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Office of Inspector General



Rural Utilities Service Controls Over Water and Waste Disposal Loans and Grants

Audit Report 09601-1-At
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U.S. Department of Agriculture
Office of Inspector General
Washington, D.C. 20250



DATE: September 30, 2010

REPLY TO
ATTN OF: 09601-1-At

TO: Jonathan Adelstein
Administrator
Rural Utilities Service

ATTN: John Purcell
Director
Financial Management Division

FROM: Gil H. Harden */s/*
Assistant Inspector General
for Audit

SUBJECT: Rural Utilities Service Controls Over Water and Waste Disposal Loans and
Grants

This report presents the results of the subject audit. Your written response to the draft report, dated September 29, 2010, is attached with excerpts and the Office of Inspector General's (OIG) position incorporated into the relevant Finding and Recommendation sections of the report.

We agree with management decision on five of the report's six recommendations. However, we are unable to accept management decision on Recommendation 5. Documentation and/or actions needed to reach management decisions for this recommendation is described in the OIG Position section of the report.

In accordance with Departmental Regulation 1720-1, please furnish a reply within 60 days describing the corrective action taken or planned and the timeframes for implementing the recommendation for which management decision has not been reached. Please note that the regulation requires management decision to be reached on all recommendations within 6 months from report issuance, and final action to be taken within 1 year of each management decision to prevent being listed in the Department's annual Performance and Accountability Report. Please follow your agency's internal procedures in forwarding documentation for final action to the Office of the Chief Financial Officer.

We appreciate the courtesies and cooperation extended to us by members of your staff during this audit.

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Rural Utilities Service Controls Over Water and Waste Disposal Loans and Grants

Executive Summary

Through its water and waste disposal system loan and grant program, the Rural Utilities Service (RUS) provides direct loans, guaranteed loans, and grants for water, sewer, storm water, and solid waste disposal facilities in cities and towns with 10,000 or less inhabitants. The Office of Inspector General (OIG) initiated this audit to evaluate the controls in place to provide direct loans and grants to rural communities.

We reviewed the direct loan and grant program, which had obligations of \$6.18 billion nationwide from fiscal years (FY) 2005 through 2008. Our review covered the States of Tennessee, Alabama, and Minnesota, which accounted for \$484 million in direct loan and grant obligations during those years.

Generally, we found RUS' internal controls to be adequately designed and operating for the locations we reviewed. However, we identified two instances where RUS officials could enhance agency procedures for approving water and waste disposal system loans and grants.

- Rural Development officials in Tennessee did not require a special income survey to determine the appropriate interest rate and level of grant funding obligated to the City of Crossville, Tennessee. Tennessee State agency officials initially inquired whether a special income survey was needed but deferred to the judgment of the area director, who concluded that a survey was not needed because the area was designated as rural. By deferring to the area director and not requesting additional information to support the income of the area, the Tennessee Rural Development State Office may have assigned an incorrect interest rate to a \$1.2 million loan to the City of Crossville, as well as obligated \$800,000 in grant funds that the city may be ineligible to receive.
- Rural Development officials in Alabama did not adequately document evidence of health or sanitary problems to justify awarding seven applicants a higher percentage of grant funds. This occurred because State officials did not believe that specific evidence, i.e., a violation letter from a health regulatory body, was needed to prove that the health or sanitary problems existed. By not requiring adequate evidence to ensure that projects were necessary to alleviate a health or safety problem, the Alabama Rural Development State Office may have obligated more than \$7.2 million in grant funding than was allowable for seven projects. Officials in the other States we reviewed (Tennessee and Minnesota) were aware that such a letter was needed to provide evidence of a health or sanitary problem.

During the course of our review, the American Recovery and Reinvestment Act of 2009 (Recovery Act) was passed. As a result, we expanded our scope to gain an understanding of how program operations and internal controls were affected by the Recovery Act. We identified a concern with the method RUS uses for allocating funds, which may impact administration of Recovery Act funds. We recommended that RUS apply additional criteria for allocating the approximately \$3.8 billion in funds included in the Recovery Act for loans and grants for water

and waste disposal systems in rural areas. Loan and grant funds are allocated to each Rural Development State office based on a formula that uses the demographics of rural population, rural population below the poverty line, and nonmetropolitan unemployment. Although we agree with the use of these specific demographics, we believe that additional criteria should be used (e.g., a threshold of priority points). On June 5, 2009, we issued a Fast Report to alert agency management of the issue. In a response dated June 26, 2009, Rural Development did not agree, stating that its current allocation method is required by statute and is fair. We have not yet performed an analysis to determine the extent to which Rural Development may be funding water and waste disposal projects that are less in need of its assistance to the detriment of projects that are more in need of its assistance. This type of analysis will be part of our examination, which was initiated in September 2009, of the use of Recovery Act funding for this program.

Recommendation Summary

We recommend that RUS require the City of Crossville to conduct a special income survey for its project to determine the median household income of the service area and to use this information to adjust the loan interest rate and grant amount according to the results of that survey. Also, we recommend that RUS deobligate the more than \$7.2 million in excess grant funds awarded to the seven projects in Alabama.

Agency Response

In RUS' September 29, 2010, response to the draft report, the agency generally agreed with Findings 1 and 2, but provided an alternative action plan to conducting a special income survey for Recommendations 1 through 3. RUS agreed with Recommendations 4 and 5. Applicable sections of the response have been included in the recommendations section for each finding. RUS' entire response to the draft report is included at the end of this report.

OIG Position

We accept the management decisions for Recommendations 1 through 4 and 6. The actions needed to reach management decision on Recommendation 5 are provided in the OIG Position section for this recommendation.

Background & Objectives

Background

The United States Department of Agriculture Rural Development administers the water and wastewater loan and grant program to improve the quality of life and promote economic development in rural America. This assistance is available through Rural Development's Rural Utilities Service programs, which fund water and wastewater systems, including solid waste disposal and storm drainage, in rural areas and in cities and towns with a population of 10,000 or less. Funds are available to public entities such as municipalities, counties, special-purpose districts, and Indian tribes. In addition, funds may be made available to corporations operated on a not-for-profit basis. Priority is given to public entities in areas with less than 5,500 people to restore a deteriorating water supply, or to improve, enlarge, or modify a water facility or an inadequate waste facility. Also, preference is given to requests which involve the merging of small facilities and to those serving low-income communities.

The water and waste disposal system loan and grant program was authorized by Section 306 of the Consolidated Farm and Rural Development Act of 1972, as amended. Loan and grant funds may be used to (1) construct, repair, modify, expand, or otherwise improve water supply and distribution systems and waste collection and treatment systems, including storm drainage and solid waste disposal facilities; (2) acquire needed land, water sources, and water rights; and (3) pay costs such as legal and engineering fees when necessary to develop the facilities.

To receive loan assistance the borrower must be a public entity. This can include municipalities, Indian tribes, and corporations not operated for profit. Applicants must (1) be unable to obtain the needed funds from commercial sources at reasonable rates and terms; (2) have the legal capacity to borrow and to repay loans, to pledge security for loans, and to operate and maintain the facilities; and (3) propose facilities that are consistent with any development plans of the State, multi-jurisdictional area, counties, or municipalities where the project is to be located. All facilities must comply with Federal, State, and local laws, including those involving zoning regulations, health and sanitation standards, and water pollution control. For loans, three different interest rates are used—market, intermediate, and poverty—based on the community's affluence.¹

As part of the total project costs, grants may also be provided in lieu of loans, to reduce user costs to a reasonable level. Such grants fund a maximum of 75 percent of eligible project costs. A project may qualify for a grant up to 75 percent of the total project cost if the median household income of the service area is below the higher of the poverty line or 80 percent of the State median household income (SNMHI) and the project is necessary to alleviate a health or

¹ Title 7 *Code of Federal Regulations* (C.F.R.) 1780.13 (a): The poverty interest rate will not exceed 5-percent annually. The intermediate interest rate will be set at the poverty rate plus one-half of the difference between the poverty rate and the market rate, not to exceed 7-percent per annum. The market rate will be set using as guidance the average of the Bond Buyer (11-GO Bond) index for the 4-weeks prior to the first Friday of the last month before the beginning of the quarter.

sanitary problem.² Projects that will serve residents with incomes between 80 and 100 percent of the SNMHI can qualify for grant funding of up to 45 percent of the total project costs whereas projects with incomes exceeding 100 percent of the SNMHI are ineligible for grant funding.³ During the course of our review, the Recovery Act was passed to provide additional loan and grant funds for water and waste disposal projects.⁴ As a result, we expanded our scope to include determining how current program operations were impacted by the Recovery Act. The Recovery Act included approximately \$3.8 billion in funds for water and waste disposal systems loans and grants in rural areas. Congress, in enacting the Recovery Act, emphasized the need for accountability and transparency in the expenditure of the funds. Further, on February 18, 2009, the Office of Management and Budget (OMB) issued initial guidance that required Federal agencies to establish rigorous internal controls, oversight mechanisms, and other approaches to meet the accountability objectives of the Recovery Act.⁵ On March 30, 2009, Rural Development notified the State offices that Recovery Act funds were available for the water and waste disposal loan and grant program.

From March 30, 2009, through July 2, 2010, the Rural Utilities Service (RUS) obligated \$2.6 billion in grants and loans with Recovery Act funds. Our role, as mandated by the Recovery Act, is to oversee agency activities to ensure funds are expended in a manner that minimizes the risk of improper use.

Objectives

The overall audit objective was to evaluate internal controls governing the provision of loans and grants to rural communities under the RUS water and waste disposal system loan and grant program. Specifically, we determined (1) if borrowers receiving direct loans and grants met eligibility requirements and (2) if there was adequate oversight to ensure that loan and grant funds were being used for their intended purposes.

After the enactment of the Recovery Act, we expanded the objective of this audit to gain an understanding of how program operations may be impacted by the Recovery Act.

² The medium household income is calculated by the United States Census Bureau and updated in each decennial census. The service area is the area that can be reasonably serviced by the project. The SNMHI is the median household income of the State's nonmetropolitan counties and portions of metropolitan counties outside of cities, towns, or places of 50,000 or more population.

³ 7 C.F.R. 1780.10 (b)(2).

⁴ *Public Law* 111-5, dated February 17, 2009.

⁵ On April 13, 2009, OMB issued, "Updated Implementing Guidance for the American Recovery and Reinvestment Act of 2009."

Section 1: RUS State Office Officials Could Enhance Agency Policies

Finding 1: A Special Income Survey is Needed to Determine the Appropriate Interest Rate and Grant Amount for One Borrower

Rural Development officials should have required a special income survey to determine financial need prior to approving a loan and grant for a water/waste project in Crossville, Tennessee.^{6,7} State officials initially questioned the income of the residents of the service area due to the land and lot prices within the area. However, the responsible area director stated that a special income survey was unnecessary because the area was designated rural. State office officials stated they deferred to the judgment of the area director because they stated he knew the area better than they did. As a result, the City of Crossville may have received an incorrect interest rate for a \$1.2 million loan and may not have been eligible for grant funds totaling \$800,000.⁸

Federal regulations state that grant funds may not be used to pay any costs of a project when the median household income of the service area is more than 100 percent of the nonmetropolitan median household income of the State.⁹ If the median household income of the service area is more than 100 percent of the nonmetropolitan median household income, then the project could only receive the market interest rate on loans, not the intermediate or the poverty rate.

In order to determine the median household income of the service area, Rural Development used data from the 2000 decennial census. Though this was a reasonable first step, these data are unlikely to be up-to-date because the project area is a new development built after the 2000 census. Regulations state that if there is reason to believe that the census data are not an accurate representation of the median household income within the area to be served, other relevant data may be obtained, such as a survey.¹⁰ Special income surveys are conducted by an outside party. Through activities such as phone calls or door-to-door surveys, they determine the median household income of the service area. These independent surveys can be used as relevant data to dispute the census reported income of a service area. Other applicants in the State of Tennessee have successfully used special income surveys to dispute the census information reported for their service areas.¹¹ However, we found no cases where Tennessee State officials had questioned a service area and chosen to perform special income surveys.

During the approval process for this loan and grant, one State Rural Development official wrote in an email to the area specialist and in the loan and grant file that a special income survey may

⁶ A special income survey is income data collected by an independent third party for the purpose of determining the true median household income of the service area.

⁷ Tennessee Rural Development officials informed us on July 6, 2010, that they have not yet disbursed any loan or grant funds to the City of Crossville for this project. Since these funds have not been disbursed, RUS has the opportunity to defer or delay the disbursement until a special income survey is conducted, revise the interest rate as appropriate, and deobligate the grant funds, if appropriate.

⁸ The project was obligated in fiscal year (FY) 2008.

⁹ Title 7, C.F.R. 1780.10b.

¹⁰ Title 7, C.F.R. 1780.1b.

¹¹ For example, the Hillsboro, Burwood, & Thompson's Station Utility District disputed the SNMHI reported by the 2000 census of \$57,185 for their service area and submitted a special income survey conducted by the Greater Nashville Regional Commission showing that the income of the service area was actually \$18,751. The State office used the \$18,751 figure when determining their interest rate and grant amount.

be necessary because lot and house prices may indicate a higher median income level than that of the latest decennial census in 2000. The median household income for the proposed project was \$28,321 according to the 2000 census, while the average listing price for property in that service area (subdivision) was more than \$278,000.¹² This is an indicator that Rural Development could have used to strongly consider a special income survey. However, the area director stated that a special income survey was not necessary because the housing development was located in a rural area. The State official stated that he deferred judgment to the area director because he believed the area director knew the service area best.

Our review of the City of Crossville's loan and grant application also found that the residents of the community committed \$3 million to help fund the project. Due to the average listing price of homes in the development and the ability of the residents to raise \$3 million for the project, Rural Development should have conducted a special income survey to determine the development's median income and the appropriate interest rate and grant amount. We believe that a special income survey also would have likely determined that the representative median income in the service area exceeded the SNMHI of \$37,269. Accordingly, the project would have been ineligible for grant funding for up to 75 percent and would cause the interest rate on the loan would have likely increased.

Recommendation 1

Require the borrower to conduct a special income survey for the project to determine the median household income of the service area and use this information to determine the loan interest rate and grant amount applicable for this project.

Recommendation 2

If the special income survey results in an adjustment to median household income, adjust the loan rate accordingly and require the borrower to reimburse RUS for any loss of interest revenue.

Recommendation 3

If the special income survey shows the borrower to be ineligible for the grant, deobligate or recover the \$800,000 in grant funds, as appropriate.

Agency Response to Recommendations 1 through 3

In its September 29, 2010, response, RUS stated the following:

Conducting an income survey for this project would be difficult and costly to the Agency and the community. It has been more than 2 years since the underwriting on this loan was conducted. It would be difficult to conduct an income survey at this point that would accurately reflect incomes at the time. Factors, such as the downturn in the economy and the housing market, changes in residents since 2008, and in-migration of retirees to this community from other parts of the country would likely impact the results of the survey.

¹² Homes in the development listed for \$278,054 on average according to a listing of properties with homes as of December 5, 2008.

The Agency cannot require the applicant to conduct and pay for the survey; therefore, the cost of any such undertaking would be incurred by the Agency. Typically, an income survey approved by USDA Rural Development would require a sampling of 80 percent of the property owners in the area to be served. Associated survey costs could be significant.

Independent of the audit findings, the Agency was notified that, due to a favorable bidding climate, bids received on the project were lower than anticipated and that the grant funds for the project will not be needed. Accordingly, those funds have been deobligated. In addition, we have reviewed the case file and believe that [the] appropriate interest rate was offered. * * *

Given the deobligation of grant funds, the Agency's review and the cost and complicating factors associated with a survey more than 2 years after the original underwriting, we would offer an alternative to conducting a survey. As an alternative to the recommendations presented, the Agency would propose to issue additional staff guidance on the appropriate circumstances for conducting income surveys. This guidance will be drafted and delivered to staff no later than March 31, 2011. The Agency will also incorporate this new guidance into its training course content.

OIG Position

We accept management decision for these Recommendations.

Finding 2: The Alabama Rural Development State Office Did Not Adequately Document Evidence of a Health or Sanitary Problem Prior to Awarding Grant Funds

The Alabama Rural Development State Office awarded grant funds to seven grantees without adequate evidence that the projects were necessary to alleviate a health or sanitary problem. Alabama Rural Development officials believed that a violation letter from a regulatory agency was not necessary to prove the existence of a health or sanitary problem, as the RUS regulation does not specifically define what evidence is needed. Since we confirmed that some of the projects were not necessary to alleviate a health or sanitary problem and Rural Development officials had no support that other projects were necessary, we questioned the obligations of over \$7.2 million in grant funds for those projects (see exhibit A).

A project can qualify for a grant up to 75 percent of the total project cost if the median household income of the service area is below the higher of the poverty line or 80 percent of SNMHI and the project is necessary to alleviate a health or sanitary problem. Projects with incomes between 80 and 100 percent of SNMHI can qualify for grant funding up to 45 percent of the total project costs whereas projects with incomes exceeding 100 percent of SNMHI are ineligible for grant funding.¹³ Although the regulation states that in order to receive more than 45 percent of total project costs in grant funding the project must be necessary to alleviate a health or sanitary

¹³ Title 7, C.F.R. 1780.10 (c).

problem, it does not define what specific evidence is sufficient to prove the necessity. The Office of Inspector General (OIG) contacted a RUS official to obtain this definition and were told that sufficient evidence would consist of a violation letter from a regulatory agency, such as the health department. RUS officials also stated that revised guidance is necessary to require violation letters.

During our review of project applications for the State of Alabama, we found that seven out of the eight projects that received grant funds in excess of 45 percent of total project costs lacked adequate evidence indicating that the project was necessary to alleviate a health or sanitary problem (i.e., violation letters).¹⁴ Application files for three of the seven borrowers did contain letters from local health departments stating general support for those projects. We contacted these local health departments to determine if the projects were necessary to alleviate a health or sanitary problem. Local health department officials informed us that while they supported the projects and provided support letters to Rural Development, the projects were not necessary to alleviate health or sanitary problems. For example, the local health department in Greene County wrote a letter in support of the Greene County Water and Sewer Authority project to build a county water system for the service area. However, the health department official who wrote the letter informed us that although private wells in the service area occasionally contained bacteria, they were able to correct the problem by chlorinating the wells. We asked if he felt the project was necessary to alleviate the health or sanitary problem; he stated it was not.

Alabama Rural Development officials stated that they did not believe a violation letter was necessary to document a health or sanitary problem. The officials believed health or sanitary problems existed for these projects because they either received support letters from local health departments or the preliminary engineering report cited a deficiency in the existing water system.¹⁵ For example, a deficiency from an engineering perspective may be that (1) water drains too slowly in the project area or (2) that bacteria were noted in the water. However, this would not by itself be considered sufficient evidence of a health or sanitary problem. We contacted RUS national office officials to obtain clarification of what is considered acceptable evidence to support this condition. RUS officials informed us that proper evidence would be a health or sanitary violation letter from a regulatory body. Furthermore, it was represented to the OIG that the need to include violation letters to support projects receiving more than 45 percent of total project costs in grant funding was common knowledge among the staff at the Minnesota and Tennessee State offices, the other two State offices we visited.

By not requiring adequate evidence to ensure that the projects were necessary to alleviate a health or sanitary problem, the Alabama Rural Development State Office may have obligated more than \$7.2 million in grant funding than was allowable for seven projects. See Table 1 below for the grant amount awarded to the borrowers and the percentage of total project compared to eligible percentage and grant amount.

¹⁴ The eighth project file included a consent order from the environmental management agency for the State; this is the equivalent of a violation letter from a health department as it proves the project is necessary to correct a health or sanitary problem.

¹⁵ Preliminary engineering reports are documents prepared by an engineer hired by the borrower. They should clearly describe the owner's present situation, analyze alternatives, and propose a specific course of action, from an engineering perspective.

Table 1: Grant Funding in Excess of Allowable Amount

Borrower	Total Project Cost	Grant Amount	Grant Percent	Eligible Grant Percent	Eligible Grant Amount	Ineligible Grant Amount
Greene County Water and Sewer Authority	\$8,874,834	\$5,974,834	67%	45%	\$3,993,675	\$1,981,159
Town of Berry	\$3,038,830	\$1,801,830	59%	45%	\$1,367,474	\$434,357
Waterworks and Sewer Board of the Town of Collinsville	\$3,628,000	\$2,236,000	62%	45%	\$1,632,600	\$603,400
Perry County Water Authority	\$5,043,900	\$3,717,900	74%	45%	\$2,269,755	\$1,448,145
Town of Somerville	\$3,702,000	\$2,702,000	73%	45%	\$1,665,900	\$1,036,100
Sumter County Sewer Authority	\$2,915,000	\$1,985,000	68%	45%	\$1,311,750	\$673,250
West Dallas Water Authority-Safford River Oak	\$4,024,000	\$2,871,000	71%	45%	\$1,810,800	\$1,060,200
Total Ineligible						\$7,236,611

Recommendation 4

Strengthen program guidance to include language which specifies what documentary evidence is required to prove a project is necessary to alleviate a health or sanitary problem.

Agency Response

In its September 29, 2010, response, RUS stated the following:

The Agency will draft revised guidance regarding the specific documentary [evidence] that is required to prove a project is necessary to alleviate a health or sanitary problem. This guidance will be delivered to staff no later than March 31, 2011. The Agency will also incorporate this new guidance into its training course content.

OIG Position

We accept management decision for this Recommendation.

Recommendation 5

Review the cases above and determine if the projects were necessary to alleviate a health or sanitary problem. If the Agency review concludes the projects were not necessary to alleviate the cited problems, deobligate the \$7,236,611 in grant funds for the seven projects and require the applicants to reimburse RUS for excessive grant funds expended.

Agency Response

In its September 29, 2010 response, RUS stated the following:

The Agency will review the cases above and determine if the project was necessary to alleviate a health or sanitary issue. The review will be completed by October 31, 2010. If the Agency determines that the project was not necessary to alleviate a health or sanitary issue, the Agency will seek reimbursement for funds as necessary.

* * * * *

OIG Position

Although RUS agreed with this Recommendation, we need additional information before we can reach management decision. RUS needs to provide copies of the final determination made for the questioned grant funds for each project or its justification for not pursuing recovery of the questionable amounts before we can accept management decision.

Finding 3: RUS' Current Method for Allocating Funds May Not Target Communities Nationwide With the Greatest Need

During the course of our review, the Recovery Act was passed. As a result, we expanded our scope to gain an understanding of how program operations and internal controls were impacted by the Recovery Act.

During our review we identified a concern with the method RUS uses for allocating funds, which may impact administration of Recovery Act funds for the water and waste disposal system program. RUS' plan to fund projects is twofold: (1) finance projects in its backlog of applications which are "shovel ready," i.e., applications are completed and funds are ready to be obligated; and (2) allocate the remaining Recovery Act funds to States using their normal allocation formula, which includes 10 percent of the Recovery Act funds being held in the national office for projects in designated persistent poverty counties.¹⁶ RUS officials informed us that this allocation method is statutory. According to the statute, "The Secretary shall allocate the amounts in each account specified in subsection (C) among the States in a fair, reasonable, and appropriate manner that takes into consideration rural population, levels of income, unemployment, and other relevant factors, as determined by the Secretary."¹⁷ Since the statute does not prescribe the formula to be used for allocating funds and allows the use of other

¹⁶ RUS was unable to provide us with a list of projects with completed applications that were ready to be funded.

¹⁷ Consolidated Farm and Rural Development Act of 1961, section 381E (f), "Allocation Among States."

relevant factors, we concluded that Rural Development should consider the relative merit of projects nationwide, not just within a State, when selecting water and waste disposal projects to fund with Recovery Act funding. This is consistent with the Secretary's "American Recovery and Reinvestment Act (ARRA) Obligation Clearance" memorandum dated March 23, 2009, which states, in part, that the agency is to ensure that Recovery Act funds are distributed on the merit of the proposed project rather than historical formulae or oral promises.

Rural Development personnel assign priority points to water and waste disposal projects based on criteria including health hazards or income of the area. For example, a project will receive 30 points if the median household income of the service area is below the poverty line and an additional 25 points if it also alleviates an emergency situation, such as meeting Safe Drinking Water Act requirements. We believe that the priority points assigned to a project should be considered a relevant factor when awarding Recovery Act funds among projects nationwide. RUS should establish a threshold of merit (e.g., 50 priority points) that a project must meet to be eligible for Recovery Act funds.

Without considering the relative merit of projects on a nationwide basis, Recovery Act funds may not go to those projects which show the greatest need. Of the 193 projects selected to receive Recovery Act funding, 23 projects totaling \$47.8 million received less than 50 priority points. RUS should use its established criteria to guide decisions to award funds to worthy projects nationwide in line with the purposes of the Recovery Act.

We have not yet performed an analysis to determine the extent to which Rural Development is funding water and waste disposal projects with low priority points that may delay funding of projects in communities with the greatest need. As a result, we have no conclusions on the overall impact to the program. Our concern is that Rural Development could modify its project selection process to ensure that Recovery Act funds are better targeted to communities most impacted by the recession as well as those having projects with the greatest merit.

We discussed this issue in detail with agency national office officials on March 24, 2009. At that time, we recommended that RUS establish a threshold for awarding recovery funds to projects that comply with the purposes of the Recovery Act and only fund those projects with the greatest need and the highest priority points on a nationwide basis. Agency national officials did not agree with our recommendation, stating that the funds must be allocated to States according to statute. RUS officials also stated that pooling allows States to fund projects once they have obligated their initial allocation. Pooling is a process in which unobligated funds are pooled from the States at midyear and yearend and then handed out administratively by the RUS national office on a project-by-project basis. The national office uses priority point scores as criteria when distributing pooled funds. RUS officials stated that projects with less than 50 points are unlikely to be funded with pooled funds.

On June 5, 2009, we issued a Fast Report to alert agency management of this issue. In that report, we made the following recommendation.

Recommendation 6

Establish a threshold for awarding recovery funds to projects that comply with the purposes of the Recovery Act and only fund those projects with the greatest need and the highest priority points on a nationwide basis.

Agency Response

In a response dated June 26, 2009, the Under Secretary responded that instituting a minimum point eligibility requirement would prevent otherwise eligible applicants from getting assistance from Rural Development during a period in which program funds are not limited. Furthermore, he stated that Rural Development is meeting the requirements of the Recovery Act. The Under Secretary provided additional support in the five page response disagreeing with the Fast Report and recommendation. This information addressed topics regarding the use of a minimum point threshold, the consideration of priority points on a nationwide basis, and the effective targeting of communities in need.

The agency's full response to this recommendation is posted on our website with the applicable Fast Report. This report can be found at:

http://www.usda.gov/oig/recovery/recovery_reports.htm

OIG Position

We accept management decision for this recommendation. Our decision is based on the fact that we did not perform specific testing and cannot reference instances where a lower priority project was funded to the detriment of a higher priority project. We plan to examine this issue further as we continue our assessment, which was initiated in September 2009, of program activities related to the Recovery Act.

Scope and Methodology

The audit fieldwork was conducted at the RUS national office, and the Tennessee, Alabama, and Minnesota State Rural Development offices. Our review focused on direct loan and grant funds obligated between FYs 2005 and 2008. Our review at the three States encompassed \$459 million of the total \$5.9 billion in program obligations. We conducted our audit fieldwork from September 2008 to April 2009.

Initially, we targeted States in the southeast region for review.¹⁸ We selected Tennessee because it had the second highest direct loan and third highest grant amounts obligated between FYs 2005 and 2008 in the southeast region. Also, the national office conducted a program review of Tennessee in October 2007 that highlighted several isolated weaknesses with loan and grant processing and servicing in the State. We selected Alabama because it had the second highest level of grant funding in the southeast region and also because the program review conducted in September 2004 highlighted several weaknesses with loan and grant processing and servicing. We subsequently selected Minnesota for review because it had the largest application backlog (according to available RUS program data) of any State—41 water and waste disposal system projects totaling more than \$146 million.

We also reviewed at least two area offices for each State. We selected the area offices with the highest level of funding between FYs 2005 and 2008.¹⁹ We selected projects for review with the highest amount of loan and grant funding for the offices we visited.

To accomplish the audit objectives, we:

- Reviewed RUS' regulations, policies, and procedures for the water and waste disposal system loan and grant program, especially those pertaining to eligibility and use of funds.
- Identified applicable internal controls over borrower and grantee eligibility and use of funds, and evaluated them in terms of adequacy and effectiveness to (1) ensure that only eligible communities which have repayment ability are receiving program funds, and (2) ensure that loan funds and grants are being used only for the intended purposes.
- Obtained from RUS a list of all borrowers and grantees for the States selected. Using this list, we determined which area offices to visit in each selected State. We interviewed RUS and Rural Development officials and other persons as deemed appropriate.
- Examined reports of prior audits and RUS' program reviews for the water and waste disposal system loan and grant program.

To gain an understanding of the Recovery Act's impact on the water and waste disposal loan and grant program we:

¹⁸ This audit was initially a regional audit assigned to the Eastern Region, previously referred to as the Southeast Region. At the time this review was initiated, the Southeast Region encompassed the States of Alabama, Florida, Georgia, Kentucky, North Carolina, South Carolina, Tennessee, and the territories of Puerto Rico and the Virgin Islands.

¹⁹ See exhibit B for a listing of sites visited.

- Reviewed the Recovery Act along with any related guidance associated with the Act.
- Reviewed Rural Development's initial plan for providing funding to the States.

We conducted the audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objective.

Exhibit A: Summary of Monetary Results

Finding	Description	Amount	Category
1	Grant funding awarded to the City of Crossville	\$800,000	FBPTBU, Deobligation
2	Excess grant funding awarded to Greene County Water and Sewer Authority	1,981,159	Questioned Costs, Recovery Recommended
2	Excess grant funding awarded to the Town of Berry	434,357	Questioned Costs, Recovery Recommended
2	Excess grant funding awarded to the Town of Collinsville	603,400	Questioned Costs, Recovery Recommended
2	Excess grant funding awarded to the Perry County Water Authority	1,448,145	Questioned Costs, Recovery Recommended
2	Excess grant funding awarded to the Town of Somerville	1,036,100	Questioned Costs, Recovery Recommended
2	Excess grant funding awarded to the Sumter County Sewer Authority	673,250	Questioned Costs, Recovery Recommended
2	Excess grant funding awarded to the West Dallas Water Authority	1,060,200	Questioned Costs, Recovery Recommended
TOTAL		\$8,036,611	

The above table summarizes the monetary results of the audit report as detailed in Findings 1 and 2. It lists the finding number, description of the finding, dollar amount, and category of monetary exception.

Exhibit B: Sample of Sites Visited

State	Area Office	Number of Loans	Loan Amount	Number of Grants	Grant Amount
Alabama	Huntsville	12	\$30,390,000	9	\$18,185,000
	Tuscaloosa	7	14,414,000	6	11,185,364
	Bay Minette	3	5,903,000	3	8,111,900
	Total	22	\$50,707,000	18	\$37,482,264
Tennessee	Nashville	6	\$18,409,494	5	\$2,424,090
	Knoxville	9	13,343,900	7	3,374,300
	Cookeville	1	1,284,000	1	800,000
	Total	16	\$33,037,394	13	\$6,598,390
Minnesota Obligation	Alexandria	8	\$20,652,000	6	\$3,185,000
	Marshall	13	52,366,000	10	18,340,318
	Total	21	\$73,018,000	16	\$21,525,318
Minnesota Backlog	Alexandria	10	\$23,912,000	10	\$11,019,500
	Marshall	17	55,596,000	15	24,262,000
	Total	27	\$79,508,000	25	\$35,281,500
TOTAL		86	\$236,270,394	72	\$100,887,472

The above table lists the sample of sites visited. It provides the State visited, the area office, number of loans, loan amounts, number of grants, and the grant amounts.

USDA'S

Rural Utilities Service

RESPONSE TO AUDIT REPORT



United States Department of Agriculture
Rural Development

September 29, 2010

SUBJECT: Office of Inspector General (OIG) Utilities
Programs Water and Waste Disposal Loans and
Grants (Audit No. 09601-001-AT)

TO: Gil Harden
Assistant Inspector General
for Audit

Attached for your review is a response dated September 20, 2010,
from Jonathan Adelstein, Administrator, Rural Utilities Service.

This response is being submitted for your consideration to reach
management decision on recommendations 1 through 5 in the
subject report.

If you have any questions, please contact Arlene Pitter Bell of
my staff at 202-692-0083.

/S/ John M. Purcell

JOHN M. PURCELL
Director
Financial Management Division

Attachment

1400 Independence Ave, SW • Washington, DC 20250-0700
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Washington, DC 20250-9410 or call (800) 795-3272 (voice) or (202) 720-6382 (TDD).



United States Department of Agriculture
Rural Development

September 20, 2010

TO: Gil H. Harden
Acting Assistant Inspector General for Audit

THROUGH: John M. Purcell
Director
Financial Management Division

FROM: Jonathan Adelstein /S/ James R. Newby
Administrator
Rural Utilities Service

SUBJECT: Utilities Programs – Water and Waste Disposal Loans and Grants
Audit Number 09601-001-AT

This memorandum is our response to the OIG Audit number 09601-001AT draft report dated March 11, 2010. We appreciate the OIG's review of the Water and Waste Loan and Grant Program and your general finding that our internal controls are adequately designed and operating. The audit did identify findings related to loan processing in two states, Tennessee and Alabama. The Agency responses are below:

Recommendation 1

Require the borrower to conduct a special income survey for the project to determine the median household income of the service area and use this information to determine the loan interest rate and grant amount applicable for this project.

Recommendation 2

If a special income survey results in an adjustment to median household income, adjust the loan rate accordingly and require the borrower to reimburse RUS for any loss of interest revenue.

Recommendation 3

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If the special income survey shows the borrower to be ineligible for the grant, deobligate or recover the \$800,000 in grant funds, as appropriate.

Response to Recommendations 1-3

Conducting an income survey for this project would be difficult and costly to the Agency and the community. It has been more than 2 years since the underwriting on this loan was conducted. It would be difficult to conduct an income survey at this point that would accurately reflect incomes at that time. Factors, such as the downturn in the economy and the housing market, changes in residents since 2008, and in-migration of retirees to this community from other parts of the country would likely impact the results of the survey. The Agency cannot require the applicant to conduct and pay for the survey; therefore, the cost of any such undertaking would be incurred by the Agency. Typically, an income survey approved by USDA Rural Development would require a sampling of 80 percent of the property owners in the area to be served. Associated survey costs could be significant.

Independent of the audit findings, the Agency was notified that, due to a favorable bidding climate, bids received on the project were lower than anticipated and that the grant funds for the project will not be needed. Accordingly, those funds have been deobligated. In addition, we have reviewed the case file and believe that that appropriate interest rate was offered.¹

Given the deobligation of grant funds, the Agency's review and the cost and complicating factors associated with a survey more than 2 years after the original underwriting, we would offer an alternative to conducting a survey. As an alternative to the recommendations presented, the Agency would propose to issue additional staff guidance on the appropriate circumstances for conducting income surveys. This guidance will be drafted and delivered to staff no later than March 31, 2011. The Agency will also incorporate this new guidance into its training course content.

¹The State Nonmetropolitan Household Income (SNMHI) for TN is \$37,269 according to the 2000 census. This project included a total of 1,687 water users located in two counties; 748 users in Cumberland County (44.34 percent of total users of 1,687) and 939 users (55.66 percent of total users of 1,687) in Putnam County. The 2000 census indicates Putnam County census tract's MHI is \$28,811 with a population of 4,956. The 2000 MHI census for Cumberland County census tract is \$27,929 with a population of 6,553. Using this method and percentage of users for the new system, it was determined the MHI for the project area was \$28,321.

RUS Instruction 1780.10 (c) states "Grants may not be made in excess of the following percentages of the RUS eligible project development costs. Facilities previously installed will not be considered in determining the development costs.

- 1) 75 percent when the MHI of the service area is below the higher of the poverty line or 80% of the state nonmetropolitan median income and the project is necessary to alleviate a health or sanitary problem.
- 2) 45 percent when the median household income of the service area exceeds the 80 percent requirements described in paragraph (c)(1) of this section but is not more than 100 percent of the statewide nonmetropolitan median household income. "

Whether one uses a weighted MHI as described above or the higher of the two MHI incomes for this proposal, the MHI would still qualify for the intermediate interest rate and 45 percent grant eligibility.

Recommendation 4

Strengthen program guidance to include language which specifies what documentary evidence is required to prove a project is necessary to alleviate a health or sanitary problem.

Response to Recommendation 4

The Agency will draft revised guidance regarding the specific documentary evidence that is required to prove a project is necessary to alleviate a health or sanitary problem. This guidance will be delivered to staff no later than March 31, 2011. The Agency will also incorporate this new guidance into its training course content.

Recommendation 5

Review the cases above and determine if the project was necessary to alleviate a health or sanitary problem. If the Agency review concludes the projects were not necessary to alleviate the cited problems, deobligate the \$7,236,611 in grant funds for the seven projects and require the applicants to reimburse RUS for any excessive grant funds expended.

Response to Recommendation 5

The Agency will review the cases above and determine if the project was necessary to alleviate a health or sanitary issue. The review will be completed by October 31, 2010. If the Agency determines that the project was not necessary to alleviate a health or sanitary issue, the Agency will seek reimbursement for funds as necessary.

Conclusion

Rural Development is committed to administering the Water and Waste Disposal Loan and Grant Program effectively and to ensure that funds are appropriately utilized pursuant to statute and regulation. Again, we are pleased with your general finding that our internal controls are adequately designed and operating. We will conduct the requested file reviews and enhance our staff guidance as necessary to improve delivery of the program.