



## **Internal Audit Report for June 2015**

### **Summary**

Three reports were issued during the month:

- **Weymouth Oxidation Retrofit Ozonation Facilities Construction Project 104459 Audit Report**
- **Conservation Credits Program Audit Report**
- **Official Statement for the Water Revenue Refunding Bonds, 2015 Authorization, Series A1 and A2**

### **Discussion Section**

This report highlights the significant activities of the Internal Audit Department during June 2015. In addition to presenting background information and the opinions expressed in the audit reports, a discussion of findings noted during the examination is also provided.

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## **Weymouth Oxidation Retrofit Ozonation Facilities Construction Project 104459 Audit Report**

### **Background**

The Audit Department has completed a review of the accounting and administrative controls over the F.E. Weymouth Treatment Plant (Weymouth plant) Oxidation Retrofit Program (ORP), Ozonation Facilities Construction Project 104459 (Project 104459), as of March 31, 2015. Our review consisted of evaluating administration and reporting practices, and reviewing Project 104459 authorization and closeout processes. We evaluated the validity and accuracy of invoice payments for assurance that amounts billed were properly calculated, and adequately supported. Finally, we reviewed the Actual versus Budgeted costs, and compared these totals to appropriated amounts and management reports.

The Weymouth plant was placed into service in 1941 to treat water received from the Colorado River. Presently, Weymouth plant delivers a blend of treated water from the Colorado River Aqueduct and the State Water Project to Metropolitan's Central Pool portion of the distribution system. Originally sized at a capacity of 100 million gallons per day (mgd), Weymouth plant was expanded to its current capacity of 520 mgd to meet increased demands from member agencies. In addition to these expansions, Weymouth plant has had facility upgrades and improvements made throughout the years, including the ongoing ORP Project 104459. The purpose of these improvements is to comply with Stage I of the U.S. Environmental Protection Agency Disinfectant and Disinfection By-Product Rule, meet drinking water standards, and reduce taste and odor incidents. Weymouth plant is the last of five Metropolitan treatment plants to be retrofitted, as part of the ORP.

In June 2012, the Board appropriated \$140.4 million and awarded Archer Western Contractors LLC (Archer) Agreement 1741 for \$95,497,513 to construct the Ozone Generation Building, Ozone Off-Gas Destruct System, Liquid Oxygen Storage Facility, and the Hydrogen Peroxide Storage and Feed Facility. Moreover, Agreement 1741 called for Archer to construct two ozone contactors that provided ozone disinfection for an initial capacity of 260 mgd. In addition, Archer Agreement 1741 included the construction of two additional bypass contactors needed for Stage II of Weymouth plant ORP to increase ozone treatment to full capacity.

In December 2013, the Board authorized an additional \$18.5 million for construction of Stage II of Weymouth ORP to increase the ozone treatment capacity from 260 mgd to 520 mgd. This capacity increase accommodates expected future Weymouth plant treated water demands, eliminates blending restrictions associated with Metropolitan source water, and provides flexibility within the Central Pool when Prestressed Concrete Cylinder Pipe feeders are removed from service for rehabilitation. As of March 31, 2015, total expenses for Weymouth ORP were \$180.5 million, and final costs are estimated to be \$267 million. In addition, \$104.7 million of these expenditures were classified as Ozonation Facilities construction expenses of which Archer was paid \$86.2 million.

### **Opinion**

In our opinion, the accounting and administrative procedures over Weymouth plant ORP, Project 104459 include those practices usually necessary to provide for a generally satisfactory internal control structure. The degree of compliance with the policies and procedures provided effective controls from May 1, 2014 through March 31, 2015.

### **Comments and Recommendations**

#### **COMPLIANCE WITH TERMS AND CONDITIONS OF THE AGREEMENTS**

Compliance with contractual requirements is necessary to ensure accurate accounting records, proper supporting details, and adequate controls over administration of the agreements. Compliance with agreement terms and conditions ensures that parties fully discharge their duties and obligations, and exercise their legal rights associated with the multiple agreements.

Our review of 25 invoices (10 Archer and 15 various consultants) totaling \$33.6 million revealed that time records supporting labor charges of \$1,198 on one of 15 consultant invoices tested, could not be traced to Weymouth plant ORP Project 104459. Although the consultant provided an invoice breakdown of hours charged by project, timesheets specified hours worked per Task Order rather than by project covered under the Task Order.

We recommend management remind agreement administrators of the importance of compliance with agreement terms and conditions, and conduct periodic reviews to ensure compliance.

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## **Conservation Credits Program Audit Report**

### **Background**

The Audit Department has completed a review of the accounting and administrative controls over the Conservation Credits Program, as of March 31, 2015. Our review consisted of evaluating internal controls over the reservation, approval, and reporting processes for the Conservation Credits Program. Tests were conducted on the regional programs for Residential and Commercial Water-Efficient Device Rebate (Rebate) Programs, and the Turf Removal (Turf) Program. We also performed tests on the Metropolitan-Funded/Member Agency Administered (MAA) and Water-Savings Incentive (WSI) Programs.

Specifically, we verified incentive payments made to customers on the Rebate Programs, and vouched payments made for the MAA and WSI Programs. In addition, we reconciled the database maintained by third-party entity Electric & Gas Industries Association (EGIA) to board and management reports, and evaluated the validity and propriety of payments made to EGIA as the Conservation Credits Program service provider.

Since 2009, Southern California has faced severe water-supply deficits due to drought and the impact of environmental regulations in the California Bay-Delta. In 2013, California experienced the driest year on record following two consecutive dry years. On January 17, 2014, Governor Edmund G. Brown Jr. issued an Emergency Drought Declaration for the state of California and called on everyone to conserve and use water wisely. Subsequently, the State Water Resources Control Board (SWRCB) adopted emergency regulations for conservation.

In response, the Water Resource Management (WRM) Group developed proposals that expanded water-saving programs, increased the Conservation Credits Program budget, and raised consumer awareness. These strategies were approved by the Board, and consisted of incentives and resources in four areas:

1. Rebate Programs were extended to continue to provide incentives for consumers to purchase water-efficient devices. Examples include high-efficiency toilets, weather-based irrigation controllers, and high-efficiency clothes washers.
2. Turf Program incentives were expanded to provide funds to offset the costs of removing turf, in order for participants to replace turf with lower water-using alternatives.
3. The Conservation Credits Program provides funds for MAA Programs, using Metropolitan incentives to promote water-use efficiency.
4. Regional education, communications, and advertising campaigns were funded to provide classroom instruction on native landscape designs, expand on Metropolitan's outreach efforts, and further the statewide awareness campaign. Significant actions include:

|    | DATE           | EVENT   | ACTION  |
|----|----------------|---|---|
| 1  | September 2013 | Turf Removal Incentive                              | Turf removal incentive increased from \$0.30 to \$1.00 per square foot.                                       |
| 2  | January 2014   | Drought Declaration                                 | Governor issued Emergency Declaration.  |
| 3  | February 2014  | Additional Budget                                   | Program budget increased by \$20 million to a total of \$60 million.  |
| 4  | February 2014  | Board Resolution                                    | Board adopts a Water Alert Resolution.  |
| 5  | March 2014     | Advertising Campaign                                | Board authorized advertising campaign.  |
| 6  | April 2014     | Executive Order                                     | Governor issued Executive Order to redouble conservation efforts.   |
| 7  | May 2014       | Turf Removal Incentive                              | Turf removal incentive increased to \$2 per square foot.  |
| 8  | June 2014      | TV Advertising                                      | Advertising begun, emphasizing turf removal.  |
| 9  | July 2014      | Emergency Regulations                               | SWRCB adopted emergency regulations for statewide urban-water conservation.                                   |
| 10 | December 2014  | Additional Budget                                   | Program budget increased by \$40 million to \$100 million.  |
| 11 | May 2015       | Additional Budget and Modifications to Turf Program | Program budget increased by \$350 million to \$450 million and implemented modifications to the Turf Program. |

Viewed in the aggregate, the Rebate and Turf Programs evolved over time in the wake of extended drought conditions and in response to a maturing, water conservation focused marketplace. These Rebate and Turf Programs run concurrently, span multiple fiscal years, and have similar target audiences and monetary incentives. The Conservation Credits Program consists of the regional Rebate, Turf Removal, MAA, WSI, and Landscape Training/Surveying Programs, and advertising campaigns.

## **Regional Residential/Commercial Rebate and Turf Removal Programs**

The regional Rebate Programs are device-based reimbursement incentives. The regional Turf Program incorporates residential, commercial, and public agency projects. These programs are administered by EGIA, under an agreement that expires in 2017. Incentives are based on rates established by the agreement, although they can be supplemented by other sources. That is, Metropolitan incentives can be enhanced by member agencies, local agencies, or state grant funding. It is important to note that not all Conservation Credits Program reservations follow through to completion, and receive incentive payments. While most residential Rebate Program reservations resulted in incentive payments, only 60 percent of commercial requests were completed. Moreover, for the Turf Program a similar rate of attrition is predicted such that only 60 percent of turf removal reservations will follow through to completion. The Conservation Credits Program generated unparalleled interest, particularly in reservations for turf removal incentives which strained the board-approved budget.

## **Metropolitan-Funded/Member Agency Administered Program**

The MAA Program is funded by Metropolitan and administered by respective member agencies, and retail agencies. Incentives are based on contract terms between Metropolitan, member agencies, retail agencies, or up to the project cost whichever is lesser. The MAA Program allows flexibility for agencies to implement projects specific to their service area, and explore innovative water-savings projects.

## **Water-Savings Incentive Program**

The WSI Program is a collaborative effort between Metropolitan, member agencies, and large water-using customers to improve water-use efficiency. Metropolitan pays incentives based on the amount of water saved, up to \$0.60 per 1,000 gallons saved per year over the project life (10 years maximum). Eligible projects under the WSI Program include installation of commercial or industrial high-efficiency equipment, industrial water process improvements, agricultural and landscape water efficiency improvements, and water management services.

## **Landscape Training/Surveying and Advertising/Marketing Programs**

The Landscape Training/Surveying Programs provide classroom instruction on native landscape designs and includes a survey report on water use data collected, recommendations for improving the site's irrigation efficiency, and available financial incentives. The Advertising/Marketing Program provides for the conservation campaign. The WRM Water-Efficiency Team (WET) is responsible for administering the Conservation Credits Program, establishing and monitoring procedures and controls, reporting conservation rebate activities, and maintaining a high-level of customer service. WET is also responsible for monitoring requests for funding, and posting activity trends through weekly reports to the member agencies. The External Affairs Group is responsible for the Advertising/Marketing Program.

## **Opinion**

In our opinion, the accounting and administrative procedures over the Conservation Credits 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 controls from July 1, 2014 through March 31, 2015.

Although this opinion is an acceptable rating, we do express concern over the lack of periodic reconciliations between the EGIA database and management reports. While we understand that conservation credit activity is complex and may span fiscal year boundaries, we believe that regular balancing is necessary to ensure the completeness and accuracy of input. Moreover, periodic balancing provides assurance that management reports reflect Conservation Credits Program activity, such that business plans are corroborated by cost estimates and forecasts.

We also express concern over inspection and verification controls for the MAA Programs, and noted inconsistencies in documentation requirements for various programs. It should be noted that WET management has initiated remedial actions in response to our concerns.

### **Comments and Recommendations**

#### **RECONCILIATION OF RESERVATION REQUESTS, COMMITTED, AND PAID REBATES**

Accounting control is achieved in part by performing periodic reviews and reconciliations of accounting records. These procedures provide assurance as to the propriety of the transactions affecting the accounts, identify potential erroneous entries, and describe follow-up procedures for exceptions. For the Conservation Credits Program, EGIA administers the On-Line Reservation and Application (On-Line) system for the regional Rebate and Turf Programs. EGIA is responsible for tracking and approving reservation requests, and issuing incentive payments. In addition, EGIA generates management reports for Metropolitan, member agencies, and retail agencies. WET management should perform periodic reconciliations of Conservation Credits Program activity to source documentation, to ensure the completeness and accuracy of board and management reports.

During our review, we noted that management does not perform a periodic reconciliation between the Weekly Conservation Credits Program Update Reports (Update Reports) and source data stored in the EGIA On-Line system. The Update Reports are prepared by WRM and are based on weekly activity reports of reservation requests that were accepted, committed, and paid by EGIA. WRM reports these totals to the Board and management on a monthly basis.

Our test work included a reconciliation of reservation requests that were accepted, committed, and paid through March 8, 2015 against a data dump generated from the EGIA On-Line system. These efforts included verifying totals with service provider documentation, WRM records, and financial activities recorded by the Controller's Section. Our review revealed differences of \$11.8 million, \$3.8 million, and \$1.2 million for reservation requests accepted, committed, and paid.

While these totals appear to be material, it is important to note that they are primarily the result of timing differences between when a reservation is accepted, approved, committed, and paid. Moreover, reservations requested can shift from being approved, denied, and back to being accepted and paid. These characteristics cause differences between the EGIA On-Line system and board reporting. In addition, reconciliation efforts are also affected by the fact that reservation processing can span fiscal years.

Details and explanations for the differences between board and management reporting and the EGIA On-Line system for reservation requests accepted, committed, and paid are detailed below. Financial data is from July 1, 2014 through March 8, 2015, unless otherwise noted.

## Reservation Requests - Accepted

| Item | Program Type  | Reservation Requests* | Review Results    | Difference         |     |
|------|---|-----------------------|-------------------|--------------------|-----|
| 1    | Regional Residential Device Rebates   | \$ 13,874,657.49      | \$ 13,661,786.60  | \$ 212,870.89      | (1) |
| 2    | Regional Commercial Device Rebates  | 21,704,430.47         | 19,541,934.37     | 2,162,496.10       | (1) |
| 3    | Regional Turf Removal Incentives  | 166,469,929.62        | 180,727,618.46    | (14,257,688.84)    | (2) |
| 4    | Member Agency Administered Programs   | 44,531,770.00         | 44,531,770.00     | -                  |     |
| 5    | Water Savings Incentives  | 1,943,839.02          | 1,943,839.02      | -                  |     |
| 6    | Landscape Training/Survey   | 182,800.00            | 182,800.00        | -                  |     |
| 7    | Advertising/Marketing   | 4,399,040.68          | 4,344,696.86      | 54,343.82          | (3) |
|      | Totals  | \$ 253,106,467.28     | \$ 264,934,445.31 | \$ (11,827,978.03) |     |
|      | Reservation Requests* Applications requesting funds submitted by customers and member agencies. These totals were included in board/management reports. |                       |                   |                    |     |

The net difference of \$11.8 million for accepted reservation requests was due to the following:

1. Changes to reservation status from Approved to Denied for regional reservation requests, resulted in overreporting of \$2.4 million.
2. Changes made to the reservation status from Denied to Approved for Turf Program reservation requests resulted in an underreporting of \$2.5 million. In addition, the exclusion of Turf Program reservation requests accepted after being denied from January 1, 2014 through June 30, 2014, resulted in underreporting of \$11.8 million.
3. Advertising and Marketing expenditures were overstated by \$54,000.

## Reservation Requests - Committed

| Item | Program Type   | Committed **      | Review Results    | Difference        |     |
|------|--|-------------------|-------------------|-------------------|-----|
| 1    | Regional Residential Device Rebates  | \$ 13,874,657.49  | \$ 13,661,786.60  | \$ 212,870.89     | (4) |
| 2    | Regional Commercial Device Rebates   | 21,704,430.47     | 19,541,934.39     | 2,162,496.08      | (4) |
| 3    | Regional Turf Removal Incentives   | 108,172,388.00    | 114,375,467.46    | (6,203,079.46)    | (5) |
| 4    | Member Agency Administered Program   | 44,531,770.00     | 44,531,770.00     | -                 |     |
| 5    | Water Savings Incentive  | 1,943,839.02      | 1,943,839.02      | -                 |     |
| 6    | Landscape Training/Survey  | 182,800.00        | 182,800.00        | -                 |     |
| 7    | Advertising/Marketing  | 4,399,040.68      | 4,344,696.86      | 54,343.82         | (6) |
|      | Total Conservation Programs  | \$ 194,808,925.66 | \$ 198,582,294.33 | \$ (3,773,368.67) |     |
|      | Committed ** Applications requesting funds submitted by customers and member agencies that were approved to proceed. These totals were included in board/management reports. |                   |                   |                   |     |

The net difference of \$3.8 million for committed reservation requests was due to the following:

1. See Item 1 above.
2. Changes made to the reservation status from Approved to Denied for Turf Program reservation requests resulted in overreporting of \$1.9 million. These were offset by the exclusion of Turf Program reservation requests of \$8.1 million committed to from January 1, 2014 through June 30, 2014.
3. See Item 3 above.

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## Reservation Requests – Paid

| Item | Program Type   | Paid Rebates***  | Review Results   | Difference      |     |
|------|--|------------------|------------------|-----------------|-----|
| 1    | Regional Residential   | \$ 7,806,659.03  |                  |                 |     |
| 2    | Regional Commercial  | 9,175,627.97     |                  |                 |     |
| 3    | Regional Turf  | 26,768,391.19    |                  |                 |     |
|      | Subtotal   | 43,750,678.19    | \$ 42,600,124.65 | \$ 1,150,553.54 | (7) |
| 4    | Member Agency Administered Program   | 7,465,194.77     | 7,473,518.65     | (8,323.88)      | (8) |
| 5    | Water Savings Incentive  | 789,455.20       | 725,297.70       | 64,157.50       | (8) |
| 6    | Landscape Training/Survey  | 182,800.00       | 178,800.00       | 4,000.00        | (8) |
| 7    | Advertising/Marketing  | 4,344,696.86     | 4,344,696.86     | -               |     |
|      | Total Conservation Programs  | \$ 56,532,825.02 | \$ 55,322,437.86 | \$ 1,210,387.16 |     |
|      | Paid Rebates *** These are the total Incentive/consultant payments made for the period July 1, 2014 through March 8, 2015. These totals were included in board/management reports. |                  |                  |                 |     |

The net difference of \$1.2 million for incentive consultant payments was due to the following:

1. Rebate checks totaling \$1.2 million were issued to customers by EGIA through March 8, 2015. However, EGIA invoices related to these rebates were in the process of being paid. This is a timing issue and does not need to be reflected in management reports.
2. Incentive payments for MAA Programs were understated by \$8,000. Incentive payments for WSI and Landscape Training/Surveying Programs were overstated by \$68,000.

We recommend that WET management resolve the noted discrepancies. We also recommend that management develop procedures for reconciling the source data stored in the EGIA On-Line system to the management reports, to ensure the completeness and accuracy of conservation incentives.

## POLICIES AND PROCEDURES

Operational policies and procedures should be established and documented to provide a framework for achieving group and program goals and objectives. Procedures assist management in the training of new employees, provide guidance for consistent performance of daily responsibilities, and provide a source of reference for experienced personnel. Compliance with policies and procedures is necessary to ensure accurate accounting records, proper supporting details, and adequate controls over administration of the incentive programs.

Our review of the terms and conditions of the Conservation Credits Program revealed:

1. Inconsistencies in the terms and conditions were noted between the Rebate and MAA Programs. Specifically, we noted that Rebate Programs administered by EGIA required submission of supporting documentation; whereas, some MAA Program member agencies required minimal documentation. For example, EGIA requires documentation such as supplier contract, invoice, and a signed Customer Authorization Form for incentive processing. In the MAA Programs for Las Virgenes and the Los Angeles Department of Water and Power, minimal documentation is required.

2. Inconsistencies in the terms and conditions for the Turf Program were noted between the regional Turf and MAA Programs. Under the Turf Program administered by EGIA, submission of contractor invoices is required only when the turf removal area claimed is greater than 50,000 square feet, or when the Turf Project includes synthetic turf. However, the MMA Program for member agencies (e.g., Western Municipal Water District, Municipal Water District of Orange County) requires submission of contractor invoices regardless of square footage of turf removed. We understand this is intended to limit the rebate to the lesser of incentive or project costs, regardless of project size. We also noted that some member agencies (e.g., Las Virgenes, City of Long Beach) do not require submission of contractor invoices, in support of Turf Program applications.

Our review of compliance with the terms and conditions of the Conservation Credits Program revealed:

1. Although MAA agreements have an audit provision in Section 10 – Evaluation: Audit and Record Retention, we could not locate documentation indicating that WRM had exercised this provision of the agreement.
2. Documentation could not be located to support verification of devices installed or projects completed under MMA Programs, in contrast to Section 4 - Installation Verification of the MAA Program agreement.

Inconsistencies in the terms and conditions of the agreements could cause confusion in processing conservation credit reservations. Moreover, customer confidence and acceptance could deteriorate if perception is that some programs are more advantageous or easier to access than others. Failure to comply with policies and procedures could result in inaccurate accounting records, incomplete supporting documentation, or loss to Metropolitan from unauthorized transactions.

We recommend WET management establish minimum rebate requirements to the MAA Program to ensure consistency of documentation across all programs. We also recommend that WET management establish procedures to ensure compliance to the terms and conditions of the agreement. Finally, we recommend management establish procedures for verification of installed devices or completed turf removal projects, and conduct reviews to ensure compliance.

#### REVIEW AND APPROVAL

Review and approval controls are designed to verify the accuracy of invoices for goods and services, provide assurance as to the propriety of transactions, confirm compliance with contractual terms and conditions, and ensure that follow-up procedures exist for exception processing. For the Conservation Credits Program, complete and accurate accounting is necessary to ensure thorough Conservation Credits Program reporting, and to facilitate cost estimates and forecasts. During our review we noted:

1. Outstanding checks totaling \$80,242 issued to EGIA for regional Rebate Programs in fiscal year 2010/11 were refunded in March 2015 as not being cashed by participant. Furthermore, we noted that outstanding checks totaling \$162,772.33 to EGIA for fiscal years 2011/12, 2013/14, and 2014/15 for similar circumstances have not been refunded, as of April 30, 2015.
2. Incentive payments for the Turf Program were recorded as payments in the regional Rebate Programs.

3. Western Municipal Water District invoice for \$136,448 submitted under the WSI Program was paid 182 days, after invoice due date.

We recommend WET management establish procedures for the timely refunding of stale-dated (outstanding) rebate checks. We also recommend that WET management correct the noted discrepancies in the Project Tracking Reports. Finally, we recommend that WET management remind agreement administrators the importance of making timely contract payments, and conduct periodic reviews to ensure compliance.

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### **Official Statement for the Water Revenue Refunding Bonds, 2015 Authorization, Series A1 and A2**

The Audit Department has completed a review of the Official Statement for the Water Revenue Refunding Bonds, 2015 Authorization, Series A1 and A2. We performed this review to provide the issuer of the Bonds comfort that the Official Statement for the Bonds is complete, consistent with supporting financial records, and accurate in all material respects. We completed our review in accordance with agreed-upon procedures specified by the underwriters. We found such information to be correct in all material respects. We issued letters to the underwriters describing the agreed-upon review procedures performed, and the results obtained.

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