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METROPOLITAN WATER DISTRICT OF SOUTHERN CALIFORNIA

8-12

January 5, 1995

To: Board of Directors (Finance and Insurance Committee--Action)
(Legal and Claims Committee--Action)

From: General Manager

Subject: Action Plan in Response to Auditor's Report Dated October 5, 1994
Regarding Certain Ultra-Low-Flush Toilet Program Agreements

Report

At the meeting of the Finance and Insurance Committee on December 13, 1994 and the Special Audit Committee on December 6, the Auditor's October 5, 1994 report on certain agreements under Phases One and Two of Metropolitan's ultra-low-flush (ULF) toilet non-rebate program (Program) was discussed. Specific issues were raised relating to both the internal business practices of the CTSI Corporation (CTSI) and Metropolitan's management of the Program. Management fully understands and acknowledges the concerns of your Board, and with this letter is providing your Board with specific information as requested as well as an Action Plan for addressing all of the issues in Phase Three of the Program.

Attachment A to this letter is an Action Plan identifying each of the audit issues and giving current status on each one. To date, every item raised by the Auditor is currently being addressed in the Phase Three contract and is the target of focused, more effective Program administration. In addition, a formal Closure Report will be prepared for your review at the conclusion of the current Phase Three contract. The Auditor has indicated that he intends to audit the activities of Phase Three upon its conclusion. His office will also perform a review of ULF toilet rebate programs commencing in the first quarter of 1995.

On December 15, 1994 Directors Milne and Hill visited CTSI offices to observe the business practices of CTSI and to question the corporation's principals directly concerning a number of key issues. Accompanying the Directors were Conservation Branch staff, a representative of the Planning and Resources Division Chief, the Auditor and a member of his staff, and a representative of the Legal

Department. Subsequently, a staff auditor returned to CTSI to review its current timekeeping system. He also participated in visits to two community-based organizations (CBO) with Program consultant Koeller and Company (Koeller) to review cash collection procedures and records.

Of key interest to your Board has been CTSI itself. CTSI's first contract with Metropolitan was the Water-Wise '91 Program, in which over 800,000 low-flow showerheads and conservation kits were distributed through Metropolitan's member agencies and subagencies. In 1992, CTSI undertook, at its own expense, a small pilot program to distribute ULF toilets in low-income and inner-city communities using CBO. This program became the model for a competitive Request for Proposals (RFP) issued in late 1992, which had three respondents. CTSI was unanimously chosen in a competitive process by a panel of Metropolitan and member agency staff. More complete details regarding CTSI and its principals are contained in the attached report.

A number of issues were raised in Committee discussions by Board members and documented in a letter from Director Handelman of the Special Audit Committee. All of these items are addressed in detail in the attached report and appendices. In summary, the issues are:

How were CTSI's time records kept?

The Auditor's Report cited CTSI's lack of a formal timekeeping system for exempt (e.g. salaried) employees. Whereas CTSI's hourly employees had formal time cards, the eight to ten exempt employees who worked on Phase One or Two were not required to maintain detailed time records. Accordingly, whatever time documentation was available varied from individual to individual, such as in diaries or personal computers. The exempt employees charged an average of 38 hours per week to the Program. During this project, CTSI had no clients other than Metropolitan, and thus, all time charged was deemed by staff to be legitimate Program costs in light of the work accomplished. Subsequent General Counsel review of invoice documentation provided by CTSI to staff demonstrated that information to be standard and meet Metropolitan contractual specifications. It was not until the Auditor's findings that any perception of inadequate formal timekeeping was revealed, and corrective action was promptly taken at that time. Full detail on the time billed and hourly rates of the exempt employees is contained in Attachment B.

The timekeeping issue was identified prior to the Phase Three contract, and specific formal timekeeping requirements were added to the Phase Three contract language.

Did Metropolitan receive the best price for ULF toilets purchased? What was the purpose of visiting the toilet manufacturers?

Because of the need to match an uncertain ULF toilet supply to an uncertain demand, a decision was made early in the Program to use a consultant to purchase and warehouse the toilets. This was deemed a better business practice than a direct Metropolitan purchase based on bulk competitive bid procedures. Among the other factors analyzed in this determination were: (1) member agency desire to select the ULF toilets for their programs; (2) because of ULF toilet shortage issues, it was more effective to negotiate prices and delivery terms, which resulted in lower per-toilet costs than budgeted; (3) it allowed the Program to take advantage of available supplier discounts and credit lines; and (4) it removed Metropolitan from the legal liabilities associated with being in the "chain of commerce."

Prior to any final decision to purchase by CTSI, management staff was included in the negotiations and purchasing decisions, and the prices obtained are believed to be the lowest prices possible. Metropolitan paid an average of \$66 per toilet, compared to a budgeted price of \$75 per toilet. These prices were based upon a continuing survey conducted by Metropolitan staff of lowest prices offered by all candidate suppliers. Those suppliers and quantities purchased are as follows: Kohler (50,836); Sterling (5,425); Mansfield-Norris/Kilgore (25,906); Eljer (33,962); Universal Rundle (6,196); Toto (34,894); and Briggs (960).

At the beginning of Phase Two in July 1993, it became apparent to staff that manufacturers viewed the Program as only a short-term purchasing phenomenon instituted by CTSI. It was important to Metropolitan that the Program be understood as a long-term retrofit program undertaken and funded by Metropolitan and the member agencies. Since CTSI was only the procurement agent of Metropolitan at that time, staff was concerned that without a direct relationship between Metropolitan and the manufacturers, a future transition to a new procurement agent would be difficult. The visit by management staff to the toilet manufacturers established direct relationships between Metropolitan and the manufacturers and, in most cases, solidified prices and delivery arrangements. As a result, Metropolitan will now be

able to transition between implementation contractors and maintains our purchasing relationships more effectively.

Were ULF toilet shortages actually occurring?

The supply shortages were real. Most manufacturers did not retool existing plants in time to meet the California mandates of 1992 and the federal mandates of 1994. The major supply manufacturers to this Program shut down production in order to retool, and supply shortages were felt all over the country for ULF toilets. Those manufacturers were: Kohler; Mansfield-Norris/Kilgore; and Eljer, with Universal-Rundle only providing toilets after their plant had been re-tooled. Toto continued to provide product during this period, because a new plant had been opened in Atlanta to meet the standards.

Why was it necessary to retain the services of Koeller and Company?

The Program, originally designed for 75,000 toilets in the first year, rapidly grew to 150,000 toilets. This explosive growth was a strain on CTSI as well as Metropolitan staff in administering the contract, and additional contract administration services were needed. During early 1993, a hiring freeze was in place at Metropolitan. In response to the immediate demands of the Program, Koeller was retained in April 1993 to provide Program management support and monitor CTSI's implementation and performance of the Program. As a staff consultant, Koeller worked closely with the agreement administrator to track the Program, review invoices, monitor the performance of the CBOs and CTSI, assist CTSI in toilet purchase decisions, develop internal management systems to oversee Program progress, verify volume incentive calculations, and complete a close-out analysis of the Program at the end of Phase Two. Koeller developed and maintained in-depth financial and toilet distribution databases on the Program in order to rapidly respond to management inquiries on its progress and financial status.

Finally, in response to the knowledge gained in observations of the Program, and incorporating early audit findings by the Auditor, Koeller structured a more complex and responsive Phase Three agreement that met with the approval of the General Counsel. Koeller and staff have been in close contact with the Auditor on the Program since January 1994.

Since it has been determined that there were no indications in the information provided to staff by CTSI that there was any non-compliance of the contract and that

invoices were standard, Koeller's and staff's roles were not expanded to review and direct CTSI to correct internal formal recordkeeping practices until they were brought to staff's attention in the Auditor's findings. Those, and other corrections are now being made.

Why did we enter into Phase Three of the Program in light of the conclusions of the audit?

When the Phase Three agreement was approved by your Board in June 1994, the audit was not yet complete and the written findings and recommendations were not yet available. However, several improvements had already been made and included in the Phase Three agreement language, together with a significant increase in the oversight of the contractor by the agreement administrator and Koeller. For these reasons, Metropolitan management felt that adequate controls were in place to proceed.

Was there sufficient advance review of contractual language, and was it deemed adequate? Was the contract breached, and should it have been terminated?

It has been the policy of the General Counsel's Office to participate in the approval of all conservation credits program contracts, including the CTSI contracts for toilet purchase and distribution. The Phase One and Two contracts have been recently re-reviewed, and have been found to be in accordance with standard Metropolitan contract practices.

As requested by your Board in December 1994, the General Counsel conducted a review of CTSI's performance to determine if there was a breach of contract which could give rise to potential damages. That review found that no basis exists to terminate the agreement for material breach of contract.

As discussed above, the lapses in administrative or accounting procedures by CTSI (such as the lack of a centralized, formal timekeeping system for all employees) do not appear to have resulted in inappropriate charges to Metropolitan. Also, Metropolitan only paid for Program performance. Funds advanced by CTSI, at its own risk, to CBOs for start-up and maintenance expenses until toilets were distributed, were invoiced to Metropolitan but were reconciled and paid against verified installations and performance. In addition, Metropolitan is holding back final payment of performance incentives to CTSI pending final reconciliation of verified toilet installations and other

items identified in the Auditor's report. Accordingly, Metropolitan exposure to financial and legal risk was minimal due to CTSI's perceived lax record keeping practices in Phase One and Two.

Summary

The problems encountered in the Phases One and Two contracts with CTSI were in the context of a cutting edge, first-of-its-kind program that exploded in scope over a short period of time. CTSI's timekeeping procedures have now been resolved to the satisfaction of the Auditor, and where there was a discrepancy in funds being collected and remitted, the recommendation of the Auditor was pursued and funds recovered (except where there are still negotiations over the interpretation of allowable general and administrative expenses estimated between \$10,000 and \$25,000). The remaining issues are being resolved as outlined in the Action Plan.

CTSI's management of the Program has been commended by community-based organizations and high schools, has distributed twice the number of toilets at a price lower than anticipated, has achieved a field-verified 98.7 percent installation rate (verified by PEAK, International). This Program alone has placed Metropolitan and the member agencies at the forefront of Best Management Practices implementation in California that is unmatched anywhere. However, the momentum of the Program would be threatened by a sudden termination of the CTSI contract without another entity in place to fill the gap.

While the agreements provide Metropolitan with the right to terminate the agreement upon thirty business days' notice for any reason, such termination would create serious disruptions to the Program. Such a termination would affect between 10,000 to 15,000 ULF toilets in inventory, between 2,000 and 2,500 ULF toilets in transit, would disrupt or terminate seven CBOs, would terminate 31 high school programs which are currently scheduled, would disrupt service to the Executive Program for Environmental Resources Training (EXPERT), and would delay dozens of member agency programs already in process until the next fiscal year.

For Metropolitan staff to assume the Program responsibilities and meet member agency needs for CBO, multifamily, and high school programs, it is estimated that it would take 35 to 40 persons, significant warehouse space, vehicles, and reestablish purchasing and delivery terms with distributors. Currently, there are two full-time people

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dedicated to ULF toilet and residential programs within the Conservation staff. Considering the significant ramp-up time necessary to continue the Program and the insufficient staff available, Metropolitan cannot step in to replace CTSI if the contracts are terminated.

Furthermore, it would take approximately six months to write the appropriate specifications and Requests for Proposal to go through the competitive process to select a new Program consultant. That process, in fact, is already beginning for the selection of a new consultant for the period following the conclusion of the Phase Three contracts with CTSI, which run through September 1995.

Finally, the oversight and reporting requirements on CTSI have increased extensively in Phase Three and will continue to occur. Staff is pursuing establishing a person at the CTSI facility to observe and ensure that directions and proper procedures are being carried out.

Recommendation

It is recommended that upon the completion of Phase Three, staff will provide an appropriate Closure Report summarizing the results of Phase Three activities.

John R. Wodraska
General Manager

By Debra C. Man
Debra C. Man
Chief of Planning
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Concur:

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Attachments and Appendices (2)

ACTION PLAN

Auditor Issues/Recommendations	Status	Auditor Follow-up
Contract Compliance		
a) <i>Timekeeping records for exempt employees.</i> No recommendation by Auditor.	ACTION COMPLETE: Full timekeeping system in place Aug. 1, 1994 for Program Phase Three. Auditor finds system to meet Metropolitan requirements.	COMPLETE
b) <i>Management of CBOs by CTSI.</i> Recommendation for CTSI to develop standard operating procedures and schedule of charges for CBOs.	PARTIALLY COMPLETE: (1) Improved policies and procedures to be added to existing CBO training manual. (2) Standard CBO contracts have been prepared by CTSI counsel and reviewed by Metropolitan Legal Counsel.	TO BE VERIFIED
c) <i>Recycling of used toilets from multifamily project.</i> Recommendation for CTSI to develop standard form for used toilet return.	COMPLETE: CTSI using standard form to account for used toilets.	NOT REQUIRED
d) <i>Purchases of new ULF Toilets.</i> Recommendation for CTSI to maintain complete written bid/purchase documentation for Metropolitan review.	PARTIALLY COMPLETE: Formal CTSI bid analyses and purchase documentation being transmitted to Metropolitan in accordance Letter Agreement No. 4643. Staff to document conversations and toilet purchase decisions made in conjunction with CTSI.	NOT REQUIRED
e) <i>Broken/defective ULF toilets returned for credit to manufacturer.</i> Recommendation for CTSI to maintain written log of broken/defective ULFTs.	PARTIALLY COMPLETE: (1) Written log of broken/defective toilets maintained and in possession of Metropolitan;(2) manufacturer credit invoices in possession of Metropolitan. (3) Written log to facilitate reconciliation of the two is being developed by CTSI.	TO BE VERIFIED
f) <i>ULF toilet purchase and payment responsibilities.</i> Recommendation for CTSI to separate the two responsibilities.	COMPLETE: Additional staffing and job reassignments by CTSI implemented as of October 1, 1994. Functions of purchase and payment have been separated.	NOT REQUIRED
g) <i>Inventory transaction forms.</i> Recommendation for CTSI to support transactions with completed forms.	COMPLETE: Inventory transaction forms have been in existence since Phase One. CTSI directed to comply with its own existing procedures and properly complete all forms at all times.	NOT REQUIRED
h) <i>ULF toilet inventory control.</i> System found satisfactory by Auditor.	NO ACTION REQUIRED	NOT REQUIRED

ACTION PLAN

Agreement Administration

a)	<i>Metropolitan invoice approval.</i> Recommendation for Met staff to properly complete approval slips.	COMPLETE: Metropolitan Conservation Branch implemented new internal control procedure immediately upon advice of Auditor.	NOT REQUIRED
b)	<i>ULF toilet installation verification.</i> Recommendation for Metropolitan to continue existing verification program.	COMPLETE: Metropolitan retained PEAK International in June 94 to implement quality assurance program based upon statistically valid methods. PEAK under contract to perform 2,000 residential inspections. PEAK reports 98.7% of all ULF toilets are installed.	NOT REQUIRED

Contract Cost

a)	<i>General and administrative (G&A) expenses of CTSI.</i> Recommendation for Metropolitan to seek reimbursement of certain costs.	INCOMPLETE: Metropolitan to seek reimbursement for funds billed by CTSI to prepare billings (estimated at \$10,000-15,000) and inventory reports deemed to be a G&A expense. Met staff being assisted by Auditor in identifying G&A cost elements.	IN PROGRESS
b)	<i>Funds collected by CTSI from CBOs.</i> Recommendation for Metropolitan staff to direct CTSI to remit \$7,131.	PARTIALLY COMPLETE: CTSI has remitted \$7,131 to Metropolitan. Explanation due from CTSI on funds collected from CBOs to determine whether other monies are due Metropolitan.	NOT REQUIRED
c)	<i>Copayment account reconciliation.</i> Recommendation for Met staff to direct CTSI to remit \$120,045 of Met funds.	COMPLETE: CTSI has fully remitted copayment funds due (\$120,045 - \$1,669.58 in credit card fees = \$118,375.42).	NOT REQUIRED
d)	<i>Project costs associated with the distribution of "Rebate Toilets."</i> Recommendation for Metropolitan staff to recover added costs on future projects through agency agreements.	COMPLETE: Distribution of "Rebate Toilets" no longer a part of the Program. No intent to resume distribution of "Rebate Toilets" at any future time.	NOT REQUIRED
e)	<i>Performance incentive payments.</i> Recommendations: (1) defer final incentive payment until installations are verified, (2) and exclude "Rebate Toilets" and bulk sales from the incentive calculation.	COMPLETE: Final incentive payment in process of approval. Payment is based upon verified installations as measured by returned/recycled toilets per contract. Payment excludes bulk sales and "Rebate Toilet" distributions.	TO BE VERIFIED

Contract Accounting

	<i>Recording of costs by Controller.</i> Recommendation to correct errors.	COMPLETE: Controller corrected errors. No further action required.	TO BE VERIFIED
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ULTRA-LOW-FLUSH TOILET PROGRAM

Letter Agreement No. 3826 for Phases One and Two

CTSI Corporation

Exempt Employees

Name	Program Title	Period of Contract Participation (wks)	Hours Billed to Contract	Average Wkly Billings (Hrs.)	Hourly Billing Rate	Gross Billings to Metropolitan	Formal Timesheets?
J. Craft	Principal	88	2,795.5	31.8	\$95	\$265,572.50	No (1)
L. Craft	Program Mgr.	88	1,891.0	21.5	\$75	\$141,825.00	No
R. Ruiz	Project Mgr.	30	1,015.0	33.8	\$55	\$55,825.00	No
S. Ling	Project Mgr.	88	2,928.0	33.3	\$55	\$161,040.00	No
J. Heltebrake	Project Mgr.	79	2,571.0	32.5	\$65	\$167,115.00	No
J. Sanchez	Project Mgr.	88	3,180.0	36.1	\$55	\$174,900.00	No (2)
F. Hamilton	Project Mgr.	88	3,123.0	35.5	\$55	\$171,765.00	No (2)
B. Boyle	Project Mgr.	71	1,980.0	27.9	\$55	\$108,900.00	No
J. Chapman	Project Mgr.	11	191.0	17.4	\$55	\$10,505.00	No
M. DeVan	Project Mgr.	17	192.0	11.3	\$55	\$10,560.00	No
R. Rodriguez	Whse Supv	6	286.0	47.7	\$25	\$7,150.00	No
A. Roth	Sr. Consultant	88	961.0	10.9	\$75	\$72,075.00	No
F. Sanchez	Graphics Mgr.	81	2,894.5	35.7	\$45	\$130,252.50	No
T. Jackson	Project Mgr.	20	728.0	36.4	\$45	\$32,760.00	No
D. Lessick	Project Mgr.	4	168.0	42.0	\$45	\$7,560.00	No
J. Engel	Support	58	1,798.0	31.0	\$45	\$80,910.00	No
L. King	Project Mgr.	85	2,966.0	34.9	\$25/\$45	\$85,950.00	No
C. Seiler	Project Mgr.	30	930.0	31.0	\$55	\$51,150.00	No
Total: Exempt Employees			30,598.0	347.7	\$57	\$1,735,815.00	

Other Employees

Clerical & Support Employees	8,493.5		\$27	\$225,818	Yes
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Sub-Total: Non-Warehouse 39,091.5 \$1,961,632.50

Warehouse Employees	12,676.0		\$25	\$316,900.00	Yes
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Total: All Employees 51,767.5 \$2,278,532.50

Note: Contract time period - October 26, 1992 to June 30, 1994

(1) Hours maintained in personal diary

(2) Hours maintained on personal computer