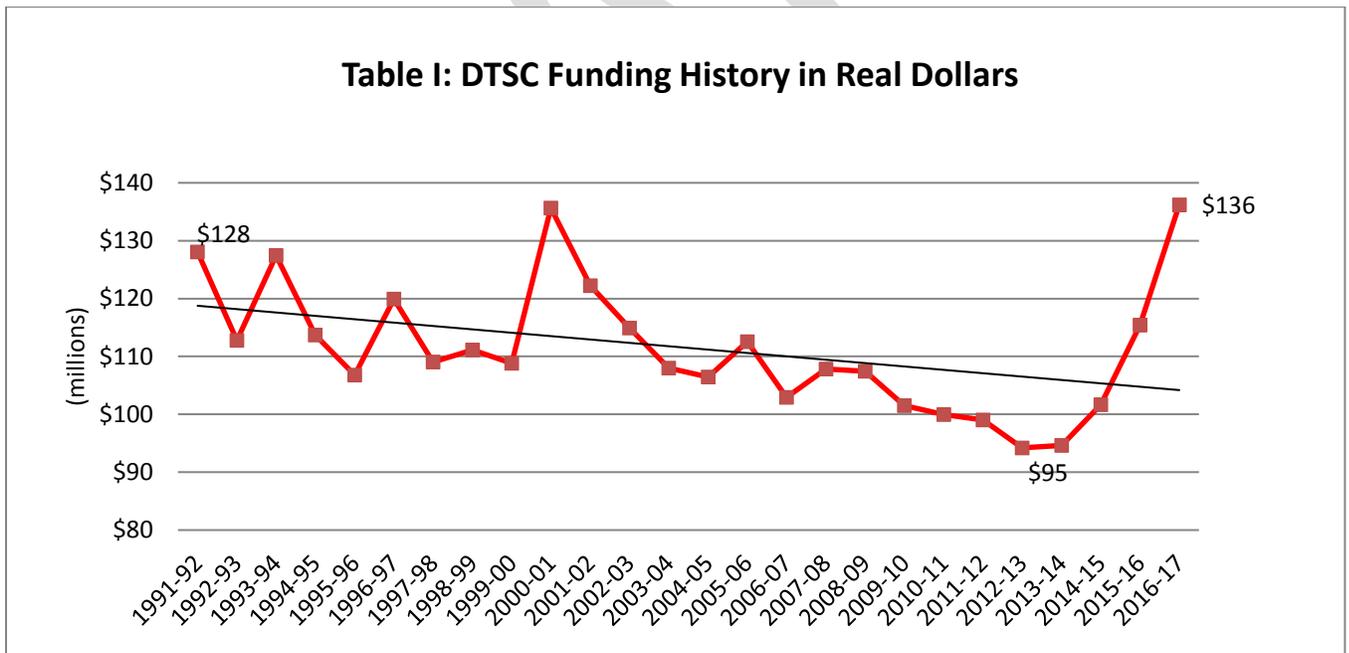


Fiscal Management Summary

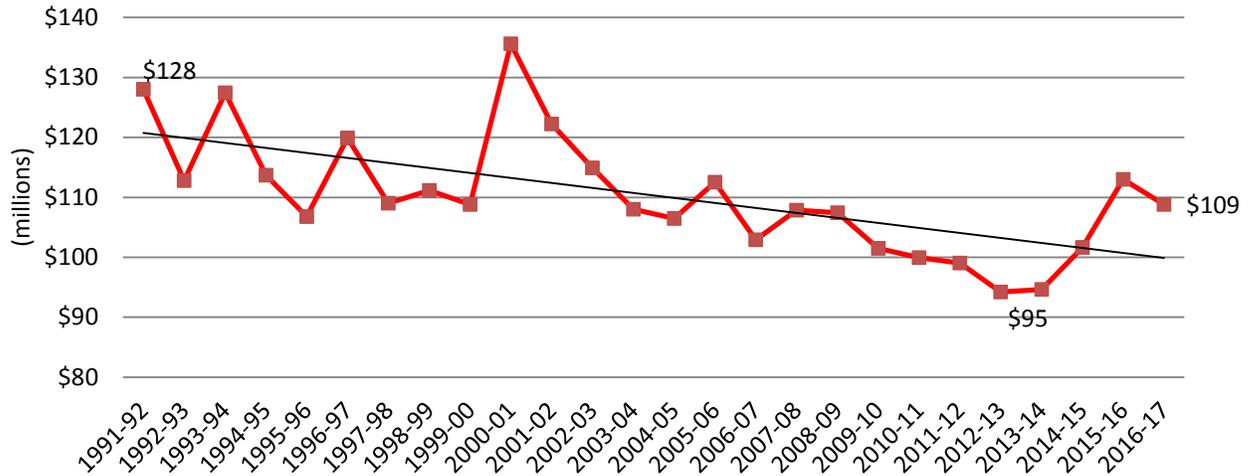
The following summary covers two DTSC fiscal management issues: its budget and cost recovery efforts. Since FY 1991-92, the Department's mandated responsibilities have increased without a commensurate increase in its budget, adjusted for inflation. Additionally, there appears to be a significant future need for funding to support remediation of Superfund and orphan sites. DTSC has made significant progress since 2011 to improve its cost recovery for cleanup work, but there is more to be done. DTSC projects that all necessary cost recovery improvements will not be in place until 2021.

Budget

DTSC's funding history increased by six percent in inflation-adjusted dollars between FY 1991-92 and FY 2016-17, with major fluctuations along the way (Table I). However, if the special augmentations to address contamination at the Argonaut and Exide sites in FY 2015-16 and FY 2016-17 are excluded from consideration, DTSC's funding history declined by 15 percent since FY 1991-92 and FY 2016-17 (Table II). With or without consideration of the Argonaut and Exide augmentations, DTSC has experienced an overall decrease in spending capability, as noted by the trend lines in both Table I and II. This occurred despite a substantial increase in legislative mandates during the period.



**Table II: DTSC Funding History in Real Dollars
Excluding \$62 Million in FY 2015-16 and FY 2016-17
for Contamination at Argonaut and Exide Sites.**



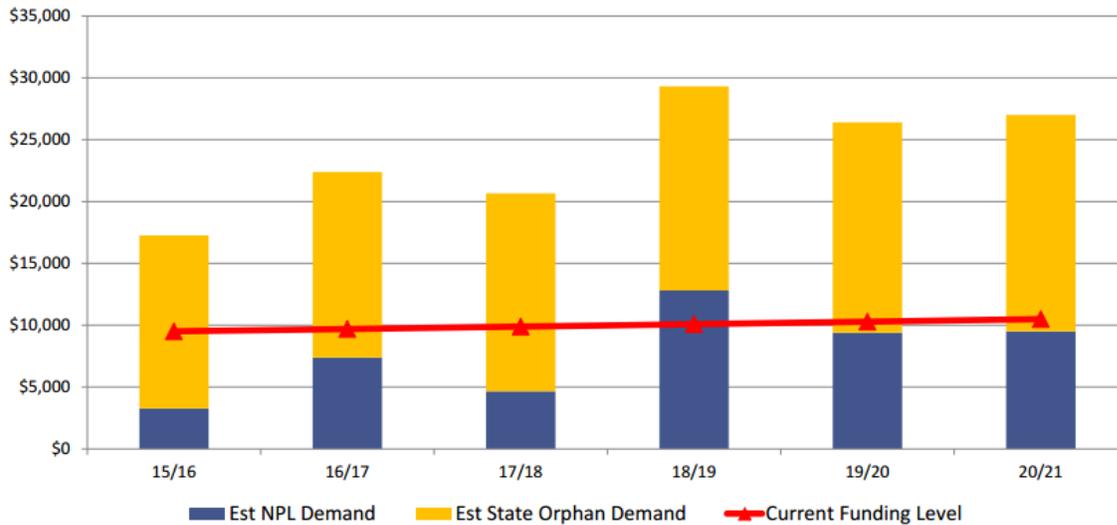
In recent years, however, the Legislature has made significant investments in DTSC’s programs. DTSC’s funding history increased by 43 percent in inflation-adjusted dollars between FY 2013-14 and FY 2016-17 if the augmentations for the Argonaut and Exide sites are factored in and 15 percent if they are not. The Legislature approved all of the funding requests submitted by the Governor in support of DTSC for FY 2016-17.

The IRP’s initial recommendations, submitted on January 28, 2016, expressed a concern about projected shortfalls in DTSC’s Site Remediation Account (SRA). The SRA is used for remediation on both contaminated National Priority List sites (Superfund sites) and contaminated sites with no responsible party that are not Superfund sites (Orphan sites).

California must pay 10 percent of the construction-phase cleanup costs on Superfund sites and 100 percent of the costs after the transition from the construction phase to on-going operations and maintenance on those sites. Beginning in FY 2018-19, the number of Superfund sites transitioning to operations and maintenance is expected to increase substantially (Table III). Superfund demand is expected to fluctuate and in some cases come close to, or exceed, the FY 2016-17 SRA appropriation, which is \$10.503 million. Unless the SRA is increased, little or no funding may be available for Orphan sites in some years going forward.

[Table III to be updated. Request to DTSC for updated information made December 30.]

TABLE III
NPL / Orphan Demand - Stable Funding Level
(\$ in thousands)



*Excludes legacy landfills.

DTSC reported at the January 13, 2016 IRP meeting that it had identified approximately 9,800 contaminated sites statewide under its purview that were not Superfund sites. The Department also reported that the number of contaminated sites that had not been identified may be many times that number. Many of the contaminated sites threaten to impact human health and/or the environment. Responsible parties no longer exist or have the ability to pay for cleanup with many of the sites. This is the scope of the Orphan site work that must be undertaken in the coming years.

AB 2891 (Chapter 704, Statutes of 2016) partially addressed this issue by expressing its intent that funds deposited in the account be appropriated each year to the SRA in an amount that is sufficient to pay for estimated costs for direct site remediation at both Superfund and Orphan sites. The IRP welcomes this expression of intent and hopes California will find the volition and have the ability to appropriate necessary funds for this purpose in the future.

Cost Recovery Efforts

By far the biggest fiscal management issue during the past few years has been the Department’s poor record of recovering its cleanup and oversight costs (response costs) from responsible parties. DTSC is authorized and required by HSC section 25360 to recover its response costs and relies on that revenue so that other Toxic Substances Control Account revenues can be used to fund additional activities such as the remediation of contaminated properties that do not have financially viable responsible parties.

DTSC called attention to this problem in its December 23, 2011 Financial Integrity and State Managers’ Accountability report, which identified \$70 million in potentially recoverable costs that had not been invoiced since 2004. Recognizing the seriousness of this information, DTSC formed a Cost Recovery Team to research the full extent of the backlog and begin putting in

place a viable system of collecting costs. This team subsequently discovered that the cost recovery problem was larger than reflected in the report. On May 31, 2013, DTSC publicly disclosed that its unrecovered response costs were \$184.5 million at 2,700 sites for the 25-year period from July 1987 through December 2012. This was about 10 percent of the total response costs during those years.

DTSC concluded that its past cost recovery efforts were impeded by various factors, including a lack of updated cost recovery policies and procedures, technological infrastructure limitations, inadequate staff communication, and the higher priority necessarily given to cleanup.

DTSC issued 27 departmental procedure memorandums (DPMs) in November of 2013 to address the lack of updated cost recovery policies and procedures. Employee training on the procedures began in the spring of 2014 and has continued on an as needed basis through 2016.

In August 21, 2013 the Joint Legislative Audit Committee directed the California State Auditor to audit the Department. State Auditor Elaine M. Howle released her report on August 7, 2014. The report concluded that “long-standing shortcomings with the Department’s recovery of costs have resulted in millions of dollars in unbilled and billed by uncollected cleanup costs (outstanding costs) dating back to 1987.” The report noted that the Department’s spreadsheet for tracking projects with outstanding costs as of March 2014 showed that it had over 1,600 projects totaling almost \$194 million in outstanding costs, of which nearly \$142 million were unbilled and almost \$52 million were billed but uncollected. It stated that problems with inadequate procedures, incomplete documentation, and misclassification of sites was so pervasive that the Department had not yet determined the exact amount that it could recover. Furthermore, it noted that DTSC may not be able to recover all of its outstanding costs due to factors such as the expiration of federal and state statutes of limitations for project cost recovery and projects that were in litigation or bankruptcy.

The report observed that DTSC had made progress in resolving its outstanding costs, updating its procedures, and training its staff, but it nevertheless made several recommendations for additional improvements. Two of those recommendations were directed at the Legislature, and nine were aimed at DTSC. The Legislature addressed the State Auditor’s recommendations by passing AB 273 (Chapter 456, Statutes of 2015) and AB 276 (Chapter 459, Statutes of 2015). AB 273 increased the interest rate for late payments. AB 276 authorized DTSC to require certain financial information from potentially responsible parties. Those measures are expected to help increase the collection rate, which has been about 80 percent according to the Department. DTSC reported at the November 16, 2016 IRP meeting that, as of two days earlier, it had fully implemented all nine of the recommendations for Department action to maximize opportunities to recover costs, to improve the accuracy of the outstanding costs in its billing system, and to ensure that it loads accurate billing data into its billing system.

In July of 2014, DTSC began implementing two cost recovery work plans. One of them, EnviroStor Enhancements for Cost Recovery, was to incorporate cost tracking codes request and closeout processes into the Department’s EnviroStor data system. The other plan, Sustainable Cost Recovery Systems, was to maximize the recovery of DTSC’s response costs by

implementing sustainable systems for cost recovery management, DPM updates, policy development, and training. DTSC reported to the IRP in November 2016 that it had addressed the objectives of the work plans with two exceptions. One of the unfulfilled objectives was to transfer the Department's billing activities to FISCAL. In January 2015 the FISCAL program office informed DTSC that its system would be unable to meet the unique accounts receivable billing functions of the Department's Cost Recovery Billing System (CRBS). DTSC, therefore, is pursuing improvements to its CRBS in lieu of using FISCAL. The second unfulfilled objective was to use staff input, lessons learned, evolving organizational structure, and assessed priorities to update the DPMs. Although DTSC completed updates to five DPMs in February 2015, it delayed other updates to allow for data systems and processes to further develop and to focus on reducing the historic backlog of unreimbursed response costs. DTSC indicated to the IRP in December 2016 that it will update the remaining 22 DPMs and complete an additional DPM pertaining to the statute of limitations by January 2018.

In 2014, the Legislature approved 14 limited-term cost recovery positions for FY 2014-15 and 2015-16 to reduce the backlog. Six of those positions were for individuals who, among other duties, were to act as administrative project managers (APMs) for a pilot program dedicated to performing tasks previously assigned to technical project managers (TPMs). According to DTSC, the TPMs historically prioritized the cleanup of contaminated properties over the process of pursuing responsible parties for reimbursement of DTSC's response costs. The APMs were to work side by side with the TPMs in each branch office, focus their efforts on billing and other administrative tasks associated with site cleanup, and thereby allow the TPMs to focus on the technical aspects of cleanup projects. The 14 limited term positions expired on July 1, 2016, but the pilot program was judged a success, and DTSC subsequently redirected five positions to ensure that its cost recovery efforts were adequately supported by APMs. DTSC reported to the IRP that it continues to assess the results of its cost recovery process improvements and will selectively adjust resources as needed.

DTSC reported to the IRP on November 16, 2016 that, working from a universe of 1,621 backlogged sites, DTSC had fully addressed 1,410, or 87 percent, and that the remaining 211 sites, or 13 percent, had been fully evaluated, although all possible actions had not been taken on them. Of the remaining 211 sites, DTSC was actively pursuing responsible parties or advanced investigations for 106; DTSC was completing formal documentation, discovery, or U.S. EPA lead for 51; and 54 sites were in pending or active litigation, settlement, or bankruptcy proceedings. DTSC also reported to the IRP that it had recovered roughly \$6.9 million of the \$90 million in costs from the 1,410 addressed sites. The unrecovered costs included write-offs, data corrections, and the results of settlement agreements.

One major structural obstacle remains for DTSC's cost recovery efforts: its antiquated Cost Recovery Billing System (CRBS). The CRBS runs on obsolete technology, is no longer supported by the technology vendor, and lacks functionality for DTSC as well as transparency for third parties. According to DTSC, the complex conversion to new billing system technology is one of its highest priorities. The Department is pursuing funding and conducting the required IT procurement authorization process to improve the CRBS, but the improved billing system is not expected to go online until January of 2021. As DTSC stated in a Cost Recovery Summary it

drafted in January 2016, “The delay in acquiring this [new billing] system represents a significant risk to the Department.”

It is critical for DTSC improve upon its history of recovering its response costs from responsible parties. At the same time, DTSC’s billing procedures must be fair and clear. The California Chamber of Commerce and a coalition of business organizations have alleged to the IRP that the Department’s billing procedures result in invoices lacking justification, explanation, and transparency, leading to unnecessary disputes. The coalition asserts that DTSC frequently fails on a timely basis to engage in the meet-and-confer process before a new phase of cleanup activity, provide cost estimates for cleanup work that DTSC expects to perform, submit invoices, and respond to billing disputes. The coalition believes DTSC structure and protocol do not give the TPMs the necessary tools for technical and fiscal project management. The coalition maintains that DTSC’s indirect cost rate is too high and that the Department should seek public comment during the rate-setting process. The coalition believes that DTSC often bills parties for the time it devotes to addressing fee disputes and that this practice should be prohibited if certain thresholds are met. Finally, the coalition believes there is a lack of coordination and communication between DTSC’s billing department and the TPMs. As examples of this problem, the coalition asserts that invoices lack important detail and that when they are disputed, the billing department is not advised to halt interest charges for any unpaid amounts subject to the dispute.

At the November 16, 2016 IRP meeting, DTSC representatives acknowledged that DTSC’s invoices do not have as much detail as they ideally should have and that the Department continues to evaluate its billing processes. However, they affirmed that billing disputes amount to a small portion of the Department’s overall billing (28 formal disputes from approximately 4,000 invoices in 2015), that the Department is diligent about resolving them in a timely manner (an average of 30 days to resolve “typical” formal disputes), that it does not charge for staff time spent on dispute resolution, and that it waives accumulated interest if a dispute is found valid.

Conclusions

Like all enterprises, DTSC needs appropriate resources to execute mandated requirements. The recent investments made by the Legislature when combined with more efficient management by DTSC appear to have closed the gap, but the looming cost of Superfund and Orphan sites will require a significant evaluation. The Legislature and DTSC deserve credit for the considerable work since 2011 to address very serious and long-standing problems with the Department’s recovery of its response costs. The IRP believes that DTSC has a much better handle on its cost recovery backlog than it did a few years ago and that it has put in place a strong foundation for the future. DTSC’s staff made cost recovery a focus and a part of their everyday life after receiving a wake-up call and considerable attention from the Legislature and the Department’s executive leadership. Further work must be done to put in place a requisite billing system and make it more transparent for responsible parties. In addition, the state must remain vigilant to ensure this problem does not occur again.

Update on Previously Submitted IRP Fiscal Management Recommendations

In its January 28, 2016 initial report to the Governor and Legislature, the IRP made three fiscal management-related suggestions for the Governor and the Legislature.

1. Support the Governor's 2016-2017 budget proposal for DTSC.

This recommendation has been addressed. The Legislature approved all budget change proposals for DTSC in the 2016 Budget Act.

2. Increase the DTSC's SRA funding to address the projected shortfall for orphan site cleanup and transition of federal sites to state operations and maintenance oversight.

AB 2891 (Committee on Environmental Safety & Toxic Materials), Chapter 704, Statutes of 2016, expressed intent of the Legislature that funds be appropriated each year to the Site Remediation Account in an amount that is sufficient to pay for estimated costs for direct site remediation at both federal Superfund orphan sites and at state orphan sites, and that not less than \$10,750,000 be appropriated in the Annual Budget Act each year to the account for direct site remediation costs. The bill also required DTSC to include those estimated costs in a report submitted to the Legislature with the Governor's budget each year. However, future funding must be appropriated in future state budgets.

3. Provide position authority and funding to DTSC to maintain the 14.0 limited-term cost recovery staff positions through 2018 or make them permanent.

The 14 limited-term positions expired on July 1, 2016.

In its January 28, 2016 initial report to the Governor and Legislature, the IRP made one fiscal management-related suggestion for DTSC.

1. DTSC should provide timely Health and Safety Code section 57007 Biennial Report by 1/1/17 and tie report to DTSC "Fixing the Foundation," including documenting compliance with all goals and objectives therein.

DTSC submitted this report on _____.

Recommendations for the DTSC to Improve Fiscal Management

1. Assign APMs to cases to ensure that administrative tasks such as loading documents, scheduling meetings, etc. have the same priority as technical tasks. This should not add to total project costs if done efficiently.

2. Closely monitor the development of the new billing system that will replace DTSC's current archaic and unsupported system.
3. Finish all DPM updates and drafting of new DPMs called for in DTSC work plans by January 2018.
4. Establish time deadlines for meet and confer as well as the preparation of cost estimates and establish a procedure for the resolution of cost estimate disputes pursuant to HSC section 25269.5, per the California Chamber of Commerce November 9, 2016 letter to the IRP.
5. Make process improvements if cost recovery revenue is less than 90 percent of fees invoiced.
6. Periodically evaluate the percentage of direct to indirect (overhead) costs against other state agencies to ensure consistent accounting.
7. Develop a clear and understandable explanation of indirect costs for responsible parties.
8. In conjunction with the development of the annual budget, analyze DTSC fees to ensure that timely recommendations are made to the Governor to adjust them to levels consistent with their intended purpose.

Recommended Goals and Performance Metrics for Fiscal Management

1. Number and percentage of backlogged cleanup sites that are fully addressed.
2. Total recovered costs from fully addressed cleanup sites in the backlog.
3. Number of unaddressed cleanup sites in backlog by cost recovery status categories.
4. Percent of cost recovery fees invoiced for cleanup sites that are paid per year.
5. Percent of cleanup costs that are not billed per year.
6. Average time required to generate collection letters for cost recovery billing system per year.
7. Average number of days to resolve formal cost recovery billing disputes per year.
8. Percentage of cost recovery invoices that are formally disputed by responsible parties per year.

9. Time spent researching, reconciling, and adjusting costs for cost recovery billing system per year.
10. Percentage of project work requests completed on time by support service specialists per year.
11. Percentage of project work requests completed on budget by support service specialists per year.

Information Requests to the DTSC on Fiscal Management

1. Report progress in developing the mechanisms and metrics DTSC is creating to ensure an effective and efficient cost recovery effort going forward. (Five mechanisms and metrics were listed as a key to future success in the January 2016 report on cost recovery.)

#