



- Internal Audit Report for July 2009

Summary

Four reports were issued during the month:

- **Oxidation Retrofit Programs – Mills Plant, Ozone Contactors No. 3 and No. 4 (1650) and System Reliability Upgrade (1655) Audit Report**
- **Semitropic Water Banking and Exchange Program and Arvin-Edison Water Management Program Audit Report**
- **Legal Contracts and Settlements Audit Report**
- **Official Statement for the Water Revenue Refunding Bonds, 2009 Authorization Series D, and 2008 Authorization Series D**

Discussion Section

This report highlights the significant activities of the Internal Audit Department during July 2009. In addition to presenting background information and the opinion expressed in the audit reports, a discussion of findings noted during the examination is also provided.

Oxidation Retrofit Programs – Mills Plant, Ozone Contactors No. 3 and No. 4 (1650) and System Reliability Upgrade (1655) Audit Report

Background

The Henry J. Mills Water Treatment Plant was placed into service in 1978 to supply treated State project water to Eastern Municipal Water District and Western Municipal Water District of Riverside County. The plant had an initial capacity of 75 million gallons per day (mgd). Upon completion of the Mills Oxidation Retrofit Project in 2003, the plant capacity increased to 160 mgd.

In March 2005, the Board authorized the Mills Capacity Upgrade Program to increase the hydraulic capacity of the ozone contactors to match the full capacity of the plant (326 mgd), and to rehabilitate existing plant facilities to restore full plant capacity. The need for this capacity is due to increasing treated water demands in eastern Riverside County.

As part of this capacity upgrade, Metropolitan entered into a \$14.6-million contract with C.W. Roen Construction Company (Roen) in July 2007 to construct additional ozone contactors to the Mills Oxidation Retrofit Project. The work under this contract includes constructing two ozone contactors (No. 3 and No. 4), making the tie in to existing process and utility lines, and installing two Metropolitan-furnished ozone control panels. As of February 2009, Metropolitan has paid Roen \$10.9 million under this contract.

In January 2008, Metropolitan entered into a \$3.4-million procurement contract with Ozonia North America, Incorporated to purchase a fourth ozone generator with ancillary equipment. This will allow one of the three duty generators to be removed from service for scheduled preventative or emergency corrective maintenance, without impacting the restored 326 mgd plant capacity or compliance with the U.S. Environmental Protection Agency Disinfectant/Disinfection Byproduct Rule. Deliveries of this

equipment started in April 2009 and are scheduled to be completed in August 2009. As of February 2009, Metropolitan has paid a total of \$433,307 to Ozonia North America, Incorporated.

In January 2009, in an effort to reduce near-term capital expenditures, staff proposed to Metropolitan's Board that the rehabilitation of the Henry J. Mills Water Treatment Plant facilities to restore the 326 mgd treatment capacity would be deferred for two years. Accordingly, the award of a construction contract for installation of the fourth ozone generator and ancillary equipment would be deferred.

Opinion

In our opinion, the accounting and administrative procedures over the contracts 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 2007 through February 2009.

Comments and Recommendations

Project Management entails planning, organizing, and managing resources to bring about the successful completion of specific project goals and objectives. It involves monitoring and controlling activities from project initiation to project closeout. Projects are planned and managed in such a way that procurement of needed equipment and/or supplies is timed effectively and efficiently to ensure timely construction. The staging of major construction elements ensures timely completion of procurement, fabrication, delivery, and installation of major equipment components.

Our review revealed that the installation of the fourth ozone generator and ancillary equipment will be delayed by more than two years from the original completion date of December 2009. Further review revealed that the equipment delivered in April 2009, under Ozonia North America Contract 1655, has been stored since that time (\$650 per month) until the installation contract is ready to proceed. In the interim, the Water System Operations Group Management requested design changes, which will modify the existing ozone and oxygen alarm system in the Mills Ozone Generation Building to increase the operational flexibility of the ozonation process. This request was made at the end of the final design phase and has resulted in additional final design costs to incorporate the changes.

In addition, our review noted that the installation of the ozone equipment has been postponed, along with the remaining Mills Plant Capacity Upgrade Program projects, due to an unexpected drop in treated water demands in the area, and in keeping with the Board's directive to reduce and postpone expenses where possible during the ongoing economic crisis. The alarm system redesign is expected to be completed by October 2009, with the installation of the ozone generator and ancillary equipment being finished by February 2011.

We recommend that Project Management keep all Project Team members, Management, and stakeholders informed of project progress and key issues for early identification of problem areas. Further, Project Management should define roles and responsibilities of all participants and stakeholders in the decision-making process.

Semitropic Water Banking and Exchange Program and Arvin-Edison Water Management Program Audit Report

Background

In December 1994, Metropolitan entered into a water management agreement with Semitropic Water Banking and Exchange (Semitropic) to store up to 350,000 acre-feet of State Water Project water in its groundwater basins located in Kern County during wet years. This agreement, effective through November 2035, allows Metropolitan during the dry years to withdraw up to 107,000 acre-feet of stored water and to exchange Semitropic entitlements from the State Water Project.

In October 2008, Metropolitan entered into a two-month agreement with Semitropic to remove arsenic from the water withdrawn from its groundwater basins. Metropolitan withdrew 28,699 acre-feet of treated water in accordance with this pilot program through December 2008. For the test period January 2006 through December 2008, Metropolitan paid \$34.4 million to Semitropic under this program. These payments consisted of \$5.9 million for O&M fees and \$28.5 million for water costs. As of December 2008, Metropolitan has 125,500 acre-feet of water stored in Semitropic groundwater basins.

In December 1997, Metropolitan entered into a water management agreement with Arvin-Edison to store up to 350,000 acre-feet of State Water Project water in its groundwater basins located in Kern County during wet years. This agreement, effective through November 2035 allows Metropolitan, during dry years, to withdraw up to 75,000 acre-feet of stored water and/or to exchange Arvin-Edison entitlements with other Kern County water districts.

In October 2000, Metropolitan received a Proposition 13 grant (\$20 million) from the Department of Water Resources. A portion of this grant, along with \$1.2 million from Metropolitan and up to \$3.2 million from Arvin-Edison, funded the expansion of Arvin-Edison's South Canal, between the Tejon Spreading Works and the Intertie Pumping Plant. The South Canal facilities are used to transport Metropolitan's State Water Project water to the Arvin-Edison groundwater basins.

This project was completed in December 2008. From January 2006 through December 2008, Metropolitan has paid \$24.1 million to Arvin-Edison. These payments consisted of \$16.2 million for the South Canal improvements, \$745,000 for OM&R fees, and \$7.2 million for water costs. Metropolitan water stored in Arvin-Edison groundwater basins was 151,800 acre-feet as of December 2008.

Opinion

In our opinion, the accounting and administrative procedures over Semitropic and Arvin-Edison 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 January 2006 through December 2008.

Although this report expresses an acceptable opinion, concern is noted in the overpayment of water costs, missing notification required for the increase to labor rates, and unadjusted power and energy rates being applied to monthly charges.

Further review revealed that Executive Management was aware of these concerns; however, they authorized the continuation of these programs due to time constraints and the opportunity to obtain water. Also, we acknowledge that Management has initiated remedial actions in response to our concerns. We will continue to assist management in the evaluation of solutions to address these issues while being mindful of operational needs and constraints.

Comments and Recommendations

REVIEW AND APPROVAL OF INVOICES

Review and approval controls are designed to verify the accuracy of billings for goods and services, provide assurance as to the propriety of transactions, and they ensure that follow-up procedures exist for exception processing. The reviewer and approver should review expenditures listed on the invoices for propriety, and agree them to source documentation to ensure accuracy and completeness of transactions.

For Metropolitan, Program Management should perform periodic review of program expenditures to ensure compliance with the terms and conditions of the agreement. Our review of nine invoices totaling \$30.9 million (four Semitropic invoices - \$17.9 million and five Arvin-Edison invoices - \$13.0 million) revealed:

1. Arvin-Edison's reimbursable costs that were incurred to construct the South Canal Improvement Project (SCIP) and billed to Metropolitan were not substantiated with timesheets or certified payroll. SCIP was funded in part by the state's Proposition 13 and Metropolitan and completed in December 2008. Metropolitan was the primary recipient of this grant, and Arvin-Edison was the grant's subrecipient. The state required Metropolitan to keep complete and accurate records of all receipts, disbursements, and interest earned on expenditures of such funds.
2. Notification for labor rate increases could not be located for Arvin-Edison's consultant billings. We noted three of nine (33 percent) invoices tested (08-12, 08-13 and 08-17) consisted of Provost and Pritchard, whose labor rates increased to a total of \$14,580. These increases were related to the construction of SCIP.
3. Two of nine (22 percent) invoices tested (Arvin-Edison invoices 08-12 and 08-17) were overbilled by \$960. This overbilling consisted of unallowable travel charges of \$180 incurred by Provost and Pritchard and overbilled labor charges of \$780 incurred by subconsultant BSK Associates.
4. In addition, our review of water inventory recorded in the Water Information System revealed that the quantities of stored water in Semitropic were understated by 932 acre-feet (AF). Our review revealed that this inventory understatement was due to incorrect billing of water withdrawn (billed 16,600 AF rather than 15,668 AF) from Semitropic in November 2004. Consequently, Semitropic overbilled Metropolitan by \$118,355 (932 AF at \$127 per AF) since 2004. As a result of our inquiry, Program Management contacted Semitropic and Semitropic credited Metropolitan for the above amount in its May 2009 billing.

We recommend that Water Resources Management remind Semitropic and Arvin-Edison Program Management of the importance of thorough review of invoices to ensure accuracy of billed charges,

completeness of supporting documentation and compliance with the terms and conditions of the agreement.

COMPLIANCE TO TERMS AND CONDITIONS OF THE AGREEMENTS

Compliance with contractual requirements is necessary to ensure accurate accounting records, proper supporting detail, and adequate control over the administration of the agreements. Compliance with the contractual terms and conditions also ensures that parties fully discharge their duties and obligations and exercise their legal rights associated with the agreements. Our review of Semitropic and Arvin-Edison billings revealed:

1. Water costs for water withdrawn from Semitropic in November and December 2008 were billed in the month following the water withdrawal. However, the costs (\$726,500) for removing arsenic from withdrawn water were not billed until May 2009. This is in contrast to Section 2 of the Arsenic Treatment Program agreement that requires Semitropic to include and identify these costs in its invoices submitted for withdrawal payments, which in this particular case were to be included in December 2008 and January 2009 billings. This resulted in understatement of water inventory costs by the above amount as of January 2009.
2. Arvin-Edison's estimated power and energy billings (total \$4.5 million) for calendar years 2003 through 2007 have not been adjusted to actual costs as of December 2008. This is in contrast to Section 6.6.1 of Arvin-Edison agreement with Metropolitan that requires Arvin-Edison to adjust the estimated billings to actual by June 1 of the following year, or as soon as possible with any amount due to either party paid within 45 days of the receipt of the invoice.

We recommend WRM Program Management resolve the noted issue and remind Semitropic and Arvin-Edison of the need to comply with terms and conditions of the agreements. Finally, we recommend that the Program Manager establish procedures to ensure compliance to the terms of the agreements and conduct periodic reviews to ensure compliance.

MANAGEMENT REPORTING

Management reports are designed to combine information into a meaningful form, so Management can assess the program's performance and develop strategic plans to achieve program goals and objectives. Management reports allow for analysis and tracking to take place, without daily involvement from Management and provide timely feedback on program activities. These reports can be informative (e.g., amount of water deliveries, withdrawals, and available in storage) or analytical (e.g., regulation fees, power and energy costs, OM&R fees, staff labor).

Program status and activities of the Semitropic and Arvin-Edison Programs were reported to Management and the Board through monthly report "Water Surplus and Drought Management Plan on Water Supply and Demand" and semiannual report "State Water Project Strategic Initiatives." However, we noted that the information on program expenditures was not included in these reports to Management and the Board. Incomplete information provided to Management and the Board could result in delays in identifying program issues and in taking timely corrective actions.

We recommend that Water Resources Management include the program expenditures information in the monthly and semiannual reports to Management and the Board.

Legal Contracts and Settlements Audit Report

Background

The Administrative Code §6431 authorizes the General Counsel to employ Special Counsel, investigators, and technical experts to assist and/or represent in court actions, special proceedings, legislative hearings, and other proceedings so long as the amount paid in fees and expenses in any one year, in connection with any such assignment, does not exceed \$100,000. Accordingly, agreements exceeding the scope of the General Counsel's authority are subject to approval by the Board of Directors. The Legal Department has 15 attorneys administering 94 such agreements. For the period reviewed, about \$9.5 million have been paid on professional services that include these agreements.

The General Counsel is also authorized by Administrative Code §6433 to allow, compromise, or settle any claim or suit by or against Metropolitan, if the amount to be paid does not exceed \$125,000. In addition, Administrative Code §6434 authorizes the General Manager/Chief Executive Officer, upon the advice of the General Counsel, to determine that Metropolitan's claims and accounts receivable under \$125,000 are not collectible and to direct the writing off of such items. Finally, under Administrative Code §6436, the General Counsel is required to report to the Legal and Human Resources Committee on a quarterly basis the exercise of any power delegated to her by §6431, §6433 and §6434 which includes: all agreements awarded; claims and suits initiated, compromised or settled; contested matters by or before administrative agencies; and claims and accounts receivable written off.

Opinion

In our opinion, the accounting and administrative procedures over Legal Department contracts and settlements 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 November 1, 2005 through December 31, 2008.

Comments and Recommendations

COMPLIANCE WITH TERMS AND CONDITIONS OF THE AGREEMENTS

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. The terms and conditions of the agreements administered by the Legal Department require the Special Counsel or expert consultant to provide "proof of insurance coverage in an updated form during the term of the agreements." The Legal Department staff was unable to locate a current certificate of insurance for one of the agreements.

We recommend that Agreement Administrators work with Special Counsel and technical experts to ensure compliance with terms and conditions of the agreements.

Official Statement for the Water Revenue Refunding Bonds, 2009 Authorization Series D, and 2008 Authorization Series D

Background

The Audit Department has completed a review of the Official Statement for the Water Revenue Refunding Bonds, 2009 Authorization Series D, and 2008 Authorization Series D. This review was undertaken to provide the underwriters of the Water Revenue Refunding Bonds (Bonds) “comfort” that the Official Statement for the Bonds is complete, consistent with supporting financial records, and accurate in all material respects. The review was completed and no exceptions were noted. We issued letters describing the agreed upon procedures, and the results obtained to the underwriters of the Bonds.

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. 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.