

DEPARTMENT OF ENVIRONMENTAL QUALITY

**REPORT ON AUDIT
FOR THE YEARS ENDED
JUNE 30, 2010 AND JUNE 30, 2011**

APA
**Auditor of
Public Accounts**
COMMONWEALTH OF VIRGINIA

AUDIT SUMMARY

Our audit of the Department of Environmental Quality for the fiscal years ending June 30, 2010 and 2011 found:

- proper recording and reporting of all transactions, in all material respects, in the Commonwealth Accounting and Reporting System and the internal accounting system of the Department;
- no matters involving internal control and its operations necessary to bring to management's attention; and
- no instances of noncompliance with applicable laws and regulations or other matters that are required to be reported.

Virginia Water Quality Improvement Fund (WQIF)

Between fiscal years 2006 and 2011, DEQ signed 57 agreements, obligating about \$654 million in state funds, for the design and installation of nutrient reduction technology at Chesapeake Bay watershed point source discharges. Applicants understand that WQIF funding is subject to appropriations by the General Assembly and may, at times be insufficient to meet the total of their signed agreement and therefore must ensure that they have sufficient sources of other funding to complete the project in the application.

General Fund appropriations and interest on those funds financed about \$303 million of the state's obligation. Due to declining state revenues, the 2007 General Assembly authorized up to \$250 million in revenue bond proceeds to DEQ to finance the obligations of WQIF grant agreements. With \$654 million awarded in grant agreements for these projects, and available funding of \$553 million, the WQIF has obligated agreements that exceed available funds by about \$101 million. As the following table shows, based on the Governor's proposed budget, DEQ anticipates \$45 million in new WQIF funding for Fiscal 2013.

Status of Water Quality Improvement Fund as of December 31, 2011 (in thousands)

	<u>Total</u>	<u>Balance</u>
57 WQIF Projects	\$654,000	\$ 158,800
WQIF Appropriations & Interest	303,000	-
WQIF Revenue Bond Proceeds	250,000	<u>57,800</u>
Projected Shortfall (Signed Agreements)		<u>(101,000)</u>
Projected Fiscal 2013 Appropriation		45,000
Projected Future Shortfall (Signed Agreements)		<u>\$ (56,000)</u>

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AGENCY HIGHLIGHTS

The Department of Environmental Quality (DEQ) protects the Commonwealth of Virginia's natural resources by administering state and federal environmental programs, issuing permits, monitoring water and air quality, and inspecting water facilities. Additionally, DEQ conducts extensive monitoring to ensure compliance with state and federal standards for water quality, air quality, and waste management. DEQ also enforces regulations promulgated by the State Water Control Board, the Board of Waste Management, and the Air Pollution Control Board.

DEQ operates through its central office, six regional offices, and two satellite and specialized offices. Major operations involve technical and financial assistance to communities and businesses to protect environmental resources; permit, compliance and response programs for air, land, and water resources; and management of remediation and response programs. As part of administering these programs, DEQ uses various funds to account for the collection and disbursement of program funding and we discuss some of the more significant funds below.

Virginia Water Quality Improvement Fund

The WQIF finances grant projects that protect and restore water quality across Virginia. DEQ and the Department of Conservation and Recreation jointly manage the WQIF. DEQ currently provides funding to publicly-owned treatment works for the purpose of designing and installing nutrient removal technology within the Chesapeake Bay watershed to control point source pollution. The Department of Conservation and Recreation provides funding to local governments, soil and water conservation districts, institutions of higher education, and individuals to lower the amount of non-point source pollution washed from the land throughout the Commonwealth.

The WQIF receives funding from the General Fund and statutory funding as defined in the Code of Virginia, which requires 10 percent of annual statewide General Fund revenue collections that exceed the official estimates in the General Appropriation Act, and 10 percent of any unreserved General Fund balance at the close of each fiscal year not mandated for re-appropriation go into the WQIF. Fifteen percent of mandatory deposits that result from General Fund surpluses are set aside in a reserve for appropriation in years when the Commonwealth does not have a General Fund budget surplus.

Between fiscal years 2006 and 2011, DEQ signed 57 agreements, obligating about \$654 million in state funds, for the design and installation of nutrient reduction technology at Chesapeake Bay watershed point source discharges. This is largely due to the statutory requirement for DEQ to approve and enter into funding agreements with all eligible applicants. Applicants understand that WQIF funding is subject to appropriations by the General Assembly and may, at times be insufficient to meet the total of the signed agreement and therefore must ensure that they have sufficient sources of other funding to complete the project in the application.

General Fund appropriations and interest on those funds financed about \$303 million of the state's obligation. Due to declining state revenues, the 2007 General Assembly authorized up to \$250 million in revenue bond proceeds to DEQ to finance the obligations of the WQIF's grant agreements. With \$654 million awarded in grant agreements for these projects, and available funding of \$553 million, the WQIF has obligated agreements that exceed available funds by about \$101 million. As the following table shows, based on the Governor's proposed budget, DEQ anticipates \$45 million in new funding for Fiscal 2013.

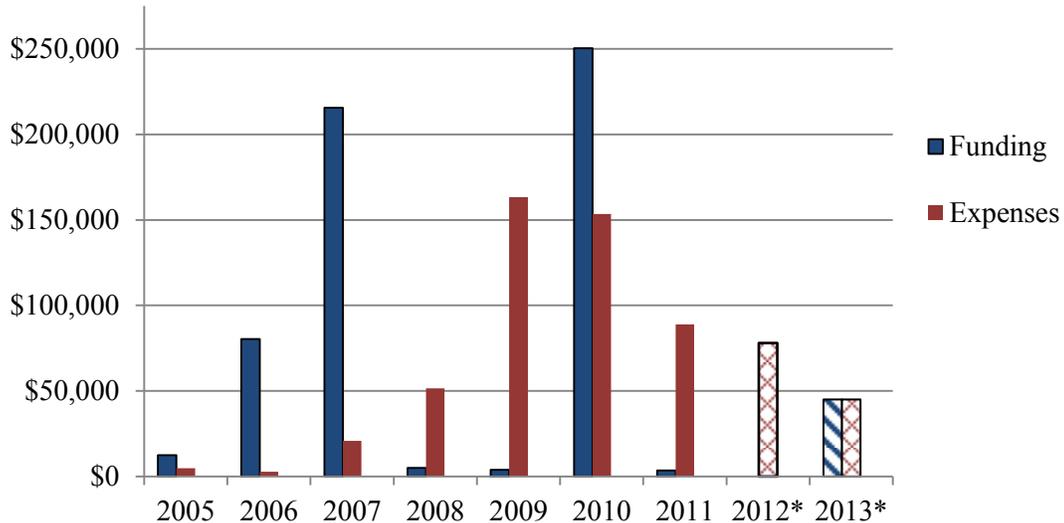
Status of Water Quality Improvement Fund as of December 31, 2011
(in thousands)

	<u>Total</u>	<u>Balance</u>
57 WQIF Projects	\$654,000	\$ 158,800
WQIF Appropriations & Interest	303,000	-
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Source: Commonwealth Accounting and Reporting System & Department of Environmental Quality

In order to compensate for the limited financing for existing projects, and to spread the remaining funds equitably among all grantees, DEQ began pro-rating grant reimbursements at 85 percent during fiscal year 2011. However, DEQ excluded ten “hardship” localities that will continue to receive unreduced grant payments until their projects are completed. Included in the Governor’s proposed budget for fiscal years 2013 and 2014 is about \$45 million in available funding for the WQIF. Because DEQ reimburses grantees as they receive invoices, DEQ cannot predict which grantees will absorb the \$56 million shortfall until current projects reach completion. DEQ has reserved about \$9 million to ensure the ten hardship localities receive full reimbursement.

Summary of Water Quality Improvement Fund Appropriations vs. Expenses
(Fiscal Years 2005 – 2013)



Source: Commonwealth Accounting and Reporting System, Department of Environmental Quality
** Projected amounts based year-to-date expenses and proposed funding*

Virginia Clean Water Revolving Loan Fund

The Virginia Clean Water Revolving Loan Fund provides a long-term renewable funding source for wastewater treatment improvement. The capitalization grant program, established by the Federal Water Quality Act, provides an annual source of federal funds for the loan fund. The loan fund offers long-term, low interest rate loans to local governments to construct or maintain infrastructures necessary to comply with the Clean Water Act requirements. DEQ contracts with the Virginia Resource Authority to manage the resources of the revolving loan fund, while DEQ retains the responsibility of reviewing and approving all disbursements of the fund.

During fiscal years 2010 and 2011, DEQ received \$26.9 million and \$51.6 million respectively, in federal funding through the American Recovery and Reinvestment Act (ARRA). The funding is currently part of the revolving loan fund program and DEQ manages the disbursements accordingly.

The Virginia Petroleum Storage Tank Fund

The Virginia Petroleum Storage Tank Fund reimburses approved clean-up costs and some third-party damages resulting from petroleum releases from storage tanks. The primary revenue for the Fund comes from a \$.006 per gallon fee on regulated petroleum products sold in the Commonwealth. Regulated products include gasoline, aviation motor fuel, diesel fuel, kerosene, and heating oil.

FINANCIAL HIGHLIGHTS

DEQ receives funding from multiple sources including general fund appropriations, special revenue funds, and federal grants. The tables below show DEQ's 2011 and 2010 original and final operating budgets, and actual operating expenses by fund. There were significant changes between the original and final budget, and between the final budget and actual expenses, for both fiscal years.

In fiscal years 2010 and 2011, DEQ's final budget was \$198 and \$225 million, respectively, more than its original budget. These significant increases resulted from the receipt of bond proceeds and American Recovery and Reinvestment Act (ARRA) funding. The increase in bond proceeds for both years relates to the issuance of \$250 million in revenue bonds to support financing for Water Quality Improvement Fund projects, as discussed above. DEQ did not originally budget for ARRA funds in either year, but had final budgets of \$44.2 million in fiscal 2010 and \$61.6 million in fiscal 2011. Over 90 percent of ARRA funding was for the Clean Water State Revolving Fund.

Analysis of Budgeted and Actual Expenses by Fund for Fiscal Year 2011 (in thousands)

	Original <u>Budget</u>	Final <u>Budget</u>	<u>Expenses</u>
General Fund	\$ 33,071	\$ 34,777	\$ 33,212
Special Revenue Funds:			
Water Quality Improvement Fund	-	3,098	-
Petroleum Storage Tank Fund	37,028	37,028	34,077
Other*	28,214	29,394	22,416
Enterprise Fund	12,287	12,147	9,873
Federal Fund	44,425	23,402	19,938
ARRA Funds	-	61,640	56,375
Clean Water Revolving Loan Fund	-	43,040	27,343
WQIF – Bond Proceeds	<u>-</u>	<u>135,500</u>	<u>89,011</u>
Total	<u>\$155,025</u>	<u>\$380,026</u>	<u>\$292,245</u>

Source: Commonwealth Accounting and Reporting System, Chapter 874 of the Appropriations Act

**Includes other special revenue funds and trust and agency funds*

The Clean Water Revolving Loan Fund had no original budget in either year because funding comes from a transfer of Federal Funds. DEQ draws down Capitalization grant funds from the federal government during the year and then transfers funding to the Clean Water Revolving Loan Fund. This transfer of funding explains the increase in the Clean Water Revolving Loan Fund, since DEQ reports the expenses in this fund and not in the Federal Fund, where there is a corresponding budget reduction in both years.

Analysis of Budgeted and Actual Expenses by Fund for Fiscal Year 2010
(in thousands)

	<u>Original Budget</u>	<u>Final Budget</u>	<u>Expenses</u>
General Fund	\$ 38,105	\$ 35,538	\$ 34,655
Special Revenue Funds:			
Water Quality Improvement Fund	55,700	70,566	70,495
Petroleum Storage Tank Fund	37,050	36,256	32,940
Other*	27,447	28,628	19,469
Enterprise Fund	12,287	12,287	9,376
Federal Fund	44,425	23,359	17,413
ARRA Funds	-	44,180	28,223
Clean Water Revolving Loan Fund	-	21,066	18,329
WQIF – Bond Proceeds	<u>-</u>	<u>141,383</u>	<u>82,975</u>
Total	<u>\$215,015</u>	<u>\$413,264</u>	<u>\$313,875</u>

Source: Commonwealth Accounting and Reporting System, Chapter 781 of the Appropriations Act
**Includes other special revenue funds and trust and agency funds*

The following table compares DEQ's expenses by major category for fiscal years 2010 and 2011. Transfer payments to local governments and other entities are DEQ's largest expense; accounting for about 75 percent of total expenses in both fiscal years 2010 and 2011, which primarily reflects the amount paid for Virginia Water Quality Improvement Fund and Clean Water Revolving Loan Fund projects.

Expenses by Major Category
(in thousands)

	<u>2011</u>	<u>2010</u>
Payments to Local Governments and Other Entities:		
Water Quality Improvement Fund & Bond Proceeds	\$ 89,011	\$153,470
Clean Water Revolving Loan Fund	27,343	18,329
Clean Water Revolving Loan Fund - ARRA	50,604	26,037
Petroleum Storage Tank Fund	24,870	23,689
Other Transfer Payments	<u>23,551</u>	<u>16,413</u>
Total transfer payments	<u>215,379</u>	<u>237,766</u>
Personal Services	58,128	57,384
Contractual Services	12,317	12,811
Other	<u>6,421</u>	<u>5,913</u>
Total	<u>\$292,245</u>	<u>\$313,875</u>

Source: Commonwealth Accounting and Reporting System

Total expenses decreased by about \$21.6 million in fiscal 2011. This is entirely attributable to the decrease in expenses from the Water Quality Improvement Fund described above, offset by an increase of \$33.7 million in federal and American Recovery and Reinvestment Act (ARRA) funding for the Clean Water Revolving Loan Fund. The increase in other transfer payments is largely due to increased federal and ARRA expenses across a variety of programs.



Commonwealth of Virginia

Auditor of Public Accounts

Walter J. Kucharski
Auditor of Public Accounts

P.O. Box 1295
Richmond, Virginia 23218

February 3, 2012

The Honorable Robert F. McDonnell
Governor of Virginia

The Honorable Charles J. Colgan
Chairman, Joint Legislative Audit
and Review Commission

We have audited the financial records and operations of the **Virginia Department of Environmental Quality** (DEQ) for the years ended June 30, 2010 and June 30, 2011. 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 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 objectives.

Audit Objectives

Our audit's primary objectives were to evaluate the accuracy of DEQ's recorded financial transactions in the Commonwealth Accounting and Reporting System for fiscal years ended June 30, 2010 and June 30, 2011, and test compliance for the Statewide Single Audit for the fiscal year ended June 30, 2011. In support of these objectives, we reviewed the adequacy of DEQ's internal controls, and tested for compliance with applicable laws, regulations, contracts, and grant agreements.

Audit Scope and Methodology

DEQ's management has responsibility for establishing and maintaining internal control and complying with applicable laws and regulations. Internal control is a process designed to provide reasonable, but not absolute, assurance regarding the reliability of financial reporting, effectiveness and efficiency of operations, and compliance with applicable laws and regulations.

We gained an understanding of the overall internal controls, both automated and manual, sufficient to plan the audit. We considered significance and risk in determining the nature and extent of our audit procedures. Our review encompassed controls over the following significant cycles, classes of transactions, and account balances.

Federal Grant Revenues and Expenditures
Systems Access
Reconciliations

Transfer Payments
Payroll
Clean Water Revolving Loan Fund
Revenues and Expenditures

Our audit did not include the physical security of the Commonwealth Enterprise Solutions Center, where Environmental Quality's system infrastructure is housed, as it is owned by Northrop Grumman Corporation and auditing of physical security is the responsibility of their external auditors.

We performed audit tests to determine whether DEQ's controls were adequate, had been placed in operation, and were being followed. Our audit also included tests of compliance with provisions of applicable laws and regulations. Our audit procedures included inquiries of appropriate personnel, inspection of documents, records, and contracts, and observation of DEQ's operations. We tested transactions and performed analytical procedures, including budgetary and trend analyses.

Conclusions

We found that the Department of Environmental Quality properly stated, in all material respects, the amounts recorded and reported in the Commonwealth Accounting and Reporting System and in DEQ's internal accounting system. DEQ records its financial transactions on the cash basis of accounting, which is a comprehensive basis of accounting other than accounting principles generally accepted in the United States of America. The financial information presented in this report came directly from the Commonwealth Accounting and Reporting System.

We noted no matters involving internal control and its operation that we consider necessary to be reported to management. The results of our tests of compliance with applicable laws and regulations disclosed no instances of noncompliance or other matters that are required to be reported under Government Auditing Standards.

Exit Conference and Report Distribution

We discussed this report with management on December 20, 2011.

This report is intended for the information and use of the Governor and General Assembly, management, and the citizens of the Commonwealth of Virginia and is a public record.

AUDITOR OF PUBLIC ACCOUNTS

LJH/alh

DEPARTMENT OF ENVIRONMENTAL QUALITY

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