

California Department of Resources Recycling and Recovery

The Beverage Container Recycling Program Continues to Face Deficits and Requires Changes to Become Financially Sustainable

Report 2014-110

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November 6, 2014

2014-110

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 California Department of Resources Recycling and Recovery's (CalRecycle) administration of the Beverage Container Recycling Program (beverage program).

This report concludes that the beverage program continues to face deficits and immediate action is needed to ensure the continued viability of the program. In each of the last four years from fiscal years 2010–11 through 2013–14 the beverage program has been operating under an annual deficit in which the revenue generated has been insufficient to cover expenditures. The collective gap between expenditures and revenues exceeded \$100 million in three of those four fiscal years. There are a variety of revenue enhancements and expenditure reductions that the Legislature should consider in addressing the fiscal strain the beverage program consistently faces. For example, reducing or eliminating the State's subsidies of beverage manufacturers and requiring them to pay the full cost of processing fees could increase revenue by as much as \$80 million. In addition, eliminating the authority for beverage distributors to retain fees for administrative costs would increase program revenue by roughly \$18 million. Furthermore, using a different revenue collection model that requires the California State Board of Equalization to collect redemption and processing fees at the point of sale when consumers purchase beverages may provide better assurance that the beverage program receives all the revenue due to it.

Ensuring its financial stability is only one of CalRecycle's challenges. An additional challenge is that the beverage program is highly susceptible to fraudulent activities. While CalRecycle's Recycling Program Enforcement Branch has developed a fraud management plan and many of its practices appear reasonable, it lacks estimates of what types of fraudulent activities pose the greatest financial risk to the beverage program. For example, it does not know how much of the beverage program's losses are attributable to paying for the recycling of out-of-state beverage containers. Lacking this insight, CalRecycle is unable to demonstrate that it is focusing its resources in the areas of highest risk to ensure the greatest financial return to the beverage program.

Respectfully submitted,



ELAINE M. HOWLE, CPA
State Auditor

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Summary

Results in Brief

The Beverage Container Recycling Program (beverage program) was created in 1986 by the California Beverage Container Recycling and Litter Reduction Act (act). The intent of the act is to encourage and increase consumer recycling; it has a goal of recycling 80 percent of the qualified beverage containers sold in California. Beverage distributors are required to make a redemption payment to the Beverage Container Recycling Fund (beverage fund) for every qualified beverage container sold or offered for sale in the State. To encourage recycling, consumers can return qualified beverage containers to recycling centers and receive payment representing the California refund value (recycling refund payment). The California Department of Resources Recycling and Recovery (CalRecycle) is responsible for enforcing and administering the act. Because not all beverage containers are recycled—CalRecycle reported that 85 percent of the containers sold in the State were recycled in 2013—funds not used to ultimately pay consumers are used instead to support the beverage program’s operational costs as well as other expenses mandated in state law.

In each of the last four years from fiscal years 2010–11 through 2013–14, the beverage program has been operating under an annual deficit in which the revenue generated has been insufficient to cover expenditures. The collective gap between expenditures and revenues across all five funds that support the beverage program exceeded \$100 million in three of those four fiscal years. The principal source of revenue comes into the beverage program through redemption payments beverage distributors make based on the number of beverages sold or offered for sale in the State. The beverage program can become financially unstable once recycling rates become too high and required recycling refund payments—those paid to consumers when they recycle their empty beverage containers—and other statutorily mandated payments cannot both be satisfied. In 2013 CalRecycle reported recycling rates were at 85 percent and had increased beyond what it calls its “break-even” point—currently a 75 percent recycling rate; based on that recycling rate, the revenue collected from beverage distributors is no longer adequate to cover the recycling refund payments and other mandated spending. Although expenditures have exceeded revenues over those past four fiscal years, the program has been receiving significant loan repayments, primarily from the State’s General Fund. In fact, these loan repayments have been so substantial that the combined ending balances in the five funds supporting the beverage program actually increased by almost \$64 million in those four fiscal years. At the end of fiscal year 2009–10, the beverage program had reached the height of its lending with

Audit Highlights . . .

Our audit of the California Department of Resources Recycling and Recovery’s (CalRecycle) administration of the Beverage Container Recycling Program (beverage program) revealed the following:

- » *In the last four fiscal years, the beverage program has been operating under an annual deficit in which the revenue generated was insufficient to cover expenditures.*
- » *The beverage program’s collective gap between revenues and expenditures across all five funds has exceeded \$100 million over three of the last four fiscal years.*
- » *There are viable options available that CalRecycle and the Legislature may want to consider for enhancing revenue and reducing expenditures to the beverage program.*
- » *CalRecycle needs to better respond to the fraud risk presented by the importation of out-of-state beverage containers for recycling refund payments.*
- » *CalRecycle is unable to demonstrate that it is focusing its limited resources in the areas of highest risk to ensure the greatest financial return to the beverage program.*

outstanding loans of \$496.8 million receivable from the General Fund and the Air Pollution Control Fund. However, these loans are now nearly repaid with only \$82.3 million outstanding. Based on the recent financial condition of the beverage program—where combined expenditures exceeded combined revenues by \$100 million in three of the last four fiscal years—immediate action is needed to ensure the continued viability of the beverage program.

A variety of revenue enhancements and expenditure reductions are available that we believe the Legislature may want to consider. For example, the most financially significant proposal is reducing or eliminating the State's subsidies to beverage manufacturers and requiring them to pay the full cost of processing fees. State law requires beverage manufacturers to pay a processing fee, which the State then uses to make processing payments to recycling centers (and other entities) to encourage them to recycle certain beverage containers, such as glass and plastic; however, the beverage program currently subsidizes more than half of these processing fees. By requiring beverage manufacturers to pay the full cost of the processing fee, the beverage program could collect additional revenue ranging between \$60 million and \$80 million annually. Another option to increase revenue includes eliminating administrative fees for beverage distributors. Under state law, beverage distributors are only required to pay 98.5 percent of the redemption payment owed to the State, keeping the remaining 1.5 percent for administrative costs. In fiscal year 2013–14, redemption revenue into the beverage fund amounted to roughly \$1.2 billion. Since the \$1.2 billion equals 98.5 percent of what could otherwise be collected, the beverage program is missing an opportunity to collect roughly \$18 million from distributors. In addition, beginning in 2013, state law requires beverage distributors to electronically report program-related data and, according to CalRecycle, electronic reporting reduces the distributors' financial and administrative burden associated with participating in the beverage program. Collectively, the options we present in this audit report provide an opportunity to achieve as much as \$233 million in annual savings and revenue enhancements. Regardless of the options the Legislature might choose, we believe change is necessary to ensure that the beverage program can remain financially stable.

CalRecycle also needs to better respond to the fraud risk presented by the importation of out-of-state beverage containers for recycling refund payments. CalRecycle's Recycling Program Enforcement Branch (enforcement branch) is responsible for inspecting and investigating beverage program participants and for protecting the beverage fund from fraudulent or improper payments. A significant fraud risk to the beverage program occurs when recycling centers redeem containers that were sold out of state—where beverage

distributors did not initially pay into the fund; the fund suffers a 100 percent loss on those payments. Beverage containers sold outside of the State may contain the California refund value logo, and thus consumers are able to bring these containers back to California and ultimately receive recycling refund payments. According to the Can Manufacturers Institute, in 2012 nearly 22.4 billion aluminum cans were sold outside of California with the California refund value logo. Assuming that as little as 3 percent of the 22.4 billion in out-of-state aluminum cans with the California refund logo were brought back to California for recycling (or roughly 672 million cans), the beverage fund would pay roughly 5 cents for each can, for a total of \$33.6 million. In this hypothetical example, the entire \$33.6 million would represent a loss to the beverage fund since the beverage distributors did not initially pay into the beverage fund for these out-of-state containers.

To increase monitoring on the State's borders, CalRecycle partnered with the California Department of Food and Agriculture (Food and Agriculture) to have Food and Agriculture's agents inspect and collect data on the amount of the empty beverage containers that individuals transport into California, which CalRecycle will then analyze for use in criminal investigations and in the prosecution of fraud suspects. However, CalRecycle has yet to analyze all of the data it receives from Food and Agriculture and indicated it will not have a formal process for analyzing these data until the end of 2014. While CalRecycle has not fully analyzed those data, it appears to have taken the initial steps necessary to establish a systematic process for monitoring and responding to the risk of out-of-state beverage containers. CalRecycle needs to continue with these efforts in order to fully evaluate the effect that out-of-state importation has on the beverage program.

While out-of-state beverage containers may represent the largest fraud risk facing the beverage program, CalRecycle has identified other areas of the program that are also at risk for fraud. CalRecycle's enforcement branch has developed a fraud management plan and many of its fraud prevention practices appear reasonable, but our review found that it lacks estimates of what types of fraudulent activities pose the greatest financial risk to the beverage program. Lacking this insight, neither the Legislature, the public, nor CalRecycle will be able to evaluate the effectiveness of CalRecycle's fraud prevention efforts.

Finally, significant disagreements exist between CalRecycle and program stakeholders regarding how much revenue should be collected. We believe the Legislature should consider a different revenue collection model that may help resolve this debate. Currently, state law requires beverage distributors to make payments into the beverage fund based on the number

of beverage containers sold, or offered for sale in California. CalRecycle performs risk-based audits each year to verify that the amounts paid to the beverage program are correct for roughly 30 to 40 beverage distributors out of more than 1,400 distributors located throughout the State, according to CalRecycle. Although CalRecycle's audits appear to add value and identify funds due to the beverage program, the amounts identified are not significant in the overall context of the beverage program. For example, according to CalRecycle it completed 39 audits during fiscal year 2013–14 and it identified just over \$8 million in funds due to the beverage program. This equates to less than 1 percent of the \$1.2 billion in revenue the beverage program recorded during that year. Moreover, because beverage containers display refund logos from multiple states and some out-of-state companies import beverages for sale in California, CalRecycle's task of identifying who owes money to the beverage program (and how much) becomes a difficult one whose accuracy is subject to debate. A potentially simpler model of revenue collection, should it be found feasible, would be for the Legislature to amend state law to require the California State Board of Equalization (Equalization) to collect redemption and processing fees at the point of sale when consumers actually purchase their beverages in California's grocery stores, convenience stores, and other consumer-facing businesses. Equalization already collects point-of-sale payments on behalf of CalRecycle for another state program—the California Tire Fee program—and CalRecycle should work with Equalization to further evaluate the feasibility and cost-effectiveness of this new revenue collection model and then report back to the Legislature. Having a revenue collection process that is customer-centric recognizes the important role consumers play in the recycling process and sends a strong signal to further encourage them to recycle.

Recommendations

The Legislature

To better ensure that the beverage program is financially sustainable, the Legislature should consider enacting statutory changes that increase revenue, reduce costs, or a combination of both. Our report lists some specific proposals for the Legislature's consideration in Table 3, beginning on page 19.

CalRecycle

To ensure that it can demonstrate that its fraud prevention efforts are maximizing financial recoveries for the beverage program, CalRecycle should both modify and annually update its fraud management plan to include the following:

- Finalize a process to analyze the data Food and Agriculture provided on out-of-state containers and act on the results to identify and prosecute those committing fraud.
- Develop fraud estimates—by type of fraudulent activity—that quantify the potential financial losses to the beverage program and the methodology CalRecycle used to develop these estimates.
- Identify the amount of actual fraud in the prior year by type of fraudulent activity, such as the financial losses resulting from the redemption of out-of-state beverage containers or the falsification of reports used to substantiate program payments.
- Identify the amount actually recovered for the beverage program in the form of cash for restitution and penalties resulting from fraud.

To ensure that all appropriate redemption payments are identified and made to the beverage fund, CalRecycle should do the following:

- Contract with Equalization to determine the feasibility and cost of transferring its revenue collection duties and audit reviews to Equalization.
- Should CalRecycle find that it is feasible and cost-effective, it should pursue legislative changes that enable Equalization to collect revenues for the beverage program at the point of sale and remit the money to the beverage fund.

Agency Comments

In its response to the audit, CalRecycle generally agreed with our report's conclusions and recommendations, but it offered additional comments regarding our recommendations; however, we needed to clarify some of its statements beginning on page 59. Further, our report did not make any specific recommendations to the California Department of Justice (Justice). Nevertheless, Justice offered comments regarding some of our conclusions and we provide clarification on page 65.

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Introduction

Background

The California Beverage Container Recycling and Litter Reduction Act (act) established the Beverage Container Recycling Program (beverage program) in 1986. The intent of the act is to encourage recycling; it has a goal of recycling 80 percent of the eligible beverage containers sold in California. The text box summarizes the containers that are eligible and not eligible under the beverage program.

The act requires beverage distributors to make a redemption payment to the California Department of Resources Recycling and Recovery (CalRecycle), which is deposited into the Beverage Container Recycling Fund (beverage fund) for every eligible beverage container offered for sale in California. Currently, the redemption payment is 5 cents for containers that hold less than 24 fluid ounces and 10 cents for containers that hold 24 fluid ounces or more. The actual amounts paid into the beverage fund may be less since beverage distributors can deduct up to 1.5 percent to help offset the beverage distributors' administrative costs for their participation in the beverage program. Beverage distributors can recoup the amounts they pay into the beverage fund by passing on those costs to beverage retailers—such as grocery stores and convenience stores—who may then pass on these costs to consumers at the time of purchase. To encourage recycling, consumers can return eligible beverage containers to recycling centers and receive the California refund value (recycling refund payment)—5 cents or 10 cents per container or an amount based on the weight of the containers. Recycling centers then return the eligible beverage containers to processors and receive the applicable recycling refund payment from the processor. Processors in turn present an invoice and shipping report for the recyclable material to CalRecycle, which then pays the recycling refund payment to the processor. In addition, CalRecycle makes payments to the processor to defray costs associated with their participation in the beverage program. In the report, we refer to these amounts as *administrative fees for processors*. Figure 1 on the following page provides an overview of how the recycling program operates and illustrates the key participants.

Beverage Containers Eligible and Not Eligible for Recycling Under the Beverage Container Recycling Program

Containers Eligible for Recycling

Beverage distributors pay into the Beverage Container Recycling Fund (beverage fund) so consumers may obtain payment for recycling metal, glass, plastic, and other material that contain the following types of beverages:

- Beer and other malt beverages
- Wine coolers and distilled spirit coolers
- Carbonated and noncarbonated beverages such as:
 - fruit juice drinks
 - soft drinks
 - water, mineral water, and sports drinks
- Coffee and tea drinks
- Vegetable juice in containers less than 16 ounces

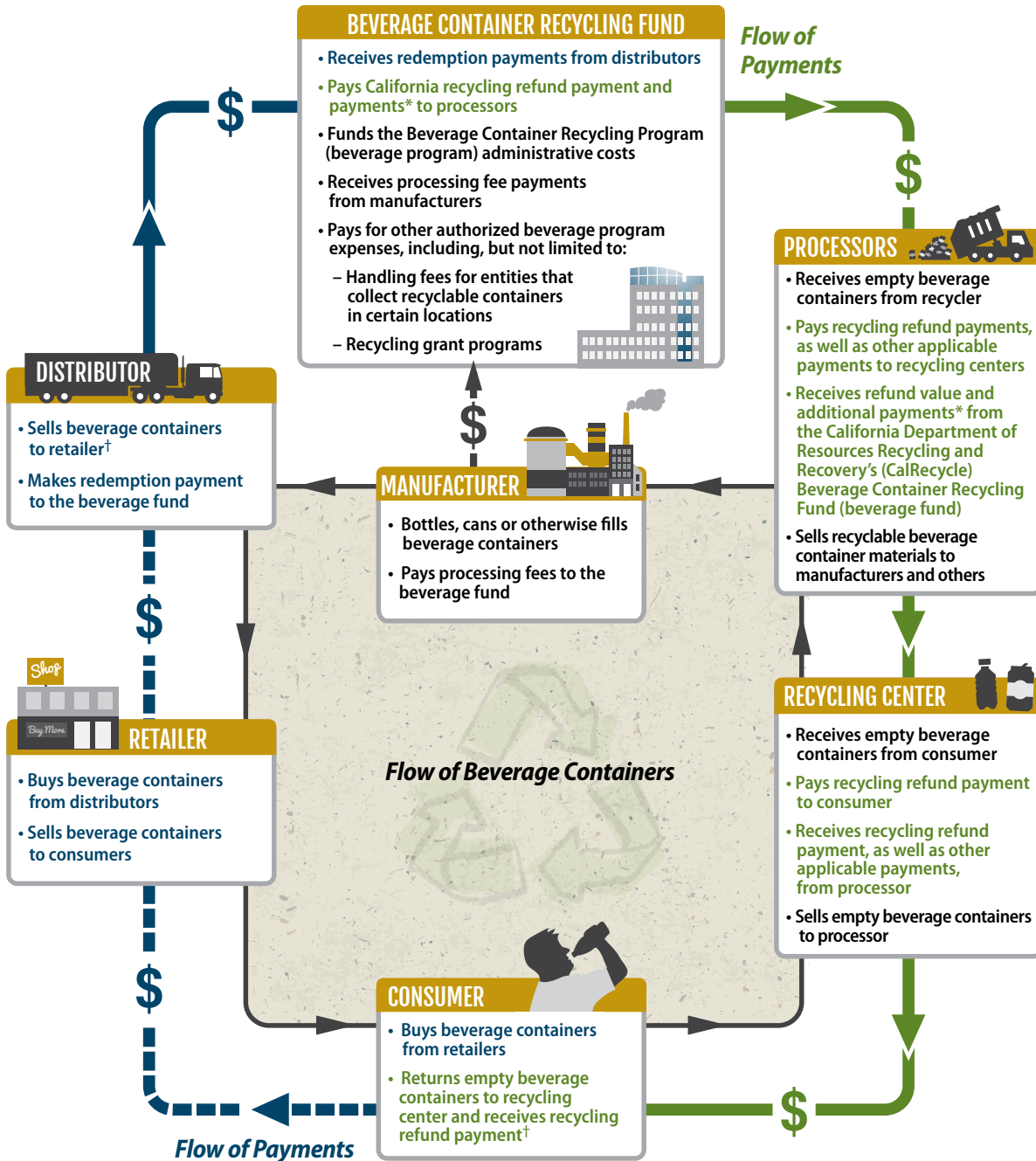
Containers Ineligible for Recycling

Beverage distributors do not pay into the beverage fund and consumers do not obtain payment for recycling metal, glass, plastic, and other material containing the following types of beverages:

- Wine
- Milk
- Medical food and infant formula
- 100 percent fruit juice in containers over 45 ounces
- Vegetable juice in containers over 16 ounces

Source: California Public Resources Code, Section 14502 et seq.

Figure 1
Flow of Payments and Recycling of Containers Under the Beverage Container Recycling Program



Source: Data obtained from CalRecycle.

* CalRecycle also pays processors processing fees, equaling the difference between the average cost to recycle plus a reasonable financial return and the average scrap value of the material in addition to administrative fees worth 2.5 percent of the recycling refund payment to offset costs associated with participation in the beverage program.

† California redemption payment (blue text) is paid when a beverage container is sold. California recycling refund payment (green text) is received when a beverage container is returned for recycling.

■ State law requires beverage distributors to make redemption payments to CalRecycle and can recoup the amounts they pay by passing on those costs to retailers who may then pass on those costs to consumers at the time of purchase.

Although beverage distributors are required to make redemption payments into the beverage fund for all eligible containers offered for sale in the State, the beverage fund makes the recycling refund payment only for eligible containers that are recycled. Because not all beverage containers sold in the State are ultimately recycled, CalRecycle can have excess revenue, which it uses to pay for the administrative costs of the beverage program as well as other authorized program expenses, including payments to support local curbside recycling programs; for handling fees paid to recycling centers to provide an incentive for recycling beverage containers in specific places, such as convenience zones located within a half-mile radius around supermarkets; and for various grants to cities, counties, and other groups to encourage beverage container recycling and litter abatement. Five state funds are dedicated to the beverage program—listed in the text box—and we include detailed tables of the beverage program’s revenues and expenditures for the past four fiscal years in Appendix A.

State law establishes CalRecycle as the administering agency for the beverage program, and in this capacity it is responsible for performing several functions. For example, CalRecycle is required to establish an auditing system to ensure that redemption payments comply with the act. To fulfill this responsibility, its office of audits performs audits of beverage distributors to test the accuracy of sales reported and the redemption payments deposited into the beverage fund. Further, its Recycling Program Enforcement Branch investigates recycling centers and processors that collect empty beverage containers from consumers to ensure that recycling refund payments are only for legitimate containers sold within the State.

Beverage Container Recycling Programs in Other States

In addition to California, nine other states and the territory of Guam currently have beverage container recycling programs, as seen in Figure 2 on the following page. Similar to California’s beverage program, these programs provide consumers with incentives to recycle by collecting a redemption payment on beverages sold within the State. The other states’ recycling programs vary in the level of government involvement and in the payment amounts. For example, according to the Container Recycling Institute and the

Five State Funds Supporting the Beverage Container Recycling Program

California Beverage Container Recycling Fund

- Primary fund for the Beverage Container Recycling Program.
- Redemption payments collected from beverage distributors.
- Recycling refund payments made to processors (and ultimately consumers).
- Transfers of funds to the glass and plastic processing fee accounts.

Glass Processing Fee Account

Used to pay processing fees for glass beverage containers.

Penalty Account

Collects civil penalties and fines to assist in carrying out beverage container recycling.

Bimetal Processing Fee Account

Used to pay processing fees for bimetal containers.

PET* Processing Fee Account

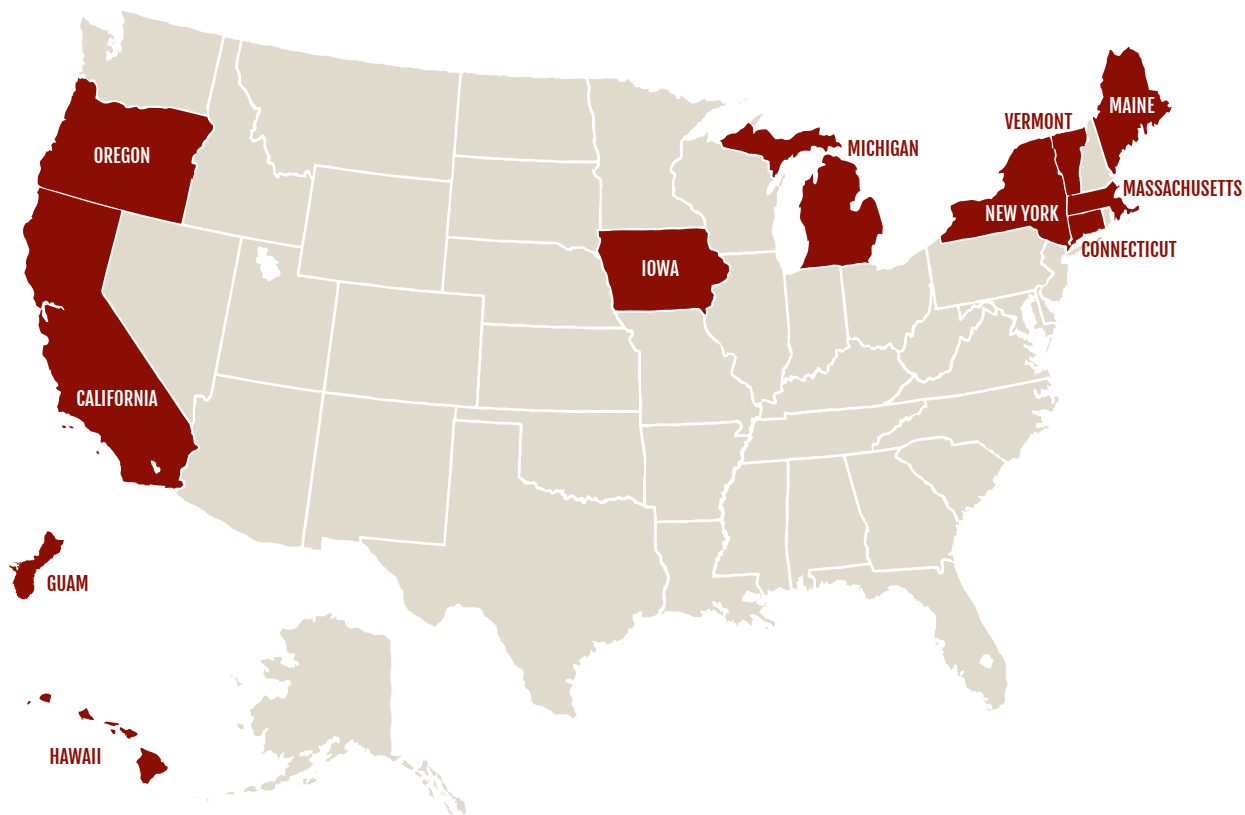
Used to pay processing fees for plastic containers.

Source: California Department of Finance—*Manual of State Funds*.

* Polyethylene Terephthalate plastic.

National Conference of State Legislatures, Michigan's recycling refund payment amount is 10 cents for all of its eligible beverage containers, while California pays 5 cents for containers that hold less than 24 fluid ounces and 10 cents for containers that hold 24 fluid ounces or more. Moreover, the types of beverages and beverage containers included in the respective beverage programs vary. For example, Iowa and Maine include wine and liquor in their programs while California excludes these beverages from its program.

Figure 2
States and Unincorporated Territories That Currently Participate in a Beverage Container Recycling Program



Sources: Data obtained from the Container Recycling Institute, National Conference of State Legislatures, and the California Public Resources Code.

Scope and Methodology

The Joint Legislative Audit Committee (audit committee) directed the California State Auditor (state auditor) to review CalRecycle's performance and anti-fraud measures within its beverage program. The audit scope includes eight audit objectives. 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 for the Beverage Container Recycling Program (beverage program) and the Beverage Container Recycling Fund (beverage fund).
2 For the past three fiscal years, evaluate the financial condition of the beverage fund.	<ul style="list-style-type: none"> • Interviewed key officials within the California Department of Resources Recycling and Recovery's (CalRecycle) accounting division and human resources division. • For fiscal years 2010–11 through 2013–14, obtained and analyzed the California State Controller's Office expenditure and revenue data regarding the financial condition of the beverage fund and the beverage program.
3 Assess the effectiveness of the current methods for identifying and addressing fraud, including practices to prevent, detect, and deter fraud.	<ul style="list-style-type: none"> • Interviewed key officials within CalRecycle's Recycling Program Enforcement Branch. • Reviewed CalRecycle's procedures to track and address beverage program fraud allegations. • Identified whether CalRecycle had estimated the overall impact of fraud on the beverage program. • Reviewed CalRecycle's fraud management plan and judgmentally selected and tested key aspects of its plan.
4 Review and assess the current policies and procedures to identify beverage distributors and whether the beverage program's practice for collecting fees and redemption payments from distributors is effective.	<ul style="list-style-type: none"> • Interviewed key officials within CalRecycle's recycling program certification and registration branch and its policy development and analysis office. • Reviewed CalRecycle's recent efforts to identify and register beverage distributors into the beverage program.
5 For the most recent year available, review a sample of completed beverage distributor audits to evaluate their adequacy and timeliness, and the subsequent collection of all associated fees owed to the beverage fund.	<ul style="list-style-type: none"> • Interviewed key officials within CalRecycle's office of audits (audits office) and its office of legal affairs (legal affairs). • Reviewed and analyzed the audits office's processes for auditing beverage distributors and pursuing any identified underpayments, including legal affairs' audit-related training materials. • Selected and reviewed nine beverage distributor audits completed in fiscal year 2012–13 and one beverage distributor audit completed in fiscal year 2013–14.
6 To the extent possible, identify any beverage program improvement designed to increase revenues and reduce costs and expenditures to the beverage fund without raising distributors' fees.	<ul style="list-style-type: none"> • Interviewed key officials at CalRecycle. • Reviewed and assessed CalRecycle's most recent and historical proposals for increasing revenues and reducing expenditures in the beverage program.
7 Evaluate the effectiveness of any changes made in response to recommendations in the California State Auditor's (state auditor) June 2010 audit report, including the status of any outstanding recommendations.	Appendix B indicates the recommendations from our June 2010 report that have not been fully implemented. Notwithstanding the findings in Appendix B, we determined that CalRecycle reasonably monitored five local conservation corps grants completed during fiscal year 2012–13. We also evaluated CalRecycle's current financial forecasting procedures for the beverage program and its management review process and found its forecasts were generally within 5 percent of actual revenues and expenditures reported in the California State Accounting and Reporting System. Further, in the Audit Results section of this audit report, we analyzed the effectiveness of CalRecycle's antifraud procedures and the timeliness of its beverage distributor audits.
8 Review and assess any other issues that are significant to the audit.	<ul style="list-style-type: none"> • Interviewed key officials within the California Department of Justice's (Justice) bureau of investigations and the Office of the Attorney General. • Reviewed CalRecycle's interagency agreements with Justice and assessed Justice's efforts to investigate potential fraud in the beverage program. • Made inquiries with the California State Board of Equalization regarding its ability to collect revenues for the beverage program.

Source: The state auditor's analysis of Joint Legislative Audit Committee audit request number 2014-110, and information and documentation identified in the table column titled *Method*.

Assessment of Data Reliability

The U.S. Government Accountability Office, whose standards we 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 relied on electronic data files from the State Controller's Office's (state controller) Budgetary/Legal Basis System to determine the beverage program's revenues, expenditures, and fund balance for fiscal years 2010–11 through 2013–14. We did not perform accuracy or completeness testing on this system. Instead we relied on the work of our financial audit team who audits the state controller's financial records as part of our annual financial report. Further, we agreed the information presented in this report with the state controller's published report. As a result, we determined these data to be sufficiently reliable for the purposes of this audit.

We also utilized various electronic data files from CalRecycle, including the California State Accounting and Reporting System (CALSTARS) and its Division of Recycling Integrated Information System (DORIIS). We determined that data reliability assessments were not required for either system due to the purposes for which we used the data. Specifically, we used the CALSTARS data to make a judgmental selection of CalRecycle employees whose wages were charged to the beverage fund during fiscal years 2010–11, 2011–12, and 2013–14. Further, we used the CALSTARS data to provide background financial information. DORIIS was used to judgmentally select items for review, including a selection of beverage program fraud allegations received by CalRecycle and instances when CalRecycle placed prepayment holds on recycling claims. For these purposes we merely needed to determine the universe from which we made our selections was complete. To determine completeness of CALSTARS we verified that CalRecycle's expenditures as recorded in CALSTARS materially agreed to the state controller's records for the period we reviewed. However, we were unable to verify the completeness of the data within DORIIS since the data entry into the system is largely a paperless process.

Audit Results

The Beverage Container Recycling Program Faces a Deficit and Different Solutions to the Problem Exist

The Beverage Container Recycling program (beverage program) has been operating under an annual deficit in which the revenue generated has been insufficient to cover expenditures in each of the last four fiscal years. The collective gap between expenditures and revenues across all five funds that support the beverage program exceeded \$100 million in three of those four fiscal years. Although the ending balance for the beverage program actually increased during this time, this increase reflects loan repayments the program was receiving during that time which masks the actual financial performance of the beverage program. These loan repayments are nearly complete, and thus the California Department of Resources Recycling and Recovery (CalRecycle) and the Legislature must determine how much longer the beverage program can maintain its current spending levels and they must decide what changes are necessary to make the beverage program financially self-sustaining. A variety of revenue enhancements and expenditure reductions exist that we believe the Legislature may want to consider and we provide a list of options in Table 3, beginning on page 19.

The Beverage Program Does Not Appear to Be Financially Sustainable

The revenue the beverage program generated was insufficient to cover expenditures in each of the last four fiscal years—2010–11 through 2013–14. The collective gap between expenditures and revenues across all five state funds that are dedicated to the beverage program—the Beverage Container Recycling Fund (beverage fund), the Glass Processing Fee Account, the Penalty Account, the Bimetal Processing Fee Account, and the PET Processing Fee Account—exceeded \$100 million in three of those four fiscal years. In fiscal year 2013–14, the financial picture improved slightly with expenditures exceeding revenue by \$28.7 million. Although closing this gap is an encouraging sign that the beverage program's financial outlook may be improving, minor fluctuations in revenue or expenditures could lead to significantly negative results. To understand why, one needs only to look at the significant amounts of money flowing into and out of the beverage program. The beverage program's collective revenues and expenditures across all five funds have consistently exceeded \$1.1 billion over the last four fiscal years. If these expenditures were to increase by only 5 percent (or if revenues fell by 5 percent), the beverage program would find itself needing to use roughly \$55 million of its reserve funds to cover the shortfall.

Given the recent history of expenditures exceeding revenues and the risk that minor fluctuations will continue, significant issues confront CalRecycle and the Legislature, including determining how much longer the beverage program can maintain its current spending levels and deciding what changes are necessary to make the beverage program self-sustaining financially. An indicator of the beverage program's financial sustainability is the collective ending balance of its five funds at the end of the fiscal year, and whether this amount has been increasing or decreasing year after year. The ending balance is simply the result of how much funding remains after accounting for all the inflows supporting the beverage program (such as revenues) and outflows (such as expenditures).

Although expenditures have exceeded revenues over the last four fiscal years, the beverage program's collective ending balance across the five funds that support the beverage program actually increased from \$248.8 million in fiscal year 2010–11 to \$312.7 million in fiscal year 2013–14 (an increase of \$63.9 million). This perhaps unexpected result stems from the fact that the beverage program has been receiving significant loan repayments from other state funds. During fiscal year 2009–10 and before, the beverage program made large loans to the State's General Fund and to a lesser degree to the Air Pollution Control Fund. At the end of fiscal year 2009–10, the beverage program had reached the height of its lending with a portfolio of \$496.8 million in loans receivable from these two funds. For context, the \$496.8 million in loans due from the General Fund and Air Pollution Control Fund represented roughly 43 percent of the more than \$1.1 billion in revenue the beverage program recorded that year. Beginning in fiscal year 2010–11, the General Fund began making substantial loan repayments to the beverage program. As of the end of fiscal year 2013–14, the General Fund still owed roughly \$82.3 million to the beverage program while the Air Pollution Control Fund has repaid all its loans.

Large cash infusions to the beverage fund coming from loan repayments from the General Fund and Air Pollution Control Fund have somewhat masked the financial performance of the beverage program.

Nevertheless, the large cash infusions to the beverage fund coming from loan repayments have somewhat masked the financial performance of the beverage program. In Table 2 we illustrate what the effect on the fund balance would have been if loan repayments were not being made to the beverage program. Our analysis shows that the collective fund balance in fiscal year 2013–14 for the beverage program would have decreased by \$21 million resulting in an ending balance of \$144.3 million (instead of the \$312.7 million currently shown in the California State Controller's Office records). Appendix A of our report provides more detailed financial information for the beverage program's five funds.

Table 2
Effects of Loan Repayments on Fiscal Year 2013–14 Combined Fund Balance

	FISCAL YEAR		
	2012–13	2013–14 [†]	2013–14 (ADJUSTED) (NO LOAN REPAYMENTS)
Beginning balance	\$254,474,592	\$165,259,073	\$165,259,073
Revenue	1,177,241,780	1,239,918,895	1,239,918,895
Transfers in	83,830,370	183,456,730	81,056,730
Other adjustments	12,667,525	6,227,361	6,227,361
Total additions*	1,273,739,676	1,429,602,986	1,327,202,986
Expenditures	1,291,225,584	1,268,611,085	1,268,611,085
Transfers out	75,680,370	15,056,730	81,056,730
Other adjustments	(3,950,759)	(1,455,946)	(1,455,946)
Total deductions*	1,362,955,194	1,282,211,869	1,348,211,869
Ending balance*	\$165,259,073	\$312,650,190	\$144,250,190
Increase/(Decrease)	\$(89,215,519)	\$147,391,117	\$(21,008,883)

Sources: California State Auditor’s analysis of the California State Controller’s Office expenditure and revenue data from the five funds that support the Beverage Container Recycling Program—the Beverage Container Recycling Fund, the Glass Processing Fee Account, the Penalty Account, the Bimetal Processing Fee, and the PET Processing Fee Account.

* Amounts may not agree due to rounding.

† Data for fiscal year 2013–14 are preliminary and have not been audited.

For the adjusted fiscal year 2013–14 amounts shown in the table, we assumed that all the amounts that CalRecycle actually transferred to its glass and plastic processing accounts (or \$81.1 million) would have come from the beverage program’s existing funds instead of being partially paid for with loan repayments from the General Fund. Therefore, the amount shown for transfers in reflects the \$81.1 million needed to pay the glass and plastic processors in that year. We increased the transfers-out amount to \$81.1 million to reflect that all transfers to the glass and plastic processing accounts would have come from beverage program funds. The importance of loan repayments can also be seen by looking at the fiscal year 2012–13 amounts in Table 2, which we have not adjusted. During fiscal year 2012–13, \$83.8 million was transferred in to the beverage program; however, only \$16.4 million (or 19.6 percent) of that amount was loan repayments. During that same year, the consolidated ending balance for the five funds dropped by \$89.2 million to an ending balance of \$165.3 million. With only \$82.3 million in loans still outstanding as of the end of fiscal year 2013–14, the beverage program cannot rely on future loan repayments to protect its fund balance, and further steps will be necessary to better ensure the program’s long-term financial sustainability.

The Legislature and CalRecycle Have a Variety of Options Available to Improve the Financial Stability of the Beverage Program

Without changes to the beverage program's fiscal operations—either through changes that enhance revenue, decrease costs, or a combination of both—recent experience from the last four years suggests that the beverage program's long-term financial health is at risk. If not for the significant cash infusions through loan repayments from other state funds, the beverage program would be in a weaker financial position than it is today. CalRecycle deserves credit for recognizing the precarious financial condition of the beverage program and for conducting outreach to stakeholders to solicit input on potential solutions. In November 2013 CalRecycle's quarterly report to the Legislature warned of the need to significantly reduce the beverage program's expenditures. A few months later, in January 2014, CalRecycle submitted a proposal to the Legislature that focused on improving the beverage program's fiscal sustainability by reducing expenditures by more than \$30 million for fiscal year 2014–15, with other proposals leading to estimated savings of more than \$100 million annually by fiscal year 2016–17.

In our view, some of CalRecycle's proposals, which we discuss in this section, have merit and present options that could be implemented in the short term through legislative action. Other solutions, such as reducing expenditures through more effective antifraud efforts, are longer-term options that we discuss later in this report. However, the beverage program appears to require immediate action. State law requires that CalRecycle maintain a contingency reserve equal to 5 percent of what it pays processors, equating to a reserve amount of roughly \$50 million. In fiscal years 2011–12 and 2012–13, the contingency reserve was \$38 million and \$71 million, respectively.

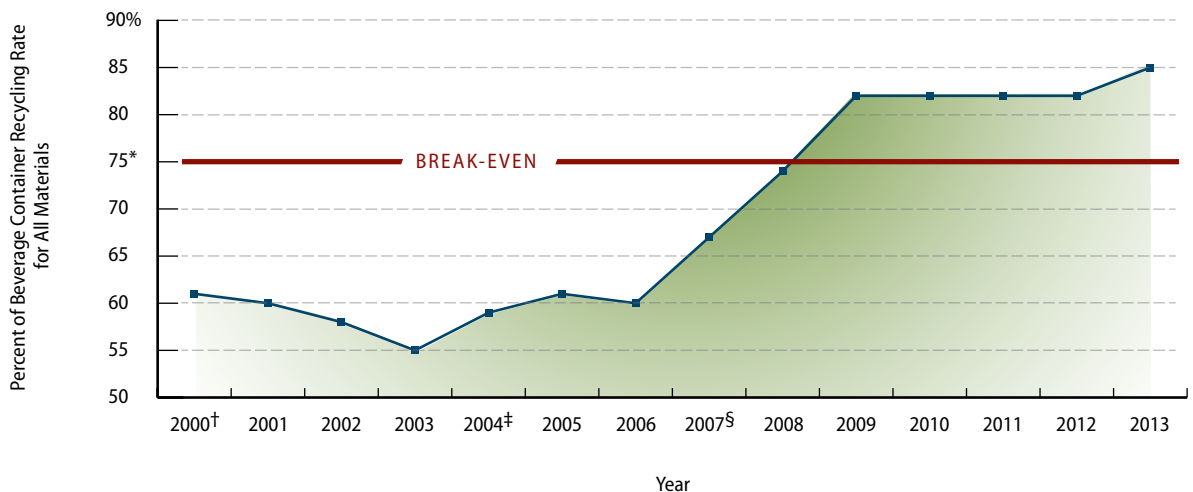
State law requires that CalRecycle maintain a contingency reserve equal to 5 percent of what it pays processors, equating to a reserve amount of roughly \$50 million.

To understand how the beverage program could go from having significant financial surpluses—to the point that it was loaning large amounts of money to other state funds—to having budget deficits, it is important to understand that the beverage program cannot achieve a high recycling rate and be financially self-sustaining. The principal source of revenue for the beverage program is the redemption payments beverage distributors make, based on the number of beverages sold or offered for sale in the State. The majority of payments out of the beverage program are for the California refund value (recycling refund payments), which are based only on those containers returned for recycling. Since state law mandates that CalRecycle make payments for a variety of other purposes besides the recycling refund payments, such as for its own administrative costs and the costs of various grant programs, the beverage program can become financially unstable if recycling rates become too high, leaving insufficient funds for the beverage

program’s other statutorily mandated payments. For example, CalRecycle reported that in fiscal year 2004–05, recycling rates hovered between 59 percent and 61 percent. During that same year, the beverage program’s revenues exceeded expenditures by more than \$40 million. By fiscal year 2012–13, however, recycling rates had reached 85 percent and revenues fell short of expenditures by more than \$100 million.

As indicated in Figure 3, recycling rates have steadily increased beyond its “break-even” point, above which, according to CalRecycle, the revenue collected from beverage distributors is no longer adequate to cover the payments to recycling processors and other mandated spending. The beverage program has a recycling goal of 80 percent and, according to CalRecycle, a much lower 75 percent recycling rate is the current break-even point where the beverage fund revenues are still able to cover recycling refund payments and the other mandated spending. As shown in the figure, the State first exceeded this 75 percent break-even recycling rate in 2008 and has been above it ever since.

Figure 3
California Beverage Container Recycling Rates
2000 Through 2013



Source: California Department of Resources Recycling and Recovery (CalRecycle) calendar year report of beverage container recycling rates for all materials.

* According to CalRecycle, the current break-even point where the Beverage Container Recycling Fund revenues can cover recycling refund payments is a 75 percent recycling rate.

† Effective January 2000, the Beverage Container Recycling Program expanded to include new beverage containers, including carbonated and noncarbonated water containers and sports drinks, among others.

‡ Effective January 2004, the California refund value (recycling refund payment) increased to 4 cents for containers that hold less than 24 fluid ounces and 8 cents for containers that hold 24 fluid ounces or more.

§ Effective January 2007, the recycling refund payment increased to 5 cents for containers that hold less than 24 fluid ounces and 10 cents for containers that hold 24 fluid ounces or more.

CalRecycle recently made two attempts to reduce the beverage program's expenditures. In May 2009 CalRecycle submitted a proposal to the Legislature that would have eliminated most of the statutorily required payments and consolidated the beverage program's various grants into a single and smaller grant program. CalRecycle estimated that these changes would have saved the beverage fund more than \$200 million annually. More recently, CalRecycle proposed a set of reforms for the fiscal year 2014–15 budget, including eliminating beverage processors' administrative fees and reducing and restructuring certain beverage program grants and payments, among others. CalRecycle estimated that once fully implemented, the proposed changes would have saved the beverage fund nearly \$127 million annually. We describe some of these proposals in more detail in Table 3.

However, the Legislature rejected both of these proposals. The April 2014 legislative staff comments regarding the fiscal year 2014–15 proposal indicated concern as to whether CalRecycle had done enough to collect all revenue due from beverage distributors and whether restructured handling fees would eliminate the recycling centers' profits and drive them to close. Although potential closure of recycling centers may negatively affect the State's recycling rate, the reality is that the beverage program has more than met its recycling goal and continues to spend more money than it is bringing in. While long-term approaches such as stronger antifraud enforcement and revenue collections may help, it is uncertain how quickly these efforts will produce results and how effective they will be at easing the beverage program's financial imbalance. As we discuss later in the report, CalRecycle lacks estimates of fraudulent program payments and has yet to quantify the fraud exposure related to redeeming out-of-state beverage containers.

When CalRecycle is confronted with inadequate resources to meet its financial commitments, statute allows it to proportionally reduce certain types of spending in the beverage program after providing the Legislature with at least 80 days' advance notice. With the Legislature's rejection of CalRecycle's latest proposals for fiscal year 2014–15, it is possible that CalRecycle will take steps to notify the Legislature and ultimately begin the process of proportionally reducing spending.¹ If the Legislature desires options other than proportional reduction, Table 3 lists some options for consideration. From fiscal years 2010–11 through 2013–14, expenditures have outpaced revenue by between \$28.7 million and \$130.9 million. Policy makers may debate the amount of needed cost savings required in the short term; however, given that three of the last four years have seen deficits of \$100 million or more, focusing on achieving \$100 million in cost savings seems like a prudent step.

The beverage program's expenditures have outpaced revenue by between \$28.7 million and \$130.9 million from fiscal years 2010–11 through 2013–14.

¹ The Legislature approved one of CalRecycle's proposals to diversify funding for local conservation corps grants, while also protecting this funding from proportional reduction.

Table 3
Potential Options to Improve the Financial Condition of the Beverage Container Recycling Program

POTENTIAL OPTION	MAXIMUM POTENTIAL SAVINGS	EXPLANATION	REQUIRED ACTION
Revenue Enhancements			
1 Processing fee offsets—Reduce or eliminate the State’s subsidies to beverage manufacturers by requiring them to pay the full cost of processing fees.	Between \$60 million to \$80 million annually	State law requires beverage manufacturers to pay a portion of the processing fees that the State pays processors (and other entities) to subsidize the cost of recycling certain beverage containers (such as glass and plastic). Currently, the Beverage Container Recycling Program (beverage program) subsidizes more than half of these processing fees. Requiring beverage manufacturers to pay the full cost of the processing fee would generate additional revenue and allow the processing fee accounts—such as the Glass Processing Fee Account and the Plastic Processing Fee Account—to be financially self-sustaining.	Amend the California Public Resources Code establishing the processing fee offsets by the beverage program and require beverage manufacturers to pay processing fees (California Public Resources Code, sections 14575 and 14581 (a)(5)(A)).
2 Administrative fees for beverage distributors—Reduce or eliminate administrative compensation to beverage distributors.	Up to \$18 million annually	State law allows beverage distributors to reduce redemption payments into the beverage fund by 1.5 percent to offset program participation costs. However, beginning in 2013, state law requires beverage distributors to electronically report information required under the beverage program. According to the California Department of Resources Recycling and Recovery (CalRecycle), electronic reporting reduces the financial burden associated with participating in the beverage program, as distributors are no longer required to submit paper reports.	Amend the California Public Resources Code to reduce or eliminate administrative offsets for beverage distributors (California Public Resources Code, Section 14574).
3 Eligible beverages—Increase the types of beverages that are subject to the requirements of the beverage program.	Unknown—depends on which beverages are added to the program.	The financial condition of the beverage program might temporarily improve if the containers for new beverages (such as wine, spirits, and milk containers) were also included in the beverage program. Theoretically, beverage distributors would pay redemption fees into the Beverage Container Recycling Fund on these new containers while payments to processors (and ultimately consumers) would be less. This gap between revenue collected and refund payments made would likely decline over time as the public became accustomed to recycling these new beverage containers.	Amend the California Public Resources Code to add additional types of beverages to the beverage program (California Public Resources Code, Section 14504).
Expenditure Reductions			
4 Administrative fees for processors—Reduce or eliminate administrative fee payments for processors.	Between \$24 million to \$27 million annually	State law requires CalRecycle to pay processors 2.5 percent of the California refund value for administrative costs associated with their participation in the beverage program. However, state law was amended to require electronic reporting, and CalRecycle indicated that electronic reporting reduces such costs.	Amend the California Public Resources Code to reduce or eliminate offsets for processors (California Public Resources Code, Section 14573).
5 Handling fees—Reduce or eliminate handling fees paid to recycling centers located in convenience zones.	Between \$40 million to \$50 million annually	Handling fees are payments to operators of a supermarket site, a rural recycler as defined in state law, or a nonprofit recycler located in a convenience zone. Convenience zones are an area within 1/2 mile of a supermarket or in an area designated by CalRecycle. The purpose for handling fees is to provide an incentive to open recycling centers in convenient locations (that is, near locations where beverages are sold) or in rural areas where it would be otherwise financially difficult to establish a recycling center. Although having convenient recycling locations likely helps to increase recycling rates, the benefit may not be worth the cost. The State has already achieved its statutory goal of an 80 percent recycling rate—achieving a rate of 85 percent in 2013—while program expenditures currently exceed revenue.	Amend the California Public Resources Code regarding the payment of handling fees (California Public Resources Code, sections 14581(a)(1) and 14585).

POTENTIAL OPTION	MAXIMUM POTENTIAL SAVINGS	EXPLANATION	REQUIRED ACTION
6 Curbside payments—Reduce or eliminate payments for curbside programs.	Up to \$15 million annually	State law requires CalRecycle to pay registered curbside entities based on their volume of beverage containers collected during a 12-month period. According to CalRecycle, these payments are no longer necessary because curbside infrastructure is completed and further payments will not result in additional expansion of the beverage program. Further, it indicated that the entities participating in the curbside programs will continue to receive the scrap and refund value for the items collected.	Amend the California Public Resources Code regarding curbside payments (California Public Resources Code, sections 14549.6 and 14581(a)(2)).
7 Plastic market development payments—Reduce or eliminate market development payments for plastic beverage containers.	Between \$10 million to \$19 million annually	CalRecycle makes these payments pursuant to state law to certain entities (such as recycling centers, processors, and product manufacturers) in order to develop California markets for empty plastic beverage containers collected for recycling. The payments are intended to encourage the (a) in-state cleaning of plastic beverage containers and (b) the processing of plastic containers into flakes, pellets, or other forms that can then be used by manufacturers. The statutory provisions allowing these payments expire in January 2017. Reducing or eliminating these payments before that time may be prudent given that program expenditures exceed revenue. Furthermore, CalRecycle already makes processing payments to encourage the recycling of plastic beverage containers.	Amend the California Public Resources Code regarding plastic market development payments (California Public Resources Code, sections 14549.2 and 14581(a)(8)(A)-(B)).
8 Quality incentive payments—Reduce or eliminate quality incentive payments to beverage program participants.	Up to \$10 million annually	CalRecycle makes quality incentive payments to entities certified under the beverage program (such as recycling centers, curbside recycling programs, and others). These payments are intended to improve the quality and marketability of empty beverage containers collected in the State. In general, CalRecycle makes this additional payment when the beverage container is sorted and cleaned. CalRecycle may make these payments for glass, plastic, and aluminum beverage containers. We note that the recycling rate for aluminum is around 100 percent, while CalRecycle already pays processing fees to encourage the recycling of plastic and glass containers.	Amend the California Public Resources Code regarding quality incentive payments (California Public Resources Code, sections 14549.1 and 14581(a)(7)).
9 Payments to cities and counties—Reduce or eliminate payments to cities and counties for litter reduction.	Up to \$10.5 million annually	CalRecycle pays \$10.5 million annually to cities and counties for beverage container recycling and cleanup activities pursuant to state law. CalRecycle relies on assertions from recipients to indicate how funds have been spent and lacks corroborating evidence to substantiate whether the goals of the beverage program have been met. Without greater accountability over spending, these expenditures should be reduced or eliminated.	Amend the California Public Resources Code regarding payments to cities and counties (California Public Resources Code, Section 14581(a)(3)).
10 Program payments to the California Department of Justice (Justice)—Reduce or eliminate CalRecycle's payments to Justice by modifying the contract's terms of payment for enforcement activities.	Up to \$3.6 million annually	CalRecycle pays Justice approximately \$3.6 million annually to conduct criminal investigations of fraudulent activity under the beverage program. Justice uses these funds to support roughly 20 full-time employees and equipment. Although Justice's work may provide a deterrent effect to those who would consider committing fraud, Justice's efforts have yielded little in terms of payments returned to the beverage fund. We discuss Justice's contributions to the beverage program in Table 5 on page 37 of our audit report.	Our report recommends that CalRecycle change the terms of how it pays Justice for its enforcement activities.

Source: California State Auditor's analysis of the California Public Resources Code.

The most financially significant proposal in Table 3 is one that CalRecycle mentioned in its recent budget proposal to the Legislature, and one we believe has merit. CalRecycle collects processing fees from beverage manufacturers (such as those entities that fill glass and plastic beverage containers) and then uses these funds to make processing payments to a processor—in addition

to making the recycling refund payment—once the container is recycled. According to CalRecycle, the original purpose of collecting processing fees was to ensure that each type of beverage container “pays its own way” for recycling. Under state law, CalRecycle is required to make processing payments when it determines that the cost of recycling a container exceeds the container’s scrap value. However, state law requires beverage manufacturers to pay only a small portion of the processing fee, while the beverage program’s existing resources pay for the difference. In fiscal year 2012–13, the beverage program collected \$11.7 million in processing fees from beverage manufacturers for glass and plastic beverage containers. During the same year, CalRecycle transferred \$67.4 million from the beverage fund to the glass and plastic processing accounts to make the related processing payments. Requiring beverage manufacturers to pay the full cost of the processing fee could bring additional revenue ranging between \$60 million and \$80 million annually into the beverage program’s glass and plastic processing fee accounts.

Other options to increase revenue include eliminating administrative fees for beverage distributors and increasing the types of beverages that are subject to the beverage program. Under state law, beverage distributors are required to pay only 98.5 percent of the redemption payment owed to the State, keeping the remaining 1.5 percent for administrative costs. In fiscal year 2013–14, redemption payments into the beverage fund amounted to roughly \$1.2 billion. Since this equals 98.5 percent of what would otherwise have been collected, the beverage program is missing an opportunity to collect roughly \$18 million. Although it did not suggest eliminating the administrative fee in its fiscal year 2014–15 proposal to the Legislature, CalRecycle argues that the administrative burden on distributors has diminished, given that reporting is now standardized into an electronic process. However, distributors will likely argue that there is still an administrative burden to complying with CalRecycle’s reporting requirements. Reviewing and quantifying the cost of the distributors’ administrative burden was outside the scope of our audit, yet it is likely that distributors incur at least some administrative expense from participating in the beverage program, though perhaps not as much as when it was a paper-based reporting process.

The final option for increasing revenue includes broadening the reach of the beverage program to include other beverage containers currently exempted under state law. For example, containers used for wine, milk, and infant formulas, among others, are exempted by statute from the beverage program’s requirements. According to CalRecycle’s deputy director (deputy director), CalRecycle does not have immediate plans to advocate broadening the recycling base for a number of reasons, including the fact that the financial benefits would be relatively short term. For example, CalRecycle’s published

Other options to increase revenue for the beverage program include requiring beverage manufacturers to pay the full cost of processing fees, eliminating administrative fees for beverage distributors, and increasing the types of beverages that are subject to the beverage program.

recycling rates show that following the addition of beverage containers filled with carbonated and noncarbonated water in January 2000, the recycling rate for all materials dropped from 61 percent to 55 percent in 2003. However, the low recycling rate only lasted for five years, after which it returned to the original rate of 61 percent in 2005.

According to the deputy director, generally the beverage fund initially benefits from adding eligible beverages by receiving additional redemption payments from beverage distributors while not having the same increase in recycling refund payments as a result of lower consumer recycling. This provides a temporary financial stopgap until recycling rates recover. We noted that several legislative bills during the 1990s would have added wine and distilled spirits to the beverage program; however, none of the bills became state law. As such, we recognize that adding such beverages to the beverage program may be difficult, even if doing so serves to further the ultimate goal of increasing recycling and conservation.

Aside from discussing ways to increase revenue, Table 3 also lists several options to reduce program expenditures. Such options include reducing or eliminating handling fees, market development payments for plastic containers, and certain payments to cities and counties, among others. Our observation about modifying the terms of payment in CalRecycle's contract with the California Department of Justice (Justice) is discussed in more detail later in this report. Collectively, the options presented in Table 3 provide an opportunity to achieve as much as \$233 million annually in savings and revenue enhancements. Regardless of the options the Legislature might choose, we believe change is necessary to ensure that the beverage program can remain financially stable.

CalRecycle Has Not Estimated the Amount of Fraud in the Beverage Program and Its Potential Effects on the Beverage Fund

CalRecycle's Recycling Program Enforcement Branch (enforcement branch) is responsible for inspecting and investigating beverage program participants and for protecting the beverage fund from fraudulent or improper payments. A significant fraud risk to the beverage program occurs when recycling centers make recycling refund payments for containers that were sold out of state—where beverage distributors did not initially pay into the beverage fund; the fund suffers a 100 percent loss on those payments. To increase monitoring on the State's borders, CalRecycle has partnered with the California Department of Food and Agriculture (Food and Agriculture). Food and Agriculture's agents inspect and collect data on the number of empty beverage containers as well as information on the individuals transporting these beverage

A significant fraud risk to the beverage program occurs when recycling centers make recycling refund payments for containers that were sold out of state.

containers into California. CalRecycle will then analyze these data for use in criminal investigations and in the prosecution of fraud suspects. However, CalRecycle has yet to analyze all the data collected from Food and Agriculture and hopes to have a clearer picture of the amount of fraud exposure in November 2014 and to develop a formal process for analyzing these data by the end of the year. Further, CalRecycle has developed a fraud management plan and many of its practices appear reasonable; however, our review found that CalRecycle lacks estimates of what types of fraudulent activities pose the greatest financial risk to the beverage program. Lacking this insight, CalRecycle is unable to demonstrate that it is focusing its limited resources in the areas of highest risk to ensure the greatest financial return to the beverage program.

CalRecycle is unable to demonstrate that it is focusing its limited resources in the areas of highest risk to ensure the greatest financial return to the beverage program.

CalRecycle Does Not Know How Much of the Beverage Fund's Losses Are Attributable to Paying for Recycling Out-of-State Beverage Containers

Although the beverage program requires additional revenue enhancements or cost reductions to better ensure its financial stability, CalRecycle also needs to better understand and quantify the fraud risk presented by the importation of out-of-state beverage containers for recycling refund payments. A variety of factors make the beverage program susceptible to fraud, and although CalRecycle has recently begun to consistently track the volume of these containers and who is transporting them into the State, it has yet to formalize its approach to analyze the data that have been collected thus far and lacks an estimate on the fraud exposure stemming from this problem. The threat posed by the fraudulent redemption of out-of-state beverage containers is not new. In February 2000 Justice informed CalRecycle's predecessor agency—the California Department of Conservation (Conservation)—of its estimate that roughly \$40 million in annual losses may be attributable to fraud, including out-of-state redemption fraud. CalRecycle needs to develop a process to consistently analyze and respond to the data it already collects on out-of-state beverage containers. By doing so, and by developing its own estimate of fraud exposure in this area, CalRecycle could better communicate to the Legislature and the public the magnitude of this problem and better demonstrate that it has a reasonable approach to investigating and preventing the redemption of out-of-state beverage containers.

To the extent that the beverage program makes recycling refund payments on out-of-state containers, it suffers a 100 percent loss on those payments. Recycling refund payments are financed by beverage distributors who pay CalRecycle based on the number of beverage containers sold or offered for sale in the State. However, when CalRecycle uses funds from the beverage fund to pay for the recycling of containers that were sold out of state—where beverage

Identifying out-of-state beverage containers at recycling centers is difficult because the California refund logo is printed on the beverage container along with logos from multiple states.

distributors did not initially pay into the California beverage fund—the beverage fund realizes a financial loss. One problem with identifying out-of-state beverage containers at recycling centers—so fraudulent refund payments can be prevented—is the fact that the California refund logo is printed on the beverage container along with the logos from other states, thus weakening the value of logos as an identification aid. Figure 4 identifies examples of these different state logos. According to the Can Manufacturers Institute, roughly 31 billion aluminum cans were sold in the United States in 2012 that included the California refund value logo. During that same time period, CalRecycle's data indicated that only 8.6 billion aluminum cans were sold in California. Assuming that as little as 3 percent of the 22.4 billion aluminum cans sold out of state were brought back to California for recycling (or roughly 672 million cans), at 5 cents for each can the beverage fund would pay a total of \$33.6 million in fraudulent recycling refund payments. In this hypothetical example, the \$33.6 million would represent a total loss to the beverage fund since the beverage distributors did not initially pay into the beverage fund for these out-of-state containers.

The clearest solution to the problem would be to require that beverage manufacturers only print the California refund logo on beverage containers to be sold in the State. However, such an approach would likely result in legal challenges from beverage manufacturers. In 2008 Michigan enacted laws requiring a state-specific mark on qualifying beverage containers indicating that a container was purchased and redeemable only in that state. However, in November 2012, the United States Court of Appeals for the Sixth Circuit Court struck down Michigan's law, ruling that it violated the Federal Commerce Clause and interfered with interstate commerce.² As a result, pursuing a solution to this problem with beverage manufacturers directly seems unlikely.

With the State having little leverage with beverage manufacturers to develop a solution to the logo problem, the chief of CalRecycle's enforcement branch (enforcement chief) told us that the State also cannot impose an outright ban on bringing empty beverage containers into California. Although California law makes it illegal for consumers to claim the California recycling refund payment for redeeming beverage containers sold outside the State—punishable by fines and/or imprisonment—it is legal to sell out-of-state empty beverage containers in California for their scrap value. In fact, the disparity can be so great between what an individual would receive for the recycling refund payment when compared to the scrap value that the difference may actually incentivize consumers crossing the state border to claim they intend to sell the containers for scrap

² In October 2013 the Supreme Court of the United States denied Michigan's petition to review the Court of Appeals' decision.

when in fact they plan to obtain the recycling refund payment. As of April 2014 the California scrap value for aluminum was just under \$1,650 per ton. In contrast, the recycling refund payment on eligible aluminum containers was \$3,160 per ton—a difference of \$1,510. Overall, the difficulty associated with identifying in-state versus out-of-state beverage containers, combined with the fact that individuals may bring out-of-state beverage containers into California with, until recently, only limited monitoring by CalRecycle, has created an environment conducive to those who would attempt to defraud the beverage program.

Figure 4
Examples of Beverage Containers With Redemption Value Logos From California and Other States



Source: California State Auditor's analysis of commercially available beverage containers.

As required by law, individuals importing over 25 pounds of empty beverage containers into the State must pass through a California border agricultural inspection station and report the load.

In 2011 CalRecycle partnered with Food and Agriculture to initiate a three-month pilot program at all 16 California border agricultural inspection stations. The pilot program involved agents from Food and Agriculture identifying and documenting vehicles importing out-of-state beverage containers. Based on the data, CalRecycle estimated a potential for \$7 million in fraud annually from rental trucks crossing the border filled with empty beverage containers. Following the pilot program, state law changed and now requires individuals importing over 25 pounds of empty beverage containers into the State to pass through an inspection station and report the load. According to its current interagency agreement with Food and Agriculture, CalRecycle plans to use the information collected from the agents at the borders to analyze trends in the data for use in criminal investigations and in the prosecution of fraud suspects. For example, according to the supervising management auditor of the enforcement branch, it has referred 13 cases to Justice and initiated five investigations based on a preliminary review of the information received. According to the enforcement chief, the information should also allow CalRecycle to estimate the volume of out-of-state beverage containers coming through the border stations and thus the potential impact on the beverage fund.

In an attempt to better monitor the inflow of out-of-state beverage containers, CalRecycle recently established regulations, effective in January 2014, that solidify what data it will collect from Food and Agriculture's border inspection stations. CalRecycle's enforcement chief acknowledged that CalRecycle has not fully analyzed all of the data collected from Food and Agriculture since the regulations passed in January 2014. He told us that CalRecycle is currently analyzing the first five months' worth of collected data and expects to have a clearer understanding of the potential size and types of fraud risk associated with imported empty beverage containers in November 2014. The enforcement chief also plans to establish a formal process for analyzing the data received from the Food and Agriculture agreement by the end of 2014.

Although CalRecycle has not fully analyzed the data it received from Food and Agriculture, it appears to have taken the initial steps necessary to establish a systematic process for monitoring and responding to the risk of out-of-state beverage containers. CalRecycle needs to continue with these efforts in order to fully evaluate the effect that out-of-state importation has on the beverage program. By doing so, CalRecycle could better communicate to the Legislature and the public the magnitude of this problem and better demonstrate that it has a reasonable approach to investigating and preventing the redemption of out-of-state beverage containers.

***CalRecycle's Fraud Prevention Efforts Are Reasonable, but Limited
Financial Recoveries Raise Questions as to Their Effectiveness***

Although perhaps the largest fraud risk facing the beverage program is represented by out-of-state beverage containers being brought to California and receiving payments for their recycling refund value, CalRecycle's enforcement branch has identified other areas of the program that are also at risk for fraud. Examples of these fraudulent activities are listed in the text box.

The enforcement branch developed a fraud management plan that identifies three broad categories of fraud that affect the beverage fund, and it identified examples of fraudulent activity under each category, based on its experience with the beverage program. Our review of CalRecycle's different fraud prevention and investigation activities revealed that it performed the types of activities that one might reasonably expect. For example, to ensure that recycling centers comply with payment requirements, enforcement branch staff periodically inspect a recycler's loads of beverage containers delivered to processor locations to ensure that only eligible beverage containers are presented for recycling refund payments and to review supporting documentation for accuracy. The enforcement branch also has a process to receive and respond to fraud leads the public provides through its telephone call centers or through e-mail.

We reviewed the enforcement branch's procedures for tracking and investigating fraud leads by examining 15 substantive leads during fiscal year 2012–13. In all 15 cases, we found that the enforcement branch could explain how it addressed all the allegations and could demonstrate how it tracked fraud leads. We also found that the enforcement branch was able to provide records explaining why it closed a particular investigation. For example, for one allegation received from a county police sergeant, we were able to identify and review the information on the enforcement branch's follow-up site visit and relevant casework, which resulted in CalRecycle's decision to deny the suspect's application to become a certified recycler.

One of CalRecycle's central processes for combating fraud focuses on preventing fraudulent payments before they occur. Specifically, CalRecycle has a practice to temporarily hold payment on a recycler's suspicious or irregular claim pending further review.

**Examples of Potential Fraud in the
Beverage Container Recycling Program**

Fraud categories and fraudulent activities identified by the California Department of Resources Recycling and Recovery's (CalRecycle) Recycling Program Enforcement Branch (enforcement branch) include the following:

Ineligible Materials-Related Fraud

- Paying or claiming the recycling refund payment on out-of-state containers.
- Claiming the recycling refund payment on previously redeemed containers, which results in CalRecycle making more than one payment for the same beverage containers.

Payment-Related Fraud

Processors or recyclers not fully paying amounts owed by underweighing returned beverage containers.

Falsified Records-Related Fraud

- Falsifying consumer transactions, shipping reports, or processor invoices.
- Falsifying beverage container volumes to secure larger payments.

Source: CalRecycle's enforcement branch Executive Summary (December 2011).

We reviewed 25 prepayment hold cases between June 2012 and June 2013 and found that CalRecycle determined that it had cause to reduce six of the 25 claims by a combined total of roughly \$1,300 for a variety of violations. Our review also found that CalRecycle generally met its policy to complete its review and release the payment holds in less than 10 business days. In three of the 25 cases, CalRecycle took between 11 and 18 days to release payment holds. However, despite CalRecycle's ability in state law to develop and implement such a prepayment control process, we noted one significant concern with its approach. Although state law authorizes CalRecycle to reduce or deny payments based on violations found during its review, our legal counsel has advised us that some of CalRecycle's policies and procedures regarding prepayment holds would likely be determined to be unenforceable underground regulations because they were not properly adopted as regulations in accordance with the Administrative Procedures Act, which requires CalRecycle and other state departments to allow public comments on proposed regulations.

Nevertheless, despite the myriad of activities that CalRecycle engages in to prevent and detect fraud, evidence we reviewed suggests that CalRecycle's antifraud activities result in relatively limited financial recoveries for the beverage program in the form of restitution (the recovery of amounts paid improperly from the beverage program) and penalty assessments against those who violate the beverage program's rules. The data for fiscal year 2012-13 further highlight our concern regarding the cost-effectiveness of CalRecycle's efforts and the importance of having fraud estimates. In fiscal year 2012-13, CalRecycle's data indicated that it conducted more than 3,500 recycling center inspections and investigations. During that same year, the beverage program recorded roughly \$1.3 million in funds owed to the beverage program in the form of both revenue from penalty assessments (roughly \$745,000) and refunds to recover improper payments (roughly \$530,000). These penalties and recoveries translate to a return of roughly \$364 per investigation or inspection. However, the chief of fiscal services told us that of the \$530,000 recorded in refunds, just over \$117,000 was as a result of enforcement branch activities; thus, the return on its efforts may be even less. While the \$1.3 million likely will not have a meaningful effect on the beverage program's financial operations, the limited return per investigation or inspection raises questions as to whether these investigations are worthwhile financially given the personnel costs of those who perform them. Based on our review of CalRecycle's accounting records, its investigation and inspection units (in both Northern and Southern California) cost roughly \$3.7 million in fiscal year 2012-13, which translates to roughly \$1,000 per inspection or investigation. As a result, it appears that it may have cost CalRecycle on average more than \$1,000 to recover just \$364. CalRecycle also indicated that its regular on-site

Based on our review of CalRecycle's accounting records, it appears that it may have cost CalRecycle on average more than \$1,000 in personnel costs to recover just \$364 in restitution for the beverage program.

inspections and its prepayment holds, among other antifraud activities, help to prevent and deter fraud. We acknowledge that CalRecycle's investigations and inspections may provide additional benefits beyond recoveries in that they serve as a deterrent to those who might otherwise attempt to defraud the beverage program. We also recognize that quantifying such a benefit is difficult. Nevertheless, we believe these results should cause CalRecycle to reconsider whether its investigations and inspections can be more effective.

To its credit, following a multiyear investigation, CalRecycle was successful in June 2014 when an administrative law judge ordered two companies and four individuals to pay restitution and administrative penalties for defrauding the beverage program. According to the administrative law judge's ruling, CalRecycle was entitled to \$32.6 million in restitution to recover fraudulently obtained payments and an additional \$18.7 million in fines and penalties. However, a CalRecycle supervising attorney indicated that the judgment has been appealed and CalRecycle will not be able to collect on the judgment until the appeal is decided, estimated in April 2015. Although such a judgment is a positive outcome and CalRecycle's press release on the ruling may have helped to raise public awareness of its activities and deter some from committing fraud, the beverage program does not financially benefit from such a judgment until it actually receives the money to which it is entitled.

Because CalRecycle has limited resources to investigate and prevent fraud, it is important that those resources be focused on the areas that put the beverage program at the most risk. However, similar to the fraud associated with obtaining refund payments for out-of-state containers, CalRecycle has not established a process that quantifies the annual amount associated with each type of fraud identified in the text box on page 27. Until CalRecycle can identify where its fraud exposure is the greatest—and how it can best detect fraud during its reviews—it will not be able to ensure that it is doing all it reasonably can to minimize fraud. CalRecycle has a variety of data with which it can begin to estimate fraud potential and then decide on the benefits of investigating such fraud. For example, with the recent regulations that became effective in January 2014, CalRecycle is now capable of developing a process to systematically track the importation of out-of-state beverage containers and to follow up with the reported shipping destinations to ensure that the beverage program did not pay for the material. Such an effort will allow CalRecycle to estimate the volume of imported beverage containers and the financial risk to the beverage program. With respect to its various investigations and inspections, CalRecycle could also begin to analyze data from its previous investigations to quantify the value of the questioned costs

Until CalRecycle can identify where its fraud exposure is the greatest, it will not be able to ensure that it is doing all it reasonably can to minimize fraud.

it had identified. Using this information, CalRecycle may conclude that the fraud risk is low, given the amounts of money involved, or it may conclude that it needs to reevaluate how it performs its investigations if it believes it should be finding more instances of fraud or improper payments. Regardless, until CalRecycle establishes metrics for the fraud potential associated with the various types of fraud it has identified, neither the Legislature, the public, nor CalRecycle will be able to evaluate the effectiveness of the beverage program's fraud prevention efforts.

It Is Unclear Whether CalRecycle Should Be Collecting More Revenue for the Beverage Program, and Altering the Process for Revenue Collection May Hold More Promise

Earlier we discussed how the beverage program's expenditures outpaced revenues from fiscal years 2010–11 through 2013–14. Such a condition is not sustainable in the long run and if this situation persists, CalRecycle and the Legislature must decide whether to reduce costs, increase revenue, or pursue a combination of both. Although quantifying how much can be saved by reducing certain costs can be readily determined based on examining the beverage program's prior expenditures, quantifying how much additional revenue could be or should be obtained is more speculative and subject to debate. For example, in March 2014, CalRecycle issued a report comparing its beverage container sales data from 2010 against the data it purchased from other industry groups. While CalRecycle concluded that the risk associated with it not identifying and collecting additional program revenue was low, a nonprofit group that focuses on recycling issues took issue with various aspects of CalRecycle's analysis, claiming that the beverage program could be missing an opportunity to collect more than \$200 million annually. The nonprofit group, called the Container Recycling Institute (CRI), largely attributed the problem to beverage distributors failing to pay what they owe to CalRecycle.

Although we do not have sufficient evidence to determine whose conclusion—CalRecycle's or CRI's—is correct with respect to the adequacy of revenue collection, the debate helps highlight an important point: the determination of how much is owed to the beverage program is largely determined by the entities that pay, which creates the risk of the underreporting of beverage container sales and the resulting revenue due to the beverage program. State law requires beverage distributors to make redemption payments to CalRecycle for every eligible beverage container they offer for sale in California. CalRecycle's Division of Recycling Integrated Information System (DORIIS) allows beverage distributors to

electronically report the number of beverage containers sold. Based on their reported information, beverage distributors inform CalRecycle of the amount of redemption payments they owe.

Although CalRecycle has taken reasonable steps to mitigate the risk that distributors have not registered or have underreported beverage container sales, auditing beverage distributors is a time-intensive process and other efforts have yielded little additional revenue to the beverage program. The Legislature may want to consider amending state law to change the revenue-collection method and instead require the collection of redemption payments at the point of sale when a consumer purchases an eligible beverage. Ultimately, consumers purchase beverages and the beverage program aims to influence customer recycling behavior by charging a fee that can be reclaimed when the consumer returns the container for recycling. Using the California State Board of Equalization (Equalization) to collect the redemption payment from beverage dealers (such as from grocery and convenience stores) may be a better means to more reliably collect revenue for the beverage program while keeping the focus on consumers. Under this new revenue-collection system, beverage dealers are simply passing on to Equalization what they collect from customers at the point of sale instead of CalRecycle relying on beverage distributors to self-report how much they owe. Although we acknowledge that beverage dealers may also have an incentive to underreport redemption fees to Equalization should the Legislature change the revenue-collection process, the financial implications of Equalization's potential involvement in the beverage program are worthy of further study.

CalRecycle Has Taken Reasonable Steps to Verify and Identify Those Who Owe Funds

CalRecycle has taken reasonable steps to mitigate the risk that distributors and others will not pay what they owe the beverage program based on its available resources. In particular, CalRecycle performs audits to verify that the amounts paid to the beverage program are correct for roughly 30 to 40 beverage distributors, which are selected for review each year based on their risk. More recently, CalRecycle began a pilot program to perform in-person surveys of beverage dealers to determine if it could identify products from unregistered beverage manufacturers and distributors who have not paid the beverage fund.

Given its limited resources—CalRecycle indicated that there are over 1,400 beverage distributors and roughly 30 audit staff—it follows a risk-based process to select entities for audit, assigning a priority score to each beverage distributor. CalRecycle

Using Equalization to collect the redemption payment from beverage dealers may be a better means to more reliably collect revenue for the beverage program.

auditors consider a variety of risk factors when determining the priority score, such as the dollar amounts the distributor pays and whether prior audit findings resulted in amounts owed to the beverage program. Table 4 shows, for fiscal year 2013–14, the top 25 distributors (by dollars paid to the beverage program) and indicates when they were last audited, according to CalRecycle’s records.

Table 4
Top 25 Beverage Distributors and When They Were Last Audited
Fiscal Year 2013–14

BEVERAGE DISTRIBUTOR*	TOTAL REDEMPTION PAYMENTS	DATE LAST AUDITED BY CALIFORNIA DEPARTMENT OF RESOURCES RECYCLING AND RECOVERY
1	\$174,725,702	September 2010
2	136,534,134	December 2012
3	130,757,974	December 2013
4	65,083,471	August 2013
5	47,560,830	January 2012
6	42,590,398	August 2014
7	32,402,885	June 2011
8	21,384,063	April 2012
9	16,558,074	May 2014
10	15,674,427	December 2010
11	13,605,288	November 2010
12	13,352,586	March 2013
13	12,263,504	November 2010
14	11,301,935	January 2012
15	11,175,216	April 2011
16	9,786,824	January 2011
17	9,624,276	March 2013
18	9,472,423	September 2010
19	9,438,100	December 2005
20	8,368,973	January 2014
21	8,128,780	March 2013
22	7,992,907	March 2008
23	7,819,316	March 2008
24	7,679,421	September 2009
25	7,641,702	November 2013
Total	\$830,923,209	

Source: California Department of Resources Recycling and Recovery (CalRecycle) data regarding the top 25 beverage distributors, by redemption payments paid and when CalRecycle last audited them.

* Because these audits relate to financial information of the beverage distributors, their identities are confidential under California Public Resources Code, Section 14554.

We reviewed nine audits completed during fiscal year 2012–13 and one audit completed in fiscal year 2013–14 and noted that CalRecycle completed these audits on average within 651 days (or 1.8 years) after it began its fieldwork with the distributor. For some audits, the auditors spent most of this time performing fieldwork, while at other times the delay was caused by audit reports awaiting clearance from CalRecycle’s quality control reviewers. According to CalRecycle’s former audit chief, fieldwork can be challenging since beverage distributors may not have records readily available for the auditors to confirm that they have remitted all payments due to CalRecycle. While beverage distributors typically can provide a report of California sales, according to the former audit chief, auditors need to see other reports to verify the completeness of the California sales report and determine whether any other beverage sales should have been included. When distributors cannot provide enough information to help corroborate the completeness of their California sales information, or when distributors delegate the reporting of their sales to third parties, delays in the audit process can occur. The former audit chief also acknowledged delays in performing quality control reviews, explaining that there are three positions to perform these reviews but two of the staff in those positions had recently retired.

We did not find evidence that the delayed completion of its audits negatively affected CalRecycle’s ability to collect any amounts due to the beverage program. In the audits we reviewed, CalRecycle’s auditors identified varying amounts due, including \$7,000 from one distributor and more than \$6.2 million from another. Until recently, state law prescribed a two-year statute of limitations for seeking amounts due, starting when auditors become aware of underpayments. This statute was recently amended, increasing the time limit from two years to a longer five-year statute of limitations. Further, according to a CalRecycle supervising attorney, if a beverage distributor disputes the finding or refuses to pay the fees or penalties, CalRecycle can file a formal accusation, which satisfies the legal requirement to take action within the prescribed statutory period. Eight of the 10 audits we reviewed included findings that resulted in amounts owed to the beverage program. CalRecycle has collected the full amount on five of these eight audits while the remaining three are either in negotiations or are being further contested by the distributor and are being handled by CalRecycle’s attorneys. Although CalRecycle’s audits appear to add value and to identify funds due to the beverage program, the amounts identified are not significant in the overall context of the beverage program. For example, according to its now-acting audit manager, CalRecycle completed 39 audits during fiscal year 2013–14 and identified just over \$8 million in funds due to the beverage program. This equates to less than 1 percent of the \$1.2 billion in revenue the beverage program recorded during that year. Again, we acknowledge that

Although CalRecycle’s audits appear to add value and to identify funds due to the beverage program, the amounts identified are not significant in the overall context of the beverage program.

In April 2014 CalRecycle began a pilot project to conduct shelf surveys of beverage dealers to identify unregistered beverage manufacturers and distributors doing business in the State.

beyond the funds they recover, there is a potentially unknown value these audits have in deterring beverage distributors that might otherwise be tempted to underreport their sales of beverage containers.

Aside from performing audits, CalRecycle has started two other initiatives aimed at better ensuring that it has identified all beverage distributors. Beginning in April 2014 CalRecycle began a pilot project to conduct shelf surveys of beverage dealers to identify unregistered beverage manufacturers and distributors doing business in the State. According to the supervisor of CalRecycle's beverage program registration unit (registration supervisor), by early October 2014, CalRecycle staff had visited 37 beverage dealers in the Sacramento area over a five-month period and had identified over 400 potential leads for investigation. Of these potential leads, CalRecycle determined that 81 were unregistered and 147 were already registered in DORIIS. She further indicated that based on their review, the remaining leads were not worth pursuing further. In addition to shelf surveys, CalRecycle has purchased data from a research organization in the hope of identifying beverage distributors who are not registered in the beverage program. Using these purchased data, CalRecycle initially identified more than 1,800 leads on distributors that may not have registered under the beverage program. However, in early October 2014, the registration supervisor indicated that CalRecycle had pursued all potential leads and had registered only 12 new beverage distributors and 14 new beverage manufacturers. Although these efforts have not yielded significant numbers of new registrations under the beverage program, they are reasonable steps that can be repeated periodically to better ensure that program participants are not evading registration.

An Alternative Model of Revenue Collection Exists That May Lessen the Risk of Underpayments to the Beverage Program

Although current law establishes a revenue collection process in which beverage manufacturers and distributors report their sales information and pay the resulting processing and redemption payments that financially support the beverage program, such a model does not need to continue and may need to change. CalRecycle's auditors find it difficult and time-intensive to audit beverage distributors and ensure that the amounts paid to the beverage program are correct. With beverage containers displaying the refund logos from multiple states and with some out-of-state companies importing beverages for sale in California, identifying who owes money to the beverage program and how much they owe becomes a difficult task for CalRecycle that is subject to disagreements. A potentially simpler model of revenue collection would be for the Legislature to amend state law to require

Equalization to collect redemption and processing payments at the point of sale when consumers purchase their beverages in California's grocery stores, convenience stores, and other consumer-facing businesses.

Having a revenue collection process that is customer-centric recognizes the important role consumers play in the recycling process and reflects the Legislature's desire to influence consumer behavior to encourage greater amounts of recycling. Focusing on the consumer makes sense because it is the consumer who has to decide what to do with the beverage container once it is empty. Although beverage manufacturers and distributors have been paying the funds that support the beverage program, market forces have likely always pushed these costs down to beverage dealers and ultimately to consumers. When enacting the beverage program, the Legislature noted the important role consumers play by stating that financial incentives and convenient return systems ensure the efficient and large-scale recycling of beverage containers. The Legislature declared its desire that recycling systems develop that assure all consumers in every region of the State have the opportunity to return beverage containers conveniently, efficiently, and economically.

One way to increase consumer awareness of recycling is to make them acutely aware that they are paying for recycling at the point of sale. CalRecycle and its predecessor agency—Conservation—have communicated to beverage dealers the importance of making consumers aware of the redemption charge being assessed at the time of purchase. For example, in June 2007 Conservation advised all retail stores that the California Redemption Value for beverages sold in California was increasing to 5 cents for beverages less than 24 ounces and 10 cents for beverages 24 ounces or more. In its letter, Conservation stated that retailers may charge the new rate and, if they do, they should show the amount as a separate line item on the cash register receipt. Further, CalRecycle's Web site advises beverage dealers (retailers) that if their location is greater than 4,000 square feet, they are required to display the refund value as a separate component of the beverage container price on all advertising and shelf labels. For example, the price for a six-pack of soda might be labeled at a dealer as "\$1.99 plus CRV" or "\$1.99 plus 30 cents CRV."

Using Equalization to collect payment at the point of sale is also consistent with the method of fee collection for another state recycling program. The California Tire Fee (tire fee) is generally assessed on the retail purchase of new tires sold with new or used motor vehicles or intended for use with, but sold separately from, on-road and off-road motor vehicles. Equalization collects the tire fee from tire retailers on behalf of CalRecycle and the

One way to increase consumer awareness of recycling is to make them acutely aware that they are paying for recycling at the point of sale.

Air Resources Board, and the proceeds are used to fund programs that promote recycling and other alternatives to landfill disposal and the stockpiling of used tires. We asked CalRecycle whether it has explored using Equalization as a partner to collect the beverage program's revenues. In response, the deputy director of administration, finance, and information technology services told us that CalRecycle had met with Equalization in 2012 to develop a cost estimate for that agency to collect redemption payments and conduct audits; however, this effort was put on hold to accommodate CalRecycle's annual budget process and was never finalized. We similarly spoke with Equalization about the feasibility of collecting revenue on behalf of the beverage program. According to a legislative analyst at Equalization, it is capable of performing point-of-sale collection of redemption payments and it currently performs audits of retailers on other fees that it is charged with collecting. She further indicated that for its other collection assignments, Equalization has the legal authority to levy both civil and criminal penalties for violations. However, she noted that the exact costs of performing these duties on behalf of the beverage program are currently unknown. Regardless, using the point of sale as the focal point for collection may lessen the uncertainty over how much revenue should be flowing into the beverage program. Given the large and fundamental change this would be to the beverage program, the Legislature may want to require that Equalization and CalRecycle analyze the feasibility of such an approach and report back on their findings to the applicable legislative policy committees.

CalRecycle Pays Justice Significantly More to Investigate Criminal Activity Than the Financial Recoveries That Result From Its Efforts

From fiscal years 2011–12 through 2013–14, Justice's criminal investigations resulted in collecting roughly \$340,000 in recoveries for the beverage program.

CalRecycle executed an interagency agreement with Justice in May 2011 that requires Justice to investigate criminal activity associated with the beverage program. Both agencies expressed their hope to successfully combat the illegal activities that threaten the beverage program through the increased cooperation and coordination called for under the agreement. The original agreement spanned the three fiscal years from 2011–12 through 2013–14 at a total cost of \$10.7 million, or roughly \$3.6 million annually. CalRecycle and Justice recently executed a new agreement that will cover the next three fiscal years—ending in June 2017—for the same amount. Although the goal of combating fraud is laudable, we question whether the agreement with Justice is financially beneficial to the beverage program. From fiscal years 2011–12 through 2013–14, CalRecycle informed us that Justice's investigations resulted in collecting roughly \$340,000 in recoveries for the beverage program. This equates to a return of less than 3 cents for every dollar paid to Justice. Justice's perspective is that the role of its agents is to stop identified fraud through its investigations and

subsequent arrests, adding that it is up to prosecutors to complete the process and seek restitution for the beverage fund. Regardless, it appears that Justice could do more to follow up with prosecutors and better communicate the results to CalRecycle. Further, we believe CalRecycle needs to reconsider how it pays Justice for its investigative activities.

According to the budget established in the interagency agreement, Justice is to use over \$2.5 million of its total \$3.6 million annual budget (or nearly 70 percent) to pay the salaries and benefits, including overtime expenses, of 20 full-time employees who are to work exclusively on supporting the beverage program. Justice’s 20 employees include 12 special agents, three investigative auditors, three criminal intelligence specialists, and two administrative staff members. According to Justice’s report to CalRecycle for the end of fiscal year 2013–14, it had received 23 referrals for investigation from CalRecycle. CalRecycle and Justice also confirmed that Justice’s staff can self-initiate their own investigations of fraud without receiving a referral from CalRecycle. As of the end of fiscal year 2013–14, Justice reported that it had closed 14 cases and arrested 26 people during that year as indicated in Table 5.

Table 5
Results From the Interagency Agreement With the California Department of Justice
Fiscal Years 2011–12 Through 2013–14

FISCAL YEAR	REFERRALS BY THE CALIFORNIA DEPARTMENT OF RESOURCES RECYCLING AND RECOVERY	CLOSED CASES*	RESTITUTION RECEIVED*†	ARRESTS*
2011–12	12	22	\$38,618	30
2012–13	23	15	12,800	25
2013–14	23	14	288,967	26
Average	19	17	113,462	27
Totals	58	51	\$340,385	81

Sources: Analysis performed by the California Department of Resources Recycling and Recovery (CalRecycle) and the California Department of Justice.

* Closed cases, restitution received, and arrests are not necessarily associated with the referrals in a given year because a referral may take several years to close.

† CalRecycle indicated that the restitution amounts shown do not reflect the entire amount of restitutions due since, according to CalRecycle’s supervisor of its cash management unit, payments received often had limited or no documentation as to the full judgment stipulated in the restitution order.

As the table shows, Justice’s special agents closed 17 cases per year on average—or fewer than 1.5 cases per special agent per year. Our review noted that the term *closed case* can mean an investigation that concluded with inconclusive results after extensive surveillance

efforts. According to the assistant chief of Justice's Bureau of Investigation (assistant chief), investigating beverage container fraud is extremely labor-intensive and requires frequent overtime to conduct surveillance and document sufficient evidence to be able to prosecute an individual. For example, according to the assistant chief, agents must witness and document beverage containers coming across the border and then follow these containers to a recycler to determine if they were claimed for the refund payment. The assistant chief stated that this level of effort is necessary to provide prosecutors with sufficient evidence to prosecute a fraud case. Moreover, she believes that Justice's investigative work has a deterrent effect on future fraud or criminal activity through its enforcement actions, such as arrests. However, she noted that such deterrent efforts do not necessarily associate with a specific, quantified dollar amount.

Our review of Justice's reports to CalRecycle found that a single investigation can span multiple years. For example, Justice's special agents closed one case in January 2014 that had begun in February 2011. The notes for this case indicate multiple instances of surveillance over more than a two-year investigation period. Initially, the special agents generally performed surveillance at least once a month but then placed the case on hold for roughly a year because of the operational needs of other investigations. Once the surveillance resumed, the agents determined that the suspects were obtaining payment for redeeming used beverage containers, but the agents could not conclude whether the beverage containers originated from outside the State. As a result, the agents kept the case open and performed additional surveillance operations roughly once a month until January 2014. After numerous attempts at surveillance and other activities, no significant recycling activity had been observed nor had any additional leads been developed, and thus the investigation was closed pending the development of new information and/or leads. We also noted other examples of cases that lasted a year or more and were closed because of insufficient leads or evidence of fraud. To reduce its costs, CalRecycle should renegotiate its agreement with Justice to pay based on the cases CalRecycle refers, limiting costs to investigations over a certain period of time. CalRecycle could agree to increase the budget for an investigation if Justice demonstrates that it has developed promising leads.

To reduce its costs, CalRecycle should renegotiate its agreement with Justice to pay based on the cases it refers, limiting costs to investigations over a certain period of time.

At other times, we saw that Justice's agents were able to act quickly on a lead and arrested multiple individuals engaged in fraud. In one case, Justice's agents completed their investigation in only a few days. The agents followed a semitrailer from Phoenix, Arizona, to Anaheim, California, where out-of-state beverage containers were offloaded into a storage facility. Agents subsequently observed a group of individuals taking these beverage containers to recycling

centers to claim the recycling refund payment. According to Justice's records, the agents immediately arrested the suspects for recycling fraud, grand theft, and conspiracy. The amount of restitution obtained, if any, was not noted on the records we reviewed.

Although Justice's efforts appear to have value, the financial return to the beverage fund seems minimal based on CalRecycle's records. The original interagency agreement required Justice to provide CalRecycle with quarterly progress reports that included, among other items, the status of completed prosecutions. According to the communication plan that further defined the responsibilities of CalRecycle and Justice, a Justice criminal intelligence specialist was assigned to "inquire and exchange information with the case agent, supervisor, and prosecuting attorney." However, in our review of Justice's quarterly reports to CalRecycle, we did not find consistent evidence of the results of completed prosecutions and the amounts of money ordered in restitution. CalRecycle's legal counsel also told us that CalRecycle's legal office does not have routine contact with Justice's Bureau of Investigation. When we asked Justice's assistant chief why her staff did not perform this important step, she stated that the Office of the Attorney General (attorney general), which prosecutes cases, was responsible for tracking prosecuted cases and communicating the results to CalRecycle. However, according to legal counsel from both CalRecycle and the attorney general, this communication does not occur consistently although the departments are developing a status report the attorney general will issue quarterly that will summarize the cases relevant to the beverage program. In our view, Justice would be better positioned to defend the value of its efforts if it tracked and consistently reported the amount of restitution due to the beverage program as a result of its investigations as required in the interagency agreement. Reporting this information can also serve as a signal to CalRecycle if prosecutors frequently decide not to pursue court action. Having this information would allow CalRecycle to ensure that it is maximizing the restitution returned to the beverage program.

Recommendations

The Legislature

To better ensure that the beverage program is financially sustainable, the Legislature should consider enacting statutory changes that increase revenue, reduce costs, or a combination of both. Our report lists some specific proposals for the Legislature's consideration in Table 3, which begins on page 19.

CalRecycle

To ensure that it can demonstrate that its fraud prevention efforts are maximizing financial recoveries for the beverage program, CalRecycle should both modify and annually update its fraud management plan to include the following:

- By December 31, 2014, formally establish a systematic process for analyzing, monitoring, and responding to the risk of fraudulent recycling of out-of-state beverage containers.
- Develop fraud estimates—by type of fraudulent activity—that quantify the potential financial losses to the beverage program and the methodology CalRecycle used to develop these estimates.
- Identify the amount of actual fraud in the prior year by type of fraudulent activity, such as the financial losses resulting from the redemption of out-of-state beverage containers or the falsification of reports used to substantiate program payments.
- Identify the amount actually recovered for the beverage program in the form of cash for restitution and penalties resulting from fraud.

To allow for public input and to prevent any legal challenges claiming that its policies and procedures regarding prepayment holds constitute unenforceable underground regulations, CalRecycle should adopt these policies and procedures as regulations in accordance with the Administrative Procedure Act.

To ensure that all appropriate redemption payments are identified and made to the beverage program, CalRecycle should do the following:

- Contract with Equalization to determine the feasibility and cost of transferring its revenue collections duties and audit reviews to Equalization.
- Should CalRecycle find that it is feasible and cost-effective, it should pursue legislative changes that would enable Equalization to collect revenues for the beverage program at the point of sale and remit the money to the beverage program.

To ensure that it effectively uses resources, CalRecycle should renegotiate its agreement with Justice to pay based on the cases CalRecycle refers, limiting costs to investigations over a predefined period of time. CalRecycle could agree to increase the budget for a particular investigation if Justice demonstrates that it has developed promising leads.

To ensure that CalRecycle has consistent evidence of the results of completed prosecutions and the amounts ordered in restitution, it should develop a status report to be issued quarterly by the attorney general that summarizes, among other things, the status of pending cases, recently closed cases, and amounts of restitution that are due to the beverage program as a result of the attorney general's prosecutions.

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 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: November 6, 2014

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Appendix A

THE BEVERAGE CONTAINER RECYCLING FUND AND ITS FINANCIAL PERFORMANCE

The Beverage Container Recycling and Litter Reduction Act requires beverage manufacturers and distributors to make payments to the California Department of Resources Recycling and Recovery (CalRecycle), which are deposited into the funds supporting the Beverage Container Recycling Program (beverage program). These payments are the main revenue source for the beverage program and provide funding for program administration costs as well as funding for the California refund value (recycling refund payments) made to consumers when they return empty beverage containers for recycling.

The Beverage Container Recycling Fund (beverage fund) is the primary fund among the five funds used to finance the beverage program's operations and accounts for more than 75 percent of total beverage program fiscal activity. In the following tables we consolidate the financial performance for all five funds associated with the beverage program. Table A.1 depicts the revenues, expenditures, and transfers made to and from the beverage program for fiscal years 2010–11 through 2013–14. As indicated in Table A.1, expenditures have consistently exceeded revenue for the fiscal years we analyzed; however, the beverage program's consolidated ending fund balance actually increased from \$248.8 million in fiscal year 2010–11 to \$312.7 million in fiscal year 2013–14 because the beverage program has been receiving loan repayments, which are accounted for in the "transfers in" row of Table A.1. As described on page 15, these loan repayments are mostly complete, with only \$82.3 million remaining.

Table A.1
Consolidated Statement of Operations for the Beverage Container Recycling Program
Fiscal Years 2010–11 Through 2013–14

	FISCAL YEAR			
	2010–11	2011–12	2012–13	2013–14 [†]
Beginning Balance	\$191,424,597	\$248,766,691	\$254,474,592	\$165,259,073
Revenue	1,183,237,600	1,171,845,996	1,177,241,780	1,239,918,895
Transfers in	206,112,468	173,865,508	83,830,370	183,456,730
Other adjustments	64,963,495	(2,273,379)	12,667,525	6,227,361

continued on next page...

	FISCAL YEAR			
	2010-11	2011-12	2012-13	2013-14 [†]
Total additions*	1,454,313,563	1,343,438,125	1,273,739,676	1,429,602,986
Expenditures	1,314,116,470	1,275,094,354	1,291,225,584	1,268,611,085
Transfers out	86,642,468	63,565,508	75,680,370	15,056,730
Other adjustments	(3,787,469)	(929,639)	(3,950,759)	(1,455,946)
Total deductions*	1,396,971,469	1,337,730,224	1,362,955,194	1,282,211,869
Ending Balance*	\$248,766,691	\$254,474,592	\$165,259,073	\$312,650,190

Sources: California State Controller's Office's Budgetary/Legal Basis Reporting System and California State Auditor's analysis.

Note: The Beverage Container Recycling Program (beverage program) is supported by five different funds, and we have consolidated the statement of operations for each fund. The Beverage Container Recycling Fund (beverage fund) is the primary fund used to support the beverage program and accounts for more than 75 percent of the amounts shown in the table. The amounts shown for transfers in and transfers out generally pertain to loan activity and the movement of funds from the beverage fund to other beverage program funds to cover the cost of making payments to encourage the recycling of certain types of beverage containers. The other four funds are the Glass Processing Fee Account, the Penalty Account, the Bimetal Processing Fee Account, and the PET Processing Fee Account.

* Amounts may not agree due to rounding.

[†] Data for fiscal year 2013-14 are preliminary and have not been audited.

In Table A.2, we summarize the assets, liabilities, and fund balance for the five funds supporting the beverage program. Table A.3 shows the consolidated revenue detail for the beverage program. Beverage distributors' redemption fees account for most of the total beverage program revenue in each fiscal year.

Table A.2
Consolidated Balance Sheet for Funds Supporting the Beverage Container Recycling Program
Fiscal Years 2010-11 Through 2013-14

	FISCAL YEAR			
	2010-11	2011-12	2012-13	2013-14 [†]
Cash	\$3,431,960	\$33,732,253	\$972,147	\$3,165,995
Investments	27,974,000	27,584,000	104,836,000	225,211,000
Receivables	251,509,787	253,538,923	188,220,850	237,769,275
Due from other state funds	141,667,877	136,416,035	40,264,967	17,364,362
Other assets	472,239	1,128,602	337,807	111,568
Total assets*	\$425,055,863	\$452,399,813	\$334,631,771	\$483,622,200
Accounts payable	\$145,040,009	\$180,126,229	\$147,266,670	\$156,313,318
Due to other state funds	20,237,969	13,102,456	18,147,397	11,032,356
Other liabilities	11,011,194	4,696,536	3,958,631	3,626,336
Total liabilities*	\$176,289,172	\$197,925,221	\$169,372,697	\$170,972,010

	FISCAL YEAR			
	2010-11	2011-12	2012-13	2013-14 [†]
Reserved	\$248,766,691	\$257,099,634	\$165,259,073	\$312,650,190
Unreserved fund balance	–	(2,625,043)	–	–
Total fund balance*	\$248,766,691	\$254,474,592	\$165,259,073	\$312,650,190

Sources: California State Controller’s Office’s Budgetary/Legal Basis Reporting System and California State Auditor’s analysis.

Notes: The Beverage Container Recycling Program (beverage program) is supported by five different funds, and we have consolidated the balance sheet statements for each fund. The Beverage Container Recycling Fund is the primary fund used to support the beverage program and accounts for more than 75 percent of the amounts shown in the table. The other four funds are the Glass Processing Fee Account, the Penalty Account, the Bimetal Processing Fee Account, and the PET Processing Fee Account. The amounts shown as receivables primarily represent revenue that has not been collected. The California Department of Resources Recovery and Recycling generally collects over \$1 billion in revenue each year on a cash basis and accrues between \$180 million and \$250 million in additional revenue.

* Amounts may not agree due to rounding.

† Data for fiscal year 2013–14 are preliminary and have not been audited.

Table A.3
Consolidated Revenue Detail for the Beverage Container Recycling Program
Fiscal Years 2010–11 Through 2013–14

	FISCAL YEAR			
	2010-11	2011-12	2012-13	2013-14 [†]
Beverage container redemption fees	\$1,158,953,505	\$1,152,467,448	\$1,175,472,075	\$1,206,121,592
Interest income from interfund loans	21,194,613	17,928,033	724,189	14,153,961
Interest income from surplus money	339,692	190,111	271,971	196,689
Penalty assessments	2,232,817	1,196,221	745,156	19,436,922
Settlements and judgments	50,000	–	–	1,500
Other revenue	466,974	64,182	28,389	8,231
Total revenue*	\$1,183,237,600	\$1,171,845,996	\$1,177,241,780	\$1,239,918,895

Sources: California State Controller’s Office’s Budgetary/Legal Basis Reporting System and California State Auditor’s analysis.

Notes: The Beverage Container Recycling Program (beverage program) is supported by five different funds, and we have consolidated the revenue accounts for each fund in the table above. The Beverage Container Recycling Fund is the primary fund used to support the beverage program and accounts for more than 75 percent of the amounts shown in the table. The other four funds are the Glass Processing Fee Account, the Penalty Account, the Bimetal Processing Fee Account, and the PET Processing Fee Account.

* Amounts may not agree due to rounding.

† Data for fiscal year 2013–14 are preliminary and have not been audited.

As indicated previously, the beverage fund is the primary fund used to support the beverage program. Since the beverage fund accounts for more than 75 percent of the amounts shown in the tables, we detailed the beverage fund’s expenditure activity—limited to CalRecycle’s expenditures—in Table A.4 on the following page for fiscal years 2010–11 through 2013–14. The amounts shown in Table A.4 only pertain to CalRecycle’s financial activity and

reflect the amounts appropriated and spent in each fiscal year. As indicated in the table, CalRecycle's primary expense was the recycling refund payments.

Table A.4
California Department of Resources Recycling and Recovery's Expenditures From the Beverage Container Recycling Fund
Fiscal Years 2010–11 Through 2013–14

	FISCAL YEAR			
	2010–11 [†]	2011–12 [†]	2012–13 [†]	2013–14 [†]
Administrative Costs				
Administrative costs subtotals	\$37,200,514	\$38,463,623	\$36,285,088	\$38,793,705
Program Payments				
Recycling refund payments	\$967,797,446	\$999,944,887	\$1,021,414,725	\$996,597,362
Administrative fees for processors	24,716,046	25,129,395	25,538,297	26,848,442
Handling fees	38,961,177	38,876,902	41,226,964	46,317,753
Quality incentive payments	10,000,000	10,346,606	6,000,000	9,599,798
Plastic market development payments	10,000,000	15,282,917	18,974,493	10,000,000
Curbside program	15,000,000	16,040,758	15,000,000	15,000,000
Program payments subtotals*	\$1,066,474,669	\$1,105,621,465	\$1,128,154,478	\$1,104,363,355
Grant Programs				
City and county payments	\$10,500,000	\$10,500,000	\$10,500,000	\$10,500,000
Local Conservation Corps grants	19,527,586	23,331,790	19,129,301	13,957,323
Grants (other) [‡]	8,844,505	8,701,647	4,707,349	1,811,697
Grant programs subtotals*	\$38,872,091	\$42,533,437	\$34,336,650	\$26,269,020
Grand Totals*	\$1,142,547,274	\$1,186,618,525	\$1,198,776,216	\$1,169,426,081

Source: California State Auditor's analysis of California Department of Resources Recycling and Recovery's (CalRecycle) California State Accounting and Reporting System.

Note: The expenditures shown in this table pertain only to CalRecycle's financial activity from the Beverage Container Recycling Fund and excludes the activities of other state departments and funds. As a result, the expenditure amounts in this table will not agree with the amounts shown in Table A.1.

* Amounts may not agree due to rounding.

[†] Table pertains to expenditures that were authorized in the applicable fiscal year, and excludes transfers to other funds supporting the Beverage Container Recycling Program.

[‡] Includes market development and expansion grants and competitive grants, among others.

Appendix B

PREVIOUS RECOMMENDATIONS NOT FULLY IMPLEMENTED

In June 2010 the California State Auditor (state auditor) published an audit report on the Beverage Container Recycling Program (beverage program) titled *Department of Resources Recycling and Recovery: Deficiencies in Forecasting and Ineffective Management Have Hindered the Beverage Container Recycling Program* (Report 2010-101). In that report, the state auditor made several recommendations to the California Department of Resources Recycling and Recovery (CalRecycle). Table B on the following page provides our assessment of CalRecycle's current progress in implementing those recommendations listed as not fully implemented in our January 2014 report titled *Recommendations Not Fully Implemented After One Year: The Omnibus Audit Accountability Act of 2006* (Report 2013-041). For example, CalRecycle's deputy director of administration confirmed that CalRecycle does not have a strategic plan but is in the process of planning collaborative workgroups to develop such a plan.

Moreover, we also determined that an additional recommendation from our prior audit report that CalRecycle had asserted was implemented had not been fully implemented. Specifically, in our 2010 report, we identified that CalRecycle did not perform oversight on its payments to cities and counties to ensure that these funds were used appropriately. We recommended that CalRecycle require periodic reporting of expenses or reporting of how funds were used after the conclusion of the award period. However, CalRecycle still does not provide any consistent oversight of these payments.

According to CalRecycle's financial resources manager, in fiscal year 2010–11, it surveyed 60 participants regarding how the funds were used but required no supporting documentation regarding the participants' responses; that was the only year this survey was sent out. Although surveys of 60 cities and counties may be reasonable given the large volume of participants, we would have expected a consistent annual or periodic reporting requirement that required supporting documentation. Because CalRecycle does not require any reporting from cities and counties on how the funds were actually spent, it has no assurance that these funds were used for the intended purposes. CalRecycle's perspective is that state law does not require it to monitor cities and counties, and therefore it is prohibited from doing so. We disagree with this interpretation of the Public Resources Code and believe that CalRecycle should be monitoring these payments to ensure they further the objectives of the beverage program.

Table B
Recommendations Not Fully Implemented From the California State Auditor's 2010 Report

Recommendations from the California State Auditor's June 2010 report titled *Department of Resources Recycling and Recovery: Deficiencies in Forecasting and Ineffective Management Have Hindered the Beverage Container Recycling Program* (Report 2010-101)

RECOMMENDATION	IMPLEMENTATION STATUS
1. The California Department of Resources Recycling and Recovery (CalRecycle) should weave benchmarks, coupled with metrics to measure the quality of its activities, into the strategic plan for the Beverage Container Recycling Program (beverage program) to allow it to better measure progress in meeting goals.	Not fully implemented
2. CalRecycle should ensure that the strategic plan incorporates all relevant activities of the beverage program.	Not fully implemented
3. To improve oversight of beverage program funds and ensure that the intended value is received from grant funds it awards, CalRecycle should implement policies to ensure that the cities and counties spend beverage program funds for recycling purposes by requiring periodic reporting of expenses or reporting of how funds were used after the grant ends.	Not fully implemented

Source: California State Auditor's analysis of information provided by CalRecycle.

California Environmental Protection Agency

Edmund G. Brown Jr., Governor



DEPARTMENT OF RESOURCES RECYCLING AND RECOVERY

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P.O. BOX 4025, SACRAMENTO, CALIFORNIA 95812

October 21, 2014

Elaine Howle*
California State Auditor
621 Capitol Mall, Suite 1200
Sacramento California

Dear Ms. Howle:

Thank you for the opportunity to review the draft report titled "The Beverage Container Recycling Program Continues to Face Deficits and Requires Changes to Become Financially Sustainable."

We agree with your conclusion that the Beverage Container Recycling Program has a structural deficit and that it is desirable to address the deficit now. Further, we appreciate the list of options---beginning with the elimination or reduction of the state's subsidies to beverage manufacturers---provided as recommendations to the Legislature. Consistent with your staff's direction, we are responding to the recommendations made specifically to CalRecycle (i.e., those recommendations found on pages 46 and 47).

With respect to the recommendations made to CalRecycle, thank you for acknowledging the efforts and progress being made to responsibly address the structural deficit without compromising the goals of the *California Beverage Container Recycling and Litter Reduction Act*. Your acknowledgement affirms CalRecycle staff's hard work and dedication in addressing these goals. However, with such success comes the awareness and responsibility that there is more to do. In that spirit, CalRecycle generally agrees with the recommendations and will strive to implement them over time. To do so, it is necessary to ensure there is a better common understanding of what is needed. Therefore, the following pages include more detailed responses to each of the recommendations.

Sincerely,

Caroll Mortensen
Director
CalRecycle

cc: Matthew Rodriguez, Secretary, CalEPA

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* California State Auditor's comments begin on page 59.

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CSA Audit Recommendation:

To ensure that it can demonstrate that its fraud prevention efforts are maximizing financial recoveries for the beverage program, CalRecycle should both modify and annually update its fraud management plan to include the following:

RESPONSE:

In principle, CalRecycle agrees with the recommendation. However, language and context are important as CalRecycle believes cost avoidance results in less financial and operational risk to the program. In reference to the paragraph above and to other areas of the report as well, CalRecycle would like to clarify the terminology being used by CSA. "Fraud prevention" is only one element of the Division of Recycling (DOR), Recycling Program Enforcement Branch's (RPEB) current Fraud Management Strategy and is defined as "actions/activities to prevent fraud from occurring." As such, "fraud prevention efforts" do not result in "financial recoveries for the beverage program." With that said, and for the purposes of effectively responding to CSA's recommendation, we assume CSA's intent is to have CalRecycle demonstrate how the Fraud Management Strategy will not only "maximize financial recoveries" via post payment investigation and/or prosecution, but also demonstrate how we will minimize losses to the Beverage Container Recycling Fund (CBCRF) via deterrence, prevention, detection and mitigation efforts as well.

Prior to 2011, CalRecycle's (and our interagency partners at the Department of Justice (DOJ)) approach to combatting program fraud focused on conducting field inspections and investigations, and subsequently pursuing criminal prosecution and/or administrative remedies against individuals and/or entities found guilty of committing program fraud and/or substantial noncompliance. While we have had success using this approach, it is limited in its effectiveness, extremely resource intensive and time consuming. Furthermore, such approaches generally do not generate large recoveries to the fund because, by the time successful judgments are obtained, the money is spent, sheltered, or becomes otherwise untraceable. Given the number of potential individuals or entities engaged in fraudulent activities, certified or registered program participants, corresponding reports, and consumer transactions within DOR/RPEB's span of control, compared to the limited resources dedicated to conducting inspections, administrative reviews, investigations and prosecutions, the reactive approach results in unacceptable risk to the fund. After 2010, therefore, DOR/RPEB began the necessary transition to implementing a more structured, balanced, and holistic approach to combatting program fraud using a model referred to as the Fraud Management Lifecycle (Lifecycle).

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The eight stages/areas of the Lifecycle include:

- o **Deterrence** - Activities intended to stop or prevent fraud before it is attempted
- o **Prevention** - Activities to prevent fraud from occurring
- o **Detection** - Activities used to identify and locate fraud prior to, during and subsequent to the completion of the fraudulent activity
- o **Mitigation** - Stop losses from occurring or continuing to occur and/or hinder a fraudster from continuing or completing the fraudulent activity
- o **Analysis** - Analyze losses that occurred despite deterrence, detection, and prevention activities to determine the factors of the loss situation (i.e., root cause analysis)
- o **Policy** - Activities to create, evaluate, communicate and assist in the deployment of policies to reduce the incidence of fraud. (Balancing prudent fraud reduction policies with resource constraints and effective management of legitimate activity is part of this stage or area.)
- o **Investigation** - Obtaining evidence and information to stop fraudulent activity, recover assets or obtain restitution and/or to provide evidence to support successful prosecution and conviction of fraudsters.
- o **Prosecution** - Is the culmination of all the success, and failures, in the Lifecycle.

Unlike the typical linear definition of "lifecycle," the Fraud Management Lifecycle's stages or areas comprise an aggregated entity (i.e., system) that is made up of interrelated, interdependent, and independent actions, functions, and operations. As such, the Lifecycle is dynamic, evolving and adaptive. The department believes that to effectively address the comprehensive nature of program fraud we must engage in activities in each of the stages or areas simultaneously, as well as sequentially. Effective fraud management requires a balance in competing and complimentary actions in and across each of the stages of the Lifecycle.

To this end, the program's fraud management approach currently includes functional activities in all eight areas or stages of the Lifecycle. The Imported Empty Beverage Container Reporting and Inspection Program, implemented in conjunction with our partners at the California Department of Food and Agriculture in February 2014, clearly falls in the lifecycle areas of Deterrence and Detection, as do regular on-site inspection and test sales at recycling centers.

Prevention related activities include the production and implementation of the Claimed Volume Reported (CVR) daily report. This report takes various claims data input by

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program participants into the Division of Recycling's Integrated Information System (DORiis) and runs it through rules-based logic to flag anomalous and/or suspect transactions. Flagged transactions can be placed on prepayment holds until validation of the claim can be performed. Mitigation relates to both program performance and to fund losses. The use of data to prevent questionable payments is clearly a mitigation activity. Staff analysis of the data from the CVR, as well as other data, are used to evaluate program participants as potential candidates for administrative review providing for targeted or more effective allocation of limited staff resources. Recently, RPEB also engaged in cross-functional activities in the Policy area by working with the CalRecycle Legal Office to develop and promulgate regulatory changes to Title 14 of the California Code of Regulations associated with allowable daily load limits for consumers, and emergency regulations to implement existing provisions in Public Resources Code (PRC), Chapter 8.5, §14596. Finally, branch auditors routinely engage in a wide variety of Investigation activities, such as placing suspect operators on prepayment inspection status, obtaining evidence and information to uncover and stop fraudulent activity, certification revocation of noncompliant and/or fraudulent operators, assess civil penalties and/or obtain restitution. Investigative staff also routinely provide tips, observations and evidence via referrals to our partners at DOJ to support their efforts to perform criminal Investigations and Prosecution of individuals/entities committing program fraud. Going forward, the enforcement branch will establish processes and procedures for Analyzing performance/outcomes, or the lack thereof, for each of the stages or areas of the Lifecycle to determine which areas and/or activities within the Lifecycle need to be enhanced, improved or discontinued.

Pursuing and implementing the activities and initiatives mentioned above, when managed using a structured management approach based upon the Fraud Management Lifecycle, will have significant short and long-term positive impacts on combatting the fraud being perpetrated against the CBCRF. It is also important to note this strategy requires continuous monitoring and reassessment in response to events within the program.

CSA RECOMMENDATION:

By December 31, 2014, formally establish a systematic process for analyzing, monitoring, and responding to the risk of fraudulent recycling of out-of-state beverage containers.

RESPONSE:

CalRecycle agrees with the recommendation. CalRecycle recently implemented regulations and the process for collecting information whenever vehicles come across the border with CRV labeled used beverage containers. The response below assumes the CSA's recommendation is related specifically to the department's implementation, in conjunction and collaboration with our interagency partners at CDFA and DOJ, of the Imported Empty Beverage Container Reporting and Inspection Program administered in

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accordance with the provisions of PRC, Chapter 8.5, §14596 and applicable sections of Title 14, Division 2, Chapter 5 of the California Code of Regulations.

The emergency regulations implementing the provisions of PRC, Chapter 8.5, §14596 were adopted on January 2014, and the Imported Empty Beverage Container Reporting and Inspection program was formally implemented on February 18, 2014. (4)

Postimplementation, the department was inundated by the number of Imported Material Report (IMR) forms collected by California Department of Food & Agriculture (CDFA) personnel at all open and operating CDFA Quarantine Inspection Stations which resulted in a data entry backlog. We are now current with our data entry and are finalizing policy and procedures for processing report forms, desk audits, report generation, analysis of the data and applicable follow-up and referral activities. CalRecycle will have the policy and procedures fully documented and implemented by December 2014, consistent with current law and based on the available resources.

CalRecycle believes that in order to effectively address the comprehensive nature of program fraud, we must continue to pursue administrative remedies against fraudulent certified and/or registered program participants, and we must continue to actively coordinate and collaborate with, and effectively support our partners at DOJ, and other law enforcement agencies in their efforts to pursue criminal investigation and prosecution of individuals or entities committing crimes and defrauding the CBCRF. Depending on what the analysis of the data reveals, CalRecycle will evaluate options and resource needs to ensure the department has the necessary staffing and funding to effectively comply with this recommendation.

CSA RECOMMENDATION:

Fraud estimates – by type of fraudulent activity-that quantify the potential financial losses to the beverage program and the methodology CalRecycle used to develop these estimates.

RESPONSE:

CalRecycle agrees with CSA that sound and appropriate metrics are important in managing program fraud. Unfortunately, obtaining a good estimate of the fraud rate is very difficult because individuals and entities committing fraud typically try to conceal their fraudulent activities and stay ahead of our efforts to stop them. In addition, the program is subject to practices that may not legally rise to the level of fraud, but are sources of programmatic and fiscal risk. Such practices are said to result in "leakage" within the program (for example, empty wine bottles redeemed at buyback centers prior to November 1, 2013). As a result, a formal methodology based upon further study and statistical estimation is necessary. Given the wide variety of variables, the associated complexity, and the professional expertise and skill needed to effectively design and develop such a model, CalRecycle will need to seek consultative services with such expertise. Developing reliable and predictive fraud estimating methodologies is extremely difficult. CalRecycle will explore contract and consultation options, as well as (5)

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- ⑤ funding needs to secure such services, to ensure that it can effectively pursue this recommendation.

CSA RECOMMENDATION:

The amount of fraud actually identified in the prior year by type of fraudulent activity, such as the financial losses resulting from the redemption of out-of-state beverage containers or the falsification of reports used to substantiate program payments.

RESPONSE:

- ⑥ For the purpose of our response, we assume that when CSA refers to "the amount of fraud actually identified in the prior year" it means the dollar amount(s) of restitution of CRV and/or other program payments associated exclusively with administrative cases initiated by DOR (e.g., investigations, probationary reviews, limited reviews and/or Handling Fee desk audits) where evidence of fraud was found and formally documented by DOR staff only and is associated with a formal remedy action (e.g., accusation, revocation, termination, settlement agreement, etc.).

In most cases, fraud requires intent, meaning that the party knew or should have known the activity or behavior they engaged in was illegal and that they willfully and knowingly engaged in the activity anyway. It is much easier to make allegations that fraud has occurred than it is to secure a definitive judgment of fraud from a court or administrative tribunal. As is often the case in our administrative hearings, while CalRecycle alleges that the certified operator engaged in fraudulent activities, the operator claims they were unaware of the illegality of their actions and/or were improperly trained by CalRecycle. If no definitive judgment is made as to whether or not fraud has occurred, attributing the associated restitution of program payments remains highly subjective and may be subject to scrutiny.

- ⑥ With that said CalRecycle will create specific criteria for more clearly identifying administrative cases which contain allegations of fraud, as opposed to those associated with noncompliance and/or negligence, track them through the remedy process and, if applicable, quantify any associated restitution amounts and report on those on an annual basis.

CSA RECOMMENDATION:

The amount actually recovered for the beverage program in the form of cash for restitution and penalties resulting from fraud.

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RESPONSE:

Assuming the response to the recommendation immediately above is valid and effectively implemented then CalRecycle's Accounting Office would be able to more effectively quantify the amount actually recovered in administrative cases identified and associated with fraudulent activities.

CSA RECOMMENDATION:

To allow for public input and to prevent any legal challenges claiming that its policies and procedures regarding prepayment holds constitute unenforceable underground regulations, CalRecycle should adopt these policies and procedures as regulations in accordance with the Administrative Procedure Act.

RESPONSE:

CalRecycle's policies and procedures regarding prepayment holds are based upon clear statutory authority. CalRecycle disagrees with the determinations attributed to the State Auditor's legal counsel and would vigorously contest any allegations that its policies and procedures regarding prepayment holds constitute unenforceable underground regulations. Nonetheless, CalRecycle will initiate rulemaking procedures no later than June 30, 2015, in order to provide increased clarity and additional public input.

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CSA RECOMMENDATION:

To ensure that all appropriate redemption payments are identified and made to the beverage program, CalRecycle should do the following:

- 1. Contract with Equalization to determine the feasibility and cost of transferring its revenue collections duties and audit reviews to Equalization.**
- 2. Should CalRecycle find that it is feasible and cost effective, it should pursue legislative changes that enable Equalization to collect revenues for the beverage program at the point-of-sale and remit the money to the beverage program.**

RESPONSE:

CalRecycle agrees with this recommendation. CalRecycle will explore the opportunity to work with the Board of Equalization (BOE) on a scope of work and various itemized deliverables. CalRecycle further agrees that feasibility and cost effectiveness should be the basis for BOE to collect redemption payments for the beverage container recycling program. Implementation of this recommendation will depend upon several other

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factors including the department's capacity to fund any potential feasibility costs, as well as appropriate cost and implementation analysis from BOE.

CSA RECOMMENDATION:

To ensure that it effectively uses resources, CalRecycle should renegotiate its agreement with Justice to pay based on the cases referred by CalRecycle, limiting cost to investigations over a predefined period of time. CalRecycle could agree to increase the budget for a particular investigation if Justice demonstrates that it has developed promising leads.

RESPONSE:

As stated previously, CalRecycle contracts with DOJ because we do not have the legal authority or expertise to conduct criminal investigations and/or prosecutions of individuals and/or entities committing crimes. CalRecycle recently renewed our interagency agreement with DOJ for a three-year period beginning with FY 14/15 and ending in FY 16/17. CalRecycle did so because we believe DOJ has been, and continues to be an effective partner and adds value to our collective efforts to combat program fraud.

Since 2012, the department and DOJ management and staff have steadily worked to improve our interagency coordination and collective effectiveness and combatting program fraud. For example, we incorporated and implemented a robust communications plan that includes monthly meetings between DOJ Agents and department investigators to review and discuss status and strategies associated with program referrals, as well as cases self-initiated by DOJ and coordinate serving of arrest and search warrants and plans for securing records and evidence. Select CalRecycle and DOJ executive staff, managers and supervisors also meet quarterly to discuss the contract, strategic initiatives, and operational issues. Finally, all dedicated DOJ staff and designated CalRecycle staff get together annually for training, participate in a gap analysis and brainstorm ways to more effectively combat program fraud.

Although both parties believe we have succeeded in many respects, as with any program, there are opportunities for improvement. With that said, we will continue our efforts to pursue collective success under the terms, conditions and funding mechanisms in the current interagency agreement and consistent with past practice when renewing interagency agreements CalRecycle will examine the necessary changes, clarifications, and opportunities to improve deliverables and outcomes for subsequent agreements. CalRecycle agrees to revisit this CSA Audit recommendation for potential implementation at the end of the term of the current interagency agreement.

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CSA RECOMMENDATION:

To ensure that CalRecycle has consistent evidence of the results of completed prosecutions and the amounts ordered in restitution, it should develop a status report to be issued quarterly by the Attorney General's Office (Attorney General) that summarizes, among other things, the status of pending cases, recently closed cases, and amounts of restitution that are due to the beverage program as a result of the Attorney General prosecutions.

CalRecycle will work with the Attorney General's Office to develop the recommended status report with an implementation date no later than December 31, 2014.

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Comments

CALIFORNIA STATE AUDITOR'S COMMENTS ON THE RESPONSE FROM THE CALIFORNIA DEPARTMENT OF RESOURCES RECYCLING AND RECOVERY

To provide clarity and perspective, we are commenting on the California Department of Resources Recycling and Recovery's (CalRecycle) response to our audit. The numbers below correspond to the numbers we have placed in the margin of CalRecycle's response.

During the publication process for the audit report, page numbers shifted. Therefore, the page numbers cited by CalRecycle in its response may not correspond to the page numbers in the published audit report.

Although CalRecycle agrees with our recommendation, its response confuses the issue by making an unnecessary distinction between fraud prevention and fraud detection efforts, stating that fraud prevention efforts do not result in financial recoveries for the Beverage Container Recycling Program (beverage program).

The intent of our recommendation is to address the problem we describe on pages 27 through 30 of the audit report. Specifically, as we state on page 28, despite the myriad of activities that CalRecycle engages in to prevent and detect fraud, evidence we reviewed suggests that CalRecycle's antifraud activities result in relatively limited financial recoveries for the beverage program, resulting in roughly \$364 in recoveries for every \$1,000 spent on its inspection and investigation activities. We believe such a result should prompt CalRecycle to reconsider whether its investigations and inspections can be more effective. The intent of our recommendation is for CalRecycle to quantify fraud exposure across all areas of the beverage program and then establish a monitoring system to consistently evaluate whether it is adequately responding to those risks. As we state on page 30, until CalRecycle establishes metrics for the fraud potential associated with the various types of fraud it has identified, neither the Legislature, the public, nor CalRecycle will be able to evaluate the effectiveness of the beverage program's fraud prevention efforts.

Although CalRecycle adopted regulations in January 2014 to facilitate the collection of data on out-of-state beverage containers entering California, the risk posed by out-of-state beverage containers has been widely known for some time. As we state on page 23, the California Department of Justice (Justice) told CalRecycle's predecessor agency in February 2000 that as much as \$40 million in annual losses may be attributable to fraud, including out-of-state redemption fraud. Nevertheless, we are pleased that

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④

CalRecycle is finalizing its policy and procedures for, among other things, processing and analyzing the California Department of Food and Agriculture's data on out-of-state beverage containers. We look forward to evaluating these new processes during our 60-day, six-month, and one-year reviews.

- ⑤ We disagree with and are perplexed by CalRecycle's response that it must obtain and rely on consultants to develop estimates of fraud for the beverage program. CalRecycle has administered the beverage program for several years and has various inspection, investigative, and auditing staff that collectively possess substantial first-hand experience with the beverage program and its participants. Furthermore, we are concerned that CalRecycle may ultimately decide it cannot implement our recommendation should it be unable to secure funding to hire a consultant. Nothing precludes CalRecycle from implementing our recommendation immediately and we note that CalRecycle did not indicate a time frame for its next steps.
- ⑥ Although CalRecycle appears to agree with our concerns, we question if CalRecycle understands the scope and breadth of our recommendation. CalRecycle has taken a narrow view of our recommendation and incorrectly interprets it to mean that it should only be tracking instances when program participants intentionally engage in illegal activities, or only when CalRecycle has formally brought an administrative action against a program participant. We note that CalRecycle's various fraud prevention and detection activities, such as prepayment holds among others, are fundamentally intended to limit inappropriate payments from the beverage program. As we state in comment 3, our recommendation is intended to ensure that CalRecycle consistently evaluates the adequacy of all of its fraud prevention and detection efforts. In an environment where program expenditures exceed revenues, CalRecycle should be positioned to evaluate the costs versus the benefits of its various activities.
- ⑦ We stand by our legal conclusion and are pleased that CalRecycle has decided to implement our recommendation because it sees value in increased public transparency for its prepayment hold process.
- ⑧ We disagree that CalRecycle should wait until its agreement with Justice expires, in June 2017, to potentially implement our recommendation. According to the provisions of the current interagency agreement, CalRecycle must review the performance and progress of the agreement at the end of each fiscal year, and it further states that such a review is an opportunity to consider changes to the scope or budget. Accordingly, we believe that CalRecycle should reconsider how it pays Justice as early as the end of fiscal year 2014-15.

KAMALA D. HARRIS
Attorney General

State of California
DEPARTMENT OF JUSTICE



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October 21, 2014

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

Re: CSA Audit Report 2014-110

Dear Ms. Howle:

The Department of Justice (DOJ) has reviewed the California State Auditor's (CSA) draft report for the California Department of Resources, Recycling and Recovery (CalRecycle) Beverage Container Recycling Program audit and appreciates the opportunity to respond to the report as it applies to DOJ. Although the CSA did not make any recommendations specific to DOJ, CSA has allowed the DOJ to respond to the draft report concerning the continued criminal enforcement efforts of both DOJ and CalRecycle.

The California Beverage Container Recycling and Litter Reduction Act requires distributors of beverage containers (cans and bottles) to make a payment in the form of a regulatory fee. The money collected goes to the California Beverage Container Recycling Fund (CBCRF). CalRecycle uses the funds in the CBCRF to repay the initial redemption payment to eligible claimants who present empty, eligible cans and bottles which is identified as the California Redemption Value (CRV). Only aluminum cans and bottles sold in California are eligible for redemption under the CBCRF program.

Over the past ten plus years, CalRecycle and DOJ have worked collaboratively to combat illegal activities against the CBCRF program and illegally obtained CRV. Early on in the relationship, DOJ enforcement personnel learned that organized criminal groups target the CBCRF by presenting non-qualifying cans and bottles for redemption CRV. These non-qualifying items may come from out-of-state, out-of-country, or were previously redeemed recycled materials. These non-qualifying materials are then brought into the State where the material is further broken down and redeemed at certified recycling centers or processors in California. Although some of these materials may bear the CRV legend, they do not qualify for redemption unless they were sold or offered for sale in California.

Program reform became extremely important as the CBCRF program became insolvent. According to information available by CalRecycle the CBCRF is facing a \$100 million structural deficit. The structural deficit is where the CBCRF program expenditures exceed the program revenues. Under the current structure, a maximum recycling rate of 70 percent is required to maintain the CBCRF program solvency. Between FY 2006-2007 and FY 2009-2010 the

* California State Auditor's comments appear on page 65.

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recycling rate increased from 63 percent to 82 percent, thereby increasing demands on the CBCRF and causing the program to operate under a structural deficit. Based on information shared during various program reform workshops held during the last several years coordinated by CalRecycle, some of the issues causing the structural deficit are illegal CRV redemption of beverage containers imported by individuals and entities into California from out-of-state and out-of-country. The illegal redemption of previously redeemed beverage containers for CRV may also be a cause.

As part of DOJ's investigative efforts, and outlined in the FY 2011-2014 Interagency Agreement with the DOJ's Bureau of Investigation (BI), enforcement personnel pursued criminal activity associated with the CBCRF. This was accomplished through investigative and prosecution methods. Information was shared with CalRecycle relevant to the protection of the CBCRF, which were obtained in the course of criminal investigations.

DOJ believes the investigative work conducted by its personnel has a deterrent effect on future fraud or criminal activity associated with the CBCRF. Investigative activity includes various law enforcement methods in documenting criminal activity, such as: surveillance, evidence collection, interviews, and search warrants, in preparation for submitting to a prosecutor. Investigative activity also includes physical arrests of violators. The deterrent effect is realized through enforcement actions, such as arrests, and the media interest in these actions. Deterrence is not necessarily associated with a specific, quantified dollar amount. The DOJ believes that each arrest will "deter" or prevent the arrestee from continuing to commit criminal acts and/or future acts. Based on the punishment imposed by the courts, the DOJ also believes that the fear of punishment will prevent others from committing similar criminal acts against the CBCRF.

By way of example, the following law enforcement actions taken by DOJ personnel helps to further demonstrate the positive impact of DOJ's work. These actions resulted in restitution totaling \$749,000 and represents only two of the many actions taken by DOJ law enforcement personnel.

CalRecycle Press Release #2013-15 (August 28, 2013)/BI Case #BI-LA2013-00020

One (1) arrest in July 2013, with an estimated \$500,000 fraudulently redeemed against the CBCRF. In December 2013 the subject was sentenced and ordered to pay \$516,000 in restitution. The recycling center certificate was revoked and the center closed.

CalRecycle Press Release #2014-10 (April 7, 2014)/BI Case #BI-SA2013-00023

Six (6) arrests in January 2014, with an estimated \$425,000 fraudulently redeemed against the CBCRF. In June 2014, the sentencing agreement stipulated, in addition to jail time and probation for all subjects, a total restitution amount of \$233,000 for all six subjects. One subject also has his collection program certificate revoked.

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In addition, DOJ investigations have increasingly revealed that recycling centers knowingly purchase unauthorized loads and out-of-state material. DOJ investigated and prosecuted such a case in *People v. Action Sales and Metals, Inc.* On May 14, 2014, a jury found the recycling business, located in the city of Wilmington, guilty of conspiracy, grand theft and recycling fraud. The court ordered Action Sales and Metals to pay \$4.8 million in restitution. Additionally, DOJ seized \$995,000 from Action and has asked the superior court to order the seized funds be paid to CalRecycle for restitution. ③

DOJ recognizes that some criminal investigations may not necessarily result in criminal prosecution, based on the necessary requirements to file a criminal case. There are also times that a criminal filing will not be pursued in lieu of a more appropriate administrative case. Personnel with CalRecycle and DOJ work collaboratively to ensure the most effective criminal prosecution is pursued, or appropriate administrative action is taken.

By way of example, the following enforcement actions taken by DOJ enforcement personnel helps to strengthen the administrative actions and findings taken by CalRecycle. These enforcement actions resulted in restitution, interest, and civil penalties totaling \$2,301,000 and represent only two of the many enforcement actions where DOJ personnel worked collaboratively with CalRecycle.

CalRecycle Press Release #2013-21 (November 19, 2013)/BI Case #BII-SF2009-00037

Criminal investigation of two (2) subjects resulted in no charges being filed, but information was shared with CalRecycle to pursue administrative action. BI case was opened in 2009 and closed in 2010. Administrative hearing in November 2012 resulted in two (2) recycling centers ordered to pay \$1,970,000 in restitution, \$60,000 in interest and \$36,000 in civil penalties, totaling \$2,066,000. ②

CalRecycle Press Release #2014-12 (April 9, 2014)/BI Case #BII-SA2010-00044

In June 2011, the criminal investigation resulted in thirteen (13) arrest warrants issued in Yolo and Lassen counties. Seven (7) of the thirteen subjects were arrested on the warrants, and ultimately resulted in sentences including jail time and probation. Five (5) subjects remain fugitives and are believed to be in Mexico. One (1) subject of the thirteen had the arrest warrant withdrawn due to her juvenile status. Investigative information was shared with Cal Recycle to pursue administrative action against the recyclers. In April 2014, the owners of the recycling centers received judgments of restitution and civil penalties totaling \$235,000. ②

DOJ recognizes the intense pressure CalRecycle is under to determine the best methods for reforming the CBCRF program. As mentioned earlier, various illegal activities may contribute to the structural deficit in the CBCRF. However, various methods can and have been utilized to assist with program reform. CalRecycle and DOJ personnel have coordinated several

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enforcement workshops/training sessions in the last few years with field personnel within both agencies to share ideas regarding program reform. As a direct result of information shared by DOJ enforcement personnel one example of a major reform effort was enacted on January 1, 2014. This was a change to the daily load limits of CRV allowable for redemption at certified recycling centers in California. The load limit was changed from 250 pounds to 100 pounds as a result of continued collaboration between DOJ and CalRecycle.

As noted by the CSA audit, DOJ agrees that we can do a better job of communicating investigative and prosecution results and DOJ will work with CalRecycle to ensure there is improvement.

Thank you again for the opportunity to review and comment on the draft audit report. Please let me know if you need additional information or if I can be of further assistance.

Sincerely,



JANETTE GUNTHER-ALLEN
Acting Bureau Chief
Bureau of Investigation
Division of Law Enforcement

For KAMALA D. HARRIS
Attorney General

cc: Nathan R. Barankin, Chief Deputy Attorney General
Elizabeth L. Ashford, Chief of Staff
Larry Wallace, Director, Division of Law Enforcement
James G. Root, Senior Assistant Attorney General
Kent Shaw, Deputy Director, Division of Law Enforcement
Tammy Lopes, Director, Division of Administrative Support
Andrew J. Kraus III, CPA, Director, Office of Program Review and Audits

Comments

CALIFORNIA STATE AUDITOR'S COMMENTS ON THE RESPONSE FROM THE CALIFORNIA DEPARTMENT OF JUSTICE

To provide clarity and perspective, we are commenting on the California Department of Justice's (Justice) response to our audit. The numbers below correspond to the numbers we have placed in the margin of Justice's response.

As we state on page 38 of the audit report, we acknowledge Justice's perspective that its efforts may have a deterrent effect. However, in an environment where the Beverage Container Recycling Program's (beverage program) expenditures have consistently exceeded revenues, CalRecycle will need to decide whether the unquantified deterrent effect derived from Justice's investigations are worth the \$3.6 million it pays to Justice annually. As a result, on page 40 we recommend that CalRecycle renegotiate how it pays Justice for its services.

①

Although Justice cites significant amounts of restitution from court judgments for the beverage program, CalRecycle is responsible for the accounting and financial reporting for the beverage program and we worked with CalRecycle's accounting staff to identify the amount of restitutions collected as a result of Justice's efforts shown in Table 5 on page 37. We note that there may be differences between the amounts awarded in a court judgment and the amounts actually collected. Further, CalRecycle's acknowledgement that it often had limited to no documentation of restitution orders further reinforces our recommendation to CalRecycle on page 41 that it obtain better information regarding the results of completed prosecutions.

②

Justice's response cites a \$4.8 million restitution order resulting from its efforts and \$995,000 that it seized from a recycler. However, we did not see evidence of Justice sharing these results with CalRecycle in either its third or fourth quarterly report from fiscal year 2013-14. We further note that Justice's response does not state that funds have been actually returned to the beverage program and, as we show in Table 5 on page 37, CalRecycle's accounting staff believe that the beverage program has only obtained roughly \$340,000 over a three-year period based on Justice's investigations. We believe, and Justice's own response acknowledges, that there needs to be better communication between both Justice and CalRecycle regarding the results of completed investigations.

③