

Office of the Auditor General
Performance Audit Report

**Great Lakes Water Quality Bond
Fund Expenditures**

Department of Environmental Quality

November 2016

The auditor general shall conduct post audits of financial transactions and accounts of the state and of all branches, departments, offices, boards, commissions, agencies, authorities and institutions of the state established by this constitution or by law, and performance post audits thereof.

Article IV, Section 53 of the Michigan Constitution



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Office of the Auditor General

Report Summary

Performance Audit

Great Lakes Water Quality Bond Fund (GLWQBF) Expenditures

Department of Environmental Quality (DEQ)

Report Number:
761-0400-16

Released:
November 2016

Public Act 396 of 2002 created the GLWQBF. Act 396 authorized the issuance of \$1 billion of general obligation bonds to finance sewage treatment works projects, storm water projects, and nonpoint source projects that improve the quality of the waters of the State. From fiscal years 2004 through 2015, GLWQBF expenditures totaled \$228.5 million. This audit was required by Section 324.19708(4) of the *Michigan Compiled Laws*.

Audit Objective			Conclusion
Objective: To assess DEQ's compliance with laws and regulations for expenditures from the GLWQBF.			Complied
Findings Related to This Audit Objective	Material Condition	Reportable Condition	Agency Preliminary Response
None reported.	Not applicable	Not applicable	Not applicable
Observations Related to This Audit Objective	Material Condition	Reportable Condition	Agency Preliminary Response
DEQ provided education and conducted marketing to make local units of government aware of the availability of GLWQBF grants and loans. As of September 30, 2015, DEQ awarded only \$394 million (39%) of the \$1 billion authorized for the GLWQBF. The GLWQBF can be utilized when funds are appropriated and communities apply for the funds and meet program criteria (<u>Observation #1</u>).	Not applicable	Not applicable	Not applicable

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Office of the Auditor General
201 N. Washington Square, Sixth Floor
Lansing, Michigan 48913

Doug A. Ringler, CPA, CIA
Auditor General

Laura J. Hirst, CPA
Deputy Auditor General



OAG

Office of the Auditor General

201 N. Washington Square, Sixth Floor • Lansing, Michigan 48913 • Phone: (517) 334-8050 • www.audgen.michigan.gov

Doug A. Ringler, CPA, CIA
Auditor General

November 10, 2016

Ms. C. Heidi Grether, Director
Department of Environmental Quality
Constitution Hall
Lansing, Michigan

Dear Ms. Grether:

I am pleased to provide this performance audit report on Great Lakes Water Quality Bond Fund (GLWQBF) Expenditures, Department of Environmental Quality.

This report is issued pursuant to Section 324.19708(4) of the *Michigan Compiled Laws*, which states that the Office of the Auditor General shall conduct an audit of the GLWQBF to ensure that the money in the GLWQBF has been expended in compliance with law.

We appreciate the courtesy and cooperation extended to us during this audit.

Sincerely,

A handwritten signature in black ink that reads "Doug Ringler". The signature is written in a cursive, flowing style.

Doug Ringler
Auditor General

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AUDIT OBJECTIVES, CONCLUSIONS, FINDINGS, AND OBSERVATIONS

COMPLIANCE WITH LAWS AND REGULATIONS

BACKGROUND

Public Act 396 of 2002 created the Great Lakes Water Quality Bond Fund (GLWQBF) to account for the proceeds of \$1 billion of Great Lakes Water Quality general obligation bonds approved by Michigan voters in November 2002. The Act directs that bond proceeds be used to finance sewage treatment works projects, storm water projects, and nonpoint source projects that improve the quality of the waters of the State. See fund description on page 14 for a more detailed explanation of the GLWQBF and its grant and loan programs.

Bonds were sold in fiscal years 2004, 2005, 2006, 2008, 2011, 2012, and 2014 (see Exhibit #1 for a summary of bonds sold by fiscal year). GLWQBF expenditures, totaling \$228.5 million for fiscal years 2004 through 2015, include disbursements of funds to municipalities, bond issue costs, and administrative expenses (see Exhibit #2 for a summary of expenditures by fiscal year).

AUDIT OBJECTIVE

To assess the Department of Environmental Quality's (DEQ's) compliance with laws and regulations for expenditures from the GLWQBF.

CONCLUSION

Complied.

FACTORS IMPACTING CONCLUSION

- Our analytical review of GLWQBF expenditures disclosed no instances of improper or unusual expenditures.
- Applications for grants and loans were thoroughly vetted and supporting documentation was obtained by DEQ prior to grant or loan approval. All applications, supporting documentation, and approvals were date stamped and maintained in hard-copy files.
- DEQ implemented and adhered to its internal control* procedures over payment processing of grants and loans.
- Our review of documentation for 48 randomly selected projects identified no instances of noncompliance with grant or loan requirements.
- We visited 4 wastewater treatment facilities and reviewed 4 in-process or recently completed projects. In all 4 instances, the project plans documented in the project files agreed with the plans implemented at the facilities.

* See glossary at end of report for definition.

- We tested a sample of 30 payments from 3 judgmentally selected nonpoint source projects and noted no exceptions.
- Observation* related to funds not being fully utilized (Observation #1).

** See glossary at end of report for definition.*

OBSERVATION #1

Funds authorized for the GLWQBF have not been fully utilized.

DEQ provided education and conducted marketing to make local units of government (counties, townships, and municipalities) aware of the availability of GLWQBF grants and loans. The GLWQBF can be utilized when funds are appropriated and communities apply for the funds and meet program criteria.

As of September 30, 2015, DEQ awarded only \$394 million (39%) of the \$1 billion authorized for the GLWQBF. The largest program, the Stormwater, Asset Management, and Wastewater (SAW) grant and loan program, was authorized \$450 million, of which DEQ awarded \$170 million in grants and \$10 million in loans from March 2014 through September 2015. DEQ anticipates that the remaining SAW grants and loans will be issued after appropriations become available in 2017 and 2018. Also, the \$80 million initially authorized in November 2002 for S2* Planning Grants has been fully awarded. However, no bonds have been sold nor funds awarded for the State Water Pollution Control Revolving Fund (SRF), Brownfield Redevelopment, and Wetland Mitigation Banking, which were authorized \$290 million, \$10 million, and \$10 million, respectively. See Exhibit #3 for a summary of funds authorized and awarded, bonds sold, and bond proceeds by grant and loan type.

According to a 2005 Senate Fiscal Agency publication, economic pressures kept municipalities from obtaining loans to finance sewage treatment works projects, storm water projects, and nonpoint source projects. GLWQBF loan requirements stipulate that a municipality must provide proof of financial stability and the ability to repay borrowed funds. The publication indicated that some municipalities did not have the revenue to qualify for bonds or make loan payments, choosing instead to make interim repairs on their ailing wastewater treatment plants and to postpone major expansion or construction. The publication also indicated that, as the economy recovers and State and local budgets stabilize, the full implementation of the bond should be realized. However, a 2015 Senate Fiscal Agency publication indicated that, in fiscal year 2013, after 10 years of appropriations, a limited number of loan applications have been received and awards issued.

Legislators took action to expand the use of the GLWQBF in fiscal year 2012 through SAW and Strategic Water Quality Initiatives Fund (SWQIF) grants and loans. In 2016, legislators again expanded the use of the GLWQBF through SWQIF to include up to half of the project costs related to the planning, design, and construction of a sewage collection and treatment system and for projects to address a substantial public health risk from treatment system failure.

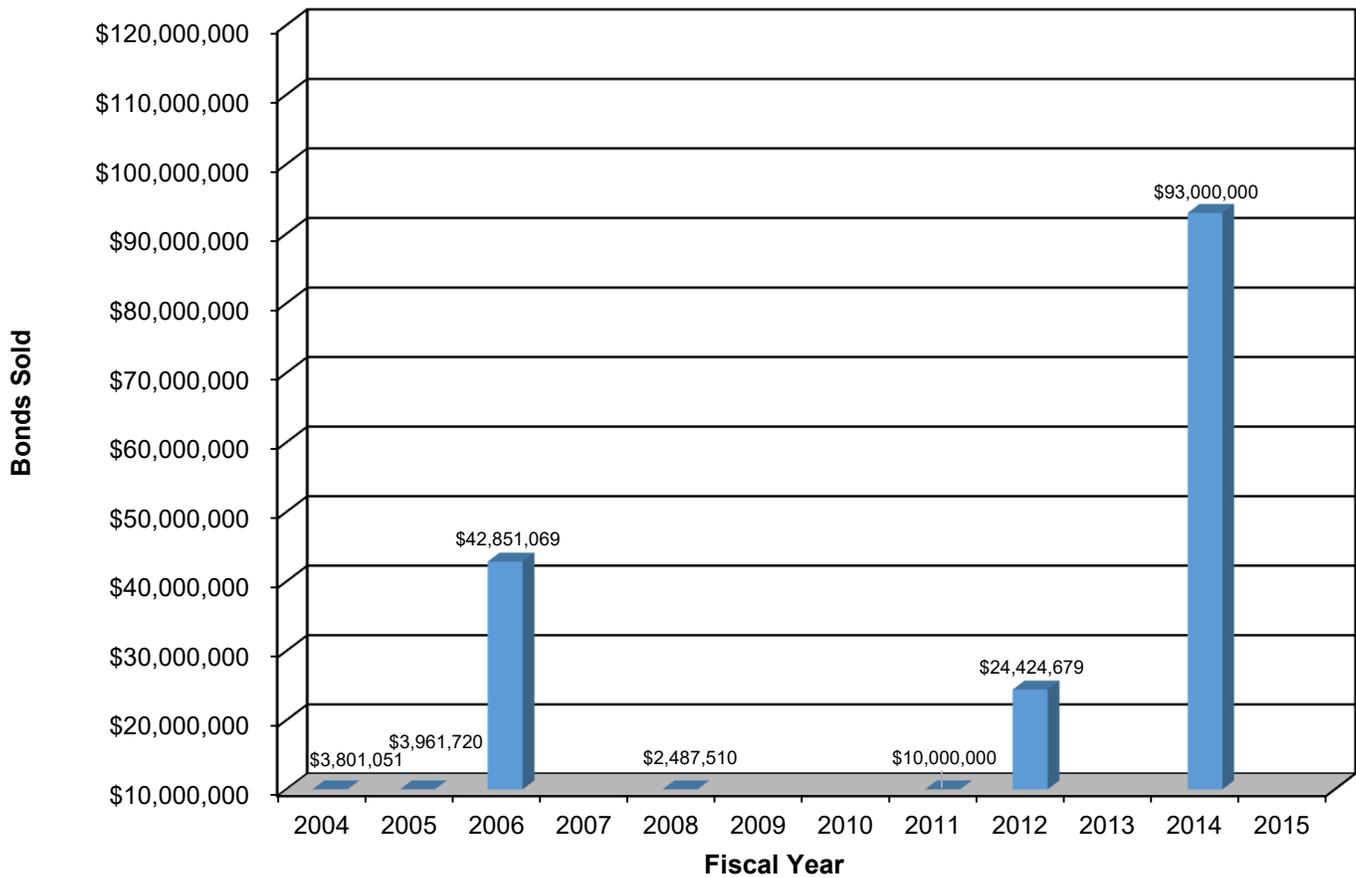
* See glossary at end of report for definition.

SUPPLEMENTAL INFORMATION

UNAUDITED
Exhibit #1

GREAT LAKES WATER QUALITY BOND FUND Department of Environmental Quality

Bonds Sold Fiscal Years 2004 Through 2015

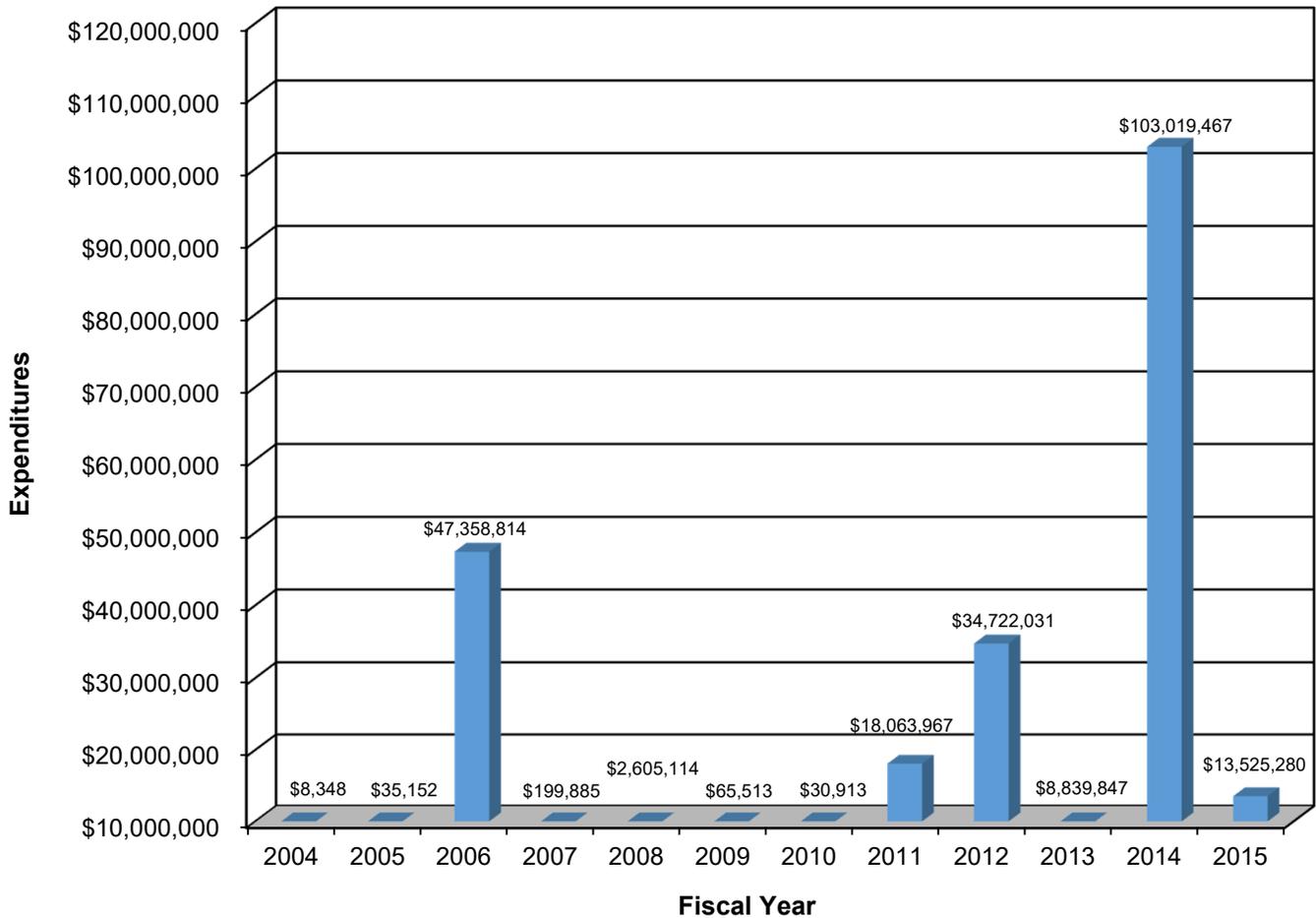


Note: Bonds were sold in fiscal years 2004, 2005, 2006, 2008, 2011, 2012, and 2014.

Source: The Office of the Auditor General prepared this exhibit using data obtained from the Michigan Municipal Bond Authority.

GREAT LAKES WATER QUALITY BOND FUND
Department of Environmental Quality

Fund Expenditures
Fiscal Years 2004 Through 2015



Note: The fund expenditure amounts include bond proceed distributions and administrative costs.

Source: The Office of the Auditor General prepared this exhibit using data obtained from DEQ.

GREAT LAKES WATER QUALITY BOND FUND
Department of Environmental Quality

Funds Authorized and Awarded, Bonds Sold, and Bond Proceeds by Grant and Loan Type
As of September 30, 2015

	Funds Authorized		Grant or Loan Funds Awarded	Bonds Sold	Awarded Amounts	
	Amount	Date			Distributed	Undistributed
SAW:		01/02/2013				
Grants	\$ 430,000,000		\$ 170,146,356	\$ 66,000,000	\$ 42,261,026	\$127,885,330
Loans	20,000,000		10,245,000	20,000,000	0	10,245,000
State Water Pollution Control Revolving Fund (SRF)	290,000,000	01/02/2013	0	0	0	0
Nonpoint Source Water Pollution	140,000,000	12/14/2010	109,095,933 *		46,436,937	62,658,996
S2 Planning Grants	80,000,000	12/14/2010	80,000,000	47,000,000	73,189,371	6,810,629
SWQIF	20,000,000	11/05/2002	24,480,000	47,526,029	18,992,526	5,487,474
Brownfield Redevelopment: Grants	5,000,000	12/14/2010	0	0	0	0
Loans	5,000,000					
Wetland Mitigation Banking	10,000,000	01/02/2013	0	0	0	0
Total	<u>\$1,000,000,000</u>		<u>\$ 393,967,289</u>	<u>\$180,526,029</u>	<u>\$180,879,860</u>	<u>\$213,087,429</u>

* This is the amount that DEQ expended for the nonpoint source program.

Note: The Great Lakes Water Quality Bond Fund allows for operational oversight of grants and loans.

Source: The Office of the Auditor General prepared this exhibit using data obtained from DEQ.

FUND DESCRIPTION

In November 2002, voters approved \$1 billion of Great Lakes Water Quality general obligation bonds to support the existing SRF and to create a new SWQIF.

SWQIF provides low-interest loans to municipalities for four types of projects:

- (1) Improvements to reduce or eliminate the amount of groundwater or storm water entering a sanitary sewer lead or combined sewer lead.
- (2) Upgrades or replacements of failing on-site systems that adversely affect public health or the environment.
- (3) Innovative storm water and wastewater technologies.
- (4) Constructive activities designed to protect water quality.

Section 324.19708 of the *Michigan Compiled Laws* provides for the following authorized amounts and uses of the Great Lakes Water Quality bond proceeds:

- **SAW Grants (\$430 million)**

Public Act 511 of 2012 created the SAW grant and loan program. SAW provides grants to municipalities for the planning, design, or implementation of innovative technology for storm water or wastewater projects to improve water quality. The grant distribution maximum is \$2 million per municipality. SAW also provides loans to municipalities to construct projects identified in the municipalities' asset management plan and improve water quality. SAW grants were distributed in three rounds:

SAW Grant Distribution			
Round	Date	Amount	Number of Grantees
1	March 2014	\$ 79,000,000	92
2	October 2014	\$ 91,000,000	115
3	December 2015	\$100,000,000	134

- **SAW Loans (\$20 million)**

SAW provides low-interest loans to municipalities to construct projects identified in the municipalities' asset management plan to improve infrastructure and the treatment process at wastewater treatment facilities and improve water quality. As of May 25, 2016, three SAW loans had been approved.

- **SRF (\$290 million)**
 SRF was created in 1988 by Public Act 316 of 1988. SRF is a low-interest loan-financing program that assists qualified municipalities with the construction of water pollution control facilities. At the time of our review, none of these funds had been appropriated or awarded.
- **Nonpoint Source Water Pollution (\$140 million)**
 Public Act 232 of 2010 authorized DEQ to spend up to \$140 million on response activities for nonpoint source water pollution as follows: not more than \$50 million in each of fiscal years 2011 and 2012 and the remaining \$40 million after October 1, 2012 if certain performance objectives had been achieved.
- **S2 Planning Grants (\$80 million)**
 S2 grants of up to \$1 million were offered for the planning and design of wastewater treatment facilities. Two rounds of \$40 million each were awarded between 2006 and 2011. DEQ has awarded 316 S2 grants totaling almost \$81 million.
- **SWQIF Loans (\$20 million)**
 DEQ began issuing SWQIF loans in 2004 to fund on-site failing septic systems and the disconnection of footing drains from sump pumps on private property. The loans also fund municipal water pollution control projects and wastewater treatment facility improvements. SWQIF has provided \$24.5 million in financial assistance to 21 municipalities.
- **Brownfield Redevelopment (\$10 million)**
 In 2010, Public Act 232 authorized \$10 million for brownfield redevelopment grants and loans to municipalities and brownfield redevelopment authorities for response activities to address nonpoint source water pollution. Of this amount, \$5 million was authorized for grants and \$5 million for loans. Funds not appropriated by September 30, 2014 may be used for response activities addressing nonpoint source water pollution. At the time of our review, none of these funds had been appropriated or awarded.
- **Wetland Mitigation Banking (\$10 million)**
 In 2012, Public Act 511 authorized \$10 million for the creation or restoration of wetlands to provide public benefits, such as flood storage, water quality protection, fish and wildlife habitat, and groundwater recharge. Funds not appropriated by September 30, 2014 may be used for response activities addressing nonpoint source water pollution. At the time of our review, none of these funds had been appropriated or awarded.

AUDIT SCOPE, METHODOLOGY, AND OTHER INFORMATION

AUDIT SCOPE

To examine the program and other records of the GLWQBF. We conducted this performance 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 conclusion based on our audit objective. We believe that the evidence obtained provides a reasonable basis for our conclusion based on our audit objective.

PERIOD

Our audit procedures, which included a preliminary survey, audit fieldwork, report preparation, and quality assurance, generally covered October 1, 2013 through March 18, 2016.

METHODOLOGY

We conducted a preliminary survey of the GLWQBF to formulate a basis for establishing our audit objective and methodology. During our preliminary survey, we:

- Interviewed DEQ Revolving Loan Division staff regarding the GLWQBF.
- Reviewed applicable State laws.
- Randomly selected and reviewed payments for SAW grants and loans, S2 grants, and SWQIF loans.
- Analyzed grant and loan applications for appropriate completion, including justification of project need.
- Verified that the Department of Attorney General approved the SAW and S2 grant applications for legal requirements.
- Determined whether grant and loan applications were processed in a timely manner.

OBJECTIVE

To assess DEQ's compliance with laws and regulations for expenditures from the GLWQBF.

To accomplish this objective, we:

- Reviewed DEQ's procedures for processing grant and loan applications.

* See glossary at end of report for definition.

- Randomly selected and reviewed 20 SAW, 21 S2, and 7 SWQIF projects for allowable costs and proper approvals. We also judgmentally selected disbursements from 3 nonpoint source projects.
- Verified for 10 judgmentally selected pay periods that DEQ payroll costs charged to the GLWQBF were appropriate.
- Visited four wastewater treatment facilities to observe the construction of in-process and recently completed projects paid for by the GLWQBF.
- Conducted interviews of employees at four wastewater treatment facilities regarding DEQ's efforts to communicate the benefits of the GLWQBF.

CONCLUSIONS

We base our conclusions on our audit efforts and any resulting material conditions* or reportable conditions*.

**AGENCY
RESPONSES**

Not applicable.

**SUPPLEMENTAL
INFORMATION**

Our audit report includes supplemental information presented as Exhibits #1 through #3. Our audit was not directed toward expressing a conclusion on this information.

* See glossary at end of report for definition.

GLOSSARY OF ABBREVIATIONS AND TERMS

DEQ	Department of Environmental Quality.
GLWQBF	Great Lakes Water Quality Bond Fund.
internal control	The plan, policies, methods, and procedures adopted by management to meet its mission, goals, and objectives. Internal control includes the processes for planning, organizing, directing, and controlling program operations. It also includes the systems for measuring, reporting, and monitoring program performance. Internal control serves as a defense in safeguarding assets and in preventing and detecting errors; fraud; violations of laws, regulations, and provisions of contracts and grant agreements; or abuse.
material condition	A matter that, in the auditor's judgment, is more severe than a reportable condition and could impair the ability of management to operate a program in an effective and efficient manner and/or could adversely affect the judgment of an interested person concerning the effectiveness and efficiency of the program.
observation	A commentary that highlights certain details or events that may be of interest to users of the report. An observation differs from an audit finding in that it may not include the attributes (condition, effect, criteria, cause, and recommendation) that are presented in an audit finding.
performance audit	An audit that provides findings or conclusions based on an evaluation of sufficient, appropriate evidence against criteria. Performance audits provide objective analysis to assist management and those charged with governance and oversight in using the information to improve program performance and operations, reduce costs, facilitate decision making by parties with responsibility to oversee or initiate corrective action, and contribute to public accountability.
reportable condition	A matter that, in the auditor's judgment, is less severe than a material condition and falls within any of the following categories: an opportunity for improvement within the context of the audit objectives; a deficiency in internal control that is significant within the context of the audit objectives; all instances of fraud; illegal acts unless they are inconsequential within the context of the audit objectives; significant violations of provisions of contracts or grant agreements; and significant abuse that has occurred or is likely to have occurred.

S2	SRF/SWQIF.
SAW	Stormwater, Asset Management, and Wastewater.
SRF	State Water Pollution Control Revolving Fund.
SWQIF	Strategic Water Quality Initiatives Fund.

