



- Board of Directors  
*Water Planning and Stewardship Committee*

2/14/2017 Board Meeting

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## Subject

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Update on the renewal of contract for the annual audit of State Water Project charges

## Executive Summary

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The current contract for the audit of Metropolitan's annual State Water Project (SWP) charges expires March 30, 2017. Metropolitan has employed a consultant to audit the calculation of the annual charges since first receiving water from the SWP in 1972. The computation of the SWP charges is unique to the California Department of Water Resources (DWR). The audit is a highly technical and specialized contract compliance review done by a professional public accounting firm. Through four Request for Proposal (RFP) and Request for Qualification (RFQ) solicitation cycles, starting in 2001 and continuing through 2012, Metropolitan sought to identify professional consultants that were interested and technically qualified to audit the annual charges. The search was broadened in each cycle and the number of respondents declined. Metropolitan received one response to the 2009 and 2012 RFP solicitations. After each solicitation, the contract was awarded to Richardson and Company, LLP (Richardson). The consultant agreements for SWP charges auditing services from 1972 until 2001 were simple annual rollover agreements. These agreements were consistent with Metropolitan's Administrative Code Section 8140(1)(h) regarding contracts for services of a professional or technical character. Staff is proposing to extend the current contract using the annual rollover agreement approach that was used successfully from 1972 through 2001.

## Description

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Since first receiving SWP water in 1972, Metropolitan has contracted with an accounting firm to audit the annual SWP charges. Until the consistent use of the Richardson firm beginning in 1991, Metropolitan has employed three Certified Public Accounting firms, resident in Sacramento, to review the annual charges. The audit has transitioned between firms and among staff within the Richardson firm as a result of mergers, conflicts of interest with the consultant's other clients, and the death of a principal. When a transition has occurred, Metropolitan has taken the steps necessary to maintain audit continuity, technical competency, and institutional knowledge by working with the consultant's senior staff assigned to the Metropolitan audit.

The audit is a highly specialized contractual compliance review of a unique and technically complex computational process. The work is not a typical audit of financial statements. The work location is Sacramento. The audit annually requires 6,300-6,700 hours with workload varying over the course of the year. During the peak periods an experienced staff of 6 to 10 individuals are performing the work.

Two consulting firms have the SWP contractual and technical accounting knowledge to complete the audit, EY (formerly Ernst and Young), and Richardson. In 1990, as a result of a merger, EY completed the review. EY also continues to audit the charges for other State Water Contractors. Metropolitan has a conflict of interest clause in our agreements. The clause restricts Metropolitan's consultant from auditing charges and related work for other water contractors and DWR. As a result of the conflict of interest clause, in 1990 EY decided not to perform the audit for Metropolitan in the future. EY assisted Metropolitan in transitioning to a new firm for the 1991 audit started by former EY employees who worked on Metropolitan's Statement of Charges audit. The new firm was Richardson.

The conflict of interest clause serves to ensure the consultant is available to support Metropolitan in resolution of claims or litigation. The most significant and controversial audit findings and claims adversely affect some State Water Contractors at the expense of others. The importance of this clause was shown in 2005 when State Water Contractors became involved in the Hyatt-Thermalito litigation. The litigation was a contract language and cost accounting dispute over the calculation and allocation of revenues from the generation of energy from the Hyatt power plant. Kern County Water Agency sued DWR. The State Water Contractors were divided in this lawsuit. EY's Contractor audit clients were on both sides in this litigation. EY found themselves in a conflict of interest situation and would not provide any litigation support to their customers. Richardson supported Metropolitan in this litigation.

Between 1972 and 2001, Metropolitan's consulting agreements were annual rollover agreements with a six-month termination notice. The agreements were consistent with Metropolitan's Administrative Code Section 8140(1)(h), which provides that all contracts estimated to cost \$75,000 or more shall be made upon a competitive procurement method of either competitive sealed bidding or best value procurement, except contracts for insurance or for services of a professional, artistic, scientific, or technical nature, among others. Starting in 2001 through 2012, Metropolitan sought audit services through three RFP's and one RFQ. During each contracting cycle, the solicitation was broadened. The four RFP/RFQ's did not result in identifying any accounting firms, other than Richardson, that are professionally and technically qualified and have an interest in performing the Metropolitan SWP charges audit. In the 2009 and 2012 solicitation processes, Richardson was the only final respondent.

There are a number of factors that discourage interest in responding to the SWP charges audit RFP. The most significant are the cost and risks associated with acquiring the specialized and unique knowledge required to gain technical competency. Staff has estimated that the investment in knowledge would be in the range of \$1 million over a three-year agreement. In a fixed cost, competitively bid RFP process, the respondent could not expect to recover that investment. The respondent would be competing against a very strong incumbent firm. Richardson is highly experienced, low cost, and an acknowledged expert by DWR, State Water Contractors, and the Sacramento CPA community. The conflict of interest restriction also prevents the consultant from leveraging its investment in knowledge by doing similar work for other water contractors. The large size of the audit, peak staffing requirements, and Sacramento location are also factors.

Before an RFP is released, staff evaluates if it is better to have the audit done by Metropolitan's internal audit staff or continue to use an external consultant. Overall, using an external consultant is the preferred choice. Using Richardson has proven to be the lowest cost, most efficient, and effective choice. Since 1991, the cumulative savings from Richardson's audit exceed \$289 million. Also, Richardson is assisting in resolving additional claims estimated at \$134 million, including the \$90 million Water Systems Revenue Surcharge claim by Metropolitan. Metropolitan pays approximately \$840,000 annually for these services. Using the services of Metropolitan's internal audit department is a viable, but more expensive, alternative. The estimated cost is in the range of an additional \$1 million or more over three years. These costs are for additional full-time staff that would be needed for only part of the year, plus office accommodation and support. A more important consideration is the independent third-party professional opinion that an external consultant provides. The independent consultant is focused on identifying errors or inconsistencies and reports whether or not they favor Metropolitan. This approach is of considerable assistance when dealing with DWR in resolution of errors and addressing contentious contract policy issues. DWR knows that the audit process is unbiased. It also provides security assurance to DWR that its largest water services customer and power market competitor is not directly accessing its accounting records.

The benefits of extending Metropolitan's consultant contract with Richardson include reduced staff cost associated with the RFP process; continued support for claims against DWR for errors in the calculation of the SWP charges; and continuation of reliable and efficient, low-cost audit services. Pending Committee feedback, staff plans to bring an action for a three-year extension to the contract with Richardson in March 2017.

**Policy**

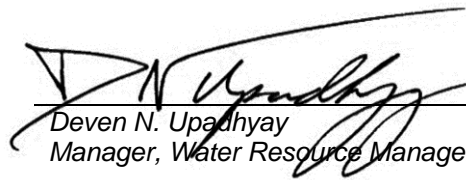
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Metropolitan Administrative Code Section 8140: Competitive Procurement


**Fiscal Impact**

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None, no action is being requested at this time

  
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Deven N. Upadhyay  
Manager, Water Resource Management

1/30/2017  
Date

  
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Jeffrey Kightlinger  
General Manager

2/1/2017  
Date

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