



- **Internal Audit Report for October 2007**

Summary

Six reports were issued during the month:

- **Bond Management Audit Report - Satisfactory**
 - **Carollo Engineers, P.C. Agreement Audit Report – Generally Satisfactory**
 - **Diemer Brutoco Contract Audit Report – Satisfactory**
 - **Interest Rate Swap Program Audit Report - Satisfactory**
 - **MWH Americas, Inc., Black & Veatch Corporation, and CH2M Hill, Inc. Audit Report – Generally Satisfactory**
 - **Towill, Inc., Coast Surveying, Inc., and Rick Engineering Company Audit Report – Generally Satisfactory**
-

Discussion Section

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

Bond Management Audit Report

Background

Metropolitan's long-term debt consists primarily of general obligation and revenue bond issues. Metropolitan's authority to levy ad valorem property taxes secures the general obligation bonds. Revenue bond obligations are special limited obligations of Metropolitan, which are secured by a pledge of Metropolitan's net operating revenues.

The Treasury/Debt Management Section in the Office of the Chief Financial Officer is responsible for managing the issuance of bonds and related debt service payments. The Controller Section in the Office of the Chief Financial Officer is responsible for accounting and financial reporting for debt transactions. The Treasury/Debt Management Section maintains master schedules that account for outstanding bonds and related activities. During fiscal year 2006/07, Metropolitan issued \$800 million in Revenue Bond Construction Funds and \$264.3 million in Revenue Refunding Bonds. As of June 2007, there were \$4.6 billion in General Obligation and Revenue Bonds outstanding.

Opinion

In our opinion, the accounting and administrative procedures over Bond Management include those practices usually necessary to provide for a satisfactory internal control structure. The degree of compliance with such policies and procedures provided effective control for the period between July 1, 2006 and June 30, 2007.

Comments and Recommendations

There were no material findings to report.

Carollo Engineers, P.C. Agreement Audit Report

Background

In August 2005, Metropolitan entered into an agreement with Carollo Engineers (Carollo), P.C. to provide engineering design services for the Weymouth Oxidation Retrofit Program. The contract's (#68899) maximum amount payable is \$8 million, and the contract is effective from August 1, 2005 through July 31, 2008. As of August 31, 2007, Metropolitan has paid Carollo \$7.7 million under this agreement.

Metropolitan's Oxidation Retrofit Program consists of retrofitting its five water treatment plants with an ozonation process to replace chlorine as the primary disinfectant to meet the Environmental Protection Agency's Disinfectant/Disinfection By-Product Rule. Total estimated Oxidation Retrofit Program costs are \$999.6 million. The Mills and Jensen Treatment Plants were the first two facilities within Metropolitan's system to be retrofitted and were placed into service in October 2003 and July 2005 respectively. Construction for the Skinner Treatment Plant is in progress, and is expected to be completed during fiscal year 2009-2010. Design for the Weymouth Treatment Plant has been completed and design is currently in progress for the Diemer Treatment Plant.

Opinion

In our opinion, the accounting and administrative procedures over the Carollo agreement 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 from contract inception on August 1, 2005 through August 31, 2007.

Comments and Recommendations

COMPLIANCE WITH TERMS AND CONDITIONS OF THE AGREEMENT

Compliance with contractual requirements is necessary to ensure accurate accounting records, proper supporting detail, and adequate control over the administration of the agreement. Compliance with contractual terms also ensures that parties fully discharge their obligations and exercise their rights.

During our review, we noted:

- Carollo's stated professional liability coverage of \$1 million for consultant's errors and omissions did not meet the minimum coverage of \$5 million, as required by Section 20 of the agreement. Upon our inquiry, the Corporate Resources' Contracting Unit obtained a revised copy for the correct coverage. However, these certificates neither identified the contract (#68899) nor the correct Carollo project number (7248A.10). Accordingly, Carollo provided revised copies showing the agreement and project numbers.

Our review of 14 invoices totaling \$3.7 million revealed:

- Metropolitan paid two invoices late (between 63 and 91 days after receipt). It should be noted that Section 9(g) of the Agreement states that, "Subject to the approval of the Agreement Administrator, Metropolitan shall make payment to the consultant within thirty days after receipt of the invoice."

We recommend that the Agreement Administrator remind personnel of the importance of compliance with established procedures and conduct tests to ensure compliance.

Diemer Brutoco Contract Audit Report

Background

In December 2005, Metropolitan entered into a \$13.9 million contract with Brutoco Engineering & Construction, Inc. (Brutoco) to provide upgrades to the chemical system facilities at the Diemer Water Treatment Plant. These upgrades (contract #1620) are required for the implementation of the Diemer Oxidation Retrofit Program (ORP) undertaken by Metropolitan to lower disinfection by-products for compliance with both Stage 1 and Stage 2 of the Environmental Protection Agency's Disinfectant/Disinfection By-Products Rule. These upgrades include the construction of four projects: ORP chemical tank farm; fluoridation facilities; canopy roof for the West Service Pump Station; and canopy roof for the sulfuric acid unloading pad.

The ORP chemical tank farm project includes the demolition of the existing wash water reclamation facility and the construction of sulfuric acid feed and storage system and three other chemical storage tanks. The fluoridation facilities project involves modification of the existing sulfuric acid tank farm and installation of chemical trenches and chemical lines. The canopy roof projects include the installation of new canopy roofs over the existing water pump station and the sulfuric acid unloading facilities. As of June 30, 2007, the four projects were 99% complete and Brutoco has been paid \$14.4 million (this includes \$500,000 in extra work orders).

Opinion

In our opinion, the accounting and administrative procedures over the Brutoco contract include those practices usually necessary to provide for a satisfactory internal control structure. The degree of compliance with such policies and procedures provided effective control for the period from December 2005 (contract inception) through June 2007.

Comments and Recommendations

There were no material findings to report.

Interest Rate Swap Program Audit Report

Background

California Government Code §5922 permits government agencies to utilize interest rate swaps to reduce debt service costs and reduce the amount or duration of interest rate risk. In September 2001, the Board adopted a Master Swap Resolution which authorizes Metropolitan to enter into

swap transactions and related agreements. The Board also approved a Master Swap Policy which defines the purpose and parameters of the Swap Program. This program is administered by the Chief Financial Officer and is used as part of the debt and investment management program. In accordance with the Master Swap Policy, a summary report of outstanding swap transactions is presented to the Business and Finance Committee on a monthly basis.

An interest rate swap is a contractual agreement between Metropolitan and a Board-approved investment banking team member (counterparty) where one party agrees to pay the other (in cash) the difference between fixed and variable interest rates or variable and fixed interest rates over an agreed period of time based upon a notional amount. The notional amount is required to compute the interests that will be periodically paid by each party. For example, Metropolitan might agree to pay a counterparty a fixed rate of 4.22 percent on a notional amount of \$100 million in exchange for receiving a variable rate equal to the weekly Securities Industry and Financial Markets Association (SIFMA) Municipal Swap Index. Metropolitan and many other public agencies use interest rate swaps as part of bond refunding in new money transactions to lower interest costs and to mitigate interest rate fluctuations and risk. As of June 2006 and 2007, there were 24 and 20 outstanding swap transactions totaling \$1.9 billion and \$1.6 billion respectively.

Opinion

In our opinion, the accounting and administrative procedures over the Swap Program 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 July 2005 through June 2007.

Comments and Recommendations

There were no material findings to report.

MWH Americas, Inc., Black & Veatch Corporation, and CH2M Hill, Inc. Audit Report

Background

The Oxidation Retrofit Program (ORP) provides an alternative disinfectant, ozone, at Metropolitan's treatment plants to remove blend restrictions, treatment capacity restrictions, and substantially lower disinfection by-product levels for compliance with both Stage 1 and Stage 2 of the Environmental Protection Agency's Disinfectant/Disinfection By-Product Rule. Metropolitan must begin monitoring and reporting compliance with Stage 2 of this rule by April 2012.

On November 18, 2002, Metropolitan entered into a consulting agreement with CH2M Hill, Inc. for an amount not to exceed \$500,000. On December 2, 2002, Metropolitan entered into a consulting agreement with Black & Veatch Corporation, for an amount not to exceed \$500,000. On December 16, 2007, Metropolitan entered into an agreement with MWH Americas, Inc. for an amount not to exceed \$500,000.

These three consultants were selected to provide specialized process engineering services for Skinner, Weymouth, and Diemer ORPs, including conducting specialized analyses; performing design tasks; and providing assistance during construction. Under the terms of these consulting agreements, no work was guaranteed to the consultants and Metropolitan will only authorize tasks as needed. As of May 31, 2007, payments to the consultants under the agreements, which are set to expire April 30, 2008, totaled \$1.5 million. Two subsequent amendments to Black & Veatch Corporation and MWH Americas, Inc. increased the maximum amount payable to \$1.2 million and \$1.5 million respectively.

Opinion

In our opinion, the operating and administrative procedures over ORP agreements with MWH Americas, Inc., Black & Veatch Corporation, and CH2M Hill, Incorporated 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 from November 18, 2002 (agreements' inception) through May 31, 2007.

Comments and Recommendations

COMPLIANCE WITH TERMS AND CONDITIONS OF THE AGREEMENT

Compliance with contractual requirements is necessary to ensure accurate accounting records, proper supporting detail, and adequate control over the administration of the agreement. Compliance with contractual terms also ensures that parties fully discharge their obligations and exercise their rights.

During our review of 45 invoices totaling \$936,000 we noted:

1. Fifteen of 45 invoices were paid between 41 to 80 days after invoice receipt. These agreements require payments within 30 days after receipt of the invoice.
2. Twenty-two of 45 invoices tested were submitted to Metropolitan without the required Small Business Enterprise (SBE) Utilization Reports. The agreements require that the consultants submit a SBE Utilization Report with each invoice indicating either the amount paid to each SBE sub-consulting firm or noting no activity.

We recommend Management remind personnel of the importance of complying with established policies, procedures, and contractual conditions. Further, we recommend Management conduct periodic reviews to ensure compliance.

Towill, Inc., Coast Surveying, Inc. and Rick Engineering Company Audit Report

Background

When real property was purchased from the federal government in the 1930s for the Colorado River Aqueduct facilities, Metropolitan did not receive a deed for the property that could be recorded in California. Under California law, Metropolitan is potentially at risk of losing its property rights if the federal government erroneously sells overlapping property rights to another entity which records the deed in California. Moreover, most of this property has not been surveyed in over 70 years, and few visible boundary markers exist that delimit Metropolitan properties from adjacent federal, tribal, and private lands.

In September 2003 and October 2003, the Board approved contracts for \$1.8 million and \$22.8 million, respectively, to proceed with the recordation of official maps solidifying Metropolitan's property rights and to perform extensive field surveys. In February 2004, Metropolitan entered into consulting agreements with Towill, Inc. (contract #59677), Coast Surveying, Inc. (#60294), and with Rick Engineering Company (#60297) in amounts not to exceed \$921,000, \$1.2 million, and \$586,000, respectively, to provide professional and technical services for surveys, maps, monuments and support work to map the exterior boundaries of various Metropolitan properties.

Under the terms of the agreements, no work was guaranteed to the consultants and Metropolitan authorized tasks as needed. As of June 30, 2007, payments to the consultants under the agreements totaled \$2.1 million. There have been no amendments to these agreements and they expire in January 2008.

Opinion

In our opinion, the accounting and administrative procedures over consulting contracts with Towill, Inc., Coast Surveying, Inc., and Rick Engineering Company 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 February 1, 2004 (contracts' inception) to June 30, 2007.

Comments and Recommendations

COMPLIANCE WITH TERMS AND CONDITIONS OF THE AGREEMENT

Compliance with contractual requirements is necessary to ensure accurate accounting records, proper supporting detail, and adequate control over the administration of the agreement. Compliance with contractual terms also ensures that parties fully discharge their obligations and exercise their rights.

Our review of 38 invoices (totaling \$976,000 of \$2.1 million) revealed:

1. Required information was not complete on 37 of 38 invoices tested (97%). Specifically, invoices did not include information such as Metropolitan's project name, agreement number, and the beginning and ending billing dates as required by Section 9 of the agreements.
2. Invoices were not signed and certified by the consultant for 28 of 38 invoices tested (74%). Section 9 (Billings and Payments) of the agreements require that the consultant's invoices be signed and certified to be true and correct to the best of consultant's knowledge.

3. Invoices were submitted without the Small Business Enterprise Utilization reports for 26 of 38 invoices tested (68%). Section 8-c of the agreements require the consultants to submit with each invoice a SBE Utilization Report indicating either the amount paid to each SBE subconsulting firm or no activity for the invoice period.
4. Invoices were input into the Oracle system with incorrect invoice dates for 2 of 38 invoices tested (5%).

We recommend that the Agreement Administrator establish procedures to ensure compliance and conduct periodic tests to verify compliance to the terms and conditions of the contracts.

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 consulted 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 in reviewing proposed payments for constructions debts incurred by the Center for Water Education.

Audit Department Quality Assurance Review

Background

As noted in the June 2007 Monthly Report, our recent External Quality Assurance Review identified recommendations that will strengthen governance and improve the professionalism of the Audit Department. This is the second of a series of reports on the status of the implementation of our action plan.

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

Several “best practice” recommendations for the consideration of the Board and/or Management were recommended during the review. The first recommendation was intended to enhance the Board’s oversight of audit activities by expanding certain responsibilities in the Executive Committee’s Charter related to the Audit Department. The Board made these changes to the Administrative Code in October 2007. Furthermore, the Administrative Code was also amended such that the General Manager’s annual reporting to the Executive Committee includes considering the effectiveness of the District’s internal control system. Finally, a recommendation was made to strengthen Management’s responsibility for controlling operations. We have provided 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 ensures appropriate deployment of Audit Department resources by reviewing and approving the Audit Department Business Plan annually. However, due to changes in risk profiles or other factors, it is prudent to periodically assess the Audit Department’s Annual Plan for appropriateness and to measure its’ progress against the Plan. Although these assessments have been conducted on a quarterly basis, our self-assessment recommended that these reports be communicated to the Board for review and concurrence. In addition, although auditors have always been responsible for follow-up to ensure that Management has responded to each Audit Report and has implemented the audit recommendations, we noted that this has not been communicated to the Board on a formal basis. Accordingly, our self-assessment concluded that a quarterly report to the Board on the status of Management’s implementation of audit recommendations should be made.

With regard to our Business Plan, we believe that the 2007/08 Audit Plan continues to address the areas of Board and/or Management concern, and those of high risk. We also believe that the Audit Department is on track towards completion of the objectives set forth in the Plan.

Audit Department activity for the quarter ended September 2007:

Types of Reviews Completed	Audit Reports Issued
Financial/Operational	8
Information Technology	1
DVL – Searl Parkway Improvements	1
Total Audit Reports	10

Analysis of Audit Report responses and status of audit findings for September 2007:

Rating	Number of Audits Issued	Responses Received	Number of Audit Findings	Number of Findings Implemented	Number of Findings In Process
Satisfactory	3	3	0	0	0
Generally Satisfactory	6	6	14	12	2
Less Than Satisfactory	1	1	3	3	0
Unsatisfactory	0	0	0	0	0
Total	10	10	17	15	2

ENHANCE AUDIT DEPARTMENT EFFECTIVENESS

Finally, during our self-assessment we noted that the Audit Department Charter could be enhanced by updating it to reflect leading governance practices such as issuing an annual opinion on internal controls over financial reporting. The Board approved related amendments to the Administrative Code concerning the Audit Department Charter in October 2007.