092552

B-114873
4-21-71

UNITED STATES GENERAL ACCOUNTING OFFICE

REPORT TO THE CONGRESS

Financial Feasibility Of Rural Water And Sewer Systems Should Be Checked More Thoroughly B-114873

Farmers Home Administration
Department of Agriculture

BY THE COMPTROLLER GENERAL OF THE UNITED STATES

092552

APRIL 21, 1971

~~715101~~

COMPTROLLER GENERAL OF THE UNITED STATES
WASHINGTON D C 20548

B-114873

To the President of the Senate and the
Speaker of the House of Representatives

This is our report pointing out that the financial feasibility of rural water and sewer systems should be checked more thoroughly by the Farmers Home Administration, Department of Agriculture.

Our review was made pursuant to the Budget and Accounting Act, 1921 (31 U.S.C. 53), and the Accounting and Auditing Act of 1950 (31 U S.C. 67).

Copies of this report are being sent to the Director, Office of Management and Budget, and to the Secretary of Agriculture.

Elmer B. Staats
Comptroller General
of the United States

COMPTROLLER GENERAL'S REPORT TO THE CONGRESS

FINANCIAL FEASIBILITY OF RURAL WATER AND SEWER SYSTEMS SHOULD BE CHECKED MORE THOROUGHLY
Farmers Home Administration
Department of Agriculture B-114873

D I G E S T

WHY THE REVIEW WAS MADE

The Farmers Home Administration (FHA) makes loans and grants for the construction and/or improvement of water and sewer systems which primarily serve farmers, ranchers, farm tenants and laborers, and other rural residents. The loans and grants are made to public and nonprofit associations.

The General Accounting Office (GAO) reviewed the procedures and practices of FHA for determining the financial feasibility of proposed systems before disbursing funds because

--reports from county FHA offices indicated that associations often lacked the minimum number of users (as established by FHA) to provide enough revenue to repay the loans and

--there had been a rapid growth in the number of systems

The loans are repayable over periods up to 40 years, with annual interest not to exceed 5 percent

When development costs of a system will result in high charges to users, grants may be made to reduce costs to a level which will result in a reasonable user charge comparable to user charges of established systems of similar size and cost in communities with similar economic conditions. Once a reasonable user charge is determined, the key factor in ensuring a system's financial success is obtaining the required number of users (See pp. 6 and 7)

FHA made loans and grants of about $1 billion to 4,668 associations from the inception of the program in 1961 to June 1970. Over 75 percent of these funds were advanced after 1966

FINDINGS AND CONCLUSIONS

Verification of user data

Contrary to its instructions FHA has disbursed loan and grant funds before adequately determining that the associations will have the minimum number of users to make their systems financially feasible.

Tear Sheet

APRIL 21, 1971

The failure of associations to have the necessary users at the time that the associations' systems go into operation is significant, because sufficient revenues may not be generated to enable the associations to continue operating their systems and meet repayments on their FHA loans

In February 1970, 123 associations were delinquent $2 million on loans of $42 million because they did not have the minimum number of users which FHA had determined were required to financially support the operation of their systems (See p. 10.)

GAO analyzed FHA and association records for 69 associations that had received loan and grant funds of $29 million. For 64 associations FHA had not independently verified the associations' user agreements and lists of potential users, which had been furnished as evidence that the minimum number of users had been obtained to fully support the operation of their systems

At the time that the associations' systems were placed in operation

--31 associations did not have the required minimum number of users established by FHA,

--22 associations had the required number of users, and

--15 associations did not have adequate records showing whether they had the required number of users.

One association had its system under construction at the time of GAO's fieldwork

Of the 69 associations, 48, which had their systems in operation for periods ranging up to 57 months, lacked sufficient users either at the time that their systems went into operation or at the time that GAO completed its review. In February 1970, 15 of the 48 associations were delinquent $533,000 on loans of $10 7 million. In GAO's opinion, 17 more associations eventually will become delinquent on loans of $4.8 million because of the lack of a sufficient number of users.

For 32 of the 48 associations for which information was readily available, GAO estimated that additional revenues of $581,000 would have been collected during periods that ranged from 3 to 56 months if the associations had obtained the required minimum number of users. (See pp 11 and 12)

Need for firm commitments from users

FHA needs to establish procedures requiring that associations obtain firm commitments from prospective users.

For example, FHA does not require an association, prior to loan closing, to obtain from each prospective user

--a cash contribution to cover the estimated cost of connecting a service line from the user's property to the association's water or sewer system and

--a user agreement which requires the user to pay a minimum monthly rate regardless of whether he actually uses the association's facilities.

Also FHA has not established a program for determining, on a systematic basis, that associations are enforcing user agreements (See p 16.)

Firm commitments in the State of Washington

Of the FHA offices in the nine States included in GAO's review, the FHA office in the State of Washington was the only one that required a water and sewer association to obtain from each prospective user, prior to loan closing, both a cash contribution and a binding user agreement.

The cash contribution covered the estimated cost of connecting a service line to the association's facilities. The user agreement required each user to pay a minimum monthly rate to the association regardless of whether he actually used the system. The cash contribution ranged from $75 to $250, and the minimum monthly rate ranged from $5 to $8 75.

GAO believes that these requirements are the principal reasons that the five Washington associations included in its review have had no major financial feasibility problems. (See pp. 16 and 17.)

Inadequate commitments elsewhere

For the remaining 64 associations included in GAO's review, FHA State offices had required 42 to obtain cash contributions. For 31 associations the required cash contributions were less than $26 which was not sufficient to cover the cost of connecting a service line.

FHA State offices required 38 of the 64 associations to obtain user agreements. The agreements obtained, however, did not commit the prospective users to use the water or sewer facilities

GAO interviewed 142 individuals who had signed user agreements with 20 of the 64 associations and who--at the time of GAO's fieldwork--were not using the associations' facilities. For the most part the individuals said that they had good working wells or that they could not afford the cost of connecting service lines to the associations' facilities. (See p. 17.)

Conclusions

The making of loans and grants to associations not having the required minimum number of users is a disservice to other rural communities which need assistance and which can meet requirements to make their systems financially successful

The demand for assistance in financing systems has been greater than the funds available during the past few years. This fact makes it increasingly important that FHA establish reasonable user requirements and procedures for enforcing such requirements, to ensure that loan and grant funds are provided to only those associations having financially feasible systems (See p 20.)

RECOMMENDATIONS OR SUGGESTIONS

FHA should require that financial assistance be provided to an association only after FHA county and State loan approval officials have verified and documented in the loan files that the association has obtained

--the number of users needed to make its proposed system financially feasible,

--a cash contribution from each prospective user to cover the estimated cost of connecting a service line from his property to the association's facilities, and

--an enforceable agreement from each prospective user committing him to pay a minimum monthly rate to the association regardless of whether he uses the system.

FHA should also establish procedures for determining, on a systematic basis, whether associations are enforcing user agreements. (See p. 20.)

AGENCY ACTIONS AND UNRESOLVED ISSUES

The Administrator of FHA said that GAO's recommendations would help FHA to further perfect its programs and that FHA planned to revise its instructions on membership requirements, user cash contribution requirements, and the enforcement of user agreements. He said also that the new instructions would be implemented after review by FHA State directors and discussion at FHA training meetings He expects that these actions will overcome the problems presented in GAO's report (See app I)

GAO plans to review FHA's revised instructions after they are issued, to ascertain whether, if properly implemented, they will provide assurance that Government funds are provided only to associations whose proposed water and sewer systems are financially feasible

MATTERS FOR CONSIDERATION BY THE CONGRESS

GAO is bringing this matter to the attention of the Congress because of the increasing congressional interest in the adequacy of rural water and sewer systems and because of the need for FHA to improve its determinations of the financial feasibility of proposed rural water and sewer systems before Federal loan and grant funds are disbursed.

Contents

ABBREVIATIONS

FHA	Farmers Home Administration
GAO	General Accounting Office
OIG	Office of the Inspector General

COMPTROLLER GENERAL'S REPORT TO THE CONGRESS

FINANCIAL FEASIBILITY OF RURAL WATER AND SEWER SYSTEMS SHOULD BE CHECKED MORE THOROUGHLY
Farmers Home Administration
Department of Agriculture B-114873

D I G E S T

WHY THE REVIEW WAS MADE

The Farmers Home Administration (FHA) makes loans and grants for the construction and/or improvement of water and sewer systems which primarily serve farmers, ranchers, farm tenants and laborers, and other rural residents. The loans and grants are made to public and nonprofit associations.

The General Accounting Office (GAO) reviewed the procedures and practices of FHA for determining the financial feasibility of proposed systems before disbursing funds because

--reports from county FHA offices indicated that associations often lacked the minimum number of users (as established by FHA) to provide enough revenue to repay the loans and

--there had been a rapid growth in the number of systems.

The loans are repayable over periods up to 40 years, with annual interest not to exceed 5 percent.

When development costs of a system will result in high charges to users, grants may be made to reduce costs to a level which will result in a reasonable user charge comparable to user charges of established systems of similar size and cost in communities with similar economic conditions. Once a reasonable user charge is determined, the key factor in ensuring a system's financial success is obtaining the required number of users. (See pp. 6 and 7.)

FHA made loans and grants of about $1 billion to 4,668 associations from the inception of the program in 1961 to June 1970. Over 75 percent of these funds were advanced after 1966.

FINDINGS AND CONCLUSIONS

Verification of user data

Contrary to its instructions FHA has disbursed loan and grant funds before adequately determining that the associations will have the minimum number of users to make their systems financially feasible.

The failure of associations to have the necessary users at the time that the associations' systems go into operation is significant, because sufficient revenues may not be generated to enable the associations to continue operating their systems and meet repayments on their FHA loans.

In February 1970, 123 associations were delinquent $2 million on loans of $42 million because they did not have the minimum number of users which FHA had determined were required to financially support the operation of their systems. (See p. 10.)

GAO analyzed FHA and association records for 69 associations that had received loan and grant funds of $29 million. For 64 associations FHA had not independently verified the associations' user agreements and lists of potential users, which had been furnished as evidence that the minimum number of users had been obtained to fully support the operation of their systems

At the time that the associations' systems were placed in operation

--31 associations did not have the required minimum number of users established by FHA,

--22 associations had the required number of users, and

--15 associations did not have adequate records showing whether they had the required number of users.

One association had its system under construction at the time of GAO's fieldwork.

Of the 69 associations, 48, which had their systems in operation for periods ranging up to 57 months, lacked sufficient users either at the time that their systems went into operation or at the time that GAO completed its review. In February 1970, 15 of the 48 associations were delinquent $533,000 on loans of $10.7 million. In GAO's opinion, 17 more associations eventually will become delinquent on loans of $4.8 million because of the lack of a sufficient number of users.

For 32 of the 48 associations for which information was readily available, GAO estimated that additional revenues of $581,000 would have been collected during periods that ranged from 3 to 56 months if the associations had obtained the required minimum number of users. (See pp. 11 and 12)

Need for firm commitments from users

FHA needs to establish procedures requiring that associations obtain firm commitments from prospective users.

For example, FHA does not require an association, prior to loan closing, to obtain from each prospective user

--a cash contribution to cover the estimated cost of connecting a service line from the user's property to the association's water or sewer system and

--a user agreement which requires the user to pay a minimum monthly rate regardless of whether he actually uses the association's facilities.

Also FHA has not established a program for determining, on a systematic basis, that associations are enforcing user agreements. (See p. 16.)

Firm commitments in the State of Washington

Of the FHA offices in the nine States included in GAO's review, the FHA office in the State of Washington was the only one that required a water and sewer association to obtain from each prospective user, prior to loan closing, both a cash contribution and a binding user agreement.

The cash contribution covered the estimated cost of connecting a service line to the association's facilities. The user agreement required each user to pay a minimum monthly rate to the association regardless of whether he actually used the system. The cash contribution ranged from $75 to $250, and the minimum monthly rate ranged from $5 to $8.75.

GAO believes that these requirements are the principal reasons that the five Washington associations included in its review have had no major financial feasibility problems. (See pp. 16 and 17.)

Inadequate commitments elsewhere

For the remaining 64 associations included in GAO's review, FHA State offices had required 42 to obtain cash contributions. For 31 associations the required cash contributions were less than $26 which was not sufficient to cover the cost of connecting a service line.

FHA State offices required 38 of the 64 associations to obtain user agreements. The agreements obtained, however, did not commit the prospective users to use the water or sewer facilities.

GAO interviewed 142 individuals who had signed user agreements with 20 of the 64 associations and who--at the time of GAO's fieldwork--were not using the associations' facilities. For the most part the individuals said that they had good working wells or that they could not afford the cost of connecting service lines to the associations' facilities. (See p. 17.)

Conclusions

The making of loans and grants to associations not having the required minimum number of users is a disservice to other rural communities which need assistance and which can meet requirements to make their systems financially successful.

The demand for assistance in financing systems has been greater than the funds available during the past few years. This fact makes it increasingly important that FHA establish reasonable user requirements and procedures for enforcing such requirements, to ensure that loan and grant funds are provided to only those associations having financially feasible systems. (See p. 20.)

RECOMMENDATIONS OR SUGGESTIONS

FHA should require that financial assistance be provided to an association only after FHA county and State loan approval officials have verified and documented in the loan files that the association has obtained

--the number of users needed to make its proposed system financially feasible,

--a cash contribution from each prospective user to cover the estimated cost of connecting a service line from his property to the association's facilities, and

--an enforceable agreement from each prospective user committing him to pay a minimum monthly rate to the association regardless of whether he uses the system.

FHA should also establish procedures for determining, on a systematic basis, whether associations are enforcing user agreements. (See p. 20.)

AGENCY ACTIONS AND UNRESOLVED ISSUES

The Administrator of FHA said that GAO's recommendations would help FHA to further perfect its programs and that FHA planned to revise its instructions on membership requirements, user cash contribution requirements, and the enforcement of user agreements. He said also that the new instructions would be implemented after review by FHA State directors and discussion at FHA training meetings. He expects that these actions will overcome the problems presented in GAO's report (See app. I)

GAO plans to review FHA's revised instructions after they are issued, to ascertain whether, if properly implemented, they will provide assurance that Government funds are provided only to associations whose proposed water and sewer systems are financially feasible.

MATTERS FOR CONSIDERATION BY THE CONGRESS

GAO is bringing this matter to the attention of the Congress because of the increasing congressional interest in the adequacy of rural water and sewer systems and because of the need for FHA to improve its determinations of the financial feasibility of proposed rural water and sewer systems before Federal loan and grant funds are disbursed

CHAPTER 1

INTRODUCTION

The Farmers Home Administration is authorized by section 306 of the Consolidated Farmers Home Administration Act of 1961, as amended (7 U.S.C. 1926), to make grants and direct and insured loans to public and nonprofit associations to finance the improvement and/or construction of water and sewer systems which primarily serve farmers, ranchers, farm tenants and laborers, and other rural residents.

In considering an association's request for loan and grant assistance, FHA evaluates the reasonableness of the user rates proposed by an association and makes determinations regarding the minimum number of users required to financially support the system.

Under FHA instructions, grants may be provided to an association when the development cost of a system will result in high charges to users. Grant assistance is provided to reduce the association's project costs to a level which will permit a reasonable user charge that will be comparable to user charges of established systems of similar size and cost in communities with similar economic conditions. Once a reasonable user charge is determined, obtaining the required number of users becomes the key factor in ensuring the financial success of a water or sewer system.

Our detailed review of the effectiveness of FHA's policies and procedures for determining the financial feasibility of water and sewer systems placed emphasis on the steps taken by FHA, prior to disbursing Government funds, to ensure that associations obtained the minimum number of users which FHA had determined were required to financially support the operation of the systems. We identified this area as being in need of improvement in our survey of FHA's water and sewer program in two States; the survey did not indicate any significant problems with respect to FHA's determinations of rates the associations should charge users.

The 1961 act provides that

--water and sewer loans to associations be made at an interest rate not to exceed 5 percent per annum,

--loans be made only when FHA determines that associations are unable to obtain sufficient credit elsewhere to finance their actual needs at reasonable rates and terms,

--loans be repaid over a period not to exceed 40 years,

--the maximum principal loan indebtedness together with grant assistance not exceed $4 million for any association at any one time, and

--the amount of grant assistance not exceed 50 percent of development costs of the water and/or sewer system.

FINANCING OF FHA WATER AND SEWER PROGRAM

FHA records show that, from inception of the water and sewer program in 1961 to June 30, 1970, FHA made loans and grants totaling about $865 million and $134 million, respectively, to about 4,668 associations to finance the improvement and/or construction of rural water and sewer facilities. For fiscal year 1971, FHA expects to make loans of about $126 million and grants of about $20 million to about 900 associations.

Direct loans are financed with Treasury borrowings and are made from FHA's Direct Loan Account up to a maximum amount established by the Congress for the program in annual appropriation acts. Grant funds are appropriated annually by the Congress.

Insured loans are made from FHA's Agricultural Credit Insurance Fund. After making these loans at an interest rate--established by law--not exceeding 5 percent, FHA sells the associations' notes to investors for periods ranging from 1 to 25 years and guarantees repayment of the loans.

To make the notes attractive to investors, FHA pays interest on the notes at rates that are competitive with interest rates being paid for private capital. Effective February 15, 1971, FHA was paying interest on associations' notes sold to investors at rates ranging from 5-3/4 to 6-3/4 percent--the higher interest rate being paid to investors purchasing the notes for 10 to 25 years. Proceeds from the sales of the notes are placed in the fund and are used to finance additional loans.

From inception of the water and sewer program in 1961 to December 31, 1969, FHA returned, due to lack of Federal funds, 5,935 applications to associations which had requested loan and grant assistance totaling $964 million. At December 31, 1969, FHA estimated that about $11 billion was required to meet the national need for adequate rural water and sewer facilities.

ORGANIZATION OF FHA

FHA maintains 41 State offices--which serve the 50 States, the District of Columbia, Puerto Rico, and the Virgin Islands--and about 1,700 county offices. Each FHA State office is headed by an FHA State director who is responsible for all program operations within his territorial jurisdiction. The FHA county offices, each under the supervision of an FHA county supervisor, are located throughout the country to serve all agricultural counties.

Applications for all loans and grants are made initially to the county or State offices. County office operations are subject to review by the district supervisor or other State office officials.

Under FHA instructions, water and sewer loans up to $350,000 may be approved by the FHA State directors and loans of $350,000 or more are reviewed by the FHA headquarters office before the loans are approved by the State directors. Development grants in excess of $75,000 are reviewed by the FHA headquarters office before the grants are approved by the State directors.

INTERNAL AUDITS OF FHA WATER AND SEWER PROGRAM

The Office of the Inspector General (OIG), Department of Agriculture, has not made a detailed audit of FHA's water and sewer program. In fiscal year 1969, OIG made a survey of all FHA's association loan programs and identified weaknesses in FHA's management of these programs, including the water and sewer program. Due in large measure to our audit of FHA's water and sewer program, OIG decided to concentrate its audit effort on FHA's recreation loan program.

CHAPTER 2

IMPROVEMENTS NEEDED IN DETERMINING

FINANCIAL FEASIBILITY OF

RURAL WATER AND SEWER SYSTEMS

Contrary to its instructions FHA has disbursed loan and grant funds to associations before adequately determining that the associations will have the minimum number of users to make their systems financially feasible.

More specifically, FHA did not (1) verify independently the listings of potential users or user agreements furnished by associations applying for water or sewer loans and grants to finance the improvement and/or construction of water and/or sewer systems nor (2) require the associations to obtain firm commitments from the potential users of the proposed water and/or sewer systems. The failure of associations to have the necessary users at the time their systems go into operation is significant because sufficient revenues may not be generated to enable the associations to continue operating their systems and meet repayments on their FHA loans.

At February 2, 1970, 270 associations were delinquent $3.3 million on outstanding loans totaling $77 million. Of these associations, 123 were delinquent $2 million on outstanding loans of $42 million because they did not have a sufficient number of users to financially support the operation of their systems.

NEED TO IMPROVE VERIFICATIONS OF USER DATA FURNISHED BY ASSOCIATIONS

FHA instructions require that, before Federal funds are disbursed, an association have a minimum number of users to support the operations of its water or sewer system. FHA considers this requirement necessary to reasonably ensure that an association will be able to operate its system successfully. The successful operation of the system includes repayment of its loan, payment of current operating expenses, and establishment of a cash reserve.

Our review indicated that, as evidence that an association had obtained the minimum number of users needed to financially support its system, FHA usually accepted from the association either a list of potential users or a statement that the association had obtained a certain number of signed user agreements from potential users. A signed user agreement does not necessarily represent a firm commitment on the part of a potential user to use a completed system. (See p. 16 for our comments on the need to obtain firm commitments from potential users.)

We selected 69 associations which had been advanced loans totaling $26.3 million and grants totaling $2.7 million during the period August 1963 to February 1970 for the development of rural water and/or sewer systems in nine States and analyzed their loan and grant applications and related documents supporting their system proposals. In making our selection we generally included associations which (1) had 50 or more users, (2) had been in operation for various periods of time, and (3) were delinquent on repaying their FHA loans.

Our analysis of records maintained by FHA and the associations showed that, for 64 of the 69 associations, FHA had not made independent verifications of user listings or user agreements furnished by the associations to show that they would have the required minimum number of users to fully support the operations of their systems. Our analysis showed further that, at the time the systems for the associations were placed in operation,

--31 associations did not have the required minimum number of users as established by FHA,

--22 associations had the required number of users, and

--15 associations did not have adequate records showing whether they had the required number of users.

One association had its system under construction at the time of our fieldwork.

Our analyses showed also that, of the 69 associations, 48, which had their systems in operation for periods ranging up to 57 months, had lacked sufficient users either at the time that their systems had gone into operation or at the time that we had completed our fieldwork.

Of the 48 associations, 15 were delinquent $533,000 on outstanding loans of $10.7 million as of February 1970 and 17, in our opinion, will eventually become delinquent on outstanding loans of $4.8 million because of the lack of sufficient users. For 32 of the 48 associations for which information was readily available, we estimated that additional revenues of $581,000 would have been collected during periods ranging from 3 to 56 months if the associations had obtained the required minimum number of users.

The following three examples illustrate FHA's practice of disbursing the loan funds before adequately determining whether the associations will have the necessary users to make their systems financially feasible.

Association A

FHA made a loan of $846,000 to this association in December 1967 to finance the construction of a water system. As a condition to closing the loan, FHA required that the association have at least 735 water users and that each user be assessed an average monthly rate of about $9 when the system became operational.

FHA closed the loan on the basis of the association's statement, in writing, to the FHA county supervisor that 735 individuals had executed user agreements. The county supervisor told us that, at loan closing, he had not determined whether the association actually had obtained signed user agreements from 735 individuals.

Our review showed that only 538 individuals had actually signed user agreements and that the agreements did not represent firm commitments by the potential users to use the completed water system. In December 1968, 2 months after the system went into operation, the association had only 122 water users, and, 8 months after operations began, the association had only 351 users.

We estimated that the association's revenue was about $30,000 less than anticipated over a 7-month period as a result of the association's not having the minimum number of users. On February 2, 1970, the association was delinquent about $7,500 on its FHA outstanding loan balance of about $834,000.

Association B

FHA made a loan of $1,530,000 in March 1966 and a subsequent loan of $608,000 in April 1967 to this association to finance the construction of a water system. As a condition to closing the loan, FHA required that the association

--obtain signed user agreements from at least 1,895 users,

--obtain a cash contribution of $5 from each potential user as a good faith deposit to be used to pay a part of the cost of operating the system in the first year, and

--assess each user an average monthly rate of $6.75 when the system became operational.

FHA closed the loan on the basis of the association's statement, in writing, to the FHA county supervisor that the association had obtained the required number of user agreements and cash contributions. The county supervisor told us that, at loan closing, he had not determined whether the association actually had obtained signed user agreements and cash contributions from 1,895 potential users.

Although FHA and the association's records did not show the number of users who had signed user agreements prior to loan closing, our review showed that the association had collected cash contributions from only 1,546 users. When the system became operational in June 1967, the association had only 438 users, and, 32 months after operations began, it had 1,822 users.

We estimated that the revenue collected by the association during the first 32 months of operation was about $82,000 less than anticipated as a result of the association's not having the required minimum number of users. On February 2, 1970, the association was delinquent about

$95,000 on its FHA outstanding loan balances of about $2,084,000.

Association C

FHA made a loan of $327,000 in December 1968 and a subsequent loan of $50,000 in August 1969 to this association to purchase existing water and sewer facilities and to construct additional facilities. As a condition to closing the loan, FHA required that the association

- --obtain signed user agreements from at least 580 water users and 164 sewer users,
- --obtain a cash contribution of $5 from each potential user as a good faith deposit to be used to pay a part of the cost of operating the system in the first year, and
- --assess each user an average monthly rate of $4.25 when the system became operational.

Records at the FHA county office did not contain any information to indicate that the county supervisor, prior to loan closing, had determined whether the association had obtained signed user agreements and cash contributions from 744 potential users.

Our review showed that, when the system went into operation in September 1969, the association had obtained only 354 signed agreements and that the agreements did not represent firm commitments on the part of the potential users to use the completed water system. Only 192 potential users had paid the required cash contribution. In December 1969, 3 months after the system went into operation, the association had only 354 water users and 114 sewer users.

We estimated that the association's revenue during the first 3 months of operation was about $3,300 less than anticipated as a result of the association's not having the required number of users. This association, in our opinion, eventually will become delinquent in repaying its FHA loans if it does not obtain an additional number of users or if it does not substantially increase the user rates.

- - - -

FHA State officials responsible for the 69 systems included in our review generally agreed that FHA should have verified listings of users or user agreements furnished by the associations to ensure that the associations would have the minimum number of users needed for their systems to be financially feasible.

NEED TO ESTABLISH PROCEDURES FOR REQUIRING FIRM COMMITMENTS FROM WATER AND SEWER USERS

To provide reasonable assurance that an association will have a sufficient number of users for its water and/or sewer system for the system to be financially feasible, FHA needs to establish procedures requiring that associations obtain firm commitments from individuals who express desires to install and connect service lines from their properties to the association's water or sewer lines. In this respect FHA does not require each association, prior to loan closing, to obtain from each prospective user

--a cash contribution to cover the estimated cost of connecting a service line from the individual's property to the association's water or sewer system and

--a user agreement which requires the user to pay a minimum monthly rate to the association regardless of whether the individual actually uses the association's facilities.

Also, FHA has not established procedures for determining, on a systematic basis, that the associations are enforcing user agreements

Of the FHA offices in the nine States included in our review, the FHA State office in Washington was the only one that required a water and sewer association to obtain from each prospective user--prior to loan closing--both a cash contribution covering the estimated cost of connecting a service line from the user's property to the association's facilities and a user agreement committing the user to pay a minimum monthly rate to the association regardless of whether he actually used the system.

The five Washington State water and/or sewer associations included in our review required each potential user to (1) make a cash contribution ranging from $75 to $250 to cover the cost of a connecting line to the system and (2) pay a minimum monthly user rate ranging from $5 to $8.75.

For 32 other water and/or sewer associations in the State of Washington, similar cash contributions were required. The average cash contributions paid by the users belonging to the 37 associations amounted to $178. We believe that the requirements imposed on potential users by the FHA State office in Washington are the principal reasons that the five Washington State associations included in our review have had no major problems with respect to the financial feasibility of their water and/or sewer systems.

For the remaining 64 associations included in our review, FHA had not required

--22 associations to obtain any cash contributions. Of the 42 associations which were required to obtain cash contributions, 31 required contributions under $26 which was not sufficient to cover the cost of connecting a service line.

--26 associations to obtain user agreements. The user agreements for the remaining 38 associations generally did not commit signers to use the water or sewer facilities.

We interviewed 142 individuals who had signed user agreements with 20 of the 64 associations and who, at the time of our fieldwork, were not using the associations' facilities. For the most part these individuals advised us that they were not using the associations' facilities because they had good working wells or they could not afford the cost of connecting service lines from their properties to the associations' facilities.

The following two examples illustrate the lack of firm commitments from users and the need for FHA to establish procedures requiring associations to obtain firm commitments from potential users.

Association D

FHA made a loan of about $1.3 million to this association in February 1968 to finance the construction of a water system. As a condition to closing the loan, FHA required that the association have at least 1,150 signed user agreements. Records at the FHA county office did not show whether the required number of user agreements had been obtained at the time of the loan closing in February 1968. The system was completed and went into operation in November 1969. In February 1970, 3 months after operations began, FHA records showed that only 608 individuals were using the association's system.

We interviewed six individuals who had signed user agreements but who were not using the system as late as March 1970. Of the six individuals, five stated that they had good water supplies from their own ground wells and that they had no intentions of using the association's water system. The other individual stated that he had not developed his property and therefore had no need to obtain water from the association.

We noted that the agreements signed by these individuals had not required them to pay a minimum monthly rate to the association regardless of whether they actually used the system. The cash contribution of $5 required from each potential user was not based on the estimated cost of connecting a service line from the individual's property to the association's water system.

We estimated that revenue collected by the association during the first 4 months of operation was about $16,000 less than anticipated as a result of the association's not having the required number of users. On February 2, 1970, the association was delinquent $20,648 on its FHA outstanding loan balance of $1,251,000.

Association E

FHA made a loan of $175,000 and a grant of $175,000 to this association in May 1968 to finance the construction of a water system. As a condition to closing the loan and grant, FHA required that the association have at least 180 signed user agreements. At the time of the loan closing in May 1968, the association, however, had obtained agreements to use the system from only 143 individuals, and in November 1969, a year after the system became operational, only 115 of the 143 individuals were using the association's system.

We interviewed 13 of the 28 individuals who were not using the system, to obtain their reasons as to why they were not using the association's facilities. Of the 13 individuals, six stated that they had adequate supplies of water from their ground wells and had no current need to purchase water from the association, four stated that they could not afford either the monthly user rate or the cost of installing service lines from their properties to the association's water line, and three stated that they would use the system in the near future.

We noted that the agreements signed by these individuals had not required them to pay minimum monthly rates to the association regardless of whether they actually used the system. The cash contribution of $5 required from each potential user was not based on the estimated cost of connecting a service line from an individual's property to the association's water system. This association, in our opinion, will become delinquent in repaying its FHA loan if there is no substantial increase in the number of users or in the user rate.

CHAPTER 3

CONCLUSIONS, RECOMMENDATIONS, AND AGENCY COMMENTS

CONCLUSIONS

FHA made loans and grants for financing the improvement and/or construction of water and/or sewer systems to associations which did not have the minimum number of users necessary for the systems to be operated successfully. The making of loans and grants to associations not having the required minimum number of users is a disservice to other rural communities which need loan and grant assistance and which have the required users to make their water and sewer systems financially successful.

As noted on page 8, the demand for assistance in financing water and sewer systems has been greater than the funds available during the past few years. This fact makes it increasingly important that FHA establish reasonable user requirements and procedures for enforcing such requirements, to ensure that loan and grant funds are provided only to those associations having financially feasible systems.

RECOMMENDATIONS TO THE ADMINISTRATOR, FHA

To provide greater assurance that an association's proposed system is sound and financially feasible, FHA should revise its instructions to require that financial assistance--loans and grants--be provided to an association under the water and sewer program only after FHA county and State loan approval officials have verified and documented in the loan files that an association has obtained

--the required number of users to make its proposed system financially feasible,

--a cash contribution from each prospective user to cover the estimated cost of connecting a service line from the user's property to the association's facilities, and

--an enforceable user agreement from each prospective user, which commits the user to pay at least a minimum monthly rate to the association regardless of whether he uses the system.

Also FHA should establish procedures for determining, on a systematic basis, whether associations are enforcing user agreements.

AGENCY COMMENTS

The Administrator, FHA, advised us by letter dated February 4, 1971 (see app. I), that our recommendations would help FHA further perfect its programs and that FHA planned to reinforce its instructions relating to water and sewer loans and grants with regard to membership requirements, user cash contribution requirements, and the enforcement of user agreements. He stated that the revised instructions would be implemented after review by FHA State directors and discussion at FHA training meetings in February 1971.

The Administrator stated also that it was his expectation that, through these revised instructions and training meetings with field staffs, FHA would overcome the problems presented in our report.

The Administrator stated further

--that FHA was giving a high priority in the administration of its programs to the strengthening of program terms and conditions and was putting heavy stress on the supervision of loans and

--that, in terms of the total outstanding loans for water and sewer systems, FHA had a good history in loan collections and that a preponderance of its borrowers were operating successfully.

He also pointed out that FHA had issued new and improved requirements for positive user verification while our review was in process.

We agree that, on an overall basis, FHA's history of loan collections under its water and sewer program has generally been satisfactory. As pointed out on pages 10 and 12, however, many borrowers are delinquent on their loan because they lack sufficient users to financially support their systems.

Our review further revealed a number of associations which, in our opinion, would eventually become delinquent on their loans if they did not obtain additional users or increase their user rates. We believe that, if loans continue to be made without adequate determinations regarding the sufficiency of users, the rate of loan delinquencies under the program will increase.

The improved user verification requirements referred to by the Administrator were included in a bulletin issued to field personnel in August 1970, subsequent to the completion of our fieldwork and discussions of our findings with FHA headquarters officials.

The bulletin, which expires in July 1971, provides that the FHA county or district supervisors verify user agreements signed by rural residents who have expressed a desire to support a proposed water or sewer system. Verification can be done by making personal contacts or by sending verification letters to the rural residents. This type of requirement should be incorporated in FHA's revised instructions.

We plan to review FHA's revised instructions after they are issued, to ascertain whether, if properly implemented, they will provide assurance that Government funds are provided only to associations whose proposed water and sewer systems are financially feasible.

CHAPTER 4

SCOPE OF REVIEW

Our review was made at the FHA headquarters office in Washington, D.C., and at the FHA State offices at Little Rock, Arkansas; Gainsville, Florida, Atlanta, Georgia, Orono, Maine, Jackson, Mississippi; Raleigh, North Carolina, Portland, Oregon, and Wenatchee, Washington. Each State office is responsible for FHA activities in one or more States.

We reviewed the pertinent policies and procedures under which FHA makes loans and grants to public and nonprofit associations for the improvement and/or construction of rural water and sewer facilities. We examined FHA and association records relating to 69 associations in 9 States--Arkansas, Florida, Georgia, Maine, Mississippi, North Carolina, Oregon, Vermont, and Washington--and interviewed 142 individuals who had signed user agreements. We also reviewed loan delinquency reports on the 270 water and sewer associations reported delinquent as of February 2, 1970.

APPENDIXES

UNITED STATES DEPARTMENT OF AGRICULTURE
FARMERS HOME ADMINISTRATION
WASHINGTON D C 20250

FICE OF THE ADMINISTRATOR

FEB 4, 1971

Mr. Bernard Sacks
Assistant Director
Civil Division
General Accounting Office
Washington, D. C

Dear Mr Sacks.

We appreciate the opportunity to review and comment on the draft of your report to the Congress on "Improvements Needed in Determining the Financial Feasibility of Rural Water and Sewer Projects."

We are giving a high priority in the administration of the FHA programs to the strengthening of program terms and conditions and we are putting heavy stress on the supervision of the loan. In terms of the total outstanding, we have a good history in loan collections and a preponderance of our borrowers are operating successfully. Your recommendations will help to further perfect our programs.

As you know, we issued new and improved requirements for positive user verification while this audit was in process and we plan to further reinforce our instructions in the areas of membership, user cash contribution requirements, and user agreement enforcement.

Our revised instructions will be circulated for review by state directors and will be discussed at the training meetings in February. Following these meetings, the instructions will be implemented.

It is my expectation that through revised instructions and training meetings with field staffs, we will overcome the problems presented in your draft report.

Sincerely,

JAMES V. SMITH
Administrator

PRINCIPAL OFFICIALS OF THE DEPARTMENT OF AGRICULTURE RESPONSIBLE FOR THE ADMINISTRATION OF ACTIVITIES DISCUSSED IN THIS REPORT

	Tenure of office	
	From	To
SECRETARY OF AGRICULTURE		
Clifford M. Hardin	Jan. 1969	Present
Orville L. Freeman	Jan. 1961	Jan. 1969
ASSISTANT SECRETARY OF AGRICULTURE FOR RURAL DEVELOPMENT AND CONSERVATION		
Thomas K. Cowden	Apr. 1969	Present
John A. Baker	Mar. 1961	Jan. 1969
ADMINISTRATOR, FARMERS HOME ADMINISTRATION		
James V. Smith	Jan. 1969	Present
Howard Bertsch	Apr. 1961	Jan. 1969

U S GAO Wash , D C