's and AO's determine affordability based on the communities proposed operating budget. Reasonable rates are determined on the basis of (1) the community's median household income or (2) user charges for similar systems in the area. RUS has the discretion to decide which approach will be used to determine the amount of grant funds provided. According to RUS, most decisions are based on the user charges for similar systems.

Grant and loan applicants must provide completed applications and supporting documentation to servicing officials in order to determine eligibility for grant and loan funding. RUS servicing offices maintain servicing files that include applications, supporting documentation, and subsequent servicing actions. Water and waste projects receive grant and/or loan obligations after applications are completed and approved. RUS water and waste projects include all activities a water and waste applicant undertakes that are financed in whole or part with RUS assistance.

Two previous Office of Inspector General (OIG) audits of RUS' graduation (refinancing) process¹ and one audit of its new loanmaking operations² disclosed that RUS was competing with commercial lenders in its servicing and loanmaking operations and was not actively seeking the type of investment lenders who were interested in refinancing and/or financing water and waste loan borrowers. In response to our recommendations, RUS officials agreed to (1) revise National office (NO) and SO guides to evaluate AO decisions not to graduate loans, (2) require SO's to maintain a complete list of commercial lenders with an interest in financing community program projects and make trial referrals when appropriate, and (3) revise regulations to require all applicants to contact at least one potential source of commercial credit and certify in writing that the applicant is unable to finance the proposed project from their own resources or through commercial credit at reasonable rates and terms.

In its fiscal year (FY) 1996 Federal Managers' Financial Integrity Act (FMFIA) annual report, RD recognized RUS water and waste program loan activities as a material internal control weakness. RD determined RUS internal controls needed to be strengthened to ensure commercial credit was sought for water and waste disposal projects. In its FY 1998 FMFIA annual report, RD reported that RUS had corrected the cited

¹ Audit No. 04099-146-TE, FmHA Survey of Community Program Loan Graduation, dated June 1989, and Audit No. 09099-1-KC, Graduation of Community Program Loans, dated September 1995.

² Audit No. 09601-1-KC, Eligibility of Water and Waste Loans, dated December 1996.

internal control weaknesses in loan activities by conducting training for field personnel and developing a database of lenders interested in financing water and waste program projects.

During the 1998 House of Representatives budget hearings, RUS officials responded to Congressional questions that new, streamlined procedures would ensure grant and loan applicants submitted meaningful documentation of attempts to obtain commercial credit before RUS grants and loans were made.³

RUS programs are administered by the Washington, D.C., NO, 47 SO's, and over 800 field offices. The water and waste program was initiated approximately 60 years ago. Since program inception, grant and loan funding totaled about \$8 billion and \$18 billion, respectively. From FY 1992 through FY 2001, direct water and waste grants totaled about \$4.5 billion and loan appropriations totaled about \$7.7 billion. During FY 2001 through FY 2003, RUS water and waste grant funding is expected to exceed \$1.7 billion.

OBJECTIVES

The overall audit objective was to determine the effectiveness of instructions implemented by RUS to ensure limited water and waste grant funds were used to benefit only applicants unable to obtain credit from other sources. The specific audit objectives were to determine if (1) water and waste applicants independently sought credit from creditable commercial sources prior to approval of RUS grants, (2) servicing officials approached interested investment lenders themselves or returned incomplete applications, prior to approving grants, and (3) whether interested investment lenders could have financed the statistically selected projects with or without the use of RUS grant obligations.

SCOPE

The audit design included a statistical analysis of water and waste projects receiving concurrent RUS grant and loan obligations. The audit universe was comprised of 905 water and waste projects receiving RUS grant obligations on or after January 1, 1997, and before September 7, 2000. The audit universe was designed to include grant obligations located in the contiguous United States and each grant obligation was for at least \$500,000. The projects in the audit universe were stratified into six strata with respect to the grant obligation amount. Outstanding grant obligations for the 905 projects in the audit universe totaled about \$1 billion. We accumulated financial data (including Certified Public Accountant (C.P.A.) reports, project summaries,

³ FY 1998 Hearing Questions, Rural Development.

grant determinations, and/or borrower budgets and balance sheets) from the year prior to the grant application through the year the sampled grant obligation was made. In accordance with our sampling plan, we selected 75 grants to review. After reviewing 38 of the 75 statistically selected grants, we found that we had precise projections within allowable tolerances without reviewing all 75 grants. See exhibit B for the statistical sampling plan and exhibit C for our statistical estimates.

To accomplish the audit objectives, fieldwork was performed at the NO, the Missouri SO, and two Missouri AO's.

We conducted this audit in accordance with Government Auditing Standards.

METHODOLOGY

We initiated our review by gaining an understanding of the water and waste program administered by RUS. We reviewed the applicable Code of Federal Regulations (CFR) and RUS Instructions, Bulletins, Staff Instructions and Procedure Notices related to the water and waste program. We conducted interviews with NO officials and SO and AO personnel responsible for administering the selected cases in our sample, where appropriate. Also, SO personnel in the nine States were asked to provide information on their policies in administering the program within their respective States, including their procedures for obtaining applicant evaluations from commercial credit sources.

For the selected grant recipients in our sample; we requested and reviewed copies of grant applicant documents from the nine States' servicing office files, analyzed C.P.A. reports contained in RUS files, obtained additional information from State, area, and local servicing officials, as needed, and obtained a commercial lender's written opinions as to whether the commercial sector would have been able to provide the financing for 38 of the selected projects, with or without grant assistance from RUS, based on the information made available to us by RUS.

We also attempted to obtain individual written opinions from another commercial investment lender as to whether it or the commercial sector could have provided financing for the sampled projects. Officials of the investment lender stated they had noticed no material change in RUS lending policies and instructions after they had assisted us in previous audits in evaluating borrowers' potential for commercial financing. Therefore, they declined to assist us in reviewing the grants sampled for this audit.

FINDINGS AND RECOMMENDATIONS

CHAPTER 1	LIMITED WATER AND WASTE GRANT FUNDS NOT LEVERAGED WITH INTERESTED INVESTMENT LENDERS FOR MAXIMUM BENEFIT
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FINDING NO. 1

RUS did not limit grant subsidies to only applicants who could not develop their water and waste projects without Government assistance as required by the Consolidated Farm and Rural Development Act (7 U.S.C. 1983). These grant recipients also received the loan portion of their project funding from RUS, even though complete project financing was available from commercial sources of credit. For those applicants who could not viably fund their projects without grant funds, RUS provided funding for the entire projects, even though the loan portion of the financing package was available from commercial lending sources. These conditions occurred because RUS loan and grantmaking policies and practices contradicted the Department's and RD's stated objectives and goals in its Strategic Plans and Performance Reports. These plans and reports state that, whenever possible, assistance is to be provided in cooperation with other sources in order to leverage limited resources. RUS policy was to determine if a grant was needed to viably finance applicants' requests for project funding without first consulting with commercial lending sources and, if so determined, to award grants to these projects without allowing lenders the opportunity to evaluate viability of the funding of the project from commercial sources. Also, RUS policy and procedures allowed it to exclusively provide the loan portion of project funding any time it awarded grant funds. The loan portion was also made without determining if commercial funding was available. RUS further did not follow its existing procedures for completing required contacts with commercial lenders and these contacts were often outdated by the time the grants and loans were awarded to applicants. As a result, RUS was competing with commercial lenders by denying them the opportunity to initially finance water and waste projects. RUS awarded a statistically estimated \$85.5 million in grant money that was not needed to make the projects financially viable and it made a statistically estimated \$97.9 million in RUS loans concurrently with the unneeded grant funds. In addition, RUS competed with loans from the private sector for another statistically estimated \$163.3 million in loans to those who did need the grants in order to fund their projects. Finally, we statistically estimated that commercial lender

contacts were not made for 286 projects with grant amounts totaling \$325.4 million. (See exhibit C for the statistical estimates.)

Statutory requirements prohibit the agency from competing with commercial sources of credit.⁴ Title 7 CFR requirements, included in RUS Instruction 1780, state that applicants must certify in writing and the agency shall determine and document that the applicant is unable to finance the proposed project from their own resources or through commercial credit at reasonable rates and terms.⁵ RUS Staff Instructions state the agency policy is to maximize the use of water and waste funds to benefit those who are unable to obtain credit from commercial sources.⁶ Servicing officials are required to evaluate the applicant's potential to obtain other credit before notifying the applicant of eligibility or proceeding with a full application.⁷ RUS Staff Instructions state that applicants who may be able to finance projects through commercial sources should be referred to interested lenders.⁸ Applicants must provide evidence they have contacted potential sources of commercial credit and the lender's response.⁹ RUS may approve a grant and/or loan only when the applicant has provided required information, processing and approval officials have evaluated the application information and other pertinent information to determine the impact commercial financing would have on user rates, and determined other credit is not available at reasonable rates and terms, and included appropriate documentation in the case file.¹⁰ Upon completion of the initial application review, the processing office will forward the draft grant determination to the approval official.¹¹ However, we found actual RUS lending policies and practices were not consistent with its objectives of using grant and loan assistance in a manner to maximize the use of limited water and waste funds. RUS Staff Instructions state that all discussions with other lenders and information obtained should be based on the entire amount of assistance needed and should not reflect any possible RUS grant assistance.¹² RUS Instructions further provide that where RUS grant funds are used in conjunction with a RUS loan, the loan will be for the maximum term permitted.¹³ RUS officials also stated that it is agency policy to not make grants for the purpose of lowering loan funding requirements in order to make commercial financing feasible.

⁴ Title 7 U.S.C. (1983).

⁵ RUS Instruction 1780.7(d), dated June 4, 1999.

⁶ RUS Staff Instruction 1780-6, dated December 1997, paragraph 1.1.

⁷ RUS Staff Instruction 1780-6, paragraphs 1.1 to 1.4.

⁸ RUS Staff Instruction 1780-2, paragraph 2.1, dated July 11, 1997.

⁹ RUS Staff Instruction 1780-6, paragraph 3.1.

¹⁰ RUS Staff Instruction 1780-6, paragraph 3.7.

¹¹ RUS Staff Instruction 1780-2, paragraph 2.4.

¹² RUS Staff Instruction 1780-6, paragraph 3.1.

¹³ RUS Instruction 1780.13(e).

The USDA Strategic Plan for FY's 2000-2005 states that, whenever possible, USDA assistance is to be provided in cooperation with other sources in order to leverage limited resources.¹⁴ The USDA long-term strategy is to draw private capital into rural areas by partnering with commercial lenders to jointly finance projects and encourage third-party specialty lenders who finance specific projects at reduced rates. The USDA FY 2002 Annual Performance Plan also noted that, in the coming years, USDA would work to establish or expand rural water systems by leveraging limited Department resources with those of other organizations.

The RD FY 2001 Annual Program Performance Report cited accomplishments related to the objective of providing financing for modern, affordable water and waste disposal services in rural communities. The report stated that 613 rural water systems were developed or expanded which provided quality drinking water in compliance with the Safe Drinking Water Act. Also, RD reported that 309 rural waste disposal systems were developed or expanded which provided quality waste disposal service in compliance with State and Federal environmental standards. RD reported that total funding for water and environmental programs totaled \$1.41 billion in FY 2001 and reported that 40,600 jobs were generated as a result of facilities constructed with water and waste program funds.

Also, the RD FY 2001 Annual Program Performance Report established key goals and performance indicators related to maximizing leverage of loan funds to increase the number of rural residents assisted by the rural housing, community facility, telecommunications, telemedicine, and distance learning, and rural electric programs. The report included actual results indicating the goals were met for most of these programs. For example, RD reported that during FY 2001, the number of single family housing borrowers assisted through leveraging of loan funds was 103 percent of the established target and the number of rural home loan partnerships was 132 percent of the established goal. However, the RD portion of the USDA Strategic Plans and its Annual Performance Reports did not include any goals or performance measures for successful referrals of RUS water and waste grant and loan applicants to commercial lending sources or use of joint or cooperative financing arrangements with the private sector.

Availability of limited RUS grant and loan funds has resulted in a continuing backlog of community requests for water and waste project financing assistance. RUS officials' recent Congressional testimony

¹⁴ The Government Performance and Results Act (GPRA, P.L. 103-62) requires agencies to develop strategic plans, set performance goals, and report annually on actual performance compared to goals. The plans and goals should be incorporated into the operational management of agencies and programs.

confirmed the limited availability of RUS grant funds.¹⁵ For example, in March 2002, RUS reported the backlog of grant applications totaled over \$1 billion. During House of Representatives Committee on Appropriations hearings for FY 2003, RUS officials noted there was a current backlog of about 1,500 nonfunded water and waste loan applications totaling about \$2.4 billion. RUS stated the backlog had remained at about this level for several years.

RUS NO officials stated they considered the backlog to be due to delays in processing grant and loan applications as well as to limitations on available grant and loan funds. To expedite their requests, RUS officials stated applicants occasionally are given the option of accepting reduced grant funding or delaying financing until additional grant funds are available. RUS NO officials noted that if applicants were unwilling to wait for their requests to be awarded, they could also contact commercial lenders to obtain credit from them, if they elected to begin projects immediately. RUS NO officials noted that applicants elected to delay projects in order to obtain the benefits of RUS expertise and advice. Also, communities sometimes chose to wait for RUS to keep rates reasonable. However, the fact that applicants have withdrawn their applications and obtained financing from commercial sources to expedite completion of their projects indicates that they did not need RUS grant and/or loan assistance.

RUS officials stated that because an applicant could not wait for funding did not mean they did not need RUS grant and loan assistance. RUS does not have sufficient funding to provide the needs for all applicants that apply. We recognize applicants want RUS grants and loans because RUS loans are generally for longer terms and lower interest rates than commercial credit. However, the applicant's ability to actually obtain commercial credit shows that they did not need the RUS grant and loan assistance.

We found RUS was competing with and not leveraging its limited grant and loan funds with commercial lenders as follows:

- a. RUS provided six of the statistically selected water and waste projects with \$7.9 million of unnecessary grant funds that could have been replaced by financing with funds from commercial loans from the private sector. Commercial investment lenders were not contacted to determine their interest in financing the projects because the applicants were not required to contact commercial investment lenders once RUS determined the project could not be viably funded without

¹⁵ Source: Agriculture, Rural Development, Food and Drug Administration, and related Agencies Appropriations for 2003, Subcommittee of the Committee on Appropriations, House of Representatives.

the use of grant funds. We statistically estimated RUS provided 97 projects with grant funds totaling about \$85.5 million, which were not needed because interested investment lenders could have financed the entire projects with loans. Based on our projections, we are 95 percent certain that at least \$22.3 million of grant funds could have been replaced with loan financing from commercial sources. Our estimate of \$85.5 million has a sampling precision of 74.0 percent.

At our request, a nationwide investment lender reviewed 38 of the statistically selected grants and provided written opinions as to whether commercial lenders would have provided financing for the projects based on the available information contained in the RUS borrower files. The investment lender stated that its firm or others in the commercial market would have financed six of the projects in their entirety with financing from commercial loans. The commercial investment lender said that all six of these projects could have been successfully financed solely with funds provided by loans and grant funds were unnecessary to make financing of the projects viable. The six statistical sample grant obligations totaled about \$7.9 million.

To illustrate, details for one of the six grants the investment lender opined that they or others in the commercial market would have financed are as follows:

During August 1999, RUS funded a grant to Aqua Water Supply Corporation (nonprofit corporation) in Texas totaling \$1,257,000 and a concurrent loan for the project totaling \$2,293,000. RUS financing for the project totaled \$3,550,000. The project objective was to expand existing water production and treatment facilities to provide an adequate quantity and quality of water for their expanding customer base. RUS files indicate the project would serve about 11,600 users, had unrestricted net assets totaling about \$20.3 million, and had annual net cash flow provided from operating activities totaling about \$1.4 million. In March 1999, an existing creditor (a larger nonprofit corporation) offered to finance the project with a 20-year loan at an 8.55 percent taxable fixed rate (required for commercial lenders under State law). RUS files indicate the corporation elected to request RUS financing for the project, in part, to avoid a potential takeover by the larger corporation. The RUS loan was made at 4.75 percent (nontaxable rate) for 40 years.

The investment lender assisting us told us their firm or others in the commercial market would have financed the entire project from loan funds and the project was financially viable without the use of grant funds. The nationwide investment lender estimated user

rates would only increase about 6 percent with a general market 20-year loan and a fixed, taxable financing rate of 8.5 percent. The increase was nominal and acceptable under RUS criteria.

Texas SO officials stated that, at the time the project was financed using grant funds, they determined it was doubtful the applicant would have been able to obtain commercial credit at reasonable rates and terms. Texas SO officials stated they considered several factors, including balance sheet nonrestricted assets, annual cash flow, and consistency in user numbers and user rates in making their determination. Texas SO officials stated their professional judgment was a factor in making the determination. However, RUS files indicate the nonprofit corporation refinanced previous commercial loans totaling between \$6.2 and \$6.5 million with a large Texas commercial lender while the RUS grant and loan application was being considered. RUS files indicate that Aqua Water Supply Corporation also contacted a local bank that was not interested in financing the project and it declined the cited financing offer from a larger water supply corporation for the \$3.55 million project financed with the RUS grant and concurrent loan included in our review. In addition, the Texas SO officials stated that Aqua Water Supply Corporation obtained loan financing for subsequent projects from a nationwide commercial lender. SO officials stated the corporation is currently in the process of refinancing its existing RUS loans with this commercial lender.

RUS NO officials stated that a preliminary determination of the availability of other credit could be determined without contacting commercial credit sources on each loan inquiry if current lending criteria were maintained on credit availability. They further stated that they believed most of their grant recipients would be unable to obtain commercial financing for their projects. RUS officials planned to incorporate this policy into their written instructions in cases where they determined a grant was needed. Also, RUS NO officials stated they believed the concept of leveraging their limited funds for new grants and loans funds was more applicable to coordination with other federal or State agency loan and grant programs, rather than utilizing commercial lending sources. RUS NO officials stated that they did not perceive the leverage concept as being applicable to collaboration with commercial lenders on financing water and waste projects.

Based on the results provided by the commercial lender that assisted us, we agree that most grant recipients would be unable to obtain commercial credit for their projects. However, our statistical sample, which is representative of the audit universe, also revealed that a

substantial amount of grant funds (\$85.5 million to 97 projects) was unnecessarily disbursed to projects who could have obtained their funding instead from commercial loans.

We disagree with RUS plans to codify its policy so that no test for other credit will be required for those projects where RUS officials determined the use of grant funds are necessary to make financing of the projects viable. Our audit results support the need to continue with and improve oversight over current requirements to test for other credit.

- b. In addition to the unnecessary use of grant funds, RUS also completed the financing packages for the six cited projects by making loans totaling \$6,667,600. As discussed above, the applicants were not required to seek commercial sources of credit because RUS had determined that the loans would not be sound without grants to supplement the financing with loans. However, commercial investment lenders would have provided all financing for these cited water and waste projects, in their entirety, with loan funds. We statistically estimated that RUS provided unnecessary loan funds totaling about \$97.9 million to finance these projects that investment lenders would have replaced with commercial loans, if given the opportunity.
- c. RUS provided another 11 of the 38 statistically selected water and waste projects with unnecessary loan funds totaling \$13,235,000 that could have been financed commercially if RUS had collaborated with commercial lenders to use their loan funds to complete financing for projects which were not financially viable without utilizing RUS grant funds. RUS procedures prohibit decoupling grant and loan funding to allow financing of the loan portion of water and waste projects by commercial lenders. RUS procedures do not allow commercial lender funding for the loan portion of projects where grants were actually a necessary part of the financing package to enable projects to be financially viable.¹⁶ As a result, our statistical analysis estimated 169 grant recipients who actually needed the grants received unnecessary concurrent RUS loan funding totaling about \$163.3 million that could have been financed by loan funds from commercial lenders, if given the opportunity.

The investment lender who assisted us stated the commercial lenders would have been interested in participating in joint financing of the loan portion of the cited projects. The investment lender stated the amount of RUS grant and loan fund resources needed to viably fund these

¹⁶ RUS Staff Instruction 1780-6, paragraph 3.1.

projects would have been reduced if available commercial financing had been utilized in project funding.

A Texas SO official agreed that, in some cases, decoupling RUS grant and loan funding and participating in joint financing could feasibly assist the agency in effectively using grant and loan funds. The Texas SO official cautioned, however, the agency would need to ensure RUS grant funds were used to benefit system users and not just subsidize commercial lenders and provide them an opportunity for increased interest rates or reduced loan terms. A Kentucky SO official agreed the agency should consider any recommendation to more effectively use grant or loan funds.

- d. RUS procedures did not always ensure commercial investment lenders were provided the opportunity to evaluate their interest in financing projects and that adequate tests for other credit were completed before RUS awarded grant funds and provided companion loan financing. This occurred, in part, because RUS officials substituted their own evaluation for the required evidence of commercial lender reviews. Also, RUS procedures do not require SO and AO reviews of applications and supporting documentation for sufficiency with RUS requirements at the time the grant and/or loan is awarded. As a result, we estimated that 286 grants in our sample universe totaling \$325.4 million were funded with incomplete or inadequate tests for other credit. Based on our projections, we are 95 percent certain that at least \$217.5 million of grants were funded with inadequate or untimely tests for other credit. Our estimate of \$325.4 million has a sampling precision of 33.2 percent.

Our review of the statistically selected applicant case files for evidence the borrowers contacted investment lenders capable of making water and waste loans revealed the following:

- No evidence of evaluation by any commercial lender was documented for 22 of 38 statistically selected grant and loan files we reviewed. (See exhibit D.) In addition, local banks were the only lender contacts documented for nine projects. Local lenders do not normally provide permanent financing for water and waste projects, due to their own lending policies and State regulations. The lenders contacted for these nine projects were not on the SO approved list of lenders. RUS Staff Instructions do not specifically require applicants for new grants and loans to contact investment lenders that normally make water and waste grants and loans in the

State.¹⁷ Interested investment lenders reviewed only seven sample projects before RUS grants and loans were funded.

The nine SO's we reviewed were preparing comprehensive lists of investment lenders active in the States. However, the State comprehensive investment lender listings were used primarily to refer borrowers identified as having loans with graduation potential to sources of potential refinancing. SO and AO servicing officials often did not take action to require applicants to contact investment lenders on the SO lists prior to approving funding for new grants or loans to the projects.

RUS SO and AO servicing officials did not believe reviews by commercial lenders were needed when they determined a grant was needed. A Mississippi SO official told us the State had established an unwritten policy that when servicing officials determined a grant was needed, the test for other credit was considered complete and no lender contacts were required.

- The commercial lender reviews were significantly outdated at the time grants and loans were funded for 6 of the 10 projects reviewed by local lenders. The local lender declination letters were dated as much as 5 years before the grants and loans were funded.¹⁸

Similarly, the required applicant certifications of inability to obtain other credit were not timely when grants and loans were funded for 16 files reviewed. When lengthy delays in grant and loan funding occurred after the original application, RUS did not require the applicants to obtain an up-to-date commercial lender evaluation and provide a current certification of inability to obtain other credit. As a result, applicant certifications of inability to obtain commercial credit may not have been based on the lender's current evaluation of the project.

- RUS provided grant funds to six sample projects with existing loans from commercial lenders. RUS obtained a project funding evaluation from the existing commercial lender in only one of the six cases. For five projects, RUS servicing officials substituted their own grant and loan funding analysis for an evaluation by the existing lenders. RUS servicing officials determined the applicant's

¹⁷ RUS Staff Instruction 1780-6, paragraph 3.1, states that applicants must provide evidence they have contacted potential sources of commercial credit and the lender or lenders' response.

¹⁸ RUS Staff Instruction 1780-6, paragraph 3.1(b), requires information supporting the applicant certification regarding other credit should normally have been obtained within 6 months of the date the application is submitted. The instruction does not require that the information be updated at the time the grant and/or loan is awarded.

financial position was sufficiently secure enough that RUS accepted junior lien positions to the commercial lenders or refinanced the existing commercial debt as part of the obligation.

We concluded inadequate commercial lender reviews adversely impacted the sufficiency of documentation available to support the grant and loan eligibility determinations RUS made. Many grant and loan applications included financial statements that were not audited or independently verified. Also, the project estimates of user numbers, expected user rates, and project construction and operating costs were not always consistent or well documented. Independent investment lender reviews of each water and waste grant and loan application would serve to strengthen the documentation available to enable RUS and the commercial lender to correctly determine project eligibilities for grant and loan financing.

RUS NO officials stated the quality of grant and loan eligibility documentation in project files needed improvement. RUS NO officials stated new automated spreadsheets were being developed to improve documentation of expected users and rates and expected construction and operating costs. RUS NO officials also stated the level of water and waste program training provided to field office staff contributed to weaknesses in documentation of application analysis. Due to staff reassignments and reductions, some field personnel assigned to the water and waste program did not receive the needed level of grant and loan application processing training. RUS NO officials stated that while additional training was being developed, budget shortfalls had delayed implementation.

From the results of our review, we noted some improvements in RUS communication and leverage with commercial lenders subsequent to the release of Staff Instruction 1780-6, dated December 1997. The nine SO's we reviewed prepared more complete lists of investment lenders active in their States. Investment lenders we interviewed also noted improved loanmaking opportunities in limited locations (Oklahoma, in particular). Also, RUS officials reported in Congressional testimony that during FY's 2000 through 2002, about 900 borrowers, with loan balances totaling about \$2.8 billion, were graduated to commercial credit. RUS NO officials cited the increased loan graduation rates as evidence of improved tests for other credit and cooperation with the commercial lending sources. However, RUS NO officials stated they did not believe their water and waste program borrowers could normally have obtained financing for their new projects from commercial lenders with reasonable rates and terms. RUS officials reiterated that they plan to implement new instructions stating tests for other credit will not be required if RUS officials determine a grant is needed as part of project financing.

In our view, RUS grant and loan policies and practices contradict Departmental objectives and goals for cooperation with the private sector cited for the water and waste program. A revised policy providing for referral of grant and loan recipients to commercial lenders for loan financing could provide a method for reducing the backlog of nonfunded applications. RUS policies actually mandate projects to use RUS loans when they might otherwise seek commercial financing. This policy forces investment lenders to make proposals for the entire project cost rather than proposing loans for the portion of project cost they would consider feasible in a joint-financing arrangement.

Our audit results further show that there is a need to revise current instructions to improve oversight so that creditable evaluations for other credit are always timely performed and are sufficient to ensure RUS is not competing with and is obtaining maximum benefit from commercial sources of credit. Additional management controls are needed to ensure each water and waste project proposal is creditably evaluated by an interested investment lender before an RUS grant and loan is made.

RECOMMENDATION NO. 1

Discontinue current RUS practice of awarding grant funds contingent on RUS loans being used to finance the balance of project cost. Develop and implement procedures for making RUS grants and/or loans in conjunction with joint financing arrangements with interested commercial investment lenders. Emphasize the need to work with commercial lenders in order to maximize use of limited RUS grant funds.

Agency Response

In the written response to the official draft report (see exhibit E), RUS officials stated:

A directive will be issued by January 1, 2004, advising RUS Water and Environmental Programs (WEP) staff to maximize the utilization of grant funding with the most favorable loan terms available. The directive will clearly state that RUS does not have a policy of awarding grant funds contingent on RUS loans being used to finance the project costs.

OIG Position

We agree with RUS' plan to issue a directive stating the agency does not have a policy of awarding grant funds contingent on RUS loans being used to finance the balance of project cost. In order to achieve a management decision for Recommendation No. 1, we need further information regarding whether RUS plans to develop plans and procedures for making grants and/or loans in conjunction with joint financing arrangements with interested commercial investment lenders. Also, we need to be advised of RUS' plans to work with commercial lenders in order to maximize the use of RUS grant and loan funds.

RECOMMENDATION NO. 2

Revise current policy and procedures to require that proposals from interested commercial investment lenders always be solicited and analyzed before each future grant obligation is considered by RUS. Institute NO and SO controls that ensure each complete grant and loan application includes an evaluation and response (either a declination or proposal) from at least one commercial investment lender interested in financing water and waste projects. The evaluation and response should always be with a commercial investment lender selected from the approved lists maintained by the SO's. Ensure, through this process, that water and waste grants are not awarded unless they are actually needed to make the project financing viable and the accompanying loan sound.

Agency Response

In the written response to the official draft report, RUS officials stated:

A directive will be issued by January 1, 2004, providing specific documentation and lender referral guidelines. The directive will include such items as: communicating with interested lenders routinely; maintaining current rates and terms from commercial lenders interested in the program and defining reasonable user rates at the local level through meetings or email; completing a detailed financial analysis based on current rates and terms; utilizing agency grant funds to subsidize the best loan rates and terms available to lessen the demand on grant funding and serve the maximum end users possible; and referring all applicants to other credit that show feasibility, subject to a more detailed analysis of the cost of issuance.

OIG Position

We agree RUS issuance of a new directive including the specified improvements in application documentation and lender referral guidelines would assist the agency in meeting its goal of administering the water and waste program in an effective and efficient manner. However, we continue to believe that requiring each applicant to provide at least one credible proposal from an interested investment lender is the most effective way to ensure water and waste grants are not awarded unless they are actually needed to make the project financing viable and the accompanying loan sound.

In order to achieve a management decision for Recommendation No. 2, we need to be advised whether RUS plans to establish controls that ensure each complete grant and loan application includes an evaluation and response from at least one commercial investment lender interested in financing water and waste projects. Also, we need to be advised the agency plans to require the evaluations and responses to be completed by a commercial investment lender selected from the approved lists maintained by the SO's.

RECOMMENDATION NO. 3

Establish GPRA specific objectives, goals, and performance measures for successful referrals of water and waste grant and loan applicants to commercial financing sources and/or participation in joint financing with the private sector. Establish referral goals and performance measures for each State and periodically monitor the States' grant and loanmaking operations to ensure the goals are met.

Agency Response

In the written response to the official draft report, RUS officials stated:

RUS WEP will modify the agency tracking system in FY 2004 to capture information on referrals to other credit regardless of agency participation in the funding package for interim and permanent financing. Based on the baseline data collected in FY 2005, goals and performance measures would be established for FY 2006.

OIG Position

We accept the management decision.

RECOMMENDATION NO. 4

Revise procedures to require that applicants provide updated evaluations by interested commercial lenders within 6 months of the

grant and/or loan award date. Require SO's and AO's to return those applications as incomplete where current evaluations by interested commercial lenders are not available at the time of grant and/or loan award.

Agency Response

In the written response to the official draft report, RUS officials stated:

A directive will be issued by January 1, 2004, providing guidance to require current financial analysis of commercial rates and terms to be completed within 6 months of agency obligation of funding.

OIG Position

In order to achieve a management decision for Recommendation No. 4, we need to be advised whether the planned directive will require SO's and AO's to return applications as incomplete when updated evaluations by interested commercial investment lenders are not provided within 6 months of the grant and/or loan obligation date.

EXHIBIT A – SUMMARY OF MONETARY RESULTS

Finding No.	Description	Amount	Reference
1	Investment Lender Ability To Replace Grant Obligations	\$85,492,635	<u>1/</u>
1	Investment Lender Ability To Replace Concurrent Loans (Total Obligation)	97,874,240	<u>1/</u>
1	Investment Lender Ability To Replace Concurrent Loan Only	163,309,151	<u>1/</u>
1	Analysis For Other Credit Not Complete	325,409,732	<u>1/</u>

1/ Management or Operating Improvements/Savings

EXHIBIT B – STATISTICAL SAMPLING PLAN

The general statistical sample design for this audit was a stratified simple random sampling scheme where water and waste project grants were selected from data acquired from RUS. The audit universe was comprised of 905 water and waste projects that received RUS grant obligations on, or after, January 1, 1997, and before September 7, 2000. The projects in the audit universe were located in the contiguous United States and the grant obligation for each sample project exceeded \$500,000. The universe was composed of 905 grants. The 905 grants were stratified into 6 strata with respect to the grant obligation amount.

The following table gives the specifics of the stratification used in this sample design:

Strata	Boundary Obligated Amount	Number Of Grants	Obligated Amount	Sample Units
1	\$0-\$700,000	266	\$155,620,280	11
2	\$700,000-\$900,000	165	129,351,265	10
3	\$900,000-\$1,300,000	209	221,552,000	16
4	\$1,300,000-\$1,800,000	115	173,616,302	13
5	\$1,800,000-\$2,500,000	98	203,864,500	14
6	Over \$2,500,000	52	162,389,920	11
TOTAL		905	\$1,046,394,267	75

A sample size of 75 grants was selected. The sample size of 75 was proportionally allocated with respect to the obligated amount. The grants were selected with equal probability without replacement within each strata. The grant obligations were placed into strata 1-6 using the cumulative square root of the frequencies methodology (Cochran, SAMPLING TECHNIQUES) with respect to the grant obligation amount. The sample unit within each strata was a water and waste grant obligation. The table above contains the details for this allocation and sample selection. A 95 percent two-sided confidence level was used for all the statistical estimates in this review.

Statistical Analysis.

All statistical sample design, selection, and statistical estimation were accomplished on a DELL Pentium Personal Computer using SAS and SUDAAN, a software system that analyzes sample survey data gathered from complex multistage sample designs. The statistical estimates used for projections along with their standard errors were produced

using the SAS callable version of SUDAAN. SUDAAN was written by B.V. Shah of Research Triangle Institute, Research Triangle Park, North Carolina.

The term sample precision (sp), as used in the report for estimating dollar values, averages, and number of occurrences is defined as

$$sp = \frac{t * STDERR}{PTEST}$$

where

t - t factor for a 95% two-sided lower confidence level
PTEST - point estimate (estimate of the total, mean, or number of occurrences)
STDERR - standard error of the point estimate

The sample precision for estimating percentage values is defined as

$$sp = t * STDERR$$

where

t - t factor for a 95% two-sided lower confidence level
STDERR - standard error of the point estimate (percentage value)

EXHIBIT C – STATISTICAL ESTIMATES

PROJECTED DOLLAR VALUE

CATEGORY	POINT ESTIMATE	LOWER 95% CONFIDENCE LEVEL	UPPER 95% CONFIDENCE LEVEL	PRECISION
Investment Lender Ability to Replace Statistical Sample Grants	\$85,492,635	\$22,259,522	\$148,725,748	.740
Inadequate RUS Test for Other Credit (No commercial lender review completed)	325,409,732	217,480,802	433,338,661	.332
Investment Lender Ability to Replace Related Loans (Total Obligation)	97,874,240	15,488,004	180,260,475	.842
Investment Lender Ability to Replace Loan Obligated With Sample Grant (Loan Only)	163,309,151	57,724,208	268,894,095	.647

PROJECTED NUMBER OF CASES

CATEGORY	POINT ESTIMATE	LOWER 95% CONFIDENCE LEVEL	UPPER 95% CONFIDENCE LEVEL	PRECISION
Investment Lender Ability to Replace Statistical Sample Grants	97	19	176	.809
Inadequate RUS Test for Other Credit (No commercial lender review completed).	286	181	391	.369
Investment Lender Ability to Replace Related Loans (Total Obligation)	97	19	176	.809
Investment Lender Ability to Replace Loan Obligated With Sample Grant (Loan Only)	169	76	263	.553

EXHIBIT D – RESULTS OF TEST FOR OTHER CREDIT

OIG REVIEW ¹⁹	ST	NAME	GRANT NO.	GRANT OBLIG. DATE	SAMPLE GRANT AMOUNT	INADEQUATE CREDIT TEST AMOUNT	LENDER COULD REPLACE GRANT AMOUNT	LENDER FINANCE ABILITY (RELATED LOANS)	LENDER COULD FINANCE LOAN WITH ASSISTANCE
N	AL	WASHINGTON CO. W&FPA	2	03/26/98	\$697,500				
Y	MS	SOUTHEAST NOXAPATER	7	03/24/98	545,000	\$545,000			\$668,000
Y	MS	BETHLEHEM	2	07/13/98	585,000	585,000			996,000
Y	MO	PIKE CO. PWSD NO. 1	2	12/30/99	508,000		\$508,000	\$845,000	
N	WA	LEWIS COUNTY	12	07/16/98	639,200				
Y	IL	SOUTH LAWRENCE	2	11/30/98	687,700	687,700			
N	AR	DERMOTT	2	12/17/97	684,300				
Y	MS	BEULAH HUBBARD	2	05/03/00	613,700		613,700	791,300	
Y	MS	KILN WATER & FIRE	7	07/10/00	565,800		565,800	711,700	
N	DE	DELMAR DELAWARE	7	04/08/98	611,700				
N	MN	NEW LONDON	3	12/07/99	612,000				
Y	KY	LAWRENCE COUNTY	5	12/05/97	763,000	763,000			
Y	MO	SOUTH VAN BUREN	2	08/04/99	818,000	818,000			250,000
Y	TX	OSR WSC	12	01/28/99	844,000	844,000			314,000
Y	VA	DAMASCUS	6	04/22/99	805,100				
Y	MO	HICKORY CO. PWSD NO. 2	3	03/24/99	800,000	800,000			1,200,000
N	SD	OGALLALA SIOUX TRIBE	34	09/03/99	850,000				
Y	TX	BAYSIDE	2	07/30/98	843,600	843,600			
Y	IL	HARDINVILLE WATER	7	11/19/98	750,000				
Y	SC	PELZER	3	04/22/99	815,400	815,400			726,600
Y	VA	DICKENSON CO. PSA	4	01/07/98	816,000				
Y	TX	AQUA WSC	18	08/03/99	1,257,000		1,257,000	2,293,000	
N	CA	SHASTA COUNTY	3	03/18/97	942,700				
Y	IL	BIGGSVILLE	3	02/04/99	996,600				520,000
Y	TX	MADERA VALLEY WATER	3	01/23/97	1,039,600				460,400

¹⁹ Y=Yes, N=No, ST=State, NO.=Number

OIG REVIEW ¹⁹	ST	NAME	GRANT NO.	GRANT OBLIG. DATE	SAMPLE GRANT AMOUNT	INADEQUATE CREDIT TEST AMOUNT	LENDER COULD REPLACE GRANT AMOUNT	LENDER FINANCE ABILITY (RELATED LOANS)	LENDER COULD FINANCE LOAN WITH ASSISTANCE
N	WV	GARY	2	07/22/97	976,000				
N	GA	FRANKLIN COUNTY	2	01/28/98	963,000				
N	IN	BEAR HIGH WOLF	2	04/03/97	1,138,400				
Y	MO	WAYNE CO. PWS NO. 2	2	08/08/00	1,065,000	1,065,000			1,600,000
N	AL	GORDON	4	07/25/00	1,193,600				
N	DE	HARRINGTON	7	04/08/97	905,000				
N	LA	WWD#4 OF ST. MARTIN	2	11/24/98	1,182,000				
Y	KY	ESTILL CO. WATER	14	09/22/98	900,000				
N	MT	PABLO/LAKE CTY W&S	2	04/02/98	1,247,000				
Y	KY	EAST LAUREL WATER	11	12/18/97	900,000	900,000			
N	MN	RICH PRAIRIE	6	06/26/97	1,045,000				
Y	MI	CASS COUNTY	3	11/30/98	1,273,000	1,273,000			
Y	TX	DOBBIN	4	12/19/97	1,500,000	1,500,000			
Y	KY	MC.CREARY COUNTY	16	04/15/98	1,690,000	1,690,000			
Y	PA	HARRISON TOWNSHIP	2	07/13/99	1,437,200	1,437,200			
N	GA	GLENNVILLE	4	07/13/98	1,792,094				
Y	TX	MALAKOFF VILLAGE OF	2	06/23/98	1,650,000				
N	NY	BOONVILLE	5	04/01/97	1,669,800				
N	OH	VILLAGE OF SHAWNEE	2	03/23/00	1,308,000				
N	AL	COLBERT COUNTY	2	02/23/00	1,646,000				
Y	TX	CYPRESS SPRINGS WSC	7	08/03/99	1,700,000				
N	WI	VILLAGE OF POPLAR	2	03/20/97	1,696,000				
N	TN	SPENCER	15	04/22/98	1,680,000				
N	NC	SOUTHEAST BRUNSWICK	7	11/06/97	1,760,000				
Y	IL	BLANDINSVILLE	3	04/22/98	1,400,000	1,400,000			1,500,000
Y	SC	EASTOVER	3	12/18/97	2,040,400	2,040,000			
N	FL	CEDAR GROVE	4	11/23/99	2,000,000				
Y	PA	GILPIN TWP SEWAGE	2	09/26/97	2,150,000	2,150,000			
N	WV	MINGO COUNTY PUBLIC	7	08/09/00	2,000,000				

OIG REVIEW ¹⁹	ST	NAME	GRANT NO.	GRANT OBLIG. DATE	SAMPLE GRANT AMOUNT	INADEQUATE CREDIT TEST AMOUNT	LENDER COULD REPLACE GRANT AMOUNT	LENDER FINANCE ABILITY (RELATED LOANS)	LENDER COULD FINANCE LOAN WITH ASSISTANCE
N	GA	QUITMAN CO. WATER	2	04/05/99	2,215,800				
N	MN	GREEN ISLE	2	12/17/98	1,849,000				
Y	MI	IRON RIVER	2	11/22/99	2,415,000	2,415,000			5,000,000
N	OH	MCO WATER CO.	2	04/27/99	2,224,000				
Y	VA	SUSSEX SERVICE AUTH	2	03/19/99	2,200,000				
N	WI	ABRAMS SANITARY	2	12/30/99	2,178,000				
N	LA	ST. MARTIN PH WWD#3	2	02/19/98	1,845,600				
N	OR	VENETA	2	07/06/99	2,244,300				
Y	PA	BRATTON TOWNSHIP	2	08/13/99	2,120,000				
Y	SC	SILVER SPRINGS	8	07/10/00	2,038,400		2,038,400	687,600	
N	NC	BETHEL	3	12/18/98	2,700,000				
N	OR	TURNER	2	01/14/98	3,000,000				
Y	MI	GOGEBIC RANGE WATER	4	12/23/99	2,961,000	2,961,000	2,961,000	1,339,000	
N	CA	MERCED COUNTY	6	03/17/98	4,147,650				
Y	PA	MIDWAY SEWAGE AUTH	2	11/24/99	3,317,000	3,317,000 ²⁰			
N	WA	CLE ELUM	2	03/07/97	2,795,500				
Y	PA	GREEN TOWNSHIP MUN	4	04/01/98	2,532,000	2,532,000			
N	OR	SISTERS	5	08/03/99	2,888,600				
Y	MI	WAKEFIELD	2	04/22/98	3,674,900	3,674,900			
N	LA	ST. MARTIN PH SD#2	2	04/18/00	2,964,000				
N	IN	LAGRANGE	2	04/28/00	3,184,000				
		Totals			\$116,493,144	\$35,056,800	\$7,943,900	\$6,667,600	\$13,235,000

²⁰ Local lender contact was in excess of 5 years old when sample grant was funded.

EXHIBIT E – RUS RESPONSE TO THE DRAFT REPORT

JUL 24 2003

SUBJECT: Office of Inspector General (OIG) Official
Draft Report - Water and Waste Program
Grant Eligibility
(Audit No. 09601-006-KC)

TO: Richard D. Long
Assistant Inspector General
for Audit

Attached is a memorandum dated July 23, 2003, along with attachments, from Gary J. Morgan, Assistant Administrator, Water and Environmental Programs, Rural Utilities Service, concerning Recommendations 1, 2, and 3 in the above subject audit.

This response is being submitted for your consideration to reach management decision.

If you have any questions, please contact Rochelle Diamond of my staff on 692-0077.

John M. Purcell

JOHN M. PURCELL
Director
Financial Management Division

Attachment



United States Department of Agriculture
Rural Development

Rural Business-Cooperative Service • Rural Housing Service • Rural Utilities Service
Washington, DC 20250

JUL 23 2003

SUBJECT: Office of Inspector General (OIG) Official Draft Report – Water
and Waste Program Grant Eligibility (Audit No. 09601-006-KC)

TO: John Purcell
Director
Financial Management Division

FROM: GARY J. MORGAN
Assistant Administrator
Water and Environmental Programs
Rural Utilities Service

This is in response to the Official Draft Report from OIG dated July 2, 2003. The Rural Utilities Service (RUS) Water and Environmental Programs (WEP) is committed to administering the funds appropriated for the water and waste programs in an effective and efficient manner. Extending the impact of the appropriated dollars by leveraging WEP funds with funding from other public financing sources and the private sector has been a part of the program for many years. We welcome the review findings and constructive suggestions to further improve program delivery.

Agency response to Executive Summary

While this report identifies areas that need further analysis and management attention, the report does not address the basic issue of "reasonable user rates" or provide a clear understanding of the concept of "leveraged dollars verses subsidized funding" as discussed in our meeting on May 28, 2003.

Reasonable user rates are defined by the RUS WEP as user rates comparable to other similar systems. Similar system cost is defined in RUS Instruction 1780 as the average annual equivalent dwelling unit user cost of a system within a community having similar economic conditions and being served by the same type of established system. The one lender referenced in the final report, indicated at our May 28, 2003, meeting that reasonable user rates should be in the \$40 to \$50 range per month comparable to the average cable television bill for all systems nationwide. We do not believe this is an appropriate method for determining reasonable user rates for all rural Americans.

As we discussed in the May 28, 2003, meeting, all applicants can afford 100 percent loan if the user rates are raised to a sufficient level to cover debt service. The final report was issued indicating that this one lender represented all commercial lenders and based on a statistical sampling, it was estimated that about \$85.5 million of limited grant funds were provided unnecessarily to 97 projects in our universe of 905 grant recipients. The report

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Secretary of Agriculture, Washington, DC 20250

further states that after reviewing 38 of the 75 statistically selected grants, OIG determined precise projections within allowable tolerances without reviewing all 75 grants. Statistically, these numbers may have meaning, however, without a clear and broad understanding of the terminology of reasonable user rates, the outcome can be skewed due to a narrow interpretation or the absence of an impact analysis on system users. The report does not acknowledge the projects, which were referred to other credit for interim or permanent financing.

The final report also indicates that RUS WEP loan and grant funds should be utilized to leverage commercial funding. The purpose of the water and waste program as outlined in RUS Instruction 1780 is to provide loan and grant funds for water and waste projects serving the most financially needy communities. Financial assistance should result in reasonable user costs for rural residents, rural businesses, and other rural users. It is not the intent of the program to subsidize commercial funding sources, however, it is our goal to provide funding to extend service to end users while maintaining reasonable user rates. This does not preclude the RUS WEP from leveraging loan or grant dollars with commercial funds when commercial funding is at rates and terms which maximize the utilization of loan funding prior to the inclusion of grant funding. Neither is it the intent of the RUS WEP to fund projects, which may be feasible with commercial financing provided reasonable user rates can be maintained. The RUS WEP financing is provided only when commercial credit is unfeasible. Our goal is to provide service to the end users with reasonable user rates comparable to other similar systems that would not otherwise be served if agency funds were not made available. We do not believe it is in the best interest of the Government to increase grant funding solely for the purpose of subsidizing commercial credit. Grant funds may be utilized to subsidize the best loan terms available, regardless of agency or commercial availability.

Agency response to Recommendation No. 1

A directive will be issued by January 1, 2004, advising RUS WEP staff to maximize the utilization of grant funding with the most favorable loan terms available. The directive will clearly state that RUS does not have a policy of awarding grant funds contingent on RUS loans being used to finance the project costs.

Agency response to Recommendation No. 2

A directive will be issued by January 1, 2004, providing specific documentation and lender referral guidelines. The directive will include such items as: communicating with interested lenders routinely; maintaining current rates and terms from commercial lenders interested in the program and defining reasonable user rates at the local level through meetings or e-mail; completing a detailed financial analysis based on current rates and terms; utilizing agency grant funds to subsidize the best loan rates and terms available to lessen the demand on grant funding and serve the maximum end users possible; and

referring all applicants to other credit that show feasibility, subject to a more detailed analysis of the cost of issuance.

Agency response to Recommendation No. 3

RUS WEP will modify the agency tracking system in fiscal year (FY) 2004 to capture information on referrals to other credit regardless of agency participation in the funding package for interim and permanent financing. Based on the baseline data collected in FY 05, goals and performance measures would be established for FY 06.

Agency response to Recommendation No. 4

A directive will be issued by January 1, 2004, providing guidance to require current financial analysis of commercial rates and terms to be completed within 6 months of agency obligation of funding.

ABBREVIATIONS

AO	-	Area Office
CFR	-	Code of Federal Regulations
C.P.A.	-	Certified Public Accountant
FMFIA	-	Federal Managers' Financial Integrity Act
FmHA	-	Farmers Home Administration
FY	-	Fiscal Year
GPRA	-	Government Performance and Results Act
NO	-	National Office
OIG	-	Office of Inspector General
RD	-	Rural Development
RUS	-	Rural Utilities Service
SO	-	State Office
U.S.C.	-	United States Code
USDA	-	United States Department of Agriculture
WEP	-	Water and Environmental Programs