



- **Internal Audit Report for November 2008**

Summary

Two reports were issued during the month:

- **Kern Delta Water Management Program Audit Report**
 - **IT Consulting Agreements with Fortech Software Consulting, Incorporated (62415), Westin Engineering, Incorporated (63639), Danish Hydraulic Institute Water & Environmental (65052), and Information Management Resources, Incorporated (86422) Audit Report**
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Discussion Section

This report highlights the significant activities of the Internal Audit Department during November 2008. 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.

Kern Delta Water Management Program Audit Report

Background

In November 2002, Metropolitan's Board authorized a Water Management Agreement (Program) with the Kern Delta Water District. This Program consists of several components that include the exchange of State Water Project (SWP) water supplies, storage and delivery system, and an agreement to supply water to Metropolitan. Specifically, the agreement provides Metropolitan the ability to store SWP water in a storage account of 250 thousand acre-feet (TAF) within the groundwater basin underlying the Kern Delta Water District. Furthermore, at Metropolitan's call, Kern would return a minimum of 50 TAF of water in a given year. The Program is located south of the Delta in the San Joaquin Valley, so recovery of water is not limited by the court's decision that restricts Harvey O. Banks Pumping Plant flows.

These deliveries would be made either through: (1) an exchange of stored water for SWP water in the California Aqueduct, (2) an exchange of stored water for other surface water and groundwater supplies deliverable to the California Aqueduct, or (3) the recovery of stored water directly from the Kern Delta Groundwater Basin and deliverable to the California Aqueduct. The agreement also provides that Metropolitan has transportation rights to move water through the Kern Delta facilities to facilitate water transfers.

Payment terms for this Program are structured according to a cost-plus-based formula. That is, to cover the cost of the Program facilities, Metropolitan pays \$105 per acre-foot to store ("put") water and \$40 per acre-foot to extract it. Further, after the initial 250 TAF is stored, the Program costs are reduced to \$90 per acre-foot (\$50 for put and \$40 for extraction). Additionally, these payments are adjusted for inflation and Metropolitan pays for the actual operation, maintenance and power costs for the Program facilities. However, this Program does not require any annual or storage fee payments.

On December 21, 2004, the contract was amended to modify the terms and conditions of the water storage and to change the Operation, Maintenance and Replacement (OM&R) fees. Specifically, the minimum put payment periods and acre-feet (AF) of water required in the first year (50,000 AF), fourth year (150,000 AF) and seventh year (250,000 AF) were amended to first year (60,000 AF), third year (160,000 AF) and sixth year (250,000 AF). In addition, the OM&R fees for Delivered Water and Regulated Water were amended from \$4 per AF to \$11 per AF.

In March 2007, the Board authorized action to amend the Program agreement due to increased program costs resulting from rising land costs and the effects of the Cross Valley Canal construction costs. Under this amendment, Metropolitan agreed to pay the actual cost of construction for the Cross Valley Canal. It abolished the minimum payment specified under the original agreement, and it eliminated the \$105 per acre-foot payment to store (“put”) the first 250 TAF of water. However, as of October 2008, this amendment has not been executed due to lengthy negotiations. As of September 30, 2008, Metropolitan has paid Kern Delta Water District \$31,091,320, has stored 36,290 AF, and has recovered 11,174 AF of water.

Opinion

In our opinion, the accounting and administrative procedures over the Kern Delta Water Management Program include those practices usually necessary to provide for a generally satisfactory internal control structure. Although this report contains an acceptable opinion, concern is noted in the fact that negotiations on the second amendment to the contract have languished since March 2007. We encourage Management to complete these negotiations and execute the amendments. The degree of compliance with such policies and procedures provided effective control for the period May 27, 2003 through September 30, 2008.

Comments and Recommendations

COMPLIANCE TO TERMS AND CONDITIONS OF THE AGREEMENTS

During our review, we noted that Section 2.8.2 of the Agreement states that Kern Delta would construct the: (i) Delivery Canal (except the Buena Vista Canal Extension) within 36 months; (ii) Phase 1, groundwater recharge facilities, Buena Vista Spreading Facilities, and the Buena Vista Canal Extension within 60 months; (iii) Phase 1 of the Kern Delta Program Recovery Facilities (15 new wells) completion within 48 months; and (iv) Phase 2 of the Kern Delta Program Recovery Facilities (8 new wells) to be completed within 60 months.

However, we noted that these deadlines have not been met. Furthermore, we understand that revised timetables are part of a “second amendment” to the agreement, which has been in negotiations since March 2007. These proposed revised timetables are that the: (i) Delivery Canal will be completed by June 2009; (ii) Phase I groundwater recharge facilities will be completed by December 2010; (iii) Phase I Kern Delta Program Recovery facilities will be completed by July 2009; and (iv) Phase II Kern Delta Program Recovery facilities will be completed by July 2010.

While we recognize that the completion of these projects was delayed to manage construction costs and to more efficiently match the on-line date of the facilities to when surplus water would be

available, we encourage Management to complete these extended negotiations. Properly executed agreements serve to establish contractual terms and conditions for each party and acts to ensure that parties fully discharge their duties and obligations and exercise their legal rights associated with the agreement.

IT Consulting Agreements with Fortech Software Consulting (62415), Westin Engineering (63639), Danish Hydraulic Institute Water & Environmental (65052), and Information Management Resources (86422) Audit Report

Background

The Information Technology Section is responsible for providing quality information technology services and solutions to customers, effectively aligning business and technology objectives through collaboration, in order to provide the most cost-effective solutions that facilitate and improve the conduct of business for Metropolitan. The Information Technology Strategic Plan (ITSP) provides a high-level blueprint for using the information technology to deliver Information Technology systems and services to Metropolitan. The ITSP is designed around the following goals: strengthen data security, improve water quality, enhance water reliability, and promote productivity throughout Metropolitan. These goals serve to guide strategic activity and initiatives needed to accomplish the mission, services and objectives for the Information Technology Section. Our review consisted of an examination of the following four consulting agreements that provide assistance to projects integral to the ITSP.

In August 2004 (Phase I) and February 2006 (Phase II), the Board authorized an agreement with Fortech to provide and implement an Energy Management Systems solution for hydroelectric generation. Initially set at \$450,000, the agreement was amended twice to a now not-to-exceed maximum of \$787,000.

In August 2004, the Board authorized an agreement with Westin Engineering, Incorporated to provide Project Management services with a maximum amount payable of \$2.2 million.

In October 2004, the Board authorized an agreement with the Danish Hydraulic Institute of Water and Environment to develop and implement a hydraulic model and water quality model (Real Time Operating System) for Metropolitan's water conveyance and distribution system. This agreement was entered in January 2005 in an amount not to exceed \$2.3 million.

Finally, an agreement with Information Management Resources, Incorporated was entered in May 2007 to provide on-site full-time Project Management services of a large, multiphase Network Infrastructure Upgrade Project. This agreement was in an amount not to exceed \$243,000 per contract year. As of August 2008, payments to the consultants under the four agreements reviewed totaled \$3,850,360.

Opinion

In our opinion, the accounting and administrative procedures over IT Consulting Agreements with Fortech Software Consulting, Incorporated, Westin Engineering, Incorporated, Danish Hydraulic Institute Water & Environment, and Information Management Resources, 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 December 2004 through August 2008.

Comments and Recommendations

COMPLIANCE TO TERMS AND CONDITIONS OF THE AGREEMENTS

Our review of 20 invoices totaling \$1.9 million (five Fortech invoices \$325,600; five Westin invoices \$156,000; five DHI invoices \$1,386,000 and five IMRI invoices \$66,800) revealed:

1. Consultant invoices for one of five Fortech invoices, two of five Westin invoices and four of five DHI were paid 20 to 174 days, after their due dates. This is in contrast to the Billings and Payments Section of the agreements that requires payment within 30 days after receipt of the invoice.
2. Fortech and IMRI invoices did not include information as required in the agreements, such as, the beginning and ending billing dates, the maximum amount payable and total amount previously invoiced.
3. Consultant invoices for two of five Fortech invoices and two of five Westin invoices were posted to incorrect account and subaccounts. For example, invoice was posted to Account 45400 instead of Account 12155 and subaccount 4540010 instead of 4540020. As a result, these expenditures were inaccurately recorded in the general ledger.

We recommend that IT Project Management Unit resolve the noted issues above and remind the consultants of the importance to comply with terms and conditions of the agreements. Finally, we recommend that the IT Project Management Unit establish procedures and conduct periodic reviews to ensure compliance to the terms of the agreements.

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. These meetings included extensive discussions on the progress of obtaining pipe hauling permits from the City of San Bernardino and the impact that these efforts have on project costs.

We also reviewed the procedures designed to dispose of salvaged equipment to ensure the safeguarding of assets and the propriety of the processes. 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 loss to Metropolitan. It should be noted that the IFP Manager reports on contractors' claims currently in litigation and other potential claim issues to the Board monthly.