



THE METROPOLITAN WATER DISTRICT
OF SOUTHERN CALIFORNIA

• **Internal Audit Report for March 2011**

Summary

Six reports were issued during the month:

- **Proposition 13 Conjunctive Use Program Audit Report**
- **Purchasing – Professional Services Contracting Audit Report**
- **Storage Program - Surface Storage Operating Agreement Audit Report**
- **Storage Program - Seasonal Shift Storage for Undepreciated Sunk Fixed Costs Agreements and Replenishment Service Program Audit Report**
- **Local Resources Program - Water Recycling Projects Audit Report**
- **KPMG Single Audit Report for Year Ended June 30, 2010**

Discussion Section

This report highlights the significant activities of the Internal Audit Department during March 2011. 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.

Proposition 13 Conjunctive Use Program Audit Report

Background

In March 2000, California voters approved Proposition 13 (Safe-Drinking Water, Clean Water, Watershed Protection, and Flood Protection Act) to allow the state to sell \$1.97 billion of general obligation bonds for water-related projects. In May 2000, the Governor released the State Annual Budget, which appropriated funds to the Department of Water Resources (DWR) to carry out a number of programs that provide loans and grants to local agencies for various water-related purposes.

Under Proposition 13, DWR allocated \$45 million in grants to Metropolitan to be used for groundwater storage projects within its service area. Metropolitan entered into 25-year funding agreements with several member agencies to provide funding for their groundwater Conjunctive Use Program projects. Specifically, Metropolitan contracted with the Central Basin Municipal Water District in June 2002; Three Valleys Municipal Water District in June 2002 and September 2005; Foothill Municipal Water District in February 2003; Orange County Municipal Water District in June 2003; City of Compton in February 2005; City of Long Beach in July 2005; and Western Municipal Water District in December 2006.

The \$45-million Proposition 13 funds were supplemented by \$8 million from Metropolitan to fund nine Conjunctive Use Program projects. The projects consist of the construction of groundwater production facilities, conveyance facilities, pipelines, aquifer storage recovery wells, sea barrier wells, as well as the upgrade of the volatile organic compounds treatment system and pump station. When completed, the projects will enable Metropolitan to store up to 106,000 acre-feet (AF) of surplus “wet” water in the member agency basins and produce 28,000 AF of water per year during dry, drought, or emergency periods.

Our review of eight Conjunctive Use Program projects disclosed low levels of member agency water storage as of October 31, 2010. Specifically, Metropolitan water stored in the member agency basins totaled 24,374 AF or 77 percent below the maximum water storage capacity for Metropolitan water at any time. We noted that the low storage levels resulted from significant withdrawals of approximately 60,000 AF during the period between 2007 to early 2010, when these storage programs were activated to produce supplies to offset the impact of critically dry conditions and below normal imported supplies.

Further review revealed that limited State project water supplies in 2008, 2009, and in early 2010 prevented any recovery of storage levels in these programs during this period. Lastly, we noted that the Water Resource Management (WRM) Group and Water System Operations (WSO) Group have begun to store water in member agency basins due to improved conditions, such as low demands and an improvement in imported supplies. From July through October 2010, 15,800 AF were stored in these basins.

Opinion

In our opinion, the accounting and administrative procedures over the Proposition 13 Conjunctive Use Program 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 2008 through October 2010.

Comments and Recommendations

REVIEW AND APPROVAL

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 ensure that follow-up procedures for exceptions exist. These controls should include a review to verify the recordation of transactions into the appropriate general ledger/project account.

We reviewed four Orange County Water District invoices totaling \$8.1 million and noted that the supporting timesheets for all consultant labor charges tested (\$156,000) could not be located. These labor charges were billed on five consultant invoices reviewed. Orange County Water District (OCWD) management indicated that they are in process of locating the consultant timesheets in question.

We recommend that WRM Group program management follow-up with OCWD for the missing consultant timesheets. We also recommend that WRM Group program management perform periodic review of timesheets that support the consultant labor charges billed on OCWD invoices.

COMPLIANCE TO INSURANCE, REPORTING, AND RECONCILIATION REQUIREMENTS

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 with associated agreements. We reviewed compliance to insurance, reporting, and reconciliation requirements of the funding agreements and noted:

1. Six of eight projects reviewed were not covered by environmental liability insurance as recommended by the Insurance Section of the respective agreements.
2. Annual reports and reconciliations were not completed on their respective due dates for up to six months after the June 30 fiscal year-end. We noted that although the annual reports and reconciliations for some projects were provided during the course of the audit, these reports and reconciliations were completed months after their due dates.
3. The FY 2008/09 annual report and reconciliation for Orange County Groundwater CUP could not be located. Further, although the FY 2008/09 annual reconciliation was missing, we noted that the Operating Committee had performed periodic reconciliations of water deliveries, sales, storage account balance, and notification calls made during FY 2008/09.

We recommend that the WRM Group management and WSO Group program management consider amending the funding agreements to eliminate the need for environmental liability insurance. We also recommend that WRM Group and WSO Group program management assess the reasonableness of completion dates for preparing the annual reports and annual reconciliations and consider amending their respective agreements to reflect this assessment.

Purchasing – Professional Services Contracting Audit Report

Background

The Contracting Services Team within the Business Technology Group is responsible for the procurement of professional services. Professional services include legal support, medical, architectural, financial, scientific, and consulting services in which the final products would be intellectual or artistic in nature. Contracting Services utilizes Request for Proposals, Requests for Qualifications, and Sole Source to procure professional services.

The Request for Proposals method is used where technical considerations or other factors are considered in making an award that produces value to Metropolitan. The Requests for Qualifications method is used where the scope of work is broadly defined for either making an award that reflects the most qualified and best provider to Metropolitan or for prequalifying potential respondents for a subsequent competitive solicitation. The Sole Source method is used when exemption from the competitive bidding process is justified because competition would not produce an advantage.

The procurement process encompasses initiating a Request for Proposals/Qualifications; soliciting proposals/qualifications; evaluating vendors; awarding a contract; and preparing, approving and tracking the contract. For our audit coverage of July 2007 through December 2010, there were 490 professional service contracts executed, with contract amounts and payments totaling \$131.1 million and \$92.9 million.

Opinion

In our opinion, the accounting and administrative procedures over Professional Services Contracting 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 December 2010.

Comments and Recommendations

POLICIES AND PROCEDURES

Operating policies and procedures should be established and documented to provide a framework for achieving Metropolitan goals properly and adequately. Whereas policies guide actions toward a desired outcome, procedures provide management with guidelines for consistent performance of daily operations. Within Contracting Services, procedures should be established to ensure proper controls related to employee/vendor records in the database system, effective monitoring of agreements and completeness of contract related documentation. Our review of professional service agreements and the related vendor databases revealed:

1. In order to process employee expense reimbursements that were initiated through the Travel Expense Reporting System, the Oracle Financial Application requires that employee names be entered in the Oracle Procurement Vendor Database (OPVD). We noted that this action inadvertently results in these employees being coded as valid “vendors” that could be associated with contracts or agreements. These are conflicting relationships that could result in the creation of fraudulent transactions. We noted that 2,311 of 2,926 employee records (79 percent) stored in the database could be coded as a “vendor”. Further, we noted that 910 of these 2,311 employee records (39 percent) were former employees. Prior to audit completion, Contracting Services (1) adjusted the control field in the database so that employees are no longer valid “vendors”, and (2) deactivated former employees from the database.
2. Thirty professional service agreements that expired up to over two years previously remained open in the OPVD as of December 31, 2010. Our review revealed that nineteen agreements expired from six months to one year previously; eight agreements expired from one to two years previously; and three agreements expired more than two years previously.
3. Bid evaluation documentation for thirteen professional service agreements and the documentation folders for three additional agreements could not be located.

We recommend that the Contracting Services Team develop guidelines for maintaining employee records in the OPVD. We also recommend that the Contracting Services Team update guidelines for closing out expired agreements and for maintaining and retaining contract documentation including bid solicitation, vendor evaluation and selection, as well as the agreements.

Storage Programs – Surface Storage Operating Agreement Audit Report

Background

In July 2003, Metropolitan entered into a five-year Surface Storage Operating Agreement (SSOA) with the San Diego County Water Authority (SDCWA) to manage treatment and pipeline capacity during peak demand periods at the Skinner Treatment Plant. The agreement allowed Metropolitan to deliver up to 70,000 acre-feet (AF) of water into participating reservoirs between November 1 and May 31 and authorized SDCWA to withdraw these supplies between June 1 and October 31. Further, the agreement stipulated that SDCWA was to be billed at the applicable water rates and charges, less a credit of

\$70 per AF for water withdrawn on a pre-determined schedule or \$105 per AF for water withdrawn upon a 24-hour notice (call water). Under the agreement, the SDCWA submitted monthly certifications of the storage and delivery activity to support the water invoicing process. On an annual basis, the Water Systems Operation (WSO) Group staff verified the accuracy of these records and resolved any disputes. From October 2003 through October 2008, Metropolitan delivered 274,757 AF to these reservoirs and the SDCWA withdrew 251,435 AF. Metropolitan provided incentives totaling \$17,612,966 under this agreement.

Our tests consisted of verification of the SDCWA's monthly credit certification and WSO program management's reconciliation of qualified volume against the SDWCA and its eight participating sub-agencies' source documents. We also validated that Metropolitan billed SDWCA for the correct volume, water rates and charges. Finally, we confirmed that the SDCWA passed on discounts to the eight participating San Diego agencies.

We also performed tests of the Surface Storage Operating Agreement. Specifically, we validated WSO program management's assessment of water delivered or withdrawn monthly from the storage account against Metropolitan Water Information System. We also compared water delivered or withdrawn, as recorded in Metropolitan Water Information System, against the quantity shown on Metropolitan's annual reconciliation letters to the participating agency. Finally, we tested management reporting controls to ensure timely and accurate reporting of program activities.

Opinion

In our opinion, the accounting and administrative procedures over the WSO Storage Programs - Surface Storage Operating Agreement (SSOA) 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 limited period July 2007 through October 2008.

Comments and Recommendations

There were no material findings to report.

Storage Programs – Seasonal Shift Storage for Undepreciated Sunk Fixed Costs (Shift) Agreements and Replenishment Service Program Audit Report

Background

In 1989-90, Metropolitan created the Seasonal Shift Service (SSS) Program to incentivize the construction of local production facilities, to increase conjunctive use of imported and local supplies, and to reduce member agencies' demands on Metropolitan during periods of high demand or shortage. In 1997, as this program was being phased out, Metropolitan entered into agreements with three agencies to allow them to recover costs for projects that were constructed in response to the SSS Program. These agreements became the Seasonal Shift Storage for Undepreciated Sunk Fixed Costs (Shift) Agreements. These Shift agreements were with the City of Anaheim, Municipal Water District of Orange County (MWDOC) - Irvine Ranch Water District, and the City of Long Beach were effective October 1, 1997 through May 1, 2007. In 2005, Metropolitan extended these agreements until May 1, 2008.

Under these agreements, the member agencies agreed to over-pump May through September and under-pump October through April, thus flattening out demands on the system. Metropolitan billed the member agencies at the applicable full service water rate, less an incentive of \$141 per acre-foot (AF) for treated water and \$116 per AF for untreated water. The cumulative maximum incentives and actual discounts provided under the SSS agreements from October 1997 through May 2008 were:

Agency	Cumulative Maximum Incentives	Actual Discounts Provided
Anaheim	\$2,674,065	\$2,674,064
MWDOC – Irvine Ranch Water District	\$13,255,398	\$13,255,390
City of Long Beach.	\$14,059,000	\$6,980,092

In addition, in 2003/04 Metropolitan created the Replenishment Service Program, which offered a discounted rate to agencies that stored water in local reservoirs and groundwater basins by direct and in-lieu means longer than a 12-month period. Under these agreements, responding agencies submitted monthly certifications of the storage and delivery activity to support the water invoicing process. Annually, the WSO staff verified the accuracy of these records and resolved any disputes noted.

Our tests consisted of selecting three agencies that participated in both the Shift and Replenishment Service Programs (the City of Anaheim, Municipal Water District of Orange County (MWDOC) - Irvine Ranch Water District, and the City of Long Beach). We reviewed Shift Program activity for the period October 2002 through April 2003 and Replenishment Program activity for the period July 2005 through June 2006. Specifically, we assessed the completeness and accuracy of the monthly certifications by tracing these totals to the agency, sub-agency, and independent “water master” records.

We also reviewed WSO program management’s reconciliation and confirmation of qualified volume against Metropolitan’s Automated Meter Reader and Water Information System records. In addition, we confirmed that Metropolitan billed the participating agencies for the correct volume, water rates and charges; that discounts were issued in accordance with the provisions of agreements; and the satisfactory resolution of disputes with member agencies.

For the test period July 2002 through May 2008, Shift incentives totaled \$1,536,565 for the City of Anaheim, \$9,042,762 for MWDOC – Irvine Ranch Water District, and \$3,555,766 for the City of Long Beach. For the same test period, the City of Anaheim received total replenishment incentives of \$2,640,121, MWDOC – Irvine Ranch Water District received \$2,819,548 and the City of Long Beach received \$3,499,664.

Opinion

In our opinion, the accounting and administrative procedures over the WSO Storage Programs - Seasonal Shift Storage for Undepreciated Sunk Fixed Costs (Shift) Agreements and Replenishment Service Program 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 periods July 2002 through May 2008.

Comments and Recommendations

There were no material findings to report.

Local Resources Program - Water Recycling Projects Audit Report

Background

The Local Resources Program (LRP) was established in 1998 as an incentive program for water recycling and groundwater recovery projects to help achieve regional water supply reliability goals. This program replaced the Local Projects and Groundwater Recovery Programs that were begun in 1981 and 1991. The Local Projects Program incentivized water recycling projects, whereas the Groundwater Recovery Program was designed to develop groundwater recovery projects. By June 1999, new agreements were executed to convert 15 of the 35 Local Projects Program agreements to LRP terms which provided for sliding scale incentives of \$0 to \$250 per acre-foot (AF). In addition, Request for Proposals (RFPs) issued in June 1998 and April 2003 resulted in the execution of 20 new agreements for water recycling projects totaling 82,400 AF per year.

In April 2007, the Board authorized the conversion of existing agreements from a sliding to a fixed scale incentive. Moreover, the Board authorized a new Local Resource Program that provided for a sliding scale incentive of up to \$250 per AF. The target for this new program is 174,000 AF.

As of December 31, 2010, Metropolitan had 73 water recycling projects, consisting of 60 projects currently in operation, four projects under construction, seven projects that have expired, and two that were terminated. Metropolitan has paid incentives of \$263.5 million on these projects and has produced 1.44 million AF of recycled water through that date. This audit consisted of review of five water recycling projects with incentive payments totaling \$99.1 million for 413,000 AF of recycled water through December 2010. For the test period of July 2007 through December 2010, incentive payments of \$32.2 million were issued. The projects include:

1. Conejo Creek Water Recycling Project - Calleguas Municipal Water District project which involves the construction of ancillary facilities to improve storage basins, the conversion of a reservoir to reclaimed water use; and other modifications.
2. West Basin Municipal Water District Reclamation Program – Involves the construction of a secondary effluent pump station; a pipeline from the Hyperion Treatment Plant; an advanced water recycling plant; and expansion of facilities.
3. Alamitos Barrier Reclaimed Water Project - Central Basin Municipal Water District project which consists of treatment upgrades to Title 22 disinfected tertiary water standards from the Long Beach Water Reclamation Plant. These upgrades include the construction of a control building and maintenance facility; reverse osmosis treatment train and reverse osmosis feed pumps; an aerator for stripping carbon dioxide; and chemical storage tanks.
4. Irvine Ranch Water District Recycled Water System Upgrade Project - Municipal Water District of Orange County project which consists of upgrades to the Michelson and Los Alisos water reclamation plants and the expansion of the dual distribution system to deliver recycled water to end users.

5. Eastern Municipal Water District Pipeline Reach 16 Project – Pertains to the installation of approximately 3.5 miles of recycled water pipeline and creation of a loop in the reclaimed water system.

Opinion

In our opinion, the accounting 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 2007 through December 2010.

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 projects. Compliance with contractual terms also ensures that parties fully discharge their obligation and exercise their rights.

Our review noted that the Eastern Municipal Water District Pipeline Reach 16 project was overpaid \$867 as the result of an incorrect incentive rate calculation. This overpayment has been corrected.

We recommend that the Water Resource Management remind staff of the importance of compliance with the terms and conditions of the agreement and conduct periodic reviews to ensure compliance.

KPMG Single Audit Report for Year Ended June 30, 2010

The Federal Single Audit Act of 1984, as amended by the Single Audit Act Amendments of 1996, requires state or local government units that expend \$500,000 or more of federal financial assistance in any one year to have an audit conducted for that year. The firm of KPMG, in accordance with generally accepted auditing standards promulgated by the American Institute of Certified Public Accounts, audits Metropolitan's accrual basis financial statements. In the event that a so-called "Single Audit" is required to be conducted for a particular year, the cost of such an audit is included as part of the required audit services provided by that firm under its agreement with Metropolitan.

Due to the magnitude of federal sources and moneys expended during the fiscal year ended June 30, 2010, Metropolitan was required to have a Single Audit performed. KPMG performed the necessary auditing procedures and issued the following audit reports.

1. Internal Control over Financial Reporting and on Compliance and Other Matters.
2. Compliance with Requirements Applicable to Each Major Program and Internal Control.

The report was distributed to the Board on March 30, 2011.