



- **Internal Audit Report for July 2007**

## Summary

---

Three reports were issued during the month:

- **Audit Department Quality Assurance Review – Management Response**
  - **Local Resources Program Groundwater Recovery Projects Audit Report – Generally Satisfactory**
  - **Lower Colorado River Multi-Species Conservation Program Audit Report – Satisfactory**
  - **Major Construction Projects-Brutoco Contract Audit Report – Satisfactory**
- 

## Discussion Section

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

---

## Audit Department Quality Assurance Review

### Background

As noted in the June 2007 Monthly Report, our recent External Quality Assurance Review (QAR) identified several observations and recommendations that we believe will strengthen corporate governance and improve the professionalism of the Audit Department. We concur with these recommendations and have prepared a Management Response and Action Plan. This is the first of a series of reports on the status of the implementation of our action plan. We will report our progress against these plans until complete.

The QAR contained recommendations related to Practice Advisories, or best practices as identified by the Institute of Internal Auditors. These recommendations are separated into two parts: Part I addresses matters for consideration of the Board or Management, whereas Part II addresses issues specific to the Audit Department.

### **Part I – Matters for Consideration of the Board and/or Management**

#### MATTERS FOR THE CONSIDERATION OF THE BOARD

The Executive Committee's Charter, as set forth in the Administrative Code, contains adequate authority to effectively oversee its Audit Department responsibilities. However, the QAR suggested that consideration be given to expand the Executive Committee's responsibilities to include a periodic assessment of the effectiveness of Metropolitan's internal control system. Additionally, it recommended that the Executive Committee responsibilities be revised to require an annual assessment of the Audit Department charter. We will present these proposed changes to the Administrative Code to the Executive Committee at the August 2007 Meeting.

## MATTERS FOR THE CONSIDERATION OF THE BOARD AND MANAGEMENT

One of the “Best Practices” recommendations noted during the review involves clarifying Management’s responsibility for the network of processes to manage risks and control operations (i.e. the internal control system). These responsibilities could be clarified and codified in a Management Control Policy, which would define for the Board of Directors the responsibilities of management at all levels, the Audit Department, and the Executive Committee with regard to risk management, control and governance processes. The QAR noted that, while Metropolitan has developed various policies and procedures necessary to control the organization, these policies could be enhanced by adopting a Management control policy. We have presented Management with a draft Management Control Policy for their review and consideration.

### **Part II – Issues Specific to Audit Department Activities**

#### STRENGTHEN CORPORATE GOVERNANCE

The Board reviews and approves the annual Audit Department Business Plan to ensure the adequate deployment of Audit Department resources. The Quality Assurance Review (QAR) noted that changes to the 2006/07 Audit Plan were not always formally communicated to the Executive Committee for review. Additionally, the QAR noted that the process to ensure timely Management responses and corrective actions related to audit reports could be improved.

We will provide the Executive Committee with quarterly assessments of progress vs. the 2007/08 Audit Plan beginning September 2007. In addition, we are utilizing our automated audit system, TeamMate, to better track Management responses and corrective actions.

#### COMPLIANCE WITH POLICIES AND PROCEDURES

In order to ensure high quality and professional audit work, auditors should conform to established Audit Department policies and procedures. The QAR noted that procedures related to the annual Audit Plan process were not always followed. Additionally, review of audit documents indicated that evidence of audit supervision could be enhanced. Lastly, auditors were not always fully compliant with established audit planning procedures.

We have implemented actions to strengthen compliance with Audit Department policies and procedures. First, we utilized the documented risk assessment process in developing the recently approved 2007/08 Audit Plan. Secondly, we provided two half-day training sessions to audit staff regarding audit planning and audit fieldwork. Lastly, we will perform periodic internal planning and work paper assessments to ensure adherence to established policies and procedures.

#### ENHANCE AUDIT DEPARTMENT EFFECTIVENESS

During our self-assessment, we noted that while the Audit Department Charter and Policies and Procedures Manual generally include the characteristics necessary to foster a quality Audit Department, the periodic updating of both documents should be performed.

We have updated the Audit Department Charter for consideration by the Executive Committee and Board. Additionally, we have begun the annual update of the Policies and Procedures Manual (next revision due September 2007) and have drafted an expanded policy related to the continuing professional development of audit staff.

---

## **Local Resources Program Groundwater Recovery Projects Audit Report**

### **Background**

The Local Resources Program (LRP) was established in 1998 as a competitive incentive program to encourage development of new groundwater recovery and water recycling projects to help achieve regional water supply reliability goals. The LRP replaced the Groundwater Recovery Program (GRP) and Local Projects Program (LPP) initiated in 1991 and 1982, respectively. The GRP was designed to facilitate the development of groundwater recovery projects, and the LPP, the development of both water recycling and 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 groundwater recovery and water recycling projects. Metropolitan executed agreements for fourteen projects (three groundwater recovery projects and eleven water recycling projects) selected under the first competitive RFP and for ten projects (two groundwater recovery projects and eight water recycling projects) selected under the second competitive RFP.

Through March 2007, Metropolitan has provided approximately \$69 million of incentive payments for the distribution of approximately 370,000 acre-feet of recovered groundwater. Since the LRP-Groundwater Recovery Projects inception, Metropolitan has entered into agreements for twenty-four projects with contract yield totaling approximately 84,000 acre-feet per year. Eighteen of these projects are currently in operation, four under construction, and two were not implemented.

### **Opinion**

In our opinion, the operating and administrative procedures over LRP-Groundwater Recovery 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 March 2007.

### **Comments and Recommendations**

Our audit revealed the following concerns.

#### **FINANCIAL INCENTIVES CALCULATION**

The contract agreements for fifteen Groundwater Recovery Projects require that the Regional Supply Unit (RSU) of the Water Resource Management Group complete an annual reconciliation of financial activity. These reconciliations are used to calculate the incentive payments to

member and sub-agencies. Specifically, the agreement requires RSU to collect project cost data, calculate the project's unit cost (cost per acre-foot), and compare this cost to Metropolitan's prevailing water rate (currently \$250 acre-foot). The incentive payment, then, is the lesser of the project's calculated unit cost or the \$250 per acre-foot, and is applied to eligible groundwater deliveries for that year. RSU then compares these incentive calculations to any estimated payments made in order to adjust for over/under payments. These reconciliations provide reasonable assurance as to the accuracy of incentive payments and completeness of supporting documentation.

Our review of eight Groundwater Recovery projects for FY 2003-04 and FY 2004-05 revealed that the calculated contribution rates for five projects (Arlington Desalter, Chino Basin Desalter, Madrona Desalination, Menifee Basin Desalter, and Tustin Desalter Projects) ranged from \$267 to \$1,128 per acre-foot. Accordingly, Metropolitan paid the maximum financial incentive of \$250 per acre-foot to these projects. However, we understand that RSU Management is considering modifying these contracts to eliminate the need for the annual reconciliations by having fixed-incentive based agreements. These changes are being proposed as improving the efficiency and effectiveness of the incentive payment process.

While these changes could reduce staff time needed to administer the groundwater recovery agreements, future changes to either the project's unit cost or Metropolitan's water rates could result in incentive payments greater than the project's unit cost. This could occur if the project's unit cost was reduced to a point below Metropolitan's water rate or if water rates rose above the project's unit cost. Furthermore, changes in the agreement to eliminate the annual reconciliation would prevent this outcome from being detected.

We recommend that RSU continue to conduct its analysis of final contribution rates (historical data and future estimates) for the fifteen-groundwater recovery agreements to establish a fixed and reasonable rate for each project. Once these rates are established, we recommend that RSU consider negotiating with the Member Agencies and sub-agencies to amend the term of existing agreements to adopt the new rates.

#### ASSESSMENT AND RECONCILIATION PROCEDURES

The Local Resources Program Administration Guide defines the policies and procedures utilized by the Regional Supply Unit (RSU) to administer Groundwater Recovery Projects and to complete the annual reconciliations.

During our review of FY 2003-04 and FY 2004-05 activities, we noted delays in completing the reconciliations for three of eight projects tested. Specifically, annual reconciliations for Arlington Desalter, Mission Basin Desalter, and Menifee Desalter Projects were completed between one to four months after their due dates. We understand that these delays were the result of changes made to staff assignments.

We recommend that the RSU staff to adhere to the assessment and reconciliation procedures and to the completion dates provided for in the Administration Guide.

## PRODUCTION YIELD

The Groundwater Recovery Agreements include performance provisions for the start of each project and for meeting ongoing production targets. These agreements also include provisions that allow Metropolitan, Member Agencies, and sub-agencies to mutually amend the terms and conditions of the agreement at anytime. When a project fails to meet specified production targets Metropolitan may, with concurrence from the Member/sub-agency, reduce the contractual yield or terminate the agreement.

Our review of recovered groundwater deliveries revealed that four projects (Burbank Lake St. GAC Treatment, Capistrano Beach Desalter, Irvine Desalter, and West Basin Desalter projects) did not produce yields in FY 2003-04 and FY 2004-05. Regional Supply Unit (RSU) management indicated that the Burbank Lake St. GAC Treatment project is required to resume water deliveries within ninety days of promulgation of new Chromium 6 limits by California Department of Health Services (CDHS). RSU Management has also indicated that the Capistrano Beach Desalter and the Irvine Desalter projects will commence production by July 2007, and the West Basin Desalter will resume production after a permit for a new well is received from CDHS.

In addition, our review also revealed that seven projects, as detailed below, were not producing at their capacity. RSU Management has a process in place to continuously evaluate and assess project development and to enforce performance provisions of the agreement.

	Project	% of Production Below Capacity	
		FY 2004-05	FY 2003-04
1.	Menifee Basin Desalter	80%	51%
2.	Tustin Desalter	68%	16%
3.	Oceanside Desalter-Phases 1 and 2	66%	51%
4.	Juan Well Filter Facility	63%	56%
5.	Colored Water Treatment Facility	55%	76%
6.	Beverly Hills Desalter	48%	29%
7.	Lower Sweetwater Desalter- Phase 2	45%	43%

We recommend that the RSU continue to evaluate the groundwater recovery project's ability to produce and deliver recovered water. Furthermore, we recommend that RSU work to modify those agreements that continue to have production below their capacity to a reduced yield that is mutually agreed by all parties.

---

## Lower Colorado River Multi-Species Conservation Program Audit Report

### Background

In February 2005, the Board approved Metropolitan's participation and funding of the Lower Colorado River Multi-Species Conservation Program (LCR MSCP), a 50-year habitat conservation plan covering the Lower Colorado River. The LCR MSCP is a joint partnership formed by the Bureau of Reclamation (Reclamation) with other federal agencies and water,

power, and wildlife agencies in Arizona, California, and Nevada to address the effects of Reclamation's operations and maintenance activities on listed species in the Lower Colorado River. The main goals of LCR MSCP are to conserve habitat and work towards recovery of listed species, optimize opportunities for future water and power resources development and water transfers, exchanges, and banking arrangements, and provide the basis for issuance of incidental take authorizations for the activities of the program participants. Currently, LCR MSCP provides conservation measures for a total of twenty-seven species, including six that are currently listed as threatened under the Endangered Species Act (ESA). Reclamation is responsible for implementing the conservation measures under LCR MSCP, and Metropolitan, along with other LCR MSCP members, participates in a Steering Committee that oversees Reclamation's work. Participation in LCR MSCP provides Metropolitan the following: (1) Permit for incidental take diversion of a full Colorado River Aqueduct; (2) Permit for incidental take resulting from future water transfers of up to 522,300 acre-feet per year; (3) Incidental take protection in the event that certain species are listed as endangered or threatened; and (4) A cost cap on the cost of future ESA compliance on the Lower Colorado River.

The estimated total cost to implement LCR MSCP is approximately \$626 million in 2003 dollars over the 50-year term. This total includes the costs for establishing new habitat, operating the fish rearing and stocking program, providing protection for existing habitat and the new conservation areas, and implementing the scientific monitoring and research program. Federal parties are paying one-half, and California is paying 25% and Arizona and Nevada each is paying 12.5% of the total program cost. California's share of the program is approximately \$157 million or 25% of the total program costs. Metropolitan's contribution is \$88.5 million (56.5% of California's share) or roughly 14% of the total program costs over 50 years. As of April 2007, Metropolitan has contributed approximately \$ 3.8 million to LCR MSCP.

### **Opinion**

In our opinion, the accounting and administrative procedures over the LCR MSCP include those practices usually necessary to provide for a satisfactory control structure. The degree of compliance with such procedures provided effective control during the period from program inception in April 2005 through April 2007.

### **Comments and Recommendations**

There were no material findings to report.

---

## **Major Construction Projects-Brutoco Contract Audit Report**

### **Background**

In May 2005, Metropolitan entered into a \$29.3 million contract with Brutoco Engineering and Construction, Inc. (Brutoco) to construct the Solids Handling Facilities and to relocate the Vehicle Maintenance Center (VMC) and the Entrance Gate Facilities at the Robert B. Diemer Filtration Plant. The construction of the Solids Handling Facilities will provide flexibility and improvement in treating various blends of water at the plant, which has been treating a higher percentage of State Water Project water due to decrease in Colorado River water allocation to Metropolitan in

recent years. The new handling facilities will include a solids dewatering facility building, a truck loading facility, two sludge thickeners, four elevated solids storage hoppers, and a pump station. The relocation of the VMC from the plant's southwest corner to the northwest hill will minimize interference with future work in the Oxidation Retrofit Projects at the plant. The VMC provides maintenance to vehicles used in plant's operations and Metropolitan's distribution system. The relocated VMC will include a new vehicle maintenance building, a covered vehicle wash area, and a refueling station. Finally, the relocation of the Entrance Gate Facilities will provide a suitable line-of-sight and place additional security between the plant boundary and the western portion of the plant. The relocated Entrance Gate Facilities will include a prefabricated guard shack, entrance gates, drop arm gates, and security equipment. The three projects are anticipated to complete in October 2007, and Metropolitan has paid Brutoco \$28.0 million for these projects as of April 2007.

### **Opinion**

In our opinion, the accounting and administrative procedures over Major Construction Projects-Brutoco Contract No. 1607 include those practices usually necessary to provide for a satisfactory internal control structure. The degree of compliance with such procedures provided effective control for the period from May 2005 (contract inception) through April 2007.

### **Comments and Recommendations**

There were no material findings to report.

---

## **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 Board monthly.

### **Center for Water Education**

Assisted management on the review and assessment of proposed payments of the Center for Water Education's construction debts.