



San Joaquin Valley Air Pollution Control District

To Cover Its Costs, It Recently Increased Permit Fees and Continues to Use Supplemental Revenue but Can Improve Consistency and Transparency for Certain Program Requirements

Report 2015-125

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April 5, 2016

2015-125

The Governor of California
President pro Tempore of the Senate
Speaker of the Assembly
State Capitol
Sacramento, California 95814

Dear Governor and Legislative Leaders:

As requested by the Joint Legislative Audit Committee, the California State Auditor presents this audit report concerning the revenues and expenditures of the San Joaquin Valley Air Pollution Control District (district) and its implementation of certain program requirements.

This report concludes that the district's stationary source permit fees are allowable and generate fee revenue less than its costs. To make up the difference the district lawfully uses revenue each year from other sources, including revenue from penalties, interest earned, and state and federal grants, to supplement its permit fee revenue. After projecting a \$2 million shortfall for fiscal year 2014-15, the district sought, and enacted in April 2015, a fee increase of 4.8 percent beginning in fiscal year 2015-16 for the majority of its permits and an additional increase of 4.4 percent in fiscal year 2016-17. Although the district will need to continue to make use of its supplementary funding, it expects that the recent fee increases along with continued operational streamlining will enable it to balance its costs and revenues.

The district could improve the consistency and transparency of certain program requirements. Because of the role the district plays in issuing various stationary source permits, it can be named as a party in litigation under the California Environmental Quality Act (CEQA). To protect the district and its many regulated customers from the potential costs of CEQA litigation, the district requires a small number of permit applicants each year to provide the district additional financial security by signing an indemnification agreement and providing a letter of credit. Although the district has published a policy that specifies the circumstances under which permit applicants must provide indemnification agreements and letters of credit, in practice the district used its discretion to make the final decision of when to require these documents that sometimes varied from its policy and did not always document the rationale for its decisions. After we brought this matter to its attention, the district revised its policy indicating that it will conduct a case-by-case analysis for future projects and document its reasoning.

Respectfully submitted,



ELAINE M. HOWLE, CPA
State Auditor

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Summary

Results in Brief

The San Joaquin Valley Air Pollution Control District (district) adopts rules designed to meet the air quality standards for the San Joaquin Valley set by the U.S. Environmental Protection Agency related to stationary sources of pollution. To comply with federal and state law, the district has established a permitting system that requires every person or entity who operates a stationary source of air contaminants—that is, large, fixed, sources of air pollution, including power plants, refineries, and factories—to obtain a permit and pay a fee for that permit.

Our review found that the stationary source permit fees charged by the district are allowable and generate fee revenue less than its costs. From its permit fees, the district received an average of \$17.6 million, or 39 percent of its annual average operating revenue, for fiscal years 2010–11 through 2014–15. However, this revenue alone is not sufficient to cover the district's regulatory costs of inspection and review activities. To make up the difference, the district has other sources of revenue that it can lawfully use to supplement its permit fee revenue, including revenue from penalties, interest earned, and state and federal grants. For fiscal years 2010–11 through 2014–15, the district received an average of \$8.3 million annually, part of which it used to supplement its permitting program. In addition, the district maintains an unassigned fund balance in its general fund that it drew from in fiscal years 2012–13 and 2013–14. The district maintained an unassigned fund balance of between \$13.1 and \$14.3 million for fiscal years 2010–11 through 2013–14, or roughly three months of operating expenses.

During its annual budget process, the district evaluates whether its current revenue from permit fees and other supplementary sources is sufficient to cover its operations. If the budget analysis indicates that budgeted expenditures will exceed projected revenue even after the district implements feasible cost-cutting measures, the district will consider increasing its fees. Based on its annual budget analysis in 2013, the district projected a shortfall of approximately \$2 million for fiscal year 2014–15. The district later submitted a proposal to increase its permit fees, which its governing board adopted in April 2015. Specifically, the district enacted a fee increase of 4.8 percent for the majority of its permits for fiscal year 2015–16, with an additional increase of 4.4 percent for fiscal year 2016–17. Before these fee increases, the district had increased most of the permit fees by the same percentage (across the board) only two other times—in 1997 and 2008.

Audit Highlights . . .

Our audit concerning the revenues and expenditures of the San Joaquin Valley Air Pollution Control District (district) and its implementation of certain program requirements revealed the following:

- » *The stationary source permit fees charged by the district are allowable, but the fee revenue alone is not sufficient to cover the district's regulatory costs of inspection and review activities.*
- » *The district uses other sources to supplement its permit fee revenue, including revenue from penalties, interest earned, and state and federal grants.*
- » *After its most recent fee increase takes effect in fiscal year 2016–17, the district's permit fee revenue will continue to be below the costs related to each regulatory activity.*
- » *Although it had a policy, in practice the district used its discretion to make final decisions for requiring indemnification agreements and letters of credit from permit applicants that sometimes varied with its policy.*
- » *The district does not have an adequate system for requesting, maintaining, and tracking indemnification agreements and letters of credit.*

Legal requirements that apply to fees state that the district may not collect fees in excess of the costs to perform the related regulatory activity. Using the district's fiscal year 2013–14 fee revenue, we estimated that the district's revenue from each of its permit fees will continue to be 15 percent to 86 percent below the costs related to each respective regulatory activity after its most recent fee increase takes effect in fiscal year 2016–17. Therefore, to cover the costs of its operations, the district will need to use a portion of the other revenue it receives from penalties, interest earned, and state and federal grants. The district expects that the recent fee increases along with its continued operational streamlining will enable it to balance its costs and revenue.

Because of the role the district plays in issuing various stationary source permits, it can be named as a party in litigation under the California Environmental Quality Act (CEQA). Under CEQA regulations, two of the basic purposes are to inform individuals about potential, significant environmental effects of proposed activities and to identify ways that environmental damage can be avoided or significantly reduced. Under CEQA, a resident can bring a lawsuit if he or she believes those who are leading the project, or those who have some responsibility for the project, have not followed certain procedural requirements designed to protect the environment. To protect the district and its many regulated customers from the potential costs of CEQA litigation, the district requires certain permit applicants to provide the district additional financial security by signing an indemnification agreement and providing a letter of credit. An *indemnification agreement* is an agreement limiting the district's financial liability. A *letter of credit* is issued by a bank that agrees to provide prompt payment on behalf of the permit applicant, if needed. The district's published policy in place during our review specifies the circumstances under which permit applicants must provide indemnification agreements and letters of credit. However, this policy is inconsistent with the district's internal methodology for indemnification agreements for permit applicants. Specifically, the district's published policy focuses solely on the district's level of responsibility in approving the project as the determining factor in whether to require indemnification, while its internal methodology contradicts the published policy in certain instances where the district believes the project is not of public concern.

Additionally, in practice the district uses discretion to make the final decision as to whether to require an indemnification agreement and a letter of credit, and it does not always follow the published policy or internal methodology. The district justifies its decision to deviate from its policy or methodology by noting that it needs to use discretion so as not to be overly burdensome to permit applicants. For example, district rules require a dairy to obtain a

permit when it reduces the number of cattle at a site. If the district strictly followed its internal methodology, it would ask the dairy to sign an indemnification agreement, even though the change would reduce pollution and be unlikely to generate litigation. However, the district often did not document its rationale when it used discretion, with the result that we identified two similar projects for which the district made different decisions: it required an indemnification agreement and a letter of credit from one project and not the other. Without documenting its reasoning, the district cannot be fully transparent and demonstrate that it treats similar permit applicants consistently. After we discussed these concerns with the district, it published a revised policy in March 2016 indicating that the district will conduct a case-by-case analysis of whether to require an indemnification agreement or letter of credit, and it will document its reasoning. Finally, the district does not have an adequate system for requesting, maintaining, and tracking indemnification agreements and letters of credit. For one project, the district believed it had a letter of credit when it did not. For another project, the district did not request a new letter of credit to replace one that expired before the end of the agreed-upon time frame, causing the district to lose the protection it sought to obtain. Although our review revealed that the district requires these documents only from a few permit applicants, it is important for the district to ensure that the documents are in place if needed.

Recommendations

To ensure consistency between its published policy and its internal methodology so that permit applicants are aware of the district's requirements and receive equal treatment, the district should update its internal methodology by July 2016 to contain equivalent information to reflect its revised published policy.

To make certain that it can demonstrate consistency and transparency in its decision-making process when it determines which permit applicants it requires to provide additional financial security, the district—after updating its guidance documents—should follow its revised published policy and updated internal methodology for requiring indemnification agreements and letters of credit.

To ensure that the district is adequately protected from the costs of litigation, it should develop a protocol to maintain all required legal documents accurately and to make sure that those documents remain in effect. By July 2016, the district should adopt such a protocol for management of its centralized system for requesting, tracking, storing, and following up on indemnification agreements and letters of credit.

Agency Comments

The district stated that based on the concerns raised and our recommendations, as well as its core values which call for continuous improvement and open and transparent processes, it revised its policy to clearly describe the case-by-case nature of its risk management decisions and to require documentation of those decisions.

Introduction

Background

To protect air quality across the country and to promote public health and welfare, Congress enacted the federal Clean Air Act, which regulates air emissions from stationary sources, including factories and chemical plants, and mobile sources, such as motor vehicles. To implement the law, the U.S. Environmental Protection Agency (U.S. EPA) sets air quality standards for various air pollutants, establishing levels so as to protect public health and welfare. For each air quality standard, the U.S. EPA also designates geographic regions as either *attainment areas*, which are at or below the level established by the U.S. EPA for that pollutant, or as *nonattainment areas*, which are above the established level for the pollutant.

To achieve the goals of the federal Clean Air Act, the U.S. EPA works with the states, including California, under a cooperative model. States have primary responsibility for assuring air quality within their respective boundaries and must develop a state implementation plan that specifies how the state will meet and maintain air quality standards. In California, the California Air Resources Board regulates the air pollution caused by motor vehicles, and the local air quality control districts regulate the air pollution caused primarily by stationary sources—large, fixed sources of air pollution, including power plants, refineries, and factories. The San Joaquin Valley Unified Air Pollution Control District (district) adopts rules designed to meet the air quality standards set by the U.S. EPA for the San Joaquin Valley related to stationary sources of pollution.¹

The district began operating in March 1991 and was formed through the merger of existing county districts covering eight counties: San Joaquin, Stanislaus, Merced, Madera, Fresno, Kings, Tulare, and part of Kern. Figure 1 on the following page shows the boundaries of the district. State law requires that the district be governed by a 15-member board, including one member appointed by each county's board of supervisors; one medical or science professional and one physician, each appointed by the governor; and five city council members from cities within the district. These city council members are appointed by a special city selection committee consisting of one city council member from each city located within the district's territory. A majority of members on each city council chooses the member who will sit on the special city selection committee.

¹ Although the district's official name includes *Unified*, it typically uses its more common name—the San Joaquin Valley Air Pollution Control District. Therefore, throughout this report, we use its common name.

Figure 1
Boundaries of the San Joaquin Valley Air Pollution Control District



Source: San Joaquin Valley Air Pollution Control District.

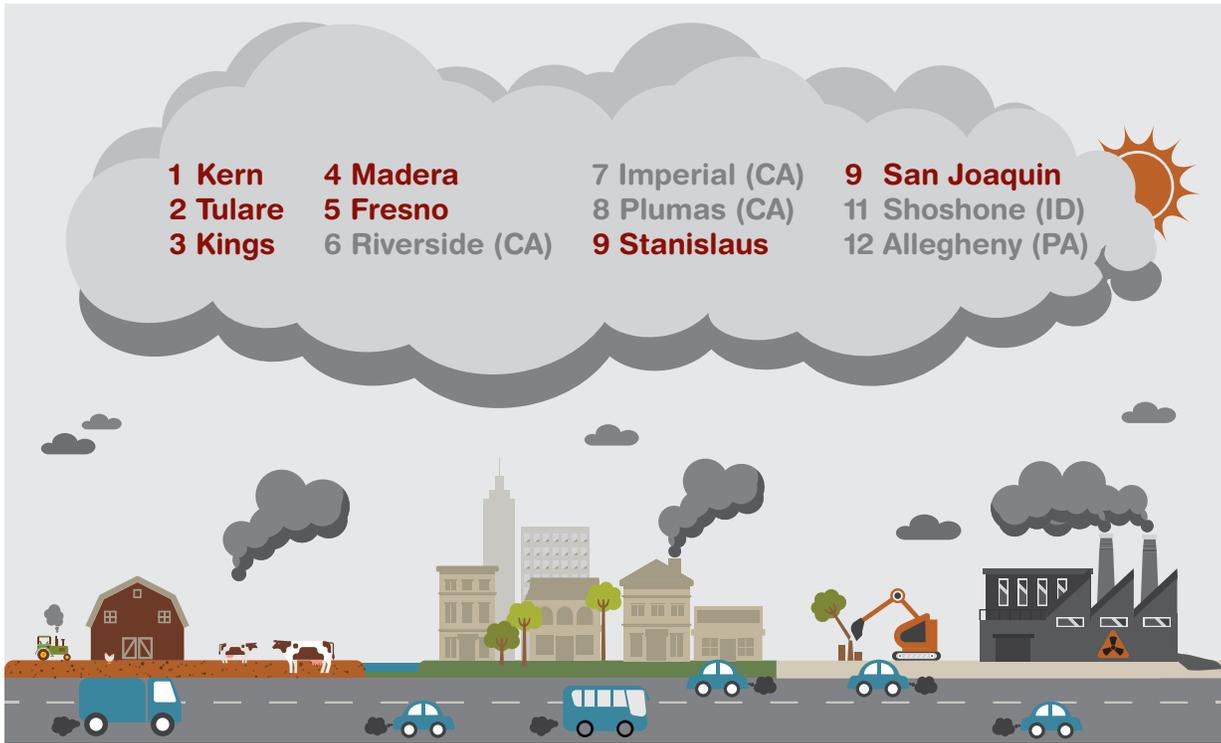
The San Joaquin Valley's climate, transportation infrastructure, industrial demographics, and geography make it highly susceptible to air pollution. In fact, the district has been designated by the U.S. EPA as a nonattainment area since the early 1990s, and it is currently designated as a nonattainment area for certain types of pollution, meaning its levels exceed the established levels for those pollutants. The district comprises the entire San Joaquin Valley Air Basin, which is approximately 250 miles long, stretching from Stockton to Bakersfield, and which is bordered on three sides by mountain ranges that capture air pollution. Pollution in the San Joaquin Valley comes from numerous sources, including 4 million residents who live in the valley and their vehicles.

The San Joaquin Valley also contains two prominent highways: Interstate 5 and State Route 99. In addition, a number of stationary sources of air pollution affect air quality in the district. According to the U.S. EPA, the San Joaquin Valley is California's top agricultural producing region, growing more than 250 unique crops. Further, the U.S. Department of Agriculture reports that California has the most dairy cows of any state in the nation, and 89 percent of the State's dairy cows live in the San Joaquin Valley. These agricultural activities create dust and other air pollutants that the district regulates. Another source of air pollution in the valley is oil and gas production from refineries. All of these factors combined have made the counties within the district among the most polluted the U.S. EPA has measured nationally for small particle pollution, as can be seen in Figure 2 on the following page. *Small particle pollution* consists of particles found in the air, such as dirt, dust, soot, smoke, and liquid droplets, that are less than 2.5 micrometers and small enough to lodge deeply in the lungs. High levels of air pollution, specifically ozone and particle pollution, threaten the health and lives of those who live in such areas by causing respiratory and cardiovascular problems—including asthma, heart attacks, and strokes—and particle pollution may also cause cancer.

District Permitting Fees and Revenue

The federal Clean Air Act requires each state to establish a stationary source permitting system (permitting system). In addition, California law authorizes every air pollution control district to establish a permitting system that requires every person who operates a stationary source of air contaminants to obtain a permit from the district. To implement its permitting system, the district has adopted rules that impose certain requirements on various activities that result in stationary source pollution, and it charges fees for issuing permits and conducting related regulatory activities. These permits include permits covering the construction and operation of certain types of pollution-causing equipment. The district may combine the fees it receives from these permits and use the funds to cover the costs of district programs related to permitted stationary sources of pollution.

Figure 2
The Most Polluted Counties for Small Particle Pollution



Source: U.S. Environmental Protection Agency's (U.S. EPA) PM_{2.5} county-level summary for annual design values for 2012 through 2014. PM_{2.5} pollution is small particles found in the air, such as dirt, dust, soot, smoke, and liquid droplets, that are less than 2.5 micrometers in size.

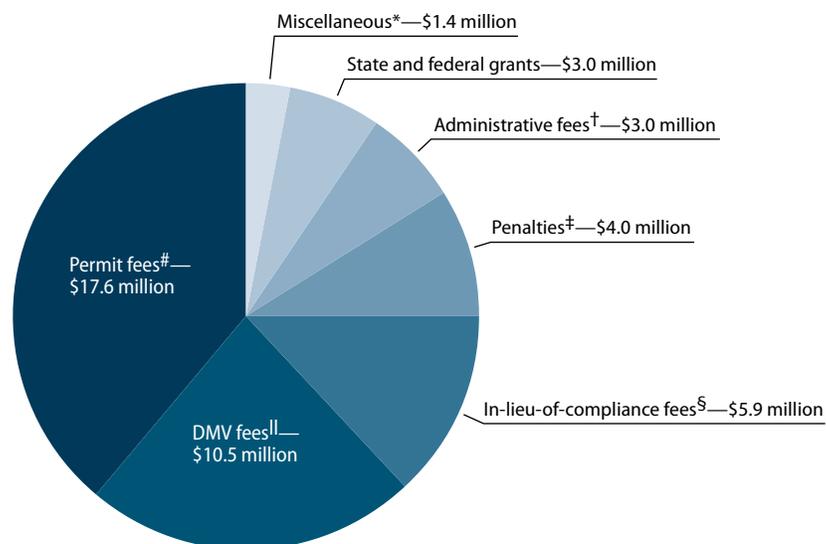
Note: Counties identified in red are seven of the eight counties that constitute the San Joaquin Valley Air Pollution Control District. Merced, the eighth county, was the 21st most polluted county for PM_{2.5} levels. Stanislaus and San Joaquin had the same annual PM_{2.5} level. The ranking includes 470 counties nationally for which the U.S. EPA calculated values based on county-reported data that met certain mandatory requirements for 2012 through 2014. Counties that did not submit information or that submitted incomplete information are not included in the ranking.

Under its permitting system, the district also charges other program fees. These other program fees—which we refer to as *special program fees*—are for specific programmatic purposes. For example, it charges a special program fee for those who register portable emissions-generating equipment. According to the proposal establishing the fee, this fee is to cover the cost of administering the portable equipment registration program. The district also regulates certain other “nontraditional” stationary sources of pollution, such as asbestos removal and wood-burning heaters, and it charges special program fees to cover the costs of regulating those specific activities. In addition, the district charges certain other fees, which we refer to as *in-lieu-of-compliance fees* because fee payers may pay these fees to avoid complying with a pollution reduction rule or to be able to comply with a less strict requirement. The district must use the revenue it obtains from these in-lieu-of-compliance fees to support pollution reduction activities related to the same types of pollution the rule seeks

to reduce. For fiscal years 2010–11 through 2014–15, the district received annual average revenue of \$5.9 million from one of its in-lieu-of-compliance fees, the Advanced Emissions Reduction Option. For two of these years, the district also received a small amount from another in-lieu-of-compliance fee, the Internal Combustion Engine Option. According to a deputy air pollution control officer, the district has spent this revenue on projects aimed at advancing emission reduction technology and on various emissions reduction projects funded by the district's grant components. Examples of the fees charged appear in the Appendix.

From fiscal year 2010–11 through 2014–15, the district's annual operating revenue averaged more than \$45.4 million, which includes revenue for its permitting activities as well as other district functions. As shown in Figure 3, the district's annual revenue from its permit fees, on average, was \$17.6 million for the same period.

Figure 3
Average Annual Operating Revenue Sources for the San Joaquin Valley Air Pollution Control District
Fiscal Years 2010–11 Through 2014–15



Sources: Accounting system and comprehensive annual financial reports for fiscal years 2010–11 through 2014–15 for the San Joaquin Valley Air Pollution Control District (district).

* Miscellaneous revenue includes sources such as interest earned.

† According to the district's director of incentives and administrative services, administrative fees are portions of grant funds received by the district designated to cover its costs to administer the grants.

‡ Penalties include revenue from charges relating to noncompliance with district rules. The district refers to these penalties as *settlements*.

§ *In-lieu-of-compliance* fees is our term for the four fees that can be paid in lieu of complying with an emissions limit.

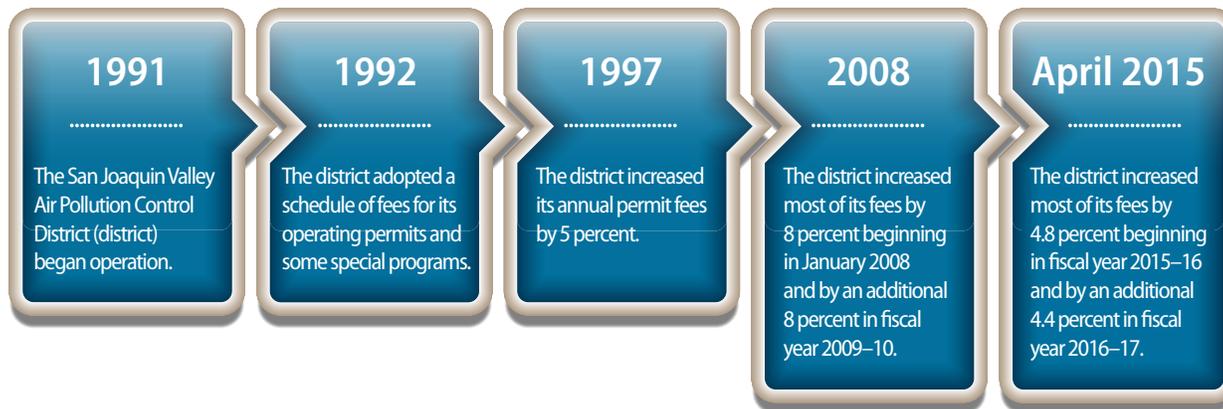
|| State law allows the district to receive fees collected from motor vehicle registrations to use to reduce air pollution from motor vehicles and for related planning, monitoring, enforcement, and technical studies necessary for the implementation of the California Clean Air Act of 1988. These fees cannot be used to support the district's stationary source permitting system.

Permit fee revenue includes revenue from construction, annual operating, and special program fees.

Since establishing its initial schedule of fees in 1992, the district has uniformly increased the majority of its fees three times: in 1997, 2008, and 2015. As shown in Figure 4, in 1997 the district increased its fees by 5 percent; in 2008, it instituted a two-part increase of 8 percent in fiscal year 2008–09 and another 8 percent increase in 2009–10; and in 2015, it instituted another two-part increase of 4.8 percent in fiscal year 2015–16 and an additional 4.4 percent in fiscal year 2016–17. The district has also amended individual rules governing air pollution to add fees. For example, the district amended a rule in January 2015 to add the option of paying a fee in lieu of compliance with a stricter emissions limit on heaters. Sellers of heaters would either have to sell only units that comply with the new limit or pay the district a fee per noncompliant unit sold.

Figure 4

Time Line of the San Joaquin Valley Air Pollution Control District's Creation and Fee Increases



Sources: District's consolidated annual financial reports, minutes from the district's governing board meetings, and staff reports to the district's governing board.

Scope and Methodology

The Joint Legislative Audit Committee directed the California State Auditor to perform an audit to determine the sufficiency of revenue from stationary sources of air pollution and permit fees and to assess whether the district's policies require certain entities to post bonds against potential lawsuits. Table 1 lists the audit objectives and the methods we used to address them.

Table 1
Audit Objectives and the Methods Used to Address Them

AUDIT OBJECTIVE	METHOD
1 Review and evaluate the laws, rules, and regulations significant to the audit objectives.	Reviewed relevant laws, regulations, and other background materials applicable to the San Joaquin Valley Air Pollution Control District (district).
2 Determine whether the district’s revenue from stationary sources and permit fees are sufficient to fund selected industries’ permitting and regulation programs including, but not limited to, the following: <ul style="list-style-type: none"> <li data-bbox="342 615 786 674">a. Review district policies and methodologies for setting fee rates. <li data-bbox="342 684 786 982">b. Assess whether the fees are reasonable and allowable. Review revenue, expenditures, and fund balances of fee-based programs over the past five fiscal years. <li data-bbox="342 993 786 1129">c. Assess if the district is supplementing certain programs with funds from other fee-based programs or other state and federal fund sources. 	<ul style="list-style-type: none"> <li data-bbox="813 615 1511 674">• Reviewed the methodology for each of the district’s rules that set a fee and determined whether the methodology was reasonable and authorized by law. <li data-bbox="813 684 1511 716">• Reviewed revenue for fiscal years 2010–11 through 2014–15. <li data-bbox="813 726 1511 758">• Reviewed the method the district uses to determine expenditures for each fee rule. <li data-bbox="813 768 1511 800">• Reviewed the process the district used for its last fee increase to assess whether revenue exceeded expenditures and whether fees were raised appropriately. <li data-bbox="813 810 1511 915">• Selected and reviewed 10 Authority to Construct permit fees from fiscal year 2010–11 through 2014–15 that district rules require it to charge based on an hourly rate that is updated each year. Our review found that the district billed the appropriate hourly rate for the number of hours indicated in its invoices. <li data-bbox="813 926 1511 982">• Reviewed the categories district staff charge time toward for activities relating to its fees and found all of the categories to be reasonably related to the fee charged. <li data-bbox="813 993 1511 1066">• For its 2015 fee increase analysis, identified the amount of supplementary revenue used by the district and determined whether, based on our review of relevant criteria, the funds could be used to supplement its fee-based programs. <li data-bbox="813 1077 1511 1129">• Reviewed the district’s process for identifying whether it has sufficient revenue to operate its fee-based programs.
3 Determine whether the district’s policies require certain entities to post bonds against potential lawsuits resulting from the district’s granting of permits including, but not limited to, the following: <ul style="list-style-type: none"> <li data-bbox="342 1140 786 1266">a. Review district methodologies for establishing bonding policies and assess whether they are reasonable. <li data-bbox="342 1276 786 1413">b. Assess which types of permits meet the bonding requirement set by the district. <li data-bbox="342 1423 786 1843">c. Determine whether the district budgets for litigation costs resulting from contested permits. If it does, assess the reasonableness of the funding amount and any relationship the funding may have to entities required to post bonds. 	<ul style="list-style-type: none"> <li data-bbox="813 1140 1511 1192">• Determined that the district does not require bonds but instead requires indemnification agreements and letters of credit when needed. <li data-bbox="813 1203 1511 1266">• Reviewed the district’s publicly available policy and internal methodology to determine when the district would require an indemnification agreement or letter of credit and determined whether the guidance was reasonable and consistent. <li data-bbox="813 1276 1511 1329">• Obtained a list of projects for which the district required the applicant to provide additional financial security. <li data-bbox="813 1339 1511 1413">• Judgmentally selected and reviewed 19 projects from fiscal year 2010–11 through 2014–15 for which the district should have required the applicant to provide an indemnification agreement and letter of credit according to its policy or internal methodology. <li data-bbox="813 1423 1511 1476">• For the 19 projects, determined whether the district followed its policy and internal methodology and whether any deviation from its policy was reasonable. <li data-bbox="813 1486 1511 1539">• The district does not discretely budget for litigation costs from contested permits. However, its legal expenditures have been minimal. <li data-bbox="813 1549 1511 1602">• The district’s average annual expenditures for its legal department for fiscal years 2010–11 through 2014–15 were \$514,600. <li data-bbox="813 1612 1511 1686">• Over the same five fiscal years, the district spent less than \$4,000 in total to hire external legal counsel to help with litigation and other matters.
4 Review and assess any other issues that are significant to the audit.	We did not note any other significant issues.

Sources: California State Auditor’s analysis of Joint Legislative Audit Committee audit request number 2015-125, and information and documentation identified in the table column titled *Method*.

Assessment of Data Reliability

The U.S. Government Accountability Office, whose standards we are statutorily required to follow, requires us to assess the sufficiency and appropriateness of computer-processed information that we use to support our findings, conclusions, or recommendations. In performing this audit, we obtained electronic data files extracted from the district's Serenic Navigator system for July 1, 2010, through June 30, 2015. We did not perform accuracy and completeness testing on these data because the district's Serenic Navigator system is a mostly paperless system. Alternatively, we could have reviewed the adequacy of selected information system controls but determined that this level of review was cost-prohibitive. However, to gain some assurance of the reliability of the data for revenue by fee category and expenditures by division, we compared Serenic Navigator information to the district's audited financial statements and found that the data were consistent with reported financial information. As a result, we assessed the data as being of undetermined reliability for the purpose of calculating the district's revenue and expenditures. Although this determination may affect the precision of the numbers we present, we found sufficient evidence in total to support our findings, conclusions, and recommendations.

Audit Results

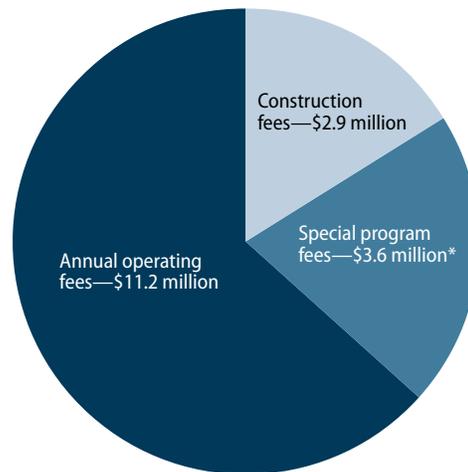
The San Joaquin Valley Air Pollution Control District's Permit Fee Revenue Is Below Its Costs, and It Supplements This Revenue With Other Sources of Funding

The stationary source permit fees (permit fees) charged by the San Joaquin Valley Air Pollution Control District (district) are allowable and generate fee revenue less than the district's costs. As described in the Introduction, the district operates a stationary source permitting system (permitting system) for which it charges fees for the permits it issues. The district initially established its permit fees in 1992. State law allows the district to adopt, by regulation, a schedule of annual fees to cover the cost of district programs related to permitted stationary sources. The district may not collect fees in excess of the associated costs.

To help determine the costs associated with the various fees, the district has established a process for staff to charge their time to activities relating to specific fee rules, which are district regulations implementing its various programs. Our review found that the activities to which district staff charged their time related reasonably to the fees charged. For example, district staff charged time to the agricultural burning fee for activities such as preparing inspections and processing permits relating to agricultural burning. The district used the hours staff charged to estimate the expenditures relating to each fee rule. For its most recent fee increase, the district calculated the costs associated with each fee by using a percentage based on the number of hours that each division charged to a particular fee compared to the total expenditures for that division. For example, in fiscal year 2013–14, staff in the district's permitting division spent 339 hours on activities related to the certified air permitting professional fee, and the district assigned a proportional share of expenditures, nearly \$45,000, to that fee. Following the district's method, we found that none of the revenue for a particular fee exceeded the regulatory costs associated with that fee.

The district's fee revenue covers only a portion of the costs of its permitting system. As noted in Figure 3 on page 9, an average of \$17.6 million, or 39 percent of the district's annual average operating revenue for fiscal years 2010–11 through 2014–15, came from its permit fees. This revenue consists of revenue from the district's construction, annual operating, and special program fees, as shown in Figure 5 on the following page. However, this revenue has not been sufficient to cover the regulatory costs of the inspection and review activities for any of the district's programs for which it charges fees. Specifically, when the district analyzed its permitting system revenue and expenditures for fiscal year 2013–14 in connection with its most recent fee increase, it found that each fee's revenue was less than the fee's associated regulatory cost.

Figure 5
Average Annual Permit System Revenue Sources for the San Joaquin Valley
Air Pollution Control District
Fiscal Years 2010–11 Through 2014–15



Source: Accounting system for the San Joaquin Valley Air Pollution Control District.

Note: The average annual permit fee revenue sources total is \$17.7 million, which is slightly higher than the amount shown in Figure 3. The differences are due to rounding.

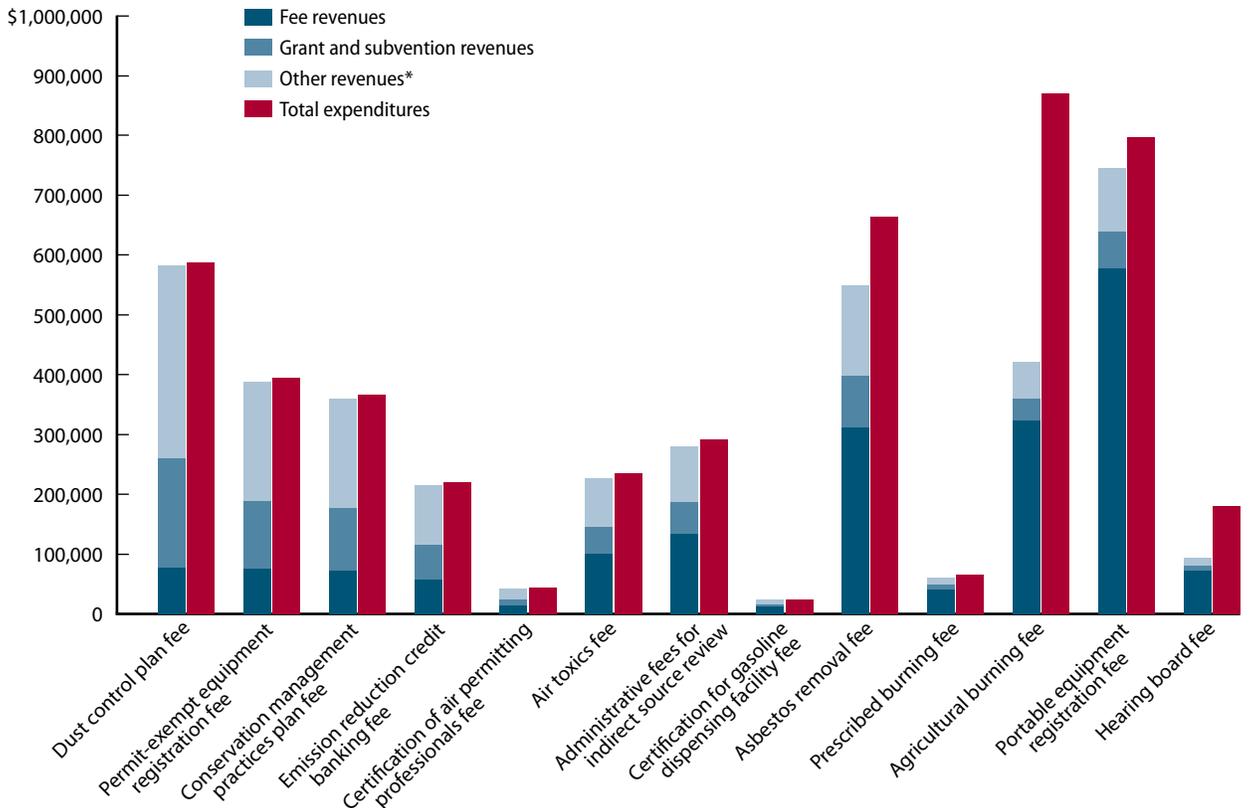
* Revenue for select special program fees is broken out in Figure 6.

The district also has other sources of revenue that it uses to supplement its permit fee revenue, including revenue from penalties, interest earned, and state and federal grants. The legal restrictions for the penalty revenue and the state and federal grants allow these amounts to be used to supplement the permitting system. For fiscal years 2010–11 through 2014–15, the district received an average of \$8.3 million annually from these other sources of revenue. Although the district identifies total supplemental revenue in its financial statements, the district does not typically distinguish how much revenue from other sources it uses to supplement its permitting system versus how much it uses for other functions. However, when calculating its most recent fee increase, it identified approximately \$4.9 million in supplementary revenue in fiscal year 2013–14 that it allocated specifically for its permitting system.

The district's director of incentives and administrative services stated that, in calculating the recent fee increase, the district allocated this \$4.9 million in supplementary revenue to the various fee rules in proportion to the district's expenditures related to each fee rule. She also stated that expenditures for each rule can fluctuate annually based on the demands of each permit or program. Therefore, according to this director, the district used its discretion to adjust the allocation of the other revenue amounts among the rules to keep the fees for each rule stable year to year.

For example, the district increased the amount of supplemental funding assigned to its dust control plan fee rule, noting costs were well above average in fiscal year 2013–14 because of conditions caused by the drought. As a result of these calculations, the district assigned each fee rule a different percentage of the supplementary funding. After this allocation, each fee’s total revenue was still less than the associated expenditures, as shown for select special program fees in Figure 6. The district also had an unassigned fund balance in its general fund, which it drew on in fiscal years 2012–13 and 2013–14. As of June 2014, the fund balance was \$13.3 million. Although the district needed to use less of its unassigned fund balance than it budgeted in fiscal years 2012–13 and 2013–14, it projected that it would continue to draw from its fund balance in the future. Budgeted use of its fund balance is one criterion the district considered when analyzing the need for a fee increase. From fiscal year 2010–11 through 2013–14, the district maintained an unassigned fund balance in its general fund of between \$13.1 and \$14.3 million, which is equivalent to roughly three months of operating expenses.

Figure 6
Select Special Program Fee Revenue and Related Expenditures for the San Joaquin Valley Air Pollution Control District
Fiscal Year 2013–14



Source: San Joaquin Valley Air Pollution Control District (district) fee review completed in 2015.

Note: The above fees include all special program fees for which the district analyzed revenue and expenditures for its most recent fee increase. It does not include the federally mandated ozone nonattainment fee, which is set in the federal Clean Air Act, and the Regulation VII alternative compliance plan review fee, as the district did not collect any revenue for the fee in fiscal year 2013–14.

* Other revenues include amounts from interest and penalties from noncompliance with district rules.

During its annual budget process, the district considers whether current revenue is adequate to cover its costs. If it is not, the district may pursue a fee increase.

As part of the district's annual budget process, it considers whether current revenue is adequate to cover costs. If not, the district may pursue a fee increase. During its budget process, the district projects the workload associated with its tasks and functions, and then it calculates the associated labor costs, including its indirect costs. In addition, the district develops five-year revenue projections for each of its fee-based rules. According to the director of incentives and administrative services, the district then determines whether the revenue other than fees, such as funding from grants and penalties as well as unassigned fund balances, are adequate to balance its budget. If the budget analysis indicates that the district will have insufficient total funds even after implementing feasible cost-cutting measures and after reviewing the need for discretionary tasks, the district will consider increasing its fees.

According to a deputy air pollution control officer, based on its annual budget analysis in 2013 and other financial information, the district informed the governing board (board) that a fee increase might be necessary. At that time, the district projected that its operating revenue would be approximately \$2 million short of its expenses for fiscal year 2014–15. In September 2013, the board approved a review of a potential fee increase. The district later submitted a proposal to amend the district's fee rules, which the board adopted in April 2015. This amendment increased the majority of the district's permitting program fees by 4.8 percent beginning on July 1, 2015, and by an additional 4.4 percent beginning on July 1, 2016.

In addition, according to the board's meeting agenda item for the proposal, the district adjusted three particular fees to ensure adequate cost recovery and to avoid circumstances in which some businesses subsidized costs for others. Specifically, the district increased its hearing board fees by the same percentage as it had increased the other fees, but it also added an excess emissions fee for certain applicants. The district's March 2015 staff report noted that certain applicants require additional staff time because of the size of the variance from district rules they are requesting from the hearing board. A *variance* is a temporary order allowing an entity to continue operations while it comes into compliance with district rules. To recoup some of these additional costs, the district imposed a new fee for variances with excess emissions. The district also changed its agricultural burning fee to \$36 per burn site. Previously, the district had charged a permit fee amount based on the number of burn locations—one site, two sites, or three or more sites. Therefore, before the change in the fee's structure, a small farmer with three burn sites would pay the same fee as a large operation with 100 burn sites. Finally, the district increased its asbestos removal fee by 37 percent for fiscal year 2015–16. A district deputy air pollution control officer indicated

that the district raised this fee because regulating asbestos removals consistently costs the district more than the revenue generated by the fee and because the asbestos removal fee is a stand-alone fee with a narrow scope of functions performed by the district.

Before the fee increase was approved in April 2015, the district had increased the majority of the permit fees by the same percentage (across the board) only two other times—in 1997 and 2008. In its most recent fee increase proposal, the staff report states that the district had minimized its need for across-the-board fee increases by adhering to fiscally conservative principles aimed at maximizing efficiency and minimizing costs, such as leveraging technology and streamlining processes to reduce related operating costs. Using the district's fiscal year 2013–14 fee revenue, we estimated that the district's permitting system fee revenue will continue to be 15 percent to 86 percent below the costs of the respective regulatory activities after its most recent fee increase takes full effect in fiscal year 2016–17. Therefore, the district will still need to make use of a portion of the other revenue it receives from penalties, interest earned, and state and federal grants to supplement its permit fee revenue. The district projected that with the fee increases and continued operational streamlining it will be able to balance its costs and revenue.

We estimated that the district's permitting system fee revenue will continue to be 15 percent to 86 percent below the costs of the respective regulatory activities after its most recent fee increase takes full effect in fiscal year 2016–17.

The District Can Improve the Consistency and Transparency of Its Process for Requiring Additional Financial Security and Indemnification From Permit Applicants

To protect the district and its many regulated customers from the potential costs of litigation, each year the district identifies projects that it considers a litigation risk and requires the permit applicants to sign an indemnification agreement and provide a letter of credit. The district issued an annual average of more than 4,600 Authority to Construct permits (construction permits) for fiscal years 2010–11 through 2014–15, and it has required fewer than 15 indemnification agreements and only 10 letters of credit on average for the last 5 fiscal years. An *indemnification agreement* is an agreement limiting the district's financial liability and has no immediate financial cost. A *letter of credit* is issued by a bank that agrees to provide prompt payment on behalf of the permit applicant, if needed, unlike a bond, which may be subject to substantial delays when the district attempts to collect. The applicant generally must pay a charge to its bank for the letter of credit. If the district draws on a letter of credit, the bank then seeks payment from the applicant.

The indemnification agreements and letters of credit that the district requires are intended to mitigate the potential costs of litigation under the California Environmental Quality Act (CEQA).

California enacted CEQA in 1970, and it is an essential component of the district's permitting process. According to state regulations, two of the basic purposes of CEQA are to inform individuals about potential, significant environmental effects of proposed activities and to identify ways that environmental damage can be avoided, significantly reduced, or mitigated. Further, state regulations require public agencies to disclose why the agencies approved projects if they involve significant environmental effects. Under CEQA, a resident can bring a lawsuit if he or she believes a project did not adequately mitigate the pollution it caused.

The district's decisions as to which projects require indemnification agreements and letters of credit are informed by the role played by the district under CEQA. Specifically, CEQA and its guidelines define an agency's role in the permitting process as that of either the lead agency or a responsible agency. The *lead agency* has principal responsibility for carrying out or approving a project that may have a significant effect upon the environment. According to state regulations, the lead agency on a project likely to have various environmental impacts that require approvals will normally be the agency with a general governmental purpose, such as a city or county, rather than an agency with a single or limited purpose, such as an air pollution control district. An entity that has some responsibility in the environmental approval process but that is not the lead agency is deemed a *responsible agency*. For example, according to the district counsel, when a dairy increases its herd, the district is most often a responsible agency because it has the single purpose of air quality management. However, air quality is just one among various environmental concerns that the project could potentially affect; these concerns include water quality, waste management, habitat conservation, and community conservation, which are outside the district's purview. CEQA regulations also include guidelines for another category the district uses in deciding whether to require an indemnification agreement: whether the proposed project may have a "significant" effect on the environment.

The district's CEQA implementation policy for construction permits, approved by district staff in 2010 and in place during our review, clearly states that when the district is the lead agency, it must require both an indemnification agreement and a letter of credit. The policy also states that when the district acts as a responsible agency for CEQA purposes, it may require an indemnification agreement. However, the district's guidance to staff—which includes a procedural memo and a decision matrix (internal methodology)—for generally identifying which projects require an indemnification agreement or letter of credit provides some inconsistent guidance to staff. As shown in Table 2, the district developed a matrix to help staff identify projects that

The district's guidance to staff for generally identifying which projects require an indemnification agreement or letter of credit provides some inconsistent guidance to staff.

require additional security through an indemnification agreement and a letter of credit. The matrix indicates that district staff should consider whether or not the permit application is a subject of public concern. In its procedural memo, the district identifies specific areas that it considers to be of public concern. Despite the fact that the district’s published policy clearly requires both an indemnification agreement and a letter of credit when the district acts as the lead agency in an authority-to-construct situation, according to the matrix, district staff would not ask for a letter of credit if the district is the lead agency on a project that has less than significant emissions and for which there is no public concern. Instead, staff would only require an indemnification agreement.

Table 2
San Joaquin Valley Air Pollution Control District’s Internal Matrix for Requiring Indemnification Agreements and Letters of Credit

DISTRICT DISCRETION	CALIFORNIA ENVIRONMENTAL QUALITY ACT DETERMINATION			
	LESS THAN SIGNIFICANT*		SIGNIFICANT*	
	DISTRICT IS LEAD*	DISTRICT IS RESPONSIBLE*	DISTRICT IS LEAD*	DISTRICT IS RESPONSIBLE*
Public concern†	Indemnification agreement and letter of credit required			
No public concern†	Indemnification agreement required	Nothing required	Indemnification agreement and letter of credit required	Indemnification agreement required

Source: San Joaquin Valley Air Pollution Control District (district).

* Under regulations adopted to implement the California Environmental Quality Act, a proposed project can be considered “significant” or “less than significant” based on the amount of air pollution generated by the project. The statute also identifies public agencies involved in the approval of the project as either *lead agency* or *responsible agency*, where the lead agency has primary reviewing responsibility.

† At the district’s discretion, it considers certain projects to be of public concern and thus more likely to generate litigation. Although the list of projects that are of public concern changes, in recent years the district has considered projects such as dairy operations, oil and gas refineries, and winery fermentation tanks to be projects of public concern.

Despite having a published policy and an internal methodology, the district does not always follow either the policy or the methodology when obtaining indemnification agreements and letters of credit from permit applicants. We reviewed 19 projects for which, based on the district’s policy and methodology, the district should have required indemnification agreements and letters of credit. For seven of the 19 projects, the district did not require indemnification agreements and letters of credit consistent with its policy or internal methodology. In three of these seven instances, the district was the lead agency, and, under the district’s policy, it should have required indemnification agreements and letters of credit. When we asked why the district did not require these documents, a deputy air pollution control officer stated that the district has never required indemnification agreements for all projects for which the district is the lead agency because it wants to avoid placing an unnecessary burden on permit applicants. For example, because the

district could be the lead agency for a project that involves little risk of litigation, such as a change in equipment that actually reduces harmful emissions, it might be reasonable for the district to use its discretion.

For the remaining four projects, the district was a responsible agency, and the projects were for facilities or operations that the district deemed to be of public concern. According to a deputy air pollution control officer, the district can require indemnification agreements and letters of credit for potentially controversial projects, but it makes that risk management decision on a case-by-case basis, taking into account several factors. For two of these projects, the district documented its reasons for not requiring the indemnification agreements and letters of credit, providing reasonable justifications that the project risks did not appear to merit them. The district did not document its rationale for not requiring indemnification agreements and letters of credit from the other two projects, both dairies, but it indicated to us that it did not require indemnification for one because the project did not involve an increase in emissions. For the other project, the district thought it had a valid letter of credit from another project by the permit applicant and thus did not need additional security. However, as we discuss later, we found that this letter of credit had expired.

Under its published policy, the district should have required an indemnification agreement and a letter of credit for two similar projects. However, it required these documents for one project but not the other.

As a result of its contradictory guidance and practices, the district did not always treat applicants with similar projects consistently. For example, for two projects involving wineries, the district, as the lead agency for both projects, should have required an indemnification agreement and a letter of credit under its published policy. However, it required these documents for one project but not the other. The district's director of permit services stated that the district did not ask for an indemnification agreement and a letter of credit from one of the applicants because the project would not result in an increase in emissions. The director of permit services acknowledged that the district did not follow its policy in this instance and stated that the district needs to revise its policy.

We also identified two projects involving the dairy industry, an industry that the district identified in its internal procedure memo as one of public concern and thus requiring indemnification agreements and letters of credit. The dairy projects both involved reducing or redistributing the herds, meaning the projects would not increase either dairy's emissions. Under district rules, a permitted polluter must obtain a new permit if there is a substantial change in projected emissions, even if the emissions will decrease. However, for these two similar projects, the district required an indemnification agreement and a letter of credit for one and not the other. When we brought this inconsistency to

the district's attention, the director of permit services told us that, unless directed by district counsel, the district does not require indemnification agreements for projects with no increase in emissions.

According to a district deputy director, the district does not always require indemnification agreements because it does not want to be overly burdensome. Although the district's position may be reasonable, as a project that reduces emissions is unlikely to result in litigation, it does not explain why the district has a practice that differs from its written policy and methodology or why similar projects are treated differently. Additionally, the district did not document the reasons for its decisions in five of the seven instances when it did not follow its published policy or internal methodology, thus decreasing the transparency of its actions. Although the district may feel it necessary to use discretion in its decisions, without documentation to support its reasons for deviating from its policy and methodology, the district cannot demonstrate transparency and that it treats similar projects fairly. After we discussed these concerns with the district, it published a revised policy in March 2016. The revised policy no longer requires the district to obtain an indemnification agreement or letter of credit. Instead, the policy provides discretion by specifying that each decision is based on a case-by-case analysis of certain factors, such as potential litigation risk and potential for significant impacts, among others. The policy also requires the district to document its reasoning for whether to require an indemnification agreement or letter of credit.

Further, the district's indemnification agreements that we reviewed differed from its published policy in place during our review. Although the district's policy states that the a permit applicant will bear the burden of liability for potential litigation and the expense of such litigation, the district's indemnification agreement only requires a permit applicant to pay the litigant's attorney's fees and court costs, and it does not require the applicant to pay the district's costs to defend itself. When we asked the district why its policy and indemnification agreement are not consistent, the district's counsel stated that the policy and indemnification agreement should be read together. However, the published policy, which is available to the public, may lead the public to believe that the district's indemnification agreement requires certain permit applicants to cover the district's entire legal costs and that such situations would leave the district with no responsibility for legal expenses related to approving CEQA projects.

We also noted lapses in the district's document retention and in its maintenance of indemnification agreements and letters of credit that could put the district at risk in the event of litigation. During our audit, the district had difficulty compiling a complete list of

Without documentation to support its reasons for deviating from its policy and methodology, the district cannot demonstrate transparency and that it treats similar projects fairly.

We found a letter of credit that expired before the date set forth in the indemnification agreement, leaving the district without the financial security it intended.

all the indemnification agreements and letters of credit it required for the past 5 years. The list initially compiled by the district was missing information for 24 of the 72 projects listed. The district later provided an updated version. However, we noted that one of the 19 projects we reviewed should have been on the updated list because it had a letter of credit but was not. Without a complete and accurate list, the district cannot ensure that it has the level of protection it sought when it required indemnification agreements and letters of credit. In another case, the district's list indicated that the district had asked for a letter of credit when it had not. We also found a letter of credit that expired before the date set forth in the indemnification agreement, yet the district did not request a renewal or document its reasoning for not requiring a renewal, leaving the district without the financial security it intended.

The district may have had difficulty in providing a complete and accurate list because a staff person in its legal department maintained the signed documents, while another staff person from its permitting department maintained the initial communication with the applicant, thus complicating the district's ability to identify which projects required these agreements and also to locate such documents. When we brought these concerns with documentation and file maintenance to the district's attention, the director of permit services acknowledged that a central location to maintain all of these records might provide for better access when questions arise about the agreements. The district has since changed its practices, and its permitting department now maintains all records.

When the district does require letters of credit, there is a cost to the permit applicant. To determine the extent of the cost of securing letters of credit by the permit applicants, we contacted nine applicants from our selected test items for which the district required letters of credit. The district requires only 10 letters of credit on average each year. We found that the costs for the letters of credit for the five applicants who spoke to us and provided supporting documentation ranged from \$625 to about \$1,400 per year. To provide context, the costs of the associated permits for which the letters of credit were required ranged from \$1,900 to \$15,000 and averaged \$8,400. According to information we obtained from our selection of applicants, the permit applicants paid the costs to their banks, and these costs varied based on the applicants' credit. A bank may charge a large business with better credit less than it would charge a business with poorer credit.

Recommendations

To ensure consistency among its published policy, internal methodology, and indemnification agreements so that permit applicants are aware of the district's requirements and are treated

equally, by July 2016 the district should update its internal methodology and indemnification agreements to contain equivalent information that reflect its revised published policy.

To make certain that it can demonstrate consistency and transparency in its decision-making process when it determines which permit applicants it requires to provide additional financial security, the district—after it updates its guidance documents—should follow its revised published policy and updated internal methodology for requiring indemnification agreements and letters of credit.

To ensure that the district is adequately protected from the costs of litigation, it should develop a protocol to maintain all required legal documents accurately and to make sure that those documents remain in effect. By July 2016, the district should adopt such a protocol for management of its centralized system for requesting, tracking, storing, and following up on indemnification agreements and letters of credit.

We conducted this audit under the authority vested in the California State Auditor by Section 8543 et seq. of the California Government Code and according to 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 specified in the Scope and Methodology section of the report. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Respectfully submitted,



ELAINE M. HOWLE, CPA
State Auditor

Date: April 5, 2016

Staff: Tammy Lozano, CPA, CGFM, Audit Principal
Nathan Briley, J.D., MPP
Kelly Reed, MSCJ
Karen Wells

Legal Counsel: Richard B. Weisberg, Sr. Staff Counsel

For questions regarding the contents of this report, please contact Margarita Fernández, Chief of Public Affairs, at 916.445.0255.

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Appendix

Fees Charged by the San Joaquin Valley Air Pollution Control District

To comply with state and federal law, the San Joaquin Valley Air Pollution Control District (district) has adopted various rules that impose certain requirements on activities that result in stationary source pollution, and it charges fees for issuing permits and conducting related regulatory activities. The table shows a selection of the district’s rules that have associated fees. We present the rules in three groups: permit fees, special program fees, and in-lieu-of-compliance fees. The table also includes the range of fee amounts that the district charges for some permits and the actions associated with the rules, as well as brief descriptions of the fees associated with those rules.

Table
Examples of Fees Charged by the San Joaquin Valley Air Pollution Control District

RULE	NAME	FEE AMOUNT	DESCRIPTION
Permit Fees*			
3010	Evaluation/air quality impact analysis fee	Staff hours spent multiplied by the prevailing weighted labor rate of the San Joaquin Valley Air Pollution Control District (district). For 2014, this rate was \$106 per hour.	Every applicant who files an application for an Authority to Construct permit (construction permit) or a Permit to Operate (annual permit) with the district shall pay an engineering evaluation fee for the processing of the application.
3010	Filing fees	\$75 per unit. Applicants for some other permits pay a different filing fee per unit, which is capped at \$1,468 per facility.	Every applicant for a construction permit or an annual permit shall pay a nonrefundable filing fee.
3020	Electric motor horsepower schedule	\$92 to \$1,080 depending on the horsepower of the equipment.	Any equipment that may cause the emission of air contaminants where an electric motor is used as the power supply shall be assessed a permit fee based on the total rated motor horsepower of all electric motors included in any source operation.
3020	Electric energy schedule	\$92 to \$1,080 depending on the kilovolt amperes (KVA) of the equipment.	Any equipment that may cause the emission of air contaminants and that uses electric energy, with the exception of electric motors in the electric motor horsepower schedule above, shall be assessed a permit fee based on the total KVA rating.
3020	Stationary container schedule	For small producers, the fee varies between \$34 and \$194 depending on the size of the tank. For other producers, the fee varies between \$79 and \$401 depending on the size of the tank.	Any stationary tank, reservoir, or other container—the contents of which may emit an air contaminant—shall be assessed a permit fee based on the container’s capacity in gallons or a cubic equivalent.
3100	California Environmental Quality Act fee (CEQA)	Staff hours spent multiplied by the district’s prevailing weighted labor rate.	Every applicant who applies for a permit for which the district prepares an environmental impact report or a negative declaration under CEQA shall pay this fee.

RULE	NAME	FEE AMOUNT	DESCRIPTION
Special Program Fees[†]			
3030	Hearing board	The fee for requesting a regular variance hearing is \$917. Other requests, such as hearings for short-term variances or appeals, range between \$276 and \$1,224.	The fees are for any action requesting a variance to a rule or any other action that requires the assembly of the hearing board. A variance is an administrative order granting temporary relief from the provisions of a district rule or regulation. In addition, the hearing board hears appeals by permit applicants and interested third parties concerning the issuance or denial of permits.
3040	Agricultural/open burning	\$36 per burn location.	The district issues permits for operations to burn agricultural waste, various field crops, diseased materials, tumbleweeds, and contraband materials, and to burn vegetative material for ditch bank and levee maintenance.
3050	Asbestos removal	The district charges fees based on the size of the project where the asbestos is removed, with a minimum fee of \$170 and a fee of \$1,921 for projects over 10,000 square feet.	Fees are for every person filing notification of an asbestos removal project: all demolitions whether or not asbestos is present and some renovations.
3170	Federally mandated ozone nonattainment fee	For major sources of nitrogen oxide compounds and volatile organic compounds, an annual fee of \$5,000 per ton in 1990 dollars, adjusted by the U.S. City Average Consumer Price Index for all urban consumers, is assessed for emissions over a given threshold.	This rule implements the ozone nonattainment penalty requirements of Section 185 of the federal Clean Air Act. The district assesses the fee on major sources of air pollution that have not installed the best available air pollution control technology.
In-Lieu-of-Compliance Fees			
4320	Advanced emission reduction options for boilers, steam generators, and process heaters greater than 5.0 MMBTU/HR	\$9,350 per ton of oxides of nitrogen (expressed as NOx) emissions plus a 4 percent administrative fee.	Operators may pay this fee in lieu of complying with emission limits for NOx from boilers, steam generators, and process heaters. According to a deputy air pollution control officer, the district has used the revenue for technology advancement projects and various emissions reduction projects under its grant funding components.
4694	Wine fermentation and storage tanks	\$11,778 per ton of applicable emissions plus a 4 percent administrative fee.	Operators of wineries may pay this fee in lieu of reducing emissions of volatile organic compounds from the fermentation and bulk storage of wine or achieving equivalent reductions from alternative emissions sources. The district stated in its fiscal year 2012–13 financial report that it will use these funds for projects that will mitigate future emissions, although the district did not collect any revenue under this rule between fiscal years 2010–11 and 2014–15.
4702	Internal combustion engines	\$9,350 per ton of nitrogen oxide emissions plus a 4 percent administrative fee.	Operators of nonagricultural operations with spark-ignited engines may elect to pay a fee in lieu of complying with the nitrogen oxides emissions limit requirement. According to a deputy air pollution control officer, the district has used the revenue for technology advancement projects and various emissions reduction projects under its grant funding components.
4905	Natural gas-fired, fan-type central furnaces	\$290 for a condensing furnace and \$225 for a noncondensing furnace.	Manufacturers of natural gas-fired, fan-type central furnaces may pay the fee per unit in lieu of complying with rules limiting nitrogen oxide emissions for the units. As of June 30, 2015, the district had not collected any revenue for this rule.

Source: San Joaquin Valley Air Pollution Control District rules.

Note: The fees in the table reflect those effective between July 1, 2015, and June 30, 2016 and do not reflect the 4.4 percent fee increase approved in April 2015 and scheduled for implementation in July 2016.

* In addition to the example fees described above showing the range of fees under the district's permit fee system, the district has annual operating fees under its Rule 3020 for fuel-burning equipment, incinerators, resource recovery equipment, electric generating equipment, steam-enhanced crude oil production wells, internal combustion engines, fuel-dispensing equipment, commercial off-site multiuser hazardous and nonhazardous waste disposal facilities, and miscellaneous equipment. The district also charges applicable equipment a Title V source permit surcharge.

† In addition to the fees described above, the district has what we have classified as special program fees for the following: emission reduction credit banking (Rule 3060), air toxics (Rule 3110), Regulation VIII alternative compliance plan review (Rule 3120), dust control plan review (Rule 3135), certification of air permitting professionals (Rule 3140), certification of gasoline-dispensing facility testers (Rule 3147), portable equipment registration (Rule 3150), permit-exempt equipment registration (Rule 3155), prescribed burning (Rule 3160), administering indirect source review (Rule 3180), conservation management practices plan review and management (Rule 3190), and the registration of wood-burning heaters (Rule 3901).

April 2016



San Joaquin Valley

AIR POLLUTION CONTROL DISTRICT



March 15, 2016

Elaine M. Howle, CPA*
 State Auditor
 621 Capitol Mall, Suite 1200
 Sacramento, CA 95814

Dear Ms. Howle,

We have reviewed your draft report of the audit that you were requested to conduct by the Joint Legislative Audit Committee. At the outset, I want to express our gratitude for the thoroughness and proficiency of your team, including the legal staff. We believe that the District was treated fairly and professionally throughout the entire process.

Thank you for a positive audit report. We are happy with the report as written, and only have a request for a minor clarifying change to the title. We believe that the draft report's title can be misleading for individuals that may not carefully read the entire report. The first part of the title references a recent fee increase and then continues to the second issue, stating "...but Can Improve Consistency and Transparency for Certain Program Requirements". The title connects two separate issues and leaves one with the impression that the consistency and transparency issue relates to the District's fee programs, rather than only the indemnity agreement process. We therefore suggest that the title be changed as follows: *"San Joaquin Valley Air Pollution Control District: To Cover Its Costs, It Recently Increased Permit Fees and Continues to Use Supplemental Revenue, and with Respect to Indemnification Agreements, It Can Improve Consistency and Transparency."*

With respect to the major focus of the audit relating to fees, we appreciate your findings that the District's fees are low compared to program costs and that the District lawfully uses supplemental sources of revenue to make up the difference. We take pride in having the lowest fees in the state. As you have noted, the District routinely assesses the costs and needed revenues for administering an active and effective air quality management program. With a strict adherence to the zero-based budgeting principles, significant investment in automation, and implementation of countless streamlining and efficiency measures, the District has been able to achieve low administrative overhead and great productivity in all program areas and therefore reduced costs.

Seyed Sadredin
 Executive Director/Air Pollution Control Officer

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* California State Auditor's comments appear on page 29.

Ms. Howle
March 15, 2016
Page 2

② The other area addressed by the audit relates to process utilized by the District to garner indemnification from the cost of litigation related to the issuance of certain District permits. This issue is of relatively minor scope. As the audit report notes, this indemnification process was required on only 13 projects per year of the 4,800 permitting projects the District issued over the past four years.

③ We appreciate your audit finding that the District exercises allowable risk-management discretion. The parties requesting the audit had questioned the need for letters of credit which they had confused with the posting of bonds. However, your audit concludes that the District should have required more letters of credit than it did. While we appreciate your strict interpretation of the District's existing policy, on which your conclusion was based, we believe that the District was correct in not requiring letters of credit for the projects cited in your report. As noted in your audit report, to avoid unnecessary burden on permit applicants, the District does not require indemnification for projects with low risk of litigation. Based on the concerns raised and the recommendations in your report, and consistent with the District's core values which call for continuous improvement and open and transparent public processes, we have revised our policy to clearly describe the case-by-case nature of these risk management decisions and to require documentation of those decisions in each project's engineering evaluation report.

Sincerely,



Seyed Sadredin
Executive Director/Air Pollution Control Officer

Comments

CALIFORNIA STATE AUDITOR'S COMMENTS ON THE RESPONSE FROM THE SAN JOAQUIN VALLEY AIR POLLUTION CONTROL DISTRICT

To provide clarity and perspective, we are commenting on the response to our audit report from the San Joaquin Valley Air Pollution Control District (district). The numbers below correspond with the numbers we have placed in the margin of the district's response.

We disagree with the district's comment that our title can be misleading for individuals who do not carefully read the entire report. Our title fairly reflects the contents of this report and is intended to only summarize its contents and is not intended to contain every detail found in the report. Further, the district's suggested title only mentions the issue with indemnification agreements and is more narrow than the concerns we identified because it does not include our concerns regarding letters of credit.

①

We also disagree with the district's comment that the title connects two issues and leaves one with the impression that the consistency and transparency issue relates to the district's fee programs. The use of *but* in the title indicates that we had no concerns with the first issue but did have concerns with the second issue.

We have updated the number of permits and indemnification agreements to which the district refers. Specifically, we updated the numbers to consistently reflect fiscal year information, and we added the most recent fiscal year 2014–15. We have also clarified the report text to indicate that the average number of permits we cite is an annual average. Therefore, as we indicate on page 17, the district issued an annual average of more than 4,600 Authority to Construct permits for fiscal years 2010–11 through 2014–15 and required fewer than 15 indemnification agreements and only 10 letters of credit on average for the last 5 fiscal years.

②

The district's statement that our audit concludes that the district should have required more letters of credit than it did is misleading. Our report does not conclude whether the district should have required fewer or greater numbers of letters of credit. Rather, our report concludes that the district did not always follow its policy and internal methodology regarding letters of credit. As we state on page 19, despite having a published policy and internal methodology, the district does not always follow either the policy or methodology when obtaining indemnification agreements and letters of credit. In some instances, we noted that the district policy required it to obtain a letter of credit and it did not.

③

