MWD
METROPOLITAN WATER DISTRICT OF SOUTHERN CALIFORNIA

Report
February 28, 2007
Office of the General Auditor

- **Internal Audit Report for February 2007**

Summary

Three reports were issued during the month:
- **Local Resources Water Recycling Projects Audit Report – Generally Satisfactory**
- **J.F. Shea Construction Contract No. 1598 Audit Report – Satisfactory**
- **Fuel Supply Audit Report – Less Than Satisfactory**

Discussion Section

This report highlights the significant activities of the Internal Audit Department during February 2007. In addition to presenting background information and the opinion expressed in the audit report, a discussion of findings noted during the examination is also provided.

Local Resources Water Program Recycling Projects Audit Report

Background

The Local Resources Program (LRP) was established in 1998 as a competitive incentive program to encourage development of new water recycling and groundwater recovery projects to help achieve regional water supply reliability goals. The LRP replaced the Local Projects Program (LPP) and the Groundwater Recovery Program (GRP) initiated in 1982 and 1991. The LPP was designed to facilitate the development of water recycling projects, and the GRP, the development of groundwater recovery projects.

By June 1999, Metropolitan executed new agreements that converted fifteen of thirty-five LPP projects to include new LRP terms, which were similar to sliding scale incentives of $0 to $250 per acre-foot paid under the GRP. In June 1998 and April 2003, Metropolitan issued the first and second competitive Request for Proposals (RFP) for the development of 53,000 and 65,000 acre-feet per year of new recycling and groundwater recovery projects. Metropolitan executed agreements for all fourteen projects selected under the first competitive RFP and for ten projects selected under the second competitive RFP.

Through September 2006, Metropolitan has provided approximately $160 million of incentive payments for the production and distribution of about 852,000 acre-feet of recycled water. Since the LRP-Water Recycling Projects inception, Metropolitan has entered into agreements for sixty-two projects with contract yield totaling approximately 280,300 acre-feet per year. Forty-four of these projects are currently in operation, eleven in design or construction, five expired, and two were terminated.

Opinion

In our opinion, the operating and administrative procedures over LRP-Water Recycling Projects include those practices usually necessary to provide for a generally satisfactory internal control structure. The degree of compliance with such policies and procedures provided effective control for the period July 2003 through September 2006.

Comments and Recommendations
Our audit revealed the following concerns.

RECYCLING PROJECTS NOT DELIVERING ANY AMOUNT

The Local Resources Program (LRP) Water Recycling Project agreements include performance provisions for the start of construction and for meeting production targets. These agreements also include provisions that allow Metropolitan and Member Agencies to mutually amend the agreement at any time. When a project fails to produce and meet specified production targets, Metropolitan may reduce the contractual yield or terminate agreement with concurrence from Member Agencies.

During our review, we noted that two Local Projects Program (LPP) Projects, Sepulveda Basin Regional Water Reclamation (Sepulveda Basin) and Eastern Regional Reclaimed Water System (Eastern Regional) had not produced and delivered any recycled water since execution of their respective agreements in 1993 and 1995. Further review revealed that, for the Sepulveda Basin Project, Water Resources Management (WRM) staff reduced the contractual yield from 1,900 to 1,500 acre-feet per year. However, the project is not in operation due to unresolved permitting issues with the Los Angeles Regional Water Quality Control Board.

For the Eastern Regional project, WRM indicates that this project is dependent on Metropolitan or its agent taking recycled water for Diamond Valley Lake Recreational Area, which is still under consideration for development. Therefore, this project is on hold. In addition, one Local Projects Program Project, Shadowridge Water Reclamation Project (Shadowridge), and one Local Resources Program Project, San Pasqual Water Reclamation Project (San Pasqual), have not produced and delivered recycled water since fiscal year 2003/04.

Our review revealed that before this period, both were consistently delivering recycled water for beneficial purposes. WRM indicates that Shadowridge is currently not in service due to high operation costs, and San Pasqual was dismantled and ceased production before fiscal year 2003/04. Furthermore, the City of San Diego has indicated that it would study reconfiguring the San Pasqual project. We noted that WRM has a satisfactory process in place to continuously evaluate and assess project development and to enforce the performance provisions in the agreements.

We recommend that WRM, in conjunction with Member Agencies/subagencies, continue to evaluate and assess the recycling projects' ability to produce and deliver-recycled water to customers in the future. If these agencies do not anticipate starting the operation in the near future, we recommend that WRM renegotiate agreements, including terminating existing agreements with the respective Member Agencies/subagencies.

FINAL CONTRIBUTION RATES CALCULATION AND FINANCIAL INCENTIVES RECONCILIATION

Agreements for twenty-two LRP projects require that WRM staff perform a complex and elaborate reconciliation process to determine the final contribution rates used in calculating the financial incentives payments to Member Agencies/subagencies each year. The annual reconciliation involves obtaining project cost data (i.e., project's annualized capital cost, replacement cost, annual operating and maintenance cost, etc.), calculating the project unit cost, and comparing this cost to Metropolitan's prevailing water rate to determine the final LRP contribution rate. This final rate, which is the lower of the project's calculated contribution rate or the maximum rate of $250 per acre-foot, is applied to eligible recycled water deliveries when calculating the project's financial incentives in each applicable fiscal year.

Management is considering eliminating the reconciliation process for those projects with high costs that support receiving the maximum LRP contribution. While we understand the goal of improving efficiency, we express concern over theses changes and recommend that Management continue to conduct its analysis of final contribution rates.

J.F. Shea Construction Contract No. 1598 Audit Report

Background
San Diego Pipeline No. 6 North Reach is a 7-mile, 10-foot diameter pipeline that will deliver water from the Colorado River and the State Water Project to the Eastern Municipal Water District and Western Municipal Water District of Riverside County. The pipeline is projected to provide up to 388 million gallons of water per day to Riverside and San Diego counties. As part of development of the Program, Metropolitan appropriated $72.88 million and awarded Contract No. 1598 for $65.8 million to J.F. Shea. The project consists of the construction of approximately seven miles of fabricated steel pipeline, constructing facility connections, installing butterfly valves, and associated work. As of December 31, 2006, this project was 99% completed and approximately $61.6 million had been paid to Shea, net of $3.7 million contract retention.

Opinion
In our opinion, the accounting and administrative procedures over the J.F. Shea contract include those practices usually necessary to provide for a satisfactory internal control structure. The degree of compliance with such procedures provided effective control during the period from contract inception of December 2004 through December 31, 2006.

Comments and Recommendations

No reportable concerns noted.

Fuel Supply Audit Report

Background

Fleet Services Unit of the Operations Support Services Section of Water System Operations (WSO) initiates fuel purchases and tracks and monitors fuel usage at field facilities in the Fuel Management System. Field staff is responsible for preparing and submitting monthly Perpetual Fuel Inventory (PFI) Reports detailing fuel deliveries, usage and inventory reconciliations. The PFI reports are submitted to Accounting Operations of the Chief Financial Officer Office ("Accounting") and Environmental Compliance (EC) within the Environmental, Health, & Safety Section of WSO. Accounting uses the PFI reports to compute diesel fuel tax and to allocate fuel usage costs to the various field locations, as well as adjusting the fuel inventory account. EC uses the PFI reports to monitor variance data to detect potential storage tank problems or other operational and environmental issues and compute underground storage tank maintenance fees.

The Contracting Services Unit of the Corporate Resources Group ("Purchasing") administers the Gasoline Card Program (Voyager card). Purchasing facilitates the issuance and processing of cards and monitors, reconciles, and approves payment of gasoline card statements. There are approximately fifty gasoline cards in use as of our audit date. The fuel inventory at September 30, 2006, was $800,360. The fuel expenses from July 1, 2005 through September 30, 2006 were $1.8 million.

Opinion

In our opinion, the accounting and administrative procedures over Fuel Supply provide for a less than satisfactory internal control structure. This opinion is the result of inadequate management control over fuel inventories. Specifically, we noted a lack of periodic reconciliations between fuel purchases, usage and inventories on hand at month end. Furthermore, review of fuel usage reports and reconciliations that were submitted revealed numerous instances where differences between fuel usage and period ending inventories were not identified nor resolved. We also noted lack of verification of fuel charges to ensure Metropolitan is charged competitive prices. It should be noted that Management has initiated remedial actions in response to these concerns.

Comments and Recommendations

As noted in the opinion, our audit revealed concerns over the Management of the project. Specific concerns in this area presented in detail, while additional comments are summarized.

PERPETUAL FUEL INVENTORY RECONCILIATIONS

The Perpetual Fuel Inventory (PFI) process is a method to track the quantity and value of fuel supplies on hand by reconciling beginning inventories, deliveries, and usage with period ending inventory measurements. The Health, Safety & Environmental Policy (HSE) for Underground Storage Tank Management (§207.3.6) establishes procedures for fuel inventory reconciliations. It states: "Regulations require that inventory reconciliation is performed for all tanks that store gasoline or diesel used for fuel dispensing or emergency generator supply."

The PFI reports are required to verify and confirm all fuel deliveries, fuel dispensing, and to ensure that no fuel leaks have occurred. The PFI reports are designed to automatically reconcile the fuel inventory, daily dispensing, and daily usage, and identify any monthly variances. If there is an abnormal variance in the fuel inventory, there may potentially be a fuel leak and Engineering Support Services must be contacted immediately to investigate the cause of the variance. All fuel dispensing storage tanks must be reconciled on a daily and monthly basis. All emergency generator storage tanks must be reconciled on a monthly and annual basis." During our review, we noted the following discrepancies:

1. PFI Reports – We were unable to locate evidence of reviews performed to ensure that reports are complete, correctly prepared and submitted on a timely basis. In addition, we noted that PFI reports from three fuel locations of Diamond Valley Lake had not been submitted before September 2006.

2. Manual and System Fuel Inventory Variance - Field offices perform fuel tank stick readings and reconcile them with the fuel management system. Differences are identified as an Environmental Compliance Department (ECD) variance; they are recorded on the PFIs, and require follow-up and resolution. HSE policy §207 3.6 requires a variance analysis of these reconciliations and that the Engineering Support Services be contacted to investigate the cause of "abnormal" variances. Note: the PFI worksheet indicates that variances above 1% require an explanation.

   Our review of eight PFI reports with ECD variances above 1% from 3rd quarter 2006 showed:

   a. One fuel facility (Soto Street) had variances ranging from 46% - 98% for the April – June 2006 period, and we were unable to locate supporting documentation for these significant differences. Further review revealed that these differences were the result of the fact that Soto Street had not been performing and inputting the stick readings on the PFI reports.

   b. We were also unable to locate supporting documentation resolving difference for four facilities (Eagle Mountain, Iron Mountain, Jensen, and Lake Mathews) with ECD variances ranging from 3% - 20%.

3. Fuel Usage Variances - We were unable to locate reconciling differences on the PFI report for ten or more gallon difference between the fuel management system and the pump usage data on eight out of forty daily entries tested.

Fuel Delivery Differences – The quantity of fuel delivered per the billing receipt should agree with the PFI report. We noted seven of thirty fuel delivery entries where quantities billed on invoices were different from quantities recorded on the PFI worksheets. These differences were about 1-2% of total deliveries of each of the facilities. We recommend Management:

1. Resolve the noted discrepancies.

2. Remind personnel of the importance of compliance to established procedures and conduct training sessions to ensure that personnel understand their duties and responsibilities.

3. Establish procedures to ensure that reconciliations are properly completed and differences between the PFI reports and month end readings are thoroughly explained and resolved.
4. Conduct Management tests to ensure compliance.

VERIFICATION OF FUEL CHARGES

Metropolitan's fuel cost is based on a price formula that incorporates the Oil Price Information Service (OPIS) Index/Report daily average price for the supplier location and any applicable supplier margin. OPIS is an industry source for fuel price benchmarks. Fuel vendors are contractually required to include an OPIS report with the original fuel invoice submitted to Metropolitan for payment. Metropolitan also subscribes to the OPIS Index/Report online services. Given the fluctuation of fuel prices on a daily basis, it is a prudent business practice to periodically review fuel prices against OPIS to assess the reasonableness of fuel invoice charges.

During our review, we were unable to locate supporting documentation for the verification of fuel charges against the OPIS index to ensure that the District is obtaining competitive prices for fuel purchases.

We recommend that Management establish procedure to verify that fuel charges compare favorably with the OPIS index to ensure that the District is obtaining competitive prices for fuel purchases.

COMPLIANCE WITH POLICIES AND PROCEDURES

Compliance with established procedures is necessary to provide for accurate and complete accounting records, adequate control over Metropolitan's expenditures for fuel, and proper supporting detail. Metropolitan's Records Retention and Disposition Schedule states that the retention period for fuel and oil usage files is three years.

During our review of procedures and request for supporting documentation, we noted that field offices observe different data retention procedures for fuel usage source documentation. Some field offices retain usage source data for years while other offices only retain data for the current few months.

We recommend that Management reiterate to staff the importance of consistently following data retention procedures.

Continuous Audit Activities (monthly reviews)

Inland Feeder Project

Our review included agreeing actual costs reported to the Board to source documentation, including the general ledger, the Inland Feeder Project (IFP) Monthly Report, and selected contract payments; reviewing estimated costs at completion; analyzing changes in various cost components; and attending on-site meetings held to review actual costs and discuss current problems. Our review did not reveal any material differences between reported amounts and supporting documentation.

In addition, our ongoing review procedures for potential claims, liability exposures, and other pending issues have been designed to track such items in accordance with applicable reporting requirements under Financial Accounting Standards #5 (Accounting for Contingencies). Accordingly, for all pending legal claims, we consult with the Chief Financial Officer, IFP management, or General Counsel's office to evaluate the magnitude of potential losses to Metropolitan. It should be noted that the IFP Project Manager reports on contractors' claims currently in litigation and other potential claim issues to the E & O Committee monthly.

We also met with IFP management to discuss the procedures utilized to review the Shea/Kenney invoices under the terms of the new agreement. Specifically, we discussed the review procedures for detailed transaction analysis of non-labor charges and Construction Contract Administration (Met staff) review responsibilities.

<u>Center for Water Education</u>
Reviewed the monthly financial statements and attended monthly Board of Directors meeting. In addition, participated in discussions with the General Manager's Office on possible transition processes.