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Water Replenishment District of Southern California:

Although the District Has Eliminated Excessive Water Rates, It Has Depleted Its Reserve Funds and Needs to Further Improve Its Administrative Practices

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CALIFORNIA STATE AUDITOR

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May 23, 2002 2000-016

The Governor of California
President pro Tempore of the Senate
Speaker of the Assembly
State Capitol
Sacramento, California 95814

Dear Governor and Legislative Leaders:

As required by Chapter 888, Statutes of 2000, the Bureau of State Audits presents its audit report concerning the operation and management of the Water Replenishment District of Southern California (district).

This report concludes that the district has eliminated excessive water rates by reducing the replenishment assessment it charges ratepayers. However, at the same time, the district has depleted its reserves from $67 million in fiscal year 1997–98 to a projected low of $6 million at June 30, 2002, thereby posing a threat to the district's ability to maintain the current quantity of groundwater in the West Coast and Central basins. This condition was caused by the district's lack of a long-term vision of its finances and temporary legislative constraints placed on the district's ability to raise funds. Moreover, the district's spending plans do not adequately explain its financing needs to the public nor clearly support its replenishment assessment. Further, the district has not adequately developed processes for the planning and implementation of its capital improvement projects nor implemented adequate accounting and administrative controls over its operating expenses.

Respectfully submitted,

Elaine M. Howle

ELAINE M. HOWLE
State Auditor

Water Replenishment District of Southern California:

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SUMMARY

Audit Highlights . . .

Although the Water Replenishment District of Southern California (district) has lowered its accumulated reserve funds and assessment rate, it lacks a long-term vision of its financing needs.

In addition, the district lacks adequate planning for its capital improvement projects and adequate accounting and administrative controls over its operating expenses.

Specifically, our review revealed that the district:

- ☑ *Lowered its reserve funds from $67 million in 1998 to a projected balance of $6 million at June 30, 2002, without establishing a minimum level of funds necessary to meet its responsibilities.*
- ☑ *Has not identified an optimum quantity of groundwater to be stored in the basins, although groundwater has dropped by 110,000 acre-feet.*
- ☑ *Does not adequately explain its calculation of the assessment rate.*

continued on next page . . .

RESULTS IN BRIEF

The Water Replenishment District of Southern California (district) was established in 1959 to counteract the effects of overpumping the groundwater in the West Coast and Central basins (basins). The California Water Code (water code) grants the district broad powers to do what is necessary to replenish and maintain the integrity of the basins. In December 1999 the Bureau of State Audits (bureau) issued a report concluding that the district's poor management had led to its charging those who pump groundwater an excessively high replenishment assessment (assessment rate). Because that report raised significant issues, the Legislature amended the water code to ensure that the district implemented the bureau's recommendations. The amendments also required the bureau to perform this follow-up audit of the district's operations and management.

One of the bureau's 1999 recommendations was that the district should reduce its reserve funds, which totaled $67 million in 1998. The district responded by lowering its reserve funds to a projected balance of slightly more than $6 million by June 30, 2002. We believe that this significant depletion may pose a threat to the district's ability to maintain the current quantity of groundwater in the basins. The district uses its reserve funds to ensure an adequate supply of groundwater, to stabilize its assessment rate, and to develop capital improvement projects that increase the reliable supply of clean groundwater in the basins. In spite of the current low level of reserve funds, the district has not established a minimum level of funds necessary for it to meet its responsibilities. Compounding the situation, the quantity of groundwater stored in the basins has dropped. During the past three years, the progress that the district has made in restoring groundwater to the basins has eroded by about 30 percent. The district has not established an optimum quantity for groundwater it should store or a minimum quantity it needs to assure an adequate supply of water to the basins' users. Without establishing targeted groundwater quantities, the district cannot fully justify its water purchase expenditures.

- ☑ *Spent $19.9 million on capital improvement projects in the last two fiscal years and has appropriated $12 million more, even though it does not have current strategic and capital improvement plans.*
- ☑ *Invested in projects without understanding their full costs or ensuring that it would receive the benefits it anticipated.*
- ☑ *Paid for services not covered under contracts and has not enforced all the terms of its contracts.*
- ☑ *Lacks written purchasing procedures and has not adequately enforced its existing policies.*

The district's current weakened financial condition was caused in part by the lack of a long-term vision for its finances. This lack of vision has in turn led to its failure to better manage its assessment rate and its reserve funds. After years of increases, its assessment rate reached a historical high of $162 per acre-foot in the mid-1990s. The district then began lowering the rate, reducing it to $112 per acre-foot by fiscal year 2000–01. The $112 rate is problematic for two reasons. First, amendments to the water code currently limit the amount the district can increase the rate, even if its costs increase. Second, the district continued the $112 assessment rate in fiscal year 2001–02 in spite of the fact that its annual Engineering Survey and Report and budget efforts indicated that it should have been charging $116 per acre-foot, the maximum rate that restrictions in the water code related to annual increases in the assessment rate allowed for that year. Furthermore, the district's decision to return nearly $30 million to the assessment ratepayers in the basins through its Clean Water Grant program in fiscal year 1998–99 helped deplete the district's reserve funds. Although the district had significant surplus funds when it initiated the grant program, these funds were created in part because it made extremely low water replenishment purchases during fiscal year 1997–98, when construction limited its ability to percolate the water into the ground, and because it accumulated funds to pay for capital improvement projects.

Although the legal constraints on the district's ability to raise its assessment rate are scheduled to expire on December 31, 2002, the constraints will still be in effect for fiscal year 2002–03, and the district projects that it will not be able purchase all of the water it determined it needs to adequately replenish the basins as well as pay for its operations and planned capital projects. Even though it plans to implement the maximum assessment rate increase allowed for fiscal year 2002–03, the district believes that in all likelihood it will have to delay water replenishment purchases to pay its operating costs and complete the projects it has already begun or to which it has made binding commitments. Because groundwater levels are declining as total water usage is rising and because the district has not identified desirable quantities of groundwater for the basins, the district may not be able to continue delaying water replenishment purchases in order to pay for its operating costs and capital improvement projects and still meet its statutory responsibilities.

The district's lack of financial vision extends to its preparation of its annual budgets. An accurate budget is important in part because inaccuracies can result in over- or undercharging ratepayers. However, the district's process for preparing its spending plans is weak. Its budget documents have not contained adequate support of its estimates or clear and complete explanations of its calculations of the assessment rate. In our review of its fiscal year 2001–02 budgeting process, we found that the district did not provide the staff who prepared the budget with adequate managerial oversight or written guidelines offering appropriate direction. The staff therefore included different levels and types of support for their estimates, prepared some elements of the budget inaccurately, and inconsistently allocated administrative costs to the district's programs. Beginning with its fiscal year 2002–03 budget, the district has reassigned responsibility for preparing the budget to the district's recently hired controller, who has begun implementing improvements in the budgeting process.

The district also does not have current strategic and capital improvement plans that identify and prioritize the implementation of its capital improvement projects. These plans can be important for giving the district's ratepayers a clear view of the long-term direction of the district and a better understanding of its ongoing needs for revenue to fund capital improvement projects. The district is creating a strategic plan to replace the plan that it prepared in 1998. Although its ability to begin new projects is limited by its low reserve funds and legal restrictions that prohibit it from incurring debt, the district has $12 million currently earmarked for projects. Moreover, the legal constraints are scheduled to expire on December 31, 2002, unless the Legislature extends them. Current strategic and capital improvement plans are therefore crucial to the district's ability to effectively and efficiently meet its statutory responsibilities. We believe that the most effective process for developing these plans would include the participation of those whom the district's programs and projects most affect, the district's ratepayers.

In order to ensure that it invests its funds in ways that will most benefit it, the district needs to establish a standardized approach for evaluating the risks involved in proposed capital improvement projects. In the past, it has invested in projects without understanding their full costs or ensuring that it would receive the benefits it anticipated. For example, the district's $10.3 million Goldsworthy Desalter facility (desalter), a large capital improvement for cleaning up saline pollution in the

West Coast Basin, is complete but the district's operating costs for the desalter are still uncertain. Prior to construction, the district failed to clarify its need for legal water rights to pump the brackish water from the basin. The need for those rights is determined by the level of salinity in the water the desalter pumps and would affect the district's costs to operate the desalter. When the district filed an action to clarify the issue, the court instructed that the extracted water had to meet the statutory definition of saline water to exempt the district from obtaining pumping rights, an amount higher than the district had originally anticipated. As a result, the district's operating costs for the desalter may increase or it may have to invest up to an additional $2.3 million to meet the requirements for a subsidy to offset the desalter's operating costs.

Further, the district continues to need improvement in its controls over its administrative costs. Although it has expanded its contracting policies, its practices are inconsistent and do not always comply with the requirements of the law. In some cases, the district has paid for services without first signing contracts and continues to maintain contracts that do not specify duration. In addition, the district could not provide evidence that it has evaluated its contracts involving fixed monthly fees to determine whether it has received services of relative value, even though it paid legislative advocacy and public relations consultants more than $442,000 under fixed-fee schedules in 2001. In addition, at the time of our review, the district lacked proper accounting procedures for paying vendors or reimbursing employees and consultants for travel. As a result, it made payments to vendors that were not authorized by management and reimbursed certain unallowable travel costs. The district's Administrative Code does not yet provide adequate guidance on which costs it will and will not allow.

Finally, the district has not ensured that its financial statements contain elements required by the water code. Its financial statements for fiscal year 2000–01 did not identify the sources of funds for its capital improvement projects and did not contain a report on the propriety of the district's operating expenses, although the law requires that the statements contain both of these pieces of information. In addition, the district's list of planned and ongoing capital improvement projects contained inaccuracies, and its calculation of its reserve funds incorrectly used ending cash balances rather than net unrestricted assets (the value of its assets minus its liabilities and its investments in facilities and equipment).

RECOMMENDATIONS

The district should adopt a policy concerning the minimum reserve funds necessary to ensure it has sufficient funds to meet its statutory responsibilities. In addition, the district should ensure that it sets its assessment rate in accordance with its needs for funds as determined through its annual budget process and Engineering Survey and Report. The rate should enable the district to maintain an adequate balance of reserve funds.

To ensure it provides for an adequate quantity of groundwater in the basins and better justifies its expenditures, the district should identify optimum and minimum quantities of groundwater at which to target its operations.

If the Legislature extends restrictions on the district's ability to raise funds for its operations and capital improvement projects beyond December 31, 2002, the district should seek changes in the water code that would allow it more flexibility to adjust its assessment rate to match its needs.

The district should implement a comprehensive process to produce a budget that supports its assessment rate. District staff should prepare a clear and complete explanation of the elements that make up the calculation of the rate that it can share with the board and present in public hearings.

To identify the programs and capital improvement projects that will aid it in fulfilling its mission, the district should continue to update its strategic and capital improvement plans. The district should implement a procedure to periodically update its capital improvement plan to ensure it bases future financing decisions on current information.

The district should adopt a standardized approach to identify all technical, legal, and financial risks related to proposed capital improvement projects. This approach should accurately present the costs and benefits of the projects, using reasonable assumptions.

The district should further strengthen its contract management procedures to ensure that it has contracts for all services for which it pays and that it receives value from those services that is comparable to the fees it pays.

To better control its administrative costs, the district should continue the development and implementation of written accounting procedures. It should also adequately document how

payments for public relations and conferences benefit the public purpose of the district and ensure that services performed by contractors are within the scope of written contracts.

The district should further amend its Administrative Code to ensure that it is consistent with the requirements of the water code; that it provides guidance to its staff on allowable and unallowable expenses; that it adequately defines what constitutes appropriate reimbursable lodging expenses, including dollar thresholds; and that it holds contractors to the same reimbursement policies as district staff for meals and lodging.

The district should take steps to ensure that it complies with the water code's requirements that its audited annual financial statements contain accurate reports concerning its capital improvement projects and the propriety of its operating expenses.

AGENCY COMMENTS

The district agreed with the audit report's recommendations. It also states that it has taken steps to implement many of the recommendations and will seek to implement the balance of them in the upcoming fiscal year. ■

INTRODUCTION

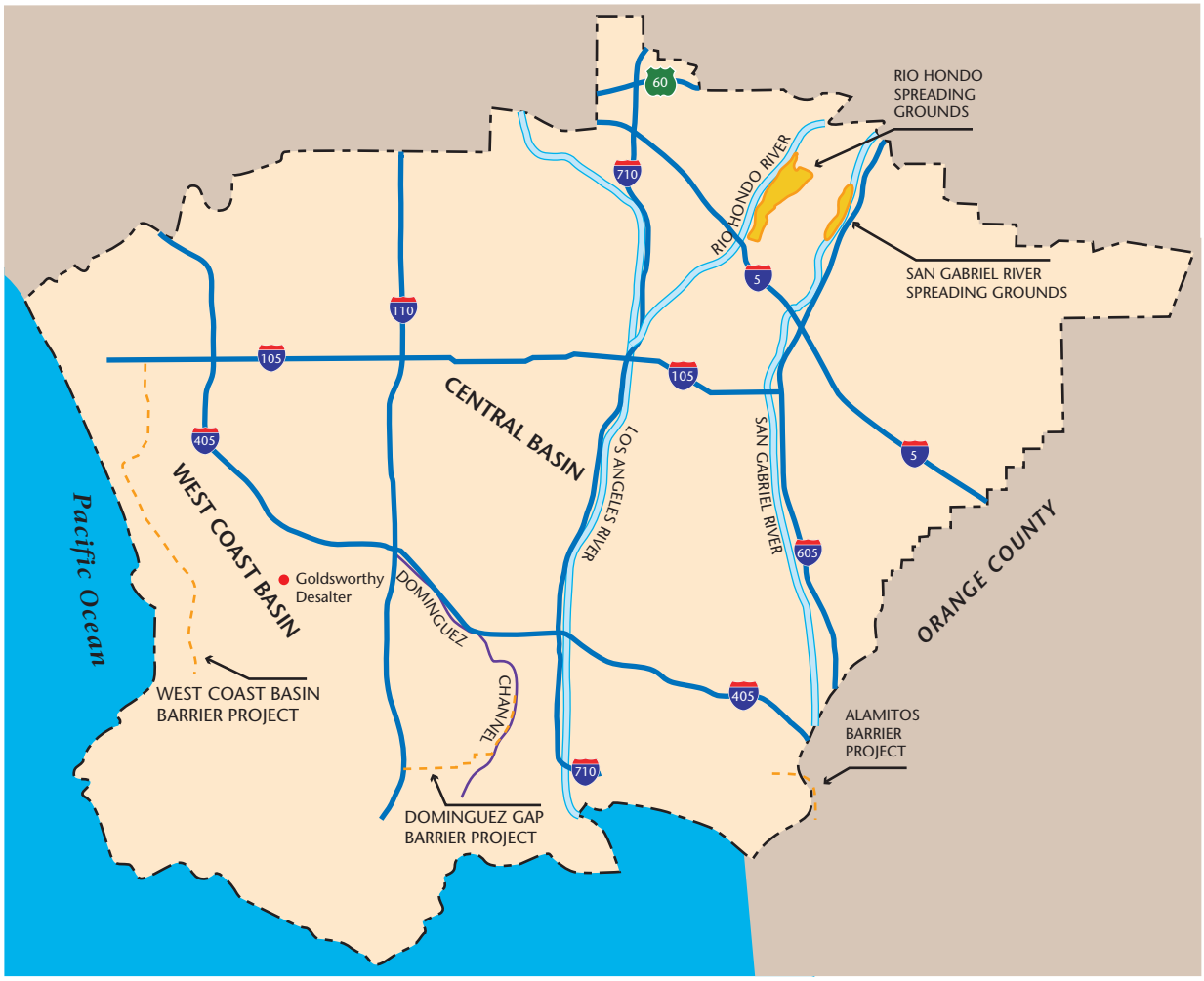
BACKGROUND

Under the terms of the California Water Code (water code), Section 60000 et seq., the voters of Los Angeles County established the Water Replenishment District of Southern California (district) in 1959. Created to counteract the effects of overpumping groundwater from the Central and West Coast basins (basins), the district's stated mission is "to provide a sufficient supply of high-quality groundwater in the Central and West Coast basins through progressive, cost-effective and environmentally sensitive basin management." The district lies entirely within Los Angeles County and serves 43 cities, including Los Angeles, Long Beach, Downey, and Torrance, as well as many businesses and private parties that own pumping rights. The district does not directly provide water to customers; rather, it ensures the health of the basins so that groundwater is available to owners of water rights. According to district estimates, nearly 40 percent of the water consumed by the area the district serves comes from groundwater sources. The rest comes from recycled water and water imported from the Colorado River and the State Water Project. Figure 1 on the following page shows the district's boundaries.

A five-member board of directors (board) governs the district, with each director representing a geographical division of the district. The directors serve four-year terms and are chosen at regularly scheduled general elections. The board acts by adopting resolutions. No agency, state or local, oversees the district. The district has 25 full- and part-time employees and is organized into four units: finance and administration; public and government affairs; water quality and planning; and operations and construction.

FIGURE 1

Water Replenishment District of Southern California



Source: Water Replenishment District of Southern California.

THE DISTRICT'S ROLE IN PROTECTING GROUNDWATER

The need for an entity to oversee the replenishment of groundwater levels in the basins had become clear by the 1950s. The increasing population of the Los Angeles area during the early part of the twentieth century had overwhelmed the area's limited sources of surface water, so communities, private water companies, and businesses began pumping groundwater. Because rainfall in the basins averages only 14 inches per year, it was not long before the pumping outstripped the basins' ability to recharge themselves through natural means. As the

groundwater levels continued to decline, some wells went dry and others had to be abandoned because of saltwater intruding into the coastal areas.

Types of entities that hold the rights to pump groundwater:

- Cities
- Water companies
- Water districts
- Businesses
- Schools
- Cemeteries
- Churches
- Individuals

Prior to the establishment of the district, local water agencies attempted to manage the groundwater level issues in the basins. The West Basin Water Association was formed in 1946, and the Central Basin Water Association was formed in 1950. These associations developed a plan to provide supplemental water to their members, limit groundwater extraction, and create a means to provide groundwater-pumping rights to users who lacked access to other water supplies. At about the same time, a number of local entities with an interest in groundwater went to court seeking specific assignments for groundwater rights, which are property rights that can be bought, sold, or leased. In 1961 and 1965, the court awarded varying amounts of groundwater rights to government agencies, businesses, and individuals. During fiscal year 2000–01, 143 parties to these judgments held a total of 217,367 acre-feet[1] of water rights in the Central Basin, and 60 parties to these judgments held a total of 64,468 acre-feet of water rights in the West Coast Basin.

The law gives the district broad authority to carry out its responsibilities, which include purchasing water to replenish the basins, administering clean water programs, and investing in projects intended to improve the reliable supply of lower-cost and clean water. The district annually purchases 100,000 to 200,000 acre-feet of water for spreading over the basins or injecting into seawater barrier wells along the coastline. "Spreading" is the district's process of piping water to selected areas in the Central Basin where it gradually soaks into the underlying aquifers. Water injected into barrier wells along the coastline forms a dam of freshwater that keeps seawater from flowing into the groundwater aquifers in areas where groundwater levels have dropped below sea level. Los Angeles County operates the spreading grounds and barrier wells, using the water the district provides.

[1] An acre-foot of water is almost 326,000 gallons, enough to meet the needs of two average families for one year.

In addition to purchasing water, the district pays entities to not pump groundwater in areas where replenishment is expensive or difficult. Under this program, named the In-Lieu Replenishment Program, the district pays entities that temporarily forgo their pumping rights to partially offset their purchases of more expensive imported water. Figure 2 on the following page shows how the district plans to replenish the 132,722 acre-feet of water identified by its draft Engineering Survey and Report (engineering report) for 2002. Figure 3 shows the district's sources for those acre-feet of water.

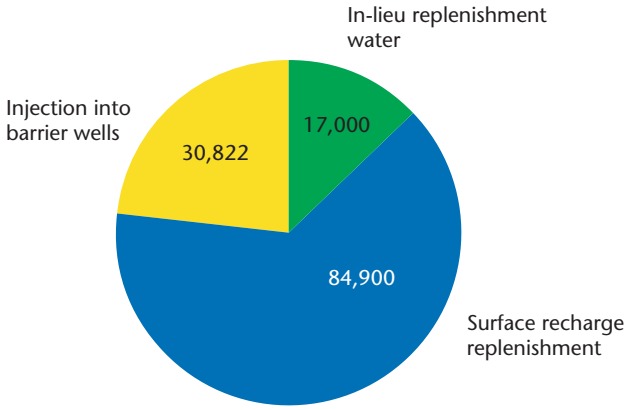
The district also operates a number of other programs that it believes benefit the basins. Under the authority of 1990 legislation that broadened its mission to include the detection, prevention, and removal of contaminants in the groundwater, the district established programs to monitor water quality, treat wellheads, remove contaminants, and mitigate the intrusion of saltwater in coastal areas. In addition, the district has plans for programs that are within its statutory authority but fall outside its traditional replenishment role. It has designed four programs to maximize the beneficial use of the basins by increasing the amount of groundwater pumped, basin groundwater storage capacity, and replenishment sources. It believes that these programs, which would permit certain entities to store water in the basins, would allow ratepayers more flexibility in exercising water rights and reduce the region's dependence on imported water. In October 2001, the Superior Court of California, County of Los Angeles, affirmed that the district has statutory authority to replenish and store water for such conjunctive use.

THE ECONOMICS OF THE WATER REPLENISHMENT DISTRICT

To fund its operations, the district has statutory authority to set and collect a water replenishment assessment from the government agencies, businesses, and individuals that own or lease water rights (ratepayers), on each acre-foot of groundwater that they pump from the basins. Its primary source of income, the replenishment assessment consists of three major components: funds for replenishment, funds for clean water, and funds for operating costs. As part of the rate-setting process, the district conducts an annual engineering survey to determine the condition of the basins and the amount of groundwater it must replenish each year. The district reports groundwater data each year using the period from October 1 through September 30, known as a water year. The district also

FIGURE 2

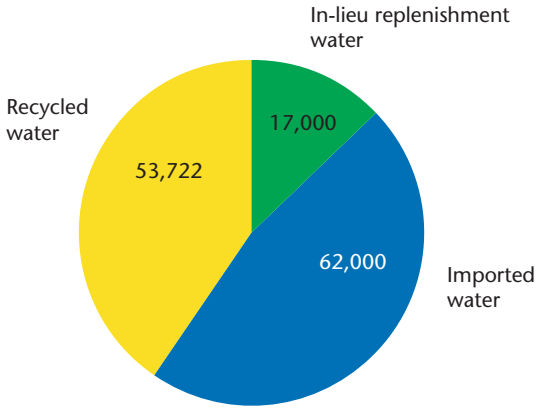
The District's Planned Methods of Water Replenishment for Fiscal Year 2002–03 (In Acre-Feet)



Source: Water Replenishment District of Southern California, Engineering Survey and Report, March 2002.

FIGURE 3

The District's Estimated Water Purchases by Source for Fiscal Year 2002–03 (In Acre-Feet)



Source: Water Replenishment District of Southern California, Engineering Survey and Report, March 2002.

determines how much money it needs to fund its programs that protect groundwater quality and to fund its operating costs. The district is required to hold public hearings on its determination of the assessment rate and to have established the assessment by its first meeting in May.

For fiscal year 2002–03, the district estimates it will collect $30.3 million in replenishment assessments. The district plans to use the assessment with its other sources of revenue and reserve funds to fund its $50.6 million budget. Of this, $29 million will go toward the costs of purchasing water to actively replenish the basins. The district plans to spend the remaining $21.6 million to fund its operating costs, programs and projects that will help remove contaminants from the groundwater supply, and capital improvement projects that will augment or improve its replenishment activities.

Even with the replenishment assessment, the basins are still a very economical source of water. For example, for fiscal year 2001–02, the district's assessment rate for groundwater was $112 per acre-foot. The cost to pump and treat the water to bring it up to drinking water standards—normally, some treatment is needed—adds slightly to the cost. In contrast, the cost of one acre-foot of treated imported water was $431, a difference of $319 per acre-foot.

FINDINGS FROM OUR 1999 AUDIT

In response to a request from the Joint Legislative Audit Committee for an audit of the district, in 1999 the Bureau of State Audits released a report titled *Water Replenishment District of Southern California: Weak Policies and Poor Planning Have Led to Excessive Water Rates and Questionable Expenses*. We concluded that the district consistently overestimated the amount it needed to collect from ratepayers for replenishment and clean water programs and that it did not take into consideration that it could use its surplus cash balances to offset future years' assessments. We further reported that the district maintained excessive cash reserves and could not identify which funds it had allocated to capital improvement projects, that it used a flawed process for determining the economic feasibility of capital projects, and that it failed to maintain controls over its administrative functions and spending. In the Appendix, we present the recommendations from our previous audit and our assessment of the district's efforts to implement changes in its practices.

During 2000 the Legislature found that the district had not been appropriately responsive to its constituents. Declaring that it intended to create a more responsive governance structure, the Legislature passed two bills placing temporary and permanent restrictions on the district's operations. The temporary restrictions, which are scheduled to expire after December 31, 2002, unless the Legislature extends them, limit the district's ability to raise its assessment rates beyond an annual cap increase and prohibit the district from incurring debt to fund capital improvement projects. The enacted legislation also temporarily created the Technical Advisory Committee, which is made up of six of the district's ratepayers who have the responsibility to advise the district on the implementation of capital improvement projects. In addition, the enacted legislation permanently restricted the amount of reserve funds the district may accumulate and added requirements to the processes the district uses to calculate its assessment rate and to contract out district work.

Since our December 1999 report, the district has taken steps to implement our recommendations and the new requirements of the statutes and to make other improvements in its operations. Some of the changes include hiring a new general manager, as well as adding a controller with needed experience in financial matters and a manager of operations to improve project management.

SCOPE AND METHODOLOGY

The California Water Code, Section 60233.5, requires the Bureau of State Audits to perform an audit of the district's operations and management. To implement this broad mandate, we focused on the recommendations from our December 1999 report and the legislation that enables the district to administer its water quality and replenishment responsibilities.

First, we interviewed district employees to gain an understanding of the steps the district had taken to implement the recommendations from our prior report and to comply with the requirements of the law. We also interviewed members of the Technical Advisory Committee and the West Coast Basin Association to gain perspective from the ratepayers on the district's progress in correcting prior deficiencies in its policies and planning.

We evaluated the district's calculation of its fiscal year 2001–02 replenishment assessment rate to determine whether it implemented our recommendations and met the related requirements of the water code. Specifically, our analysis of the district's process of determining its budget figures and assessment rates included the following tasks:

- We reviewed the district's budget and rate-setting policies to determine whether they met the requirements of the water code.

- We determined whether the district considered any estimated excess reserves in its prior year fund balances when calculating the assessment rate; whether the rate identified the separate components for replenishment, water quality, and capital improvement projects as required; and whether the district implemented the annual rate-adjustment limits that the law imposed.

- We reviewed whether the estimates for the costs of water purchases and operations that the district used to calculate its budget and set the assessment rate for fiscal year 2001–02 were reasonable.

- We ascertained whether the district had revised its reserve funds policy and the supporting goals and benchmarks. We also determined whether it had adhered to the legal limits for reserve funds.

- We evaluated whether amounts allocated to capital projects and used to reduce excess reserve funds are reasonable and based on viable projects that the board approved.

We found that the district met the water code's requirements related to rate setting. The district considered its reserve funds when calculating the assessment rate and was reasonable in its budget estimates for water purchases and capital projects.

To evaluate how effectively the district plans its capital projects, we reviewed its current efforts to update its three-year capital improvement plan, to collaborate with other agencies in the region to identify basin priorities, and to include input from the Technical Advisory Committee in its capital improvement projects planning. In addition, we inquired as to whether the district had developed a policy to ensure consistent analysis of the costs and benefits of capital project options. We also determined that it had reevaluated the feasibility of its Alamitos Barrier Recycled Water Project using more reasonable

assumptions of future water costs. Further, we reviewed the district's procurement and management of capital project construction contracts, which we found to be adequate.

Finally, we reviewed the district's efforts to improve its controls over administrative expenses. Specifically, we evaluated the district's changes to its Administrative Code to determine whether it has strengthened its policies on administrative expenses. In addition, we reviewed samples of invoices and contracts for legal and professional services, supplies, and miscellaneous payments to determine whether the district is prudently controlling its administrative expenses. ■

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CHAPTER 1

The District's Reserves Have Fallen to Levels That May Be Too Low

CHAPTER SUMMARY

The Water Replenishment District of Southern California (district) has reduced its reserve funds from a high of $67 million in 1998 to a projected balance of slightly more than $6 million on June 30, 2002. This decrease may pose a threat to the district's ability to maintain the current quantity of groundwater in the West Coast and Central basins (basins), as well as reducing its ability to proceed with capital improvement projects. In addition, the level of groundwater in the basins has fallen during the past three years. These conditions occurred in large part because the district lacks a long-term vision; as a result, it has not established a policy for a minimum level of funds it must have to ensure that it can meet its statutory obligations, nor has it established an optimum quantity for stored groundwater or a minimum quantity needed to ensure an adequate supply of water to the basins' users. Without establishing targeted groundwater quantities, the district cannot fully justify its water purchase expenditures.

The district's lack of a long-term vision for its finances has led to poor management of its reserve funds and of the replenishment assessment (assessment rate) it charges the government agencies, businesses, and individuals that pump groundwater from the basins (ratepayers). After years of increases in its assessment rate, resulting in a historical high of $162 per acre-foot in the mid-1990s, the district lowered its rates beginning in fiscal year 1997–98. By fiscal year 2000–01, the district charged $112 per acre-foot, a rate that it continued in fiscal year 2001–02 even though its annual Engineering Survey and Report (engineering report) and budget efforts indicated that it should have charged the maximum allowable rate of $116 per acre-foot. Moreover, the district returned $30 million of its reserve funds to the assessment ratepayers through the Clean Water Grant program it initiated in 1998.

Complicating the district's finances, laws restrict its ability to raise assessment rates or incur debt for capital improvement projects. Although these legal constraints are scheduled to

expire after December 31, 2002, the district projects that for fiscal year 2002–03, it will have insufficient funds to purchase all of the water it has determined it must purchase to adequately replenish the basins, pay for its operations and planned capital projects, and maintain an adequate level of reserve funds. In all likelihood, the district may have to delay water replenishment purchases to pay its operating costs and complete the projects it has already begun or to which it believes it has made binding commitments. As groundwater levels decline and total water usage rises, the district has not yet identified desirable quantities of groundwater for the basins. Thus, it may not be able to continue delaying water replenishment purchases in order to pay for its operating costs and capital improvement projects and still meet its statutory responsibilities.

Although identifying its financing needs is an important part of determining its annual assessment rate, the district's preparation of annual budgets is weak. The district's budgets are inadequately supported and the budgets contained certain errors, inconsistencies, and omissions. Moreover, budget documents and other documents presented to the board of directors (board), ratepayers, and other interested parties do not tie the district's spending needs to the assessment rate.

THE DISTRICT HAS SIGNIFICANTLY REDUCED ITS RESERVE FUNDS AND STORED GROUNDWATER QUANTITIES HAVE DECLINED

The district projects that it will have a reserve fund balance of slightly more than $6 million at June 30, 2002, a level that may pose a threat to the district's ability to maintain the current quantity of groundwater in the basins.

In response to ratepayers' criticism of its fiscal practices, the district began efforts in 1998 to reduce its accumulated reserve funds. The district projects that it will finish fiscal year 2001–02 with slightly more than $6 million in uncommitted reserve funds, about 9 percent of the previous high of $67 million. This decline, although deliberate, may result in future problems because the district has not established a minimum amount to hold in reserve to meet its responsibilities. Moreover, because the district's primary objective is to ensure an adequate supply of groundwater, its greatest expense is purchasing water to replenish the basins. As a result, its reserves can also be measured in the amount of groundwater stored in the basins, which provides some flexibility in spending from year to year. However, concurrent with the district's reduction in reserve funds, the quantity of groundwater stored in the basins has fallen sufficiently in the last three years to erode about 30 percent of the progress in replenishing the basins that the district has made since water year 1961–62.

The District Has Depleted Its Reserve Funds Well Below Allowable Levels

Since June 30, 1998, the district has allowed its reserve funds to drop by more than 90 percent without establishing a minimum level of reserve funds necessary to meet unforeseen occurrences.

The district has allowed its reserve funds, which it can use in the event of operating deficiencies to stabilize assessment rates and to pay for capital improvements, to decline from a high of $67 million on June 30, 1998, to slightly more than $6 million (projected) on June 30, 2002, a drop of more than 90 percent. However, it has not established a minimum level of funds needed to meet its statutory responsibilities to ensure an adequate supply of safe groundwater. In fact, it has allowed its reserve funds to fall below the $20 million level it asserted in our 1999 audit that it needed in order to ensure that it could meet unforeseen occurrences in its operations. At that time, the district could not provide us with the calculation it used to reach this amount.

According to the current general manager, the district now has multiple needs for reserve funds. Specifically, the general manager believes that funds are necessary for the following purposes:

- To absorb fluctuations in the quantities and prices of replenishment water while maintaining stable assessment rates.
- To pay for six months of operational expenses.
- To ensure a prompt response to groundwater contamination in the basins. According to the general manager, treating groundwater contamination soon after discovering it is less costly.
- To provide for repairs and replacement of facilities and equipment. The district reported capital assets of more than $29 million as of June 30, 2001.

However, the district has not identified the amount of reserve funds necessary for these purposes and thus has no policy on a minimum level of reserve funds

The district's ability to build the reserves to pay for these needs may be complicated by legal constraints. Beginning in fiscal year 2000–01, the California Water Code (water code) limited the district's reserve fund balance to $10 million, an amount that the district may adjust in subsequent years to reflect changes in the annual cost of the district's water purchases. In addition, the water code states that the district must earmark at least 80 percent of its reserves for water purchases, leaving the

remainder for all other purposes. Because the district has not analyzed its other needs for reserve funds, however, it cannot state definitively that the 20 percent allowed for these needs is not enough.

The Quantity of Stored Groundwater Has Fallen While Water Use Within the Basins Has Increased

The district has allowed the quantity of groundwater in the basins to drop by more than 110,000 acre-feet over a period of three years, but has not identified optimum or minimum quantities of groundwater it should store to assure an adequate supply.

According to the district's draft 2002 engineering report, the quantity of groundwater stored in the basins has declined by more than 110,000 acre-feet between October 1998 and September 2001, eroding about 30 percent of the progress made in replenishing the basins since water year 1961–62. The engineering report indicates that groundwater pumping remained fairly steady during that three-year period, but the district reduced its purchases of water for replenishment during fiscal years 1997–98 and 1998–99. According to the district's 2000 engineering report, construction by Los Angeles County at the spreading grounds limited the district's ability to replenish the basins. Although the district plans increased purchases for replenishment during fiscal year 2001–02, apparently to compensate for the prior years' reduced purchases, it also anticipates that pumping will increase in water year 2002–03 to a 21-year high of 260,786 acre-feet. In addition, the overall use of water in the basins from all sources, including groundwater, is on the rise. The draft engineering report for 2002 shows that the average total water use for the five years ending September 30, 2001, has increased by 15 percent over the average total water use for the ten years ending September 30, 1996. An increase in overall water usage can place stress on the condition of the basins in years of decreased rainfall or availability of imported water.

In spite of the decrease in stored groundwater and the increase in overall use, the district has not established an optimum quantity or minimum quantity of groundwater to retain in storage to ensure that it can provide an adequate supply to the basins' users. Knowing an optimum groundwater quantity is strategically important to the district because this quantity will provide the district with a clear objective when determining the direction and extent of its activities. A minimum groundwater quantity provides the district an early alert when usage and replenishment factors combine to stress the condition of the basins. Moreover, without targeted levels for groundwater quantities, the district cannot fully justify its planned water purchase expenditures.

When determining annual groundwater replenishment needs, the district does not consider long-term goals for groundwater storage in making its calculation.

In fact, the district and the Technical Advisory Committee (committee), a committee of six ratepayers created by statute to advise the district on capital improvement projects, currently disagree over how much water the district should purchase for fiscal year 2002–03. The committee believes the district should purchase about 13,700 acre-feet less than the district has identified it needs to purchase in order to replenish the basins, at a cost savings of slightly more than $5.3 million. However, when we asked, the committee did not provide us with justification for its numbers. On the other hand, the district calculates its water replenishment needs by estimating the annual pumping that exceeds natural replenishment in the following year rather than purchasing water to achieve a long-term goal for overall groundwater quantity in the basins. As a result, the district cannot fully justify its planned water purchases either.

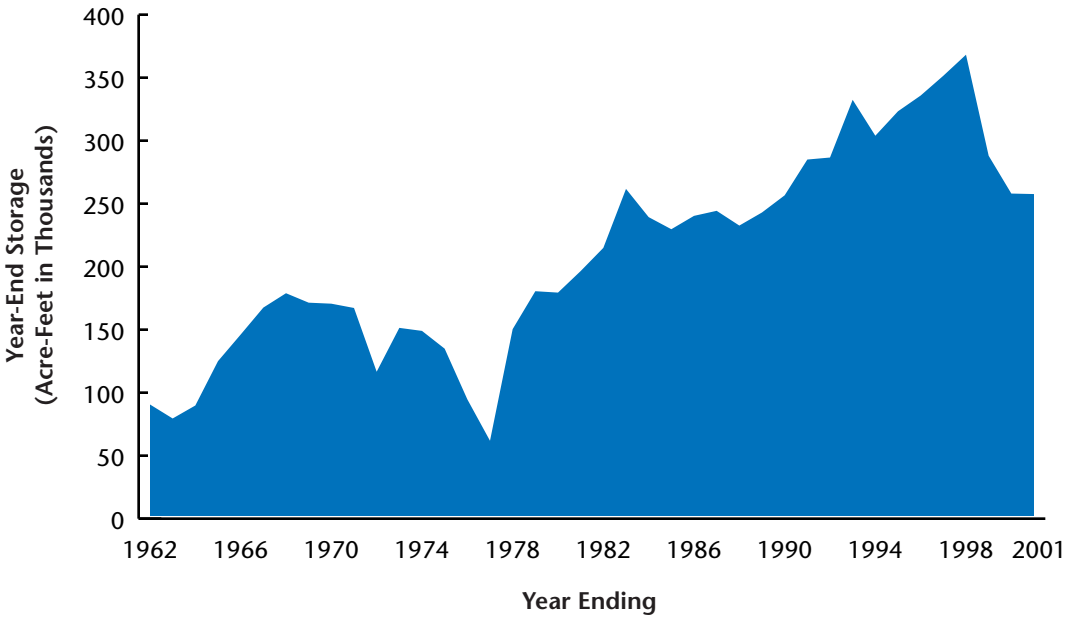
Although total water usage is increasing while the district's reserve funds and total groundwater storage quantities decrease, the basins are not immediately threatened. However, although the district does not expect problems with the basins' groundwater supply in the immediate future, the trend toward increased water use in the basins combined with the district's weakened financial condition is cause for concern, particularly in light of the fact that the district has not established either optimum or minimum groundwater storage quantities. Figure 4 on the following page shows the district's progress in replenishing the amount of groundwater stored in the basins from 1962 through water year 2000–01.

SEVERAL FACTORS HAVE CONTRIBUTED TO THE DEPLETION OF THE DISTRICT'S RESERVE FUNDS

Since 1997–98 the district has depleted its reserve fund balance through a combination of lowered assessment rates, increased water replenishment purchases, capital improvement expenditures, and disbursements to ratepayers through its Clean Water Grant program. However, the district's past decisions indicate that it lacks a long-term vision for its finances and call into question the decisions that reduced its reserves so significantly. For instance, after years of steady increases in its assessment rate, leading to a historical high of

FIGURE 4

Changes in Stored Groundwater in the Basins, 1962–2001



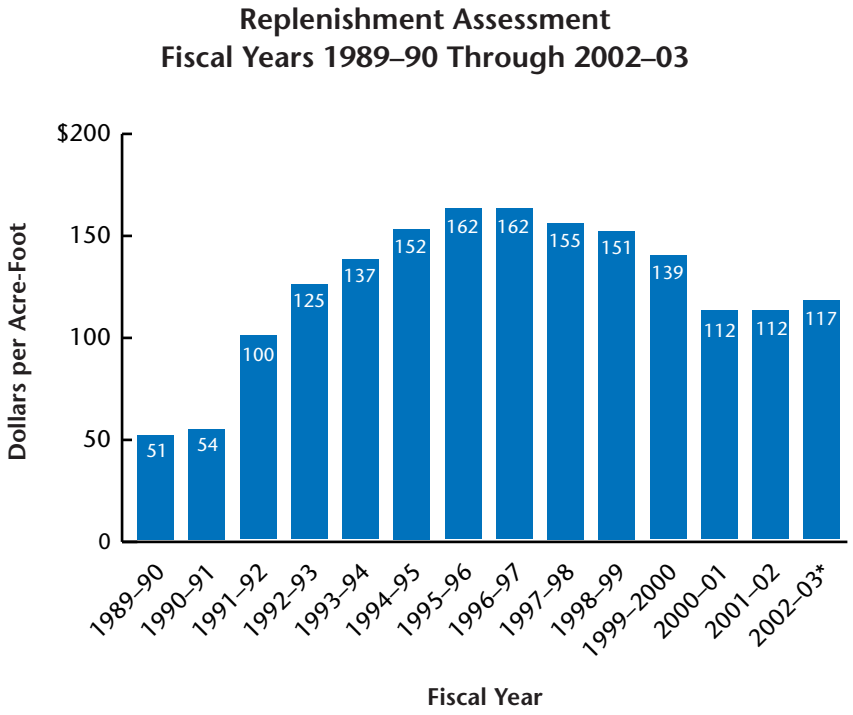
Source: Water Replenishment District of Southern California.

$162 per acre-foot in the mid-1990s, the district began lowering its rate in fiscal year 1997–98; by fiscal year 2000–01, it was charging $112 per acre-foot, a drop of almost 31 percent in four years. Yet we found that a decrease of this magnitude may not have been warranted, given the district's increased expenses and depleted reserves. Figure 5 on the following page shows the district's assessment rates from fiscal year 1989–90 through 2001–02 and its proposed rate for fiscal year 2002–03.

The District's Past Assessment Rate-Setting Decisions Lacked Long-Term Vision

The district's choice to lower its assessment rate so much and so quickly is questionable, given its decision in 1998 to return almost half of its reserve funds to ratepayers and its much increased spending for capital improvement projects, causing the district to use its reserves to fund operations. For example, in fiscal year 1998–99, the district returned $30 million to ratepayers through its Clean Water Grant program. Additionally, beginning in fiscal year 1998–99, the district

FIGURE 5



Source: Water Replenishment District of Southern California.

* Proposed in the fiscal year 2002–03 budget.

significantly accelerated its spending for capital improvement projects. Although as of June 30, 1998, the district had invested a total of $3.9 million in capital assets, it spent more than $16 million during fiscal years 1998–99 and 1999–2000, with plans for additional spending for capital improvement projects for fiscal year 2001–02. Besides stepping up its spending for capital improvement projects, the district also lowered its assessment rate nearly 20 percent in fiscal year 2000–01, from $139 to $112 per acre-foot. Because this lower assessment rate has not generated sufficient revenue to cover all of its operating costs, the district has used reserve funds to pay for the shortfall. As a result of its actions, the district has reduced its reserves from $67 million on June 30, 1998, to $12 million on June 30, 2001, and it projects the reserves will be further reduced to slightly more than $6 million by June 30, 2002. Further, the district's ability to boost its reserve funds is constrained by legislation that was enacted after it lowered its assessment to $112. This legislation limits the amount the district can increase its assessment rate to a maximum of 5 percent annually.

Assessment rates charged by the district in the last two fiscal years have not been adequate to replenish groundwater, to pay for capital improvement projects and operating expenses, and to provide adequate reserves.

Further complicating its financial situation, the district did not increase its assessment rate for fiscal year 2001–02 from the $112 per acre-foot level, despite the fact that the district's estimates of groundwater pumping and its budget indicate the assessment rate should have been $128 per acre-foot in order to fund its planned activities. Although the water code prevented the district from raising its rate to $128, it would have permitted an increase to $116, thereby offering some relief to the district's financial difficulties. According to the general manager, the board decided to set the fiscal year 2001–02 assessment rate below the level that the district budget originally identified as necessary in part because of ratepayers' criticism of past high rates. However, the decision to hold the assessment at $112 per acre-foot caused the district to abandon its original budget goal of maintaining the maximum amount of reserve funds allowed by the water code. To meet its need for water replenishment purchases, the district dedicated $3.9 million of its reserve funds to increase its budget for water purchases and lowered its planned reserve funds to a level that was 62 percent of the maximum that the water code allowed. The general manager believes that the level of reserves and the current assessment rate pose a financial hazard to the district. The district staff have proposed that the board increase the fiscal year 2002–03 rate by the maximum allowable under the water code, to $117 per acre-foot.

Current Statutory Restrictions May Hinder the District's Ability to Improve Its Financial Situation

As we mentioned, the legal restrictions imposed by the water code are among the factors influencing the district's current financial situation. The water code mandates how quickly the district can raise its assessment rate or incur debt in order to replenish groundwater, fund needed capital improvement projects and other programs, and provide for adequate reserve funds. Currently, the water code limits the district to raising its rate by the local consumer price index (CPI) plus 1 percent, with a maximum 5 percent increase above the previous year's assessment. This limitation is set to expire on December 31, 2002, although the Legislature may choose to extend that restriction.

As a result, the district cannot immediately recover financially from its past decisions. For example, the district has reduced its rate by more than 30 percent since fiscal year 1997–98 and has substantially depleted its reserve funds, as we previously discussed. Because its 2000–01 and 2001–02 rates were set at such a low level, the allowed increases for fiscal year 2002–03

will not be sufficient to meet the district's expected needs. In other words, the district cannot compensate for its questionable decisions in past years by raising its current rate. In fact, for this reason, the limitation on rate increases could prove to be a future deterrent for the district to lower its rate in years when conditions would allow.

Statutory restrictions on rate increases limit the district's ability to recover from its decision to keep its rate low in fiscal year 2001–02.

Because it chose not to increase its rate of $112 per acre-foot in fiscal year 2001–02, the district can only charge $117 per acre-foot in fiscal year 2002–03. In its draft 2002 engineering report, the district estimates that water replenishment costs alone will account for $112 of the $117 proposed rate. This leaves only $5 per acre-foot for the district's other expenditures, which for fiscal year 2002–03 the district estimates to be $37 per acre-foot. The district's proposed budget for fiscal year 2002–03 indicates that if it adopts this assessment rate, it must make cuts in either water purchases or capital improvement project spending in order to balance its budget and provide for a minimum level of reserve funds.

The restrictions on the district's ability to raise its assessment rate will also affect its plans for future programs. The district has identified several new programs intended to optimize the use of the storage space in the basins, which it believes is currently underused. Two of the programs would allow ratepayers to store groundwater for use when they have exhausted their annual pumping rights, and a third would allow entities that supply supplemental water to ratepayers to store water in the basins. The district believes these programs could increase groundwater pumping and replenishment sources, use the basins' storage capacity, and reduce costs. For example, in January 2002 the district entered into an agreement with the City of Long Beach that the district believes will demonstrate the value of conjunctive use programs by increasing Long Beach's use of the Central Basin and lowering the district's cost to provide water to the Alamitos seawater barrier wells. However, although the district believes these programs will be a benefit to the basins, they are still in the conceptual stage and the district must incur certain costs to establish the costs and benefits to the district and the ratepayers and implement the programs.

In addition to the problems inherent in any rate restriction, the current legal constraints on how much the district can increase its assessment rate each year may not be based on the most appropriate index. The CPI is reflective of consumer inflation, not necessarily of increases to the district in its cost of water purchases. For instance, the district estimated in its engineering

reports that its total cost for water would increase by 10.7 percent between 2001 and 2002 because it projected that it would have to purchase a greater proportion of more expensive imported water and that the purchase price of water from other sources would increase as well. Yet because the district's rate increase is tied to the CPI and cannot be greater than 5 percent, it will not reflect this rise in water prices. Moreover, the law is not clear on how the district should calculate the CPI, and as a result, its approach has been inconsistent. For fiscal year 2001–02, the district used the change in the CPI between June 2000 and February 2001, which resulted in a 3.57 percent increase. For fiscal year 2002–03, the district used the CPI change for the last completed fiscal year, 2000–01, which yields an increase of 5 percent.

Because the water code temporarily prohibits the district from incurring debt, the district believes that it cannot take advantage of state-operated loan programs to assist in groundwater recharge and storage projects.

A final problem is that the water code prohibits the district from incurring debt to pay for capital improvement projects. According to the district's interpretation, this provision has far-reaching effects on its ability to finance capital improvement projects. The district's counsel believes that, in addition to prohibiting the district from selling bonds, this provision also prevents the district from incurring debt to take advantage of state-operated programs to assist in groundwater recharge and storage projects. The district has applied for about $5.6 million in groundwater recharge construction loans from one such program, administered by the Department of Water Resources and funded by bonds approved by voters in March 2000. However, according to the district counsel's interpretation of the law, the district will not be able to participate in that loan program unless the water code's current restrictions on incurring debt are modified or allowed to expire. This provision of the law also expires after December 31, 2002, unless the Legislature extends it.

The District's Grant Program and Discretionary Water Purchases Have Contributed to Its Current Financial Situation

As we discussed, the district's financial situation changed significantly from 1998 to the present. Part of the reason for this change involves the district's management of its reserve funds. In response to requests for a rebate of excessive reserve funds, the district paid nearly $30 million in fiscal year 1998–99 to ratepayers through its Clean Water Grant program. Taken with the district's other actions, the return of these funds contributed significantly to the district's current weakened financial condition. Specifically, the district had accumulated a large reserve fund balance of $67 million in part because it

had reduced its water replenishment purchases during fiscal year 1997–98 and accumulated funds to pay for capital projects. Although it had been purchasing imported water for spreading at an average of 32,524 acre-feet per year, the district purchased only 952 acre-feet of imported water in fiscal year 1997–98 and no acre-feet of water during 1998–99 for that purpose. According to the district, it reduced purchases because construction in areas owned by the county that are used to percolate the water into the ground would have impeded replenishment of the groundwater.

The district made other management decisions that further depleted its reserve funds. For instance, during fiscal year 2001–02, the district will purchase additional water beyond the original estimates in its 2001 engineering report. In that report, the district assumed that the basins would receive a normal amount of natural water for replenishment during water year 2001–02. However, according to the 2002 draft engineering report, the district now expects to receive only 56 percent of the normal amount of local storm water for spreading in the Montebello Forebay, a shortfall of 23,850 acre-feet. To compensate, the district's board authorized an increase in the amount of water the district planned to purchase during fiscal year 2001–02 by 24,000 acre-feet. Although, according to the district's controller, the district lacks enough reserves to purchase all of the additional water, it projects that it will spend about $2.8 million more in fiscal year 2001–02 for purchases of spreading water than it originally estimated.

To compensate for a shortfall of storm water, the district will spend $2.8 million more to purchase water than it expected for fiscal year 2001–02.

DUE TO SHORTCOMINGS IN THE DISTRICT'S BUDGET PROCESS, ITS SPENDING NEEDS DO NOT TIE TO ITS ASSESSMENT RATE

The amount the district determines it must collect from the replenishment assessment is driven in part by the costs it budgets for capital improvement projects and other programs. However, in reviewing the district's fiscal year 2001–02 budget, we found a number of weaknesses in its processes for preparing annual budgets. The district's staff have been inconsistent about including supporting information; their preparation of certain elements of the budget has been inaccurate; and they have allocated shared administrative costs inappropriately. The district has not exercised strong managerial oversight over its budgeting process, nor has it provided the staff who prepare the budget with sufficient, documented direction.

In addition to weaknesses in preparing its spending plan, the district does not tie its affirmed spending needs to the assessment it levies on ratepayers who pump groundwater from the basins. Moreover, the data contained in the annual engineering reports that the district prepares to meet certain requirements of the water code and identify water replenishment needs does not clearly explain the amount of water the district determines it must purchase. As a result, ratepayers have criticized the district over the validity of its budgeted expenses and the need for the assessment rate it charges.

The District's Budget Lacks Strong Managerial Oversight, Adequate Documentation, and a Consistent Method of Allocating Administrative Costs

Our review of the district's fiscal year 2001–02 budget revealed that district management did not adequately instruct or supervise the district staff who prepared the budget. As a result, the budget contained inconsistencies. For instance, the expenses for certain improvement projects were misclassified, including the costs of the hydroelectric plant buyout associated with the Alamitos Barrier Recycled Water Project and the Dominguez Gap Recycled Water Project. The district correctly classified this item in the capital projects portion of the budget for the Alamitos Barrier project but included the costs in operations and maintenance for the Dominguez Gap project. Because the buyout is necessary for the completion of both projects, it belonged in the capital budget.

The level of documentation and support included for the estimates in the fiscal year 2001–02 budget varied significantly depending upon the program or unit compiling the data.

In addition, the district's lack of appropriate documentation within its budget brings into question the accuracy of its estimates. Accurate estimates are critical for the district: Overestimating expenses can cause the district to collect funds unnecessarily from ratepayers and underestimating can lead to a lack of needed revenue. Yet the level of documentation and support included for the estimates in the fiscal year 2001–02 budget varied significantly depending upon the program or unit compiling the data. For example, project and administrative managers did not include reasonable, documented explanations of many of their expense items and sometimes offered no written explanation of the assumptions that they made in arriving at their budgets. In addition, the district did not file the final adopted budget with the supporting worksheets and documentation that staff used to create it and the records of the board's changes. Without a central budget file, the district will

not have a complete baseline for comparing actual expenditures to its estimates. It also will not be able to assess changes in estimates for future budgets.

Project and administrative managers also did not consistently use historical cost data to aid their development of the budget for fiscal year 2001–02. Although historical costs are not always the standard to determine future years' estimates, they can provide a useful indication of expenses for a typical year and thereby ensure a measure of reasonableness. Of the seven project and administrative managers, only two administrative managers documented that they took past expenditures into account in preparing their budget estimates. However, both of these administrative managers estimated costs far in excess of past expenditures without providing an explanation for the additional costs. Five project managers failed to use historical data at all. This failure may have occurred in part because accounting staff provided them with actual expenses for only the first six months of fiscal year 2000–01, even though a longer history of the district's spending was available.

The district cannot fully support the allocation of its budgeted expenses to replenishment funds and clean water funds for fiscal year 2001–02.

Although the water code requires that the district separately identify how much of its assessment rate is attributable to replenishment costs and clean water costs respectively, the district did not fully comply in the fiscal year 2001–02 budget. Lacking a more accurate method, of its 17 programs and projects, the district budgeted the costs of 5, totaling about $2.6 million, evenly between the replenishment and clean water functions when it had not established how much these projects actually benefited those functions. Similarly, the district did not employ an adequate process for budgeting administrative costs between the clean water and replenishment functions. For example, although the district uses a formula that appears to properly allocate the costs for the finance and administration unit to replenishment and clean water activities, it distributes the costs for the directors, general manager, and public and government affairs unit evenly to the two functions without establishing the level of benefit each receives.

All of these examples point to a need for improved managerial oversight of the district's budget preparation process. In 1998 a consultant who reviewed the district's capital and financial planning process made similar recommendations, and although the district has not implemented all of these, it has recently taken steps to improve its budgeting practices. For instance, until fiscal year 2001–02, engineering staff, rather than staff with

For its fiscal year 2002–03 budget, the district has begun to make improvements in its presentation of its finances.

accounting or financial backgrounds, coordinated the district's budget preparation efforts. Now, the district's controller is overseeing the district's budgets, which provide noticeably more information. In February 2002 the district presented a midyear budget review to the board's finance committee, providing a detailed comparison of budgeted versus actual revenues and expenditures for the previous six months and a projection of the district's year-end financial condition. Documents distributed at a recent workshop on the fiscal year 2002–03 budget also suggest that the district is improving its presentation of its finances. During the workshop, the district placed the cash flow projection into the context of the replenishment assessment: It presented the dollars per acre-foot equivalent for each of the revenue and expenditure categories and provided comparative expenses from the prior year for administrative costs. This type of presentation more clearly demonstrates the relationship between the different elements of the district's revenues and expenses and the assessment rate.

The District's Presentations Have Not Clearly Supported Its Budgeted Spending Needs and the Resulting Assessment Rate

For its fiscal year 2001–02 budget process, the district's presentation of its annual engineering report, budget, and related documents did not contain a clear and complete explanation of the district's spending needs or the calculation of its assessment rate. District staff make these presentations to the board, ratepayers, and other interested parties at public hearings to allow public discussion of the assessment rate determination. However, in part because the district does not tie the water data with its proposed spending and assessment rates, ratepayers have criticized the district over its spending plans and questioned the level of its assessment rates.

For fiscal year 2001–02, budget documents the district provided at public hearings did not show all of the components involved in the assessment calculation, nor did they clearly tie the data drawn from the district's engineering report to district accounting reports and financial projections prepared for the budget. As a result, the district did not show how it calculated its assessment rate using its projected current year-end balance for reserve funds, estimated expenditures and revenues, and estimated groundwater pumping for the coming fiscal year. Because the water code requires the district to identify which elements of the assessment rate it will use for replenishment

and clean water activities, a complete budget presentation of the assessment rate calculation would ideally also allocate the assessment per acre-foot to the replenishment and clean water functions, as well as to capital projects for either function. Several of the internal spreadsheets used to prepare the budget contained most of the elements of a comprehensive summary of the assessment calculation, but the district did not include these spreadsheets in the budget documents it provided to the board.

In addition, the data in the district's annual engineering report does not clearly explain the number of acre-feet of water that the district's budget states that it must purchase. The district prepares the report each year to provide the district's board with information, required by the water code, regarding past and forecast future groundwater conditions in the basins so that it can determine whether to raise funds through replenishment assessments for water replenishment and groundwater protection activities. Although the district's engineering report meets the data collection requirements of the water code, we found some of the district's presentations hard to follow, particularly when we tried to tie groundwater data to the district's determination of the water purchases it needed. For example, the draft 2002 engineering report shows that it projects pumping to exceed natural replenishment in the basins by slightly more than 121,000 acre-feet, but it also shows that the district plans to purchase almost 133,000 acre-feet—12,000 more than it would seem to require—without an adequate explanation. Although the district was able to clarify for us how it calculated its estimate for total water purchases, the elements of the calculation were scattered throughout one chapter and four tables of the report and not readily apparent to even a careful reader.

Ratepayers have criticized the district over the level of its assessment rates, in part because the rates are not clearly supported by the district's engineering reports and spending plans.

In the past, the district's finances have been subject to considerable criticism from ratepayers. When the district invited the Technical Advisory Committee (committee) to participate in the fiscal year 2001–02 budget preparation process, the committee concluded that the district's budget was excessive. It stated that the quantity of water the district planned to purchase was unnecessarily high and that several of the district's programs were either redundant or staffed imprudently. The information the committee provided to us to support its position was not complete or well documented, which may bring its conclusions into question. However, because the district's presentations were also incomplete, the district was challenged to defend its

estimates. Unless it continues to improve the presentation of its spending plans, as it has started to do in its fiscal year 2002–03 budget, the district will remain vulnerable to such criticism.

RECOMMENDATIONS

To ensure that it has sufficient funds to meet its statutory responsibilities, the district should adopt a policy on a minimum reserve fund balance. That policy should specify the amount of reserves it requires to meet all of its necessary expenses, including those associated with its operations, the stabilization of its assessment rate, its ability to respond promptly to contamination issues, and its ability to repair and replace its facilities and equipment. If the district determines that it needs more reserve funds than the water code currently permits, it should consider seeking legislative approval for an increase in the allowed level.

To ensure an adequate supply of water for the basins' users, the district should establish an optimum quantity for stored groundwater that can serve as a target for its water purchases. It should also establish a minimum quantity below which it should not allow the basins to fall.

The district's board should set the annual replenishment assessment at a rate that will support the district's planned activities and ensure that it maintains the level of reserve funds it needs to meet its statutory responsibilities.

If restrictions on increasing rates are extended past December 31, 2002, the district should consider seeking legislative approval of statutory changes in the restrictions on its ability to raise funds for its operations, capital improvement projects, and reserves. Specifically, the district should pursue the following modifications to the current restrictions:

- It should request more flexibility in setting its assessment rate to ensure that it is able to replenish groundwater and fund clean water programs.

- It should seek changes in the factor that controls annual rate increases to one that is more closely linked to the changes in its costs, such as the increases to the district in its cost of water purchases. This factor should be modified by the effect of inflation on capital projects and operating costs.

- It should seek relaxed prohibitions on debt to allow it to participate in government-operated loan programs.

The district should implement comprehensive written procedures for preparing its annual budget. These should provide staff who prepare the budget with adequate direction in meeting the standards that the district's management and directors develop. The procedures should include the following:

- An explanation for how unit managers can use historical cost information as a tool to evaluate their cost estimates.
- Guidelines regarding the sort of information that can serve as a reasonable rationale for budget line items.
- An administratively feasible method for properly allocating overhead to programs and projects.
- An administratively feasible method for properly identifying replenishment and clean water program and project costs. This method should ensure that the district can accurately determine how much of its assessment rate is attributable to each program.
- Guidelines regarding the appropriate classification of noncapital and capital project expenses.
- Guidelines regarding the creation of a central budget file containing the supporting documentation used to arrive at the estimates for budget line items.

To allow for a thorough public discussion of the district's proposed assessment rate, staff should tie the district's spending plan to its calculation of the rate. The district should distribute this presentation to the board for public hearings and should distribute to attendees a presentation that includes, at a minimum, adequate data to support the proposed rate. This data should be drawn from the district's engineering report, proposed budget, and capital improvement plan. ■

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CHAPTER 2

The District Needs to Improve Its Planning and Development of Capital Improvement Projects

In order to raise funds for projects that improve the supply and quality of the groundwater in the West Coast and Central basins (basins), the Water Replenishment District of Southern California (district) is authorized to charge a replenishment assessment (assessment rate) to the entities and individuals that pump groundwater. However, the district's planning and implementation of its capital improvement projects have been inadequate. Specifically, the district does not have current strategic and capital improvement plans that identify potential projects and prioritize their implementation. Although it is updating its plans, some of its ratepayers have objected to these efforts, arguing that the district has not gone to sufficient lengths to ensure public discussion. Current law temporarily restricts the district's ability to raise new funds for projects, but these legal constraints are scheduled to expire after December 31, 2002. Whether or not the restrictions continue, comprehensive strategic and capital improvement plans are necessary if the district desires to invest its funds appropriately and improve communications with its ratepayers.

Further, despite the fact that over the past two fiscal years it has spent $19.9 million on capital improvements, the district lacks a standard process for identifying and resolving the risks attached to potential projects and for evaluating the projects' costs and benefits. As a result, the costs of some projects are likely to exceed the district's estimates, and it may not gain the benefits it expected. For instance, the district invested $10.3 million in a desalter without seeking clarification as to whether it would need legal rights to pump the saltwater from the basin. When the district sought this clarification, the court determined the level of salinity of the extracted water necessary to exempt the district from obtaining legal pumping rights to be higher than the district had planned when it built the desalter. If the water pumped by the district does not reach that level of salinity, the district's operating costs will increase or it may have to invest up to an additional $2.3 million to qualify the desalter for a subsidy of its operating costs. In addition, the district started

construction on an estimated $11.7 million recycled water project even though it has yet to resolve a critical issue that may keep the project from operating.

THE DISTRICT LACKS UPDATED STRATEGIC AND CAPITAL IMPROVEMENT PLANS

According to its understanding of its mission, the district is responsible for ensuring an adequate supply of quality groundwater and preserving the basins as a resource. However, the district does not have current strategic or capital improvement plans that identify and prioritize projects that will further its mission. A "strategic plan" is used to specify the goals and strategies of the district. A "capital improvement plan" identifies the funding sources and scheduling for the infrastructure required to support the strategic plan. Without such plans, the district cannot be certain that it identifies and implements the projects with the greatest impact on the supply of safe water in the basins. Because of budget constraints for fiscal year 2002–03, the district has little ability to launch new programs or projects; in fact, it may suspend some projects that it has not already started for its Regional Groundwater Monitoring program and for its Safe Drinking Water program. We believe that this creates an opportunity for it to develop plans, to share information about projects, and to consider ratepayers' input. Such efforts would allow it to proceed with capital improvements that best serve the interests of the region.

In addition to setting priorities and identifying future capital projects and their funding sources, capital improvement plans serve as an important means to communicate to the public.

As we noted, a strategic plan is used to set priorities and allocate resources. Ideally, a strategic plan should describe the processes, skills, technologies, and various resources that the district will use to achieve its goals and objectives. In addition, preparing the plan provides the district an opportunity to consider the programs and activities that it can terminate, reduce in scope, or transfer to other agencies. A capital improvement plan identifies the long-term projects the district is planning to build and notes the potential funding sources and financial constraints that may affect the projects' viability. The capital improvement plan can also be an important tool for providing ratepayers with a clear view of the district's long-term direction and a better understanding of the district's needs for revenue to fund the capital improvement projects.

The district prepared its most recent strategic plan in 1998, but although this plan outlined goals and objectives, it did not contain an implementation strategy. Since that time, the

Without an adequate capital improvement plan, over the last two fiscal years, the district has spent $19.9 million on capital improvements and has earmarked $12 million more.

district has actively pursued capital improvement projects, spending $19.9 million in the past two fiscal years alone, and it has earmarked an additional $12 million for current projects. Although its ability to raise funds for additional projects is currently limited by legal restrictions, these are scheduled to expire after December 31, 2002, unless the Legislature extends them. Once the restrictions expire, the district will be able to proceed with the projects it has planned under the oversight of the district's board of directors.

The district is updating its strategic plan, from which it will create a capital improvement plan. In the process, it has identified new programs it would like to introduce. Some of these are intended to optimize the use of the basins' capacity for groundwater production and storage. For instance, the programs would allow entities to bank water in the basins, thus increasing the groundwater they pump beyond their current adjudicated water rights and increasing the overall production of groundwater from the basins. Its other planned and ongoing projects generally focus on ensuring an adequate supply of clean groundwater in the basins to meet the current level of pumping. For instance, the Safe Drinking Water program involves purchasing equipment as well as designing and constructing treatment facilities that can keep in production wells that have been contaminated. Another project, the Central Basin Clean Water Project, allows the district to provide treatment equipment to remedy the contamination that is migrating from the San Gabriel Valley Basin.

However, the district has encountered resistance from some ratepayers over its vision of its mission and its proposed future projects and programs. The district invited ratepayers to participate in workshops concerning its strategic plan and its project and program selection process. The few who attended the workshops, and who also hold the majority of the water pumping rights for the basins, were not satisfied with what they perceived as a lack of information provided by the district and with the limited opportunities they had to participate in the strategic planning process. In letters to the district, these representatives voiced concerns about having too little time to evaluate and comment on the proposed projects and programs. We found that the district did not provide a preliminary estimate of the costs or benefits of the projects, did not adequately classify the projects as ongoing or proposed, and did not prioritize the projects for future implementation. This lack of information diminished ratepayers' ability to evaluate the proposals and provide comments.

Although the district is presently updating its strategic and capital improvement plans, it is encountering resistance from the basins' ratepayers over the district's vision of its mission and proposed future projects and programs.

Most of the representatives who provided comments to the district supported some of the district's ongoing projects, such as the Safe Drinking Water program. However, they believed that programs that expand the usage of the underground storage in the basins—particularly programs that allow entities to bank water in the basins and recover it without using their adjudicated water pumping rights—are a departure from the district's traditional replenishment role. These representatives stated that such projects are highly controversial and perhaps outside the jurisdiction of the district. They believe that the projects cannot be effective without input and participation from all the affected parties that own rights to pump groundwater from the basins, and that if the district moves forward on them, they should be a goal shared by the ratepayers and the district.

THE DISTRICT HAS FAILED TO IDENTIFY AND RESOLVE RISKS IN PROPOSED CAPITAL IMPROVEMENT PROJECTS

Despite the fact that it has invested $19.9 million in capital projects in the past two fiscal years, the district lacks a standard process for identifying and resolving the technical, legal, and financial risks attached to capital improvement projects prior to committing funds to them. In addition, the district has not formalized a process to examine the costs and benefits of proposed capital improvement projects in order to ensure that it chooses the best options for its investments. Consequently, the district has committed funds to projects in which important issues of concern remained unresolved. The costs of these projects are likely to exceed the district's expectations, and it may not receive the benefits it anticipated.

The District Lacks a Standard Process for Evaluating Project Risks

Changes to the California Water Code (water code) in 1990 broadened the district's responsibilities from merely replenishing groundwater to identifying, removing, and preventing contaminants in the groundwater supply. Since then, the district has invested in a number of capital improvement projects designed to improve the quantity and quality of the groundwater. However, the district began construction on at least two multimillion dollar projects without resolving critical issues that remain unresolved. It decided to proceed with these projects largely because it lacks established procedures

that would prevent it from doing so. Specifically, the district does not have a formal procedural framework that provides it with a total picture of the elements of projects—the financial, legal, and technical risks—before it commits its funds. Without such a process in place, the district risks spending its limited resources on projects that may not operate as intended without modification and may cost more than estimated.

The district invested $10.3 million in a desalter before clarifying whether it would need to obtain legal rights to pump water from the basin, and may have to spend up to $2.3 million more so it can operate the desalter and qualify for a subsidy to offset its operating costs.

One of the two projects in which the district invested is the Goldsworthy Desalter facility (desalter). The district intended to use the facility, which cost $10.3 million and began operating in November 2001, to clean up a plume of saltwater pollution trapped in the West Coast Basin. Using the desalter, the district removes brackish water from the basin, filters it to drinking water standards, and provides it for consumption. However, the district failed to clarify prior to construction whether it would need to obtain legal rights to pump the brackish water from the basin. The district asserts that it proceeded with the project only after it received a consensus on the location of the desalter from a work group made up of its ratepayers. This work group, which was aware that the concentration of chlorides, or salts, was less at the edge of the plume, agreed that the district should construct the desalter in order to prevent its advancement. The district regarded the consensus as tacit approval to pump and clean the water at that location.

However, in 2001, when the district had completed 98 percent of the desalter's construction, as a result of actions that the district filed to clarify its need for legal pumping rights, the court ruled that the district may extract saline groundwater without obtaining adjudicated water rights only when chloride levels exceed 1,000 parts per million parts of water. Although this judgment is consistent with the definition of "nonsaline water" in the water code, it established a level of chlorides at which the district is exempt from obtaining legal pumping rights at a higher level than the district planned when it built the desalter. Under preliminary permission from the courts to operate the desalter, as of February 2002, the water pumped at the project site has contained no more than 770 parts per million, 77 percent of the chloride level required to exempt the district from needing pumping rights to extract it from the ground.

The district is currently discussing the future of the desalter with a desalter work group, a work group required by the court that meets in conjunction with the Technical Advisory Committee. One option for operating the project is to count the amount of

water it pumps against adjudicated water rights in the basin. However, the district does not own pumping rights and would have to lease them at a cost that is subject to fluctuations in the market price. Moreover, the district's determination of the financial viability of the desalter was based, in part, on a subsidy from the Metropolitan Water District of Southern California (Metropolitan) to offset the operating costs of the facility. Under an agreement with the district, Metropolitan will contribute up to $250 for each acre-foot that the desalter pumps to defray the desalter's operating costs if the project results in a new source of drinking water. If the district counts the groundwater the desalter pumps against an adjudicated right in the basin, the project will not qualify for the subsidy. Another option is to pump and transport water from other areas of the saline plume that contain higher chloride levels to the desalter facility; this could cost the district as much as $2.3 million for additional construction.

The district is currently constructing an $11.7 million recycled water project, but has not finalized an agreement necessary to operate the project.

The district faces problems with a second multimillion dollar project. Although it began construction on the Alamitos Barrier Recycled Water Project (the Alamitos Barrier project) in October 2001, it has not yet resolved a critical point of contention involving Los Angeles County (county). The Alamitos Barrier project, which the district estimates will cost $11.7 million, is intended to advance-treat recycled water to drinking water standards to provide a reliable and cost-effective source of water to inject into barrier wells (rather than the imported water currently used) at Alamitos to prevent seawater intrusion along the county's border with Orange County. As a result of the project, the operator of the hydroelectric plants located near the barrier wells will lose revenue; therefore, the district's contract with the county contains a provision that the contract will not take effect—meaning that the county will not accept the recycled water from the project—until the district and the county reach agreement regarding the district's compensation to the hydroelectric plants' operator. Although the district first identified the need to resolve this condition as early as 1997, it has not yet reached a final settlement agreement. The project is scheduled for completion in November 2002, but without a resolution to this issue, the district will not be able to begin operating the facility.

The District Has Not Adopted a Standard Process for Analyzing the Costs and Benefits of Potential Projects

Although our last audit recommended that the district standardize its process for preparing cost-benefit analyses, the district still lacks a formal process to ensure that the benefits of projects exceed their costs.

In our December 1999 audit report, we recommended that the district standardize its process for preparing cost-benefit analyses for the capital improvement projects it considers for development. However, the district has not yet implemented such a policy. In a cost-benefit analysis, the district should define and evaluate the costs and perceived benefits of a proposed project and alternative projects, thus allowing it to make reasonable, informed decisions and to choose between different strategies. Further, the district should follow a consistent approach in preparing its analyses in order to avoid skewing the results in favor of projects it wants to do. Although the district states that it regularly conducts financial evaluations of its capital improvement projects, it does not have documented procedures for its staff to follow in performing cost-benefit analyses. The lack of a standard policy may result in inconsistent or poor analyses, which in turn may cause the district to forgo good projects or spend its limited funds on less-desirable alternatives.

The district argues that a standard process is impractical because its projects are so varied. For example, the district's analysis of the Alamitos Barrier project, intended to provide a reliable water supply to inject into barrier wells, included a comparison of the cost of treating water to the cost of buying imported water, whereas the analysis for the desalter, a contamination mitigation project, did not require such a comparison. Moreover, the district argues that contaminant mitigation projects do not lend themselves to analysis. Specifically, it claims that an option to contaminant mitigation that is to do nothing is not a responsible choice. It states that an analysis for a contamination mitigation project would have to take into consideration the value of the water and the underground storage space in the basins, values that no one has calculated. Similarly, analyses of replenishment projects would have to include values for the public benefits that these projects provide, such as creating reliable water sources and protecting the environment. These values are also hard to measure.

However, we believe that the district's recent difficulties with its capital improvement projects demonstrate its need for a more standardized process. Clearly, the district can develop a standardized process for comparing the costs of projects to improve groundwater production with the cost of importing the water. Although the projects vary, the district can establish a framework for defining defensible standards to measure

each project's costs and benefits—it may require, for instance, that district staff investigate and support the dollar values it uses in the analyses. Furthermore, we believe that the district could standardize a process to compare the technology options available to mitigate contaminants, ensuring that it does not spend more than necessary to remedy problems. Finally, although we agree with the district that it may not always be able to quantify the value of the storage space or of a specific project's public benefits, it can identify a relevant range of quantifiable information that it can use to determine whether measurable benefits exceed the measurable costs. Although some part of its decisions may necessarily remain subjective, such an analysis would ensure that it had the maximum amount of information when deciding how to spend its funds.

RECOMMENDATIONS

To identify the programs and capital improvement projects that will aid it in fulfilling its mission, the district should continue to create an updated strategic plan and capital improvement plan. These plans will be most beneficial to the basins the district serves if the district incorporates the following activities into their development:

- It should assess all activities it performs and their priority to the district's role versus the activities and roles of other water agencies in the region.
- It should ensure that the plans clearly identify which projects are ongoing and prioritize the proposals in the order of importance to meeting the district's statutory requirements.
- It should share with ratepayers the appropriate level of information on proposed programs and projects, including cost and benefit estimates.
- It should adopt a policy to periodically update its strategic and capital improvement plans to ensure that it bases decisions for future projects on appropriate and current information.

The district should establish a standardized approach to evaluating and selecting capital improvement projects. At a minimum, the approach should include the appropriate steps to identify

legal, technical, and financial risks of proposed projects. In addition, the district should implement a cost-benefit analysis methodology that (1) defines standards and assumptions to use when evaluating replenishment projects and (2) offers a process for weighing alternative solutions to contaminant mitigation issues.

The district should quickly define potential resolutions to the water rights issue involving the desalter, and it should implement the most suitable solution to put the desalter to work permanently removing the saltwater from the West Coast Basin.

The district should promptly come to agreement with Los Angeles County to resolve the third-party compensation issue that could potentially prevent the operation of the Alamitos Barrier project. ■

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CHAPTER 3

Although the District Has Improved Its Accounting and Administrative Controls, Problems Remain

Although the Water Replenishment District of Southern California (district) has improved its accounting and administrative controls somewhat, it needs to further control its spending for professional services and other operating costs. For example, the district has expanded and improved its contracting policies but has not always followed its policies or the requirements of the California Water Code (water code). The district has not ensured that it signs contracts for all of the services for which it pays, and it has continued to maintain contracts with unspecified duration. In one instance, the district paid a public relations consultant more than $110,000 in 2001 without putting a contract in place; in six other instances, it works with legal and legislative advocacy firms with contracts that are essentially month-to-month agreements.

Moreover, the district did not enforce the terms of one of its contracts, and district staff did not follow the board of directors' (board) policy or instructions when signing another. The district has also entered into agreements with legal, legislative advocacy, and public relations firms for fixed monthly fees of up to $10,000 per month, but it could not provide evidence that it regularly reviews its needs for these services. As a result, it may be paying for unneeded services or overpaying for the value it receives.

Although the district shows weakness in managing its contracts, certain provisions of the water code that govern contract procurement appear overly restrictive and may reduce the district's ability to operate efficiently. The water code requires that the district's board president and secretary sign all contracts, yet we believe that it would be acceptable for the board to delegate this authority to the district's general manager for contracts below a certain dollar threshold.

In addition, the district could further improve its controls over vendor payments and travel reimbursements, in part by offering more detailed guidance regarding its allowable costs and procurement policies. Although many of these payments

are small compared to the district's overall spending, the lack of adequate controls can promote a culture that is contrary to the stewardship imposed on the district as a public agency. At the time of our review, the district did not have written accounting procedures to direct staff on processing of vendor and travel payments. As a result, we observed multiple deficiencies in the approval of purchases of goods or services in the 114 payments we reviewed. Furthermore, the board approved $7,700 in travel reimbursements but could not provide evidence that the travel promoted the district's public purpose. In addition, the district's Administrative Code (district code) defines reimbursable travel costs as those that are necessary and reasonable but without specifying dollar limits. We observed reimbursements for lodging up to $280 per night in Sacramento, where more moderate lodging is readily available. The district code also fails to specify which types of expenditures it believes promote the public purpose of the district and which types it considers an unacceptable gift of public funds.

Lastly, the district has not fully complied with the reporting requirements of the water code. The water code states that the district must present in its audited financial statements a list of its capital improvement projects and their funding sources, as well as a report on the propriety of the district's operating expenses. However, in its fiscal year 2000–01 financial statements, the district provided inaccurate and incomplete information about its capital improvement projects, and it failed to include the required report on its operating expenses. As a result, interested parties could not use these statements as a source of reliable information regarding the district's operations.

THE DISTRICT HAS NOT MANAGED ALL OF ITS CONTRACTS EFFECTIVELY

Due to its lax contract management, the district has paid for services without a contract or that were outside the scope of existing contracts.

We reviewed the district's payments to 22 consultants that provided it with professional services and found a number of weaknesses in its administrative practices. For example, the district has at times paid for services that are not included in the scope of its contracts. The district has not always signed contracts prior to receiving and paying for professional services. It has also maintained contracts that do not state lengths of duration. In light of new statutory restrictions on its contracting practices, it has not renegotiated its old contracts to reflect the current requirements of the law. By disregarding the scope of services in its contracts or failing to sign contracts, the district

loses the opportunity to clarify the rights and responsibilities of the contracting parties, and thus it cannot objectively evaluate or control the costs of the services it receives. Moreover, because the district does not regularly review its contracts or consistently enforce their terms, it cannot be certain that it receives all the services specified and that the services it receives correspond to the fees it pays.

The District Has Paid for Services Not Covered Under Contracts and Has Failed to Enforce All the Terms of Its Contracts

The district paid one of its general counsels and a consultant for services that were outside the scopes of their contracts. It paid the general counsel almost $112,000 during 2001 for the services of a public relations firm, even though the general counsel's contract did not include public relations in its scope or authorize the hiring of subcontractors. The district said that the public relations firm was hired to perform litigation support. However, the firm also distributed at least five general purpose press releases during this time, indicating that its services went beyond litigation support. In addition, the district paid a consultant $10,000 in 2001, in part for participating in the selection of the new general manager, even though the consultant's contract was for strategic planning with respect to budget, capital projects, and other related matters. In both the case of the consultant and the general counsel, the district did not receive the types of services it originally negotiated for and had inadequate control over the services it did receive.

The district paid one of its general counsels almost $112,000 during 2001 for services provided by a public relations firm, even though the general counsel's contract did not include public relations in its scope or authorize the hiring of subcontractors.

Also, in our 1999 report, we noted that the district paid many vendors for services for which no contracts existed. In our review of its recent payments, we found that in 2001 the district paid two consultants a total of $17,370 without signing contracts defining the tasks the consultants were to perform and the rights and responsibilities of the parties. Specifically, the district paid a legal consultant $16,410 for arbitration services related to litigation against it and its directors. The district stated that because the consultant provided this service before the enactment of the law requiring written contracts, no contract was needed. Furthermore, the district said this service was for litigation support and thus was not subject to its district code procurement policy. However, the district code in effect at the time required all contracts for professional services to be in writing. In addition, during 2001 the district used an unwritten contract to pay its fiscal year 1998–99 auditor $964 to file a required report with the State Controller's Office for fiscal year

1999–2000. As of January 1, 2001, an amendment to the water code specifically requires the district to write contracts with vendors for all professional services, regardless of price. A written contract provides the vendor specifics about what the district envisions and gives both parties the terms and conditions that both understand and agree to, removing the potential for dispute.

The district paid more than $1.4 million in 2001 to six firms on contracts that do not specify the duration of the agreement.

Also, the district's current contracts with three legislative advocacy firms and three law firms do not specify the duration of the agreements. The district entered into most of these contracts between 1998 and 2000, although one dates to 1989. For the six firms combined, the district paid more than $1.4 million in 2001. For the law firms that share a single contract for general counsel services, the district stated that it did not define a fixed term because it faces new and constantly changing legal issues. In place of a duration clause is a clause allowing either party to cancel the contract at will. However, an amendment to the water code, effective January 1, 2001, requires professional services contracts to specify scope, duration, and payment terms at a minimum. The district argued that the contract termination clause can satisfy the requirement to specify duration and that in any case, the contracts are not subject to the statute because they were signed before the statute went into effect. Although the district is correct in stating that prior statutes did not include the current requirements, we believe the current requirements reflect sound management practice for all contracts. Periodically renegotiating its professional services contracts could benefit the district. The expiration of a contract allows the district the opportunity to reflect upon the quality and price of the services it is receiving and to better define the services it requires to meet its changing needs.

The district did not enforce the terms of one of its key contracts. In June 2000 it contracted with a consultant to be the district's interim general manager for six months at a fixed rate of $21,500 per month. The contract also contained a provision that required the interim general manager to provide four written reports at the end of the six-month period: (1) a comparative study of the district's operations to other Southern California water-related agencies; (2) a rolling five-year budget; (3) a rolling ten-year capital improvement program, including cost-benefit analyses and a plan to pay for the capital projects; and (4) recommendations to the board on the need for existing staff positions and consulting contracts. Although the district stated that the interim general manager analyzed staffing needs and developed a budget for fiscal year 2001–02, it could not provide

evidence that it received any of the reports that the contract required. Because it did not monitor the contract, it cannot be certain that it received all of the services for which it paid the consultant.

Further, district staff did not abide by the board's instructions when signing one contract. In 2001 the board awarded a three-year contract totaling $55,000 for annual financial audit services based on proposals it received. The bid it approved included a $10,000 premium in the first year for the auditor to implement newly required reporting standards for financial statements, with lower costs in the second and third years. However, rather than signing the three-year contact that the board had approved, the district's controller entered into a one-year agreement. This did not meet the terms that the board approved, and as a result, the district has no assurance that it will receive the terms of the original three-year proposal. In approving the statutes imposing more stringent contracting requirements on the district, the Legislature determined that it is important for the board to maintain final approval over all contracting. However, the district's lack of compliance renders this intended control ineffective.

Finally, the district does not maintain an adequate file of its contracts. As a result, monitoring its contracts is difficult. For example, we reviewed the district's contract files and found that it had two contracts for general counsel services from different firms. The district stated that it had cancelled one contract when it decided to hire different firms to serve as co-general counsel in 1999. However, the district did not cancel its contract with the old law firm in writing and subsequently paid the attorney for general counsel legal services performed in 2001 based on a contract dating to 1989. Moreover, the district also had at least two open contracts with one of its legislative advocacy firms, each of which required the district to pay a fixed monthly fee of $10,000 to $12,500. Although the district was paying the consultant only $10,000 per month, it may have been potentially liable for paying fees for the $12,500 contract as well.

The District Has Not Regularly Reviewed Its Legislative Advocacy and Public Relations Contracts

The district maintains working relationships with one public relations and three legislative advocacy consultants, paying each a fixed monthly fee ranging from $5,000 to $10,000, plus expenses. During 2001 the district paid these consultants

During 2001, the district paid four consultants a total of $442,000 using fixed monthly fee contracts, but could not provide evidence it received value from the contracts consistent with the fees paid.

a total of more than $442,000, but it was unable to provide evidence that it regularly reviewed its need for the consultants or evaluated whether the value it received was consistent with the fees it paid. In response to our previous audit, the district board stated that it would reassess its needs for these consultants every two months. However, the board last performed this reassessment in October 2000. Although the district's contracts with two of the consultants require them to submit monthly activity reports, the reports it receives are vague, so the district has little written documentation of the consultants' activities. The district stated that the reports are deliberately vague to protect the interests of the consultants and their contacts.

Furthermore, the district pays these consultants flat monthly fees rather than hourly fees. The district stated that a flat monthly fee is the industry standard, but at least one of its consultants offered to work partially on an hourly basis, with a base and ceiling on its total monthly compensation. When we asked the district how it benefited from the fixed monthly fees, it stated that it regularly reviews any contracts it may hold for legislative advocacy services to determine whether the value it receives from those services is consistent with the fee it pays. However, the district could not provide any evidence of those reviews. We believe that without regular reviews of performance, an hourly justification of tasks performed, or a contract expiration requiring an evaluation, the district's relationships with its legislative advocates lack built-in accountability.

The Water Code and the District Code Impose Certain Contracting Requirements That Appear Overly Restrictive

In spite of the lingering weaknesses in the district's management of its contracts, some provisions imposed by the water code and the district code appear too restrictive and may burden the district unnecessarily. In response to our December 1999 audit report, the Legislature placed certain requirements on the district's contracting practices. One added provision of the water code requires that the board president and secretary sign all contracts and other documents that the district enters into. Although this requirement allows the district's board complete oversight of contracting practices, it has the potential of being administratively burdensome for contracts below certain values. The board has tried to alleviate this condition by delegating to the general manager the authority to approve contracts for

less than $25,000; however, that policy is impractical because the general manager cannot approve a contract without the authority to sign it. In fact, during 2001 the interim general manager signed at least three contracts for $10,000 each, and the controller signed a $25,000 agreement, despite not having statutory authority to do so. We believe the board could delegate the authority to approve and sign contracts within certain limits without compromising its oversight of district business. State departments enjoy similar delegated authority from state control agencies.

The district code requires solicitations for bids for most contracts regardless of dollar amount, a process that is not administratively feasible.

Similarly, in response to our audit and the actions of the Legislature, the district enhanced the contracting provisions in its policies by adopting certain portions of the California Public Contract Code into the district code. However, one of these provisions in the district code places burdensome restrictions on the district's contracting practices. Specifically, although the water code does not require bid solicitations for contracts less than $25,000, the district code requires a formal written process for requesting proposals for most contracts and requires board approval of all contract solicitations for professional services, regardless of dollar amount. In addition, the district code requires that the district make reasonable efforts to ensure that it receives at least three bids for the purchase of materials. Although the district code allows for less formal telephone solicitation for purchases under $10,000, it provides no exemptions to the requirement, regardless of the amount of the purchase.

These requirements can cause the district to go through a relatively expensive process in pursuit of relatively inexpensive purchases or services. Requesting proposals for all contracts is not administratively feasible, and district managers do not always follow the policy. For instance, the district entered into at least two contracts, totaling about $20,000, for professional services during 2001 without first obtaining board approval for the contract solicitation. We also observed purchases of materials at small costs, under $1,000, for which the district did not obtain three bids. We believe that the district could benefit from a policy that allows for informal bidding for services contracts under a certain threshold. As a model, the Department of General Services requires state agencies to conduct formal bidding, such as requests for proposals, only for services valued at more than $5,000.

DESPITE AMENDMENTS TO ITS POLICIES, THE DISTRICT COULD FURTHER IMPROVE ITS CONTROLS OVER PURCHASES AND TRAVEL REIMBURSEMENTS

Although it has amended its policies to include the requirements of the water code and certain provisions of the Public Contract Code, the district could further improve its controls over purchases of goods and services, as well as reimbursements to staff, consultants, and board members for travel costs. As a result of its lack of written guidance, the district cannot be confident that staff process purchasing and reimbursements transactions consistently and reasonably. Moreover, it has reimbursed staff for expenses that may not have benefited the district because it lacks a clear policy on what costs are allowable. Although many of these payments are small compared to the district's overall spending, the lack of adequate controls can promote a culture that is contrary to the stewardship imposed on the district as a public agency.

The District Lacks Written Purchasing Procedures and Has Not Adequately Enforced Its Existing Policies

At the time of our audit, the district lacked written accounting procedures to govern cash disbursements and purchasing. This lack of standardized procedures has led to inconsistent practices and insufficient managerial control over purchase and payment approvals—in fact, at the time of our review, the district had no formal requirement that managers pre-approve purchases. In our review of 114 payments that the district made in 2001, we observed multiple deficiencies in payment approvals. In addition, the district paid one vendor about $28,500 in advance for printing and mailing services, not including postage. The district's invoice approval process failed to catch that the invoices included services that had not yet been provided, and although the district eventually did receive the services it paid for, it received no benefit for paying in advance. When we brought these weaknesses in controls to the district controller's attention, he initiated written purchasing and disbursement procedures that, if followed, appear adequate to strengthen the district's controls.

Our review of 114 district payments to vendors revealed the following weaknesses:

- 16 payments were for invoices that had not been approved.
- 11 payments were approved by persons without the appropriate authority or were requested and approved by the same person.
- 3 payments did not indicate whether the merchandise ordered was received.

The district has not always ensured that the costs its directors incur for conferences and travel are reasonable and necessary, as the district code requires. Consequently, the district may not be benefiting from all of the conference and travel costs

It is questionable that the district received benefit from some conference and travel costs it reimbursed.

it reimburses. For example, it reimbursed two of its directors a total of more than $7,700 for travel and conferences without documentation of the reasonableness of their expenses and the benefit of the trips to the district. One director's trip to New York City for a seminar on measuring investment performance cost the district $4,210. Although the purpose of the trip was ostensibly to gain knowledge that would aid the district in selecting an investment manager for its reserve funds, the trip took place in a period when the district projected its cash balances to decline dramatically and its need for an investment manager was questionable. In addition, the district reimbursed the director for these travel expenses even though it did not pay any registration fees for the seminar. Although the director signed in at the private club where the seminar was held, the seminar provider had no record of his registration or attendance. The director said he attended the seminar but missed portions of it and disposed of the class materials. Another director attended the annual conference for the American Association of Blacks in Energy in Hartford, Connecticut, at a cost to the district of more than $3,500. The district could not provide information about how this conference was related to water replenishment or how the director's attendance at this conference benefited the district. We found no record that the board attempted to determine whether such travel expenses were reasonable and necessary before approving the trips.

In addition, the district has not adequately controlled reimbursements to managers, directors, and consultants for travel and meal expenses. The district's policy states that employees can be reimbursed for travel and meal expenses only outside a defined local area. Meals that employees purchase for others may be reimbursable as long as those meals reasonably further the district's business interest. The policy also states that requests for expense reimbursement must be submitted within 90 days. However, in one payment made in March 2001, the district reimbursed its interim general manager $915 for local meals purchased over a nine-month period, even though his contract provided only for reimbursement of reasonable travel expenses and specifically excluded all other out-of-pocket expenses. The district also reimbursed one director for meal expenses totaling $126, in excess of the established limits of $75 per day. The district's administration manager stated that this reimbursement exceeded the daily allowance because the director took a district supplier to lunch; however, the reimbursement request showed no evidence of this. The district reimbursed other consultants nearly $3,000 without obtaining

the business purpose of the expenses. For example, during 2001 the district reimbursed a public relations consultant $1,936 for expenses (in addition to a $10,000 monthly retainer fee) when the claims the consultant submitted did not specify the business purpose of the expenses.

The District's Administrative Code Could Provide Better Guidance on Procurement

The district's policies continue to omit some critical elements of contracting practices that we identified in our previous report. Specifically, the district code does not prohibit staff from writing requests for proposals that effectively limit bidding to one bidder or altering requirements that could affect the evaluation of the bids after the district issues final requests for proposals. Either of these actions could unfairly shift the selection process to the favor of a preferred bidder. In addition, the district code broadly exempts certain contracts, such as those for retaining expert witnesses to provide consulting or testimony, from its procurement policy. Although the water code exempts these types of contracts from requirements governing the solicitation of bids, the contracts should still be subject to other provisions of the district procurement policy. For instance, such services should require written contracts, consistent with the water code.

By providing more specific guidance on allowable and unallowable expenditures, the district could ensure that its funds are used in ways that further its public purpose.

In addition, by providing more specific guidance to staff on allowable and unallowable expenditures, the district could ensure that it uses the funds in ways that further its public purpose. However, the district code is silent on the board's position as to which types of expenditures promote the district's public purpose. For example, during 2001 the district spent more than $500 for flowers for employees, directors, and nonemployees; it also spent almost $3,500 for its annual holiday party. The district stated that it views these expenses as reasonable because they support the public purpose of effective district management and maintain employee morale. However, we did not find a district policy that establishes a reasonable basis for its position, and as a result, we believe that these payments are gratuities and thus a gift of public funds. The district also paid $2,000 to cosponsor a dinner at the National League of Cities annual conference in Boston, Massachusetts. The district justified the cost by stating that many Los Angeles-area cities had representatives at the event, but otherwise it could not demonstrate how the expense furthered its public purpose, nor could it provide evidence that the board considered the necessity and reasonableness of the expense before approving it.

The district continues to lack adequate guidance on travel expense reimbursements.

Finally, as we noted in our previous report, the district code does not provide adequate guidance in its travel reimbursement policies. Rather than specifying dollar limits for lodging expenses, it requires only that the lodging be moderate and necessary. The district code also does not identify the types of expenses that are not valid business costs and that it will not reimburse, such as personal telephone expenses or in-room movies. A more prudent policy would identify allowable and unallowable expenses, require travelers to seek government rates for lodging, and limit reimbursements for lodging to a specific dollar amount without written justification for the higher cost. Further, the district's accounting policies do not require matching travel reimbursements to approved travel documents. Such matching would be a simple control to ensure that the district pays only for authorized travel and does not duplicate payments for airfare.

In the absence of adequate policies and procedures, the district paid room charges of $260 to $280 per night for hotel stays in Sacramento, where less expensive lodging is widely available. We also observed one instance in which the district paid for the same airfare twice: once when district staff made reservations for an employee by purchasing a nonrefundable ticket for the trip and a second time when it reimbursed the employee for making a separate reservation. The district is currently unsure it will receive credit for the cost of the unused airfare. In addition, the district reimbursed the same employee $139 for lodging without a receipt. In place of a receipt, the employee submitted a reservation confirmation from the hotel.

THE DISTRICT HAS NOT FULLY COMPLIED WITH MANDATED REPORTING REQUIREMENTS

Amendments to the water code require that, effective January 1, 2001, the district present certain information regarding its capital improvement projects in its annual audited financial statements and that it also include a report from its independent auditor evaluating the propriety of its operating expenses. The Legislature's intent was to ensure that the district adequately communicates with and responds to the needs of its constituents. However, the information concerning its capital improvements included in the district's June 30, 2001, financial statements was inaccurate and incomplete, and these lacked the required report describing its operating expenses. Moreover, its calculation of the level of reserve funds at that time—which it voluntarily included—was also incorrect.

The District Presented Inaccurate Information About Its Capital Improvement Projects and Accumulated Reserve Funds in Its Financial Statements

The district's financial statements for the year ending June 30, 2001, contained an incorrect and incomplete list of capital improvement projects and their related costs.

The district's financial statements for the year ending June 30, 2001, contained significant errors in the presentation of its capital improvement projects because it did not ensure that its independent auditor received the most current information on the projects' expected costs. The list of capital improvement projects included in the financial statements was flawed in two ways. First, the list that the district provided to the auditor came from a draft of the fiscal year 2001–02 budget rather than from the final version, and the two lists differed both in the projects listed and in their projected costs. According to the district's controller, the district gave the auditor the earlier version, and the auditor apparently relied on the district's assertions that the list was current. However, the final budget numbers were available in April 2001, two months before the end of the fiscal year, which should have left adequate time for the district to provide the auditor with the correct information. The differences between the list in the footnotes to the audited financial statements and the correct list of capital improvement projects that project managers prepared for the fiscal year 2001–02 budget caused an overstatement of about $3.6 million in project costs. One project was incorrectly omitted from the financial statements, and two others were incorrectly included in the financial statements but not listed in the capital budget. Additionally, notes to the financial statements showed the largest project at a projected cost of $12.8 million, but its cost was $10.7 million in the final budget.

Second, the financial statements did not identify the source of the funds that the district plans to use to complete each capital improvement project, despite the fact that the water code requires it to do so. The district can currently fund capital improvement projects in two ways: either by using existing reserve funds or by increasing the assessment for replenishment or clean water projects in future years.

Although the water code limits the amount of reserve funds the district may accumulate, it does not require the district to disclose its compliance in its audited financial statements. In its June 30, 2001, financial statements, the district voluntarily included a calculation intended to show that it complied with the water code's restrictions. To calculate reserve funds in accordance with the requirements of the water code, the district

should reduce its net assets—which consist primarily of its total assets reduced by liabilities and amounts it has invested in capital improvement projects—by any amounts it plans to keep for future capital improvement projects. However, the district erred in its calculation in three ways. First, it began its calculation with its cash balances, rather than net assets, thus overstating its reserve funds by more than $840,000. This approach is incorrect because cash that is already committed to existing liabilities is not available, and this approach ignores the district's other assets. Second, the district reduced its cash balances by using the inaccurate list of capital improvement projects included in the audited financial statements, which we described above. Finally, it reduced its cash balances using the total budgeted costs to complete the projects rather than the portion of the budgeted costs that it estimated would come from its current reserve funds.

Using this flawed method, the district presented its reserve funds balance at $8.9 million and incorrectly pronounced itself in compliance with the water code's restrictions. We calculated the correct balance to be $12.9 million, which means that the district's financial statements understated the amount by $4 million. Although this exceeds the water code's limitation of $10 million in reserve funds for fiscal year 2000–01, the district has properly applied the excess to capital improvement projects and water purchases in its fiscal year 2001–02 budget.

The District's Financial Statements Did Not Contain a Report on the Propriety of Its Operating Expenses as the Statute Requires

The district's June 30, 2001, audited financial statements did not contain a report on the propriety of its operating expenses, as the water code mandates, in part because the district did not expressly instruct its independent auditor of the requirement. The board's resolution approving the contract with the independent auditor did not specify that the auditor provide a report on the propriety of operating expenses. The district's controller considered that a financial audit conducted under generally accepted government audit standards would satisfy the requirement. However, we disagree with the district's position. The water code is clear in stating that a report on the propriety of the district's operating expenses must accompany its audited financial statements. As such, generally accepted auditing standards require the auditor to prepare a separate report. At

a minimum, the independent auditor could offer negative assurance in the standard audit report by attesting that no improper operating expenses came to its attention in the course of its audit.

RECOMMENDATIONS

To ensure that it maintains the proper level of control over the services it receives from various consultants, the district should improve its contract management procedures by taking the following steps:

- Develop scope-of-services provisions for its contracts that clearly define the tasks it requires from contractors and provide the district with clear criteria for evaluating the contractors' performance.
- Ensure that the district and professional services contractors sign a written agreement.
- Specify a duration that identifies a starting point and ending point in all contracts.
- Ensure that it enters into contracts that are consistent with the board's directions and that contracts are signed only by those authorized to do so.
- Separate contracts into active and inactive files to facilitate easier identification of the contracts under which it may have obligations.

The district should renegotiate existing contracts so that they are consistent with current minimum standards that the Legislature mandates, which require scope-of-service, duration, and payment terms.

The district should assign staff of appropriate levels to serve as contract managers. Their responsibilities should include monitoring the contractors' performance and ensuring that the district receives all of the services and products that the contracts specify.

The district should implement procedures to periodically evaluate any contracts that require fixed monthly fees to ensure that it receives services in keeping with the fees it pays.

To allow more efficient contracting practices, the district should seek legislation to amend the water code to provide the board with the authority to delegate the approval and signing of contracts below certain dollar thresholds to the district's general manager.

The board should further amend the district code through the following actions:

- Make it consistent with the requirements of the water code.
- Relax its requirement for written requests for proposals for bids for all service contracts under $25,000 and expand its informal bid policy to cover purchases of services that fall under the new threshold for formal competitive bidding.
- Exclude small purchases of materials from its informal bid solicitation process.

To better control its administrative costs, the district should continue its development and implementation of written accounting procedures. It should ensure that these procedures require it to do the following:

- Delegate spending authority to ensure that management approves purchases of goods and services exceeding a specific threshold before obligating the district.
- Allow only authorized managers to approve payments to vendors or consultants.
- Maintain documents that demonstrate efforts to ensure that the district receives value for purchases that do not require formal bidding.

Before approving reimbursement for travel or conference costs for its members, the district's board should ensure that the travel or conference will benefit the district's public purpose.

The district should amend the district code to provide the following:

- Requests for proposals that do not effectively eliminate bidders. In addition, it should prohibit altering material factors that could affect the evaluation of bids after it has issued final requests for proposals.

- Better guidance to district staff on allowable and unallowable expenses. Specifically, the board should adopt a policy regarding the types of expenses it believes promote the public purpose of the district.

- Better guidance for reimbursable lodging expenses, including dollar thresholds and a process for justifying charges in excess of those thresholds.

- A policy ensuring that it holds contractors to the same reimbursement guidelines as district staff.

To provide reliable information on its operations as the Legislature intended, the district should take the necessary steps to ensure that it complies with the reporting requirements of the water code. It should include in its audited financial statements an accurate and complete list of its capital improvement projects and their funding sources as well as a report on the propriety of the district's operating expenses. In addition, the district should ensure that it accurately calculates any disclosure of reserve funds it includes in its audited financial statements.

We conducted this review under the authority vested in the California State Auditor by Section 8543 et seq. of the California Government Code and according to generally accepted government auditing standards. We limited our review to those areas specified in the audit scope section of this report.

Respectfully submitted,

ELAINE M. HOWLE
State Auditor

Date: May 23, 2002

Staff: Nancy C. Woodward, CPA, Audit Principal
Norm Calloway, CPA
Peter A. Foggiato III
Kenneth Louie
Christopher Lief

APPENDIX

A Summary of the District's Progress Toward Implementing the Bureau's 1999 Audit Recommendations

The Bureau of State Audits (bureau) made a variety of recommendations to the Water Replenishment District of Southern California (district) in its December 1999 report. The table shows the bureau's recommendations and the district's progress implementing those recommendations.

Recommendations	District's Progress
The district should amend the way it determines its assessment rate to require that prior year estimates be compared with the actual cost of the replenishment water it purchased. If the amounts collected exceed the amounts spent to purchase water, the surplus should be used as carryover to reduce the assessment rate in the subsequent year.	Implemented. For its fiscal year 2001–02 budget, the district included its carryover balance of reserve funds in its calculation of the subsequent year's rate assessment. This action is permanently required by an amendment to the California Water Code (water code) enacted in 2000.
The district's board of directors (board) should reassess its policy regarding a prudent reserve and reduce its target reserve to $10 million to more closely reflect its budgeted operations.	Not fully implemented. The district has reduced its reserve fund balance but has not developed a policy regarding a prudent reserve. The district expects to finish the current fiscal year with a reserve of slightly more than $6 million, substantially below the $10 million maximum mandated by law.
To improve the development of the clean water portion of its assessment rate, the district should implement a process for comparing revenue collected and project expenditures during the previous year. Amounts collected but not spent on clean water programs should be carried over to reduce the subsequent year's assessment rate.	Implemented. For its fiscal year 2001–02 budget, the district considered its carryover balance of reserve funds in its calculation of the subsequent year's rate assessment. This action is permanently required by an amendment to the water code enacted in 2000.
To improve the means by which it determines the capital expenditure portion of its assessment rate, the district should determine the amount each capital project contributes to the annual rate. The board's resolution adopting the rate should specifically reference these amounts.	Not fully implemented. For the fiscal year 2001–02 budget, the district identified the total portion of the assessment rate attributable to capital improvement projects. However, it did not itemize the projects and their costs. The district listed capital improvement projects and their estimated costs in the budget but did not state their effect on the district's assessment rate.
The district should implement and refine a long-term capital projects plan.	Not implemented. The district has not implemented a long-term plan, although it is in the process of doing so.

Recommendations	District's Progress
The district should standardize its policies and practices for preparing cost-benefit analyses and for budgeting capital projects.	Not implemented. The district does not have a standard method for selecting projects that identifies their technical, legal, and financial risks and ensures that all the necessary agreements are in place before it begins construction. It also does not have a standard process for performing cost-benefit analyses of potential projects.
Regarding the Alamitos project, the district should reevaluate the feasibility of this project using a cost-benefit analysis that includes a more reasonable assumption of future water costs.	Not fully implemented. The district continues to disagree with our recommendation. It has reevaluated the Alamitos project, but it did not use Metropolitan Water District of Southern California (Metropolitan) forecasted rates. Rather, it used an annual inflation rate to forecast the future price of water. The current Metropolitan rate continues to be consistent with Metropolitan's forecasted rates.
The district should move expeditiously to petition the court to clarify the water rights issues related to the desalter project since the subsidy from Metropolitan is dependent on this action.	Implemented. The court ruled that the district may remove water that contains chlorides in excess of 1,000 parts per million. The ruling may affect the district's ability to continue operating the desalter without further expense because the desalter has not yet pumped water with chlorides in excess of 1,000 parts per million.
The district should continue to work with other water agencies in the region to identify basin priorities and to delegate responsibilities for each activity to a lead agency.	Implemented. The district's process for developing its strategic plan has incorporated outreach to representatives from other water agencies in the region in an effort to reduce or avoid duplication of effort. As the water code required, the district also included the Technical Advisory Committee, made up of representatives of the district's ratepayers, in its proceedings.
To strengthen controls over its administrative expenses, the district's board should take the following actions:	
Reaffirm its commitment to following the policies in its Administrative Code (district code) and ensure that its staff abides by its policies.	Not fully implemented. The district does not always follow its procurement policy and travel reimbursement policy and in addition, does not hold contractors to the same reimbursement policy for travel and meals as staff.
Amend and expand the district code to incorporate additional guidelines related to contracting policies and procedures and limits on the expenses it will reimburse.	Not fully implemented. The district updated its code, but it contradicts statute by allowing the general manager to approve contracts and exempting certain services from the procurement policy that are not exempted by the water code. Also, the district code provides little guidance on expenditures the district will reimburse.
Ensure that a valid contract is in place before paying for contracted services.	Not fully implemented. The district's board acted to require that a valid contract be in place before it authorizes payments for services. However, the district does not have written contracts with all its vendors. For example, through its general counsel, the district paid a consultant about $112,000 for "litigation support" without a contract.
Require that all travel expenses be supported and matched to approved travel documents.	Not fully implemented. The district requires that all expenses are supported, but it does not consistently match these expenses to approved travel documents.

Recommendations	District's Progress
Limit reimbursements to travel within a specific geographic area or require that travel out of the geographic area be brought before the board for specific action.	Implemented. The district now limits reimbursed travel to a specific geographic area and requires board approval for travel outside that area. We found, however, that the district has sometimes reimbursed contractors for local meals with district staff.
Direct its independent auditor, as part of its annual audit, to review the propriety of the district's operating expenses.	Not implemented. The district contends that its financial audit covers this requirement, but we see no evidence of such a review in the audit scope, audited financial statements, or the district's request for proposals for audit services. Further, the audited financial statements for fiscal year 2000–01 did not contain a report on the propriety of the district's operating expenses, as the statute required.
Reassess the need for 10 legislative and public advocacy firms.	Not fully implemented. The district has reduced its legislative advocacy firms to three. According to the district, it reassesses its need for advocacy firms every two months and adjusts its need based on the nature and extent of legislative activity. However, we found that the district's last formal evaluation occurred in October 2000. Moreover, its legislative advocacy firms have contracts with no defined term of duration.

Agency's comments provided as text only.

Water Replenishment District of Southern California
12621 E. 166th Street
Cerritos, California 90703

May 9, 2002

Elaine M. Howle, State Auditor*
Bureau of State Audits
555 Capitol Mall, Suite 300
Sacramento, CA 95814

Dear Ms. Howle:

The Water Replenishment District of Southern California (WRD or District) is pleased to comment on the May 2002 report of the Bureau of State Audits. The findings and recommendations differ markedly from the December 1999 State Audit report and in summary indicate substantial improvements in the administrative, financial, and management performance of the WRD.

Whereas the 1999 report was critical of the District's level of assessment and excess reserves, the current report cautions that the District's assessment may be too low and that its reserves may be insufficient. The balancing act required to simultaneously maintain an adequate assessment and a prudent reserve is an ongoing challenge. It is a complicated part of the District's job, inasmuch as both are set at a fixed time each year to anticipate unknowable conditions that subsequently develop during the year. While we acknowledge that there is no perfect formula that can apply each and every year, we nonetheless believe that the balance now is substantially better from a public policy standpoint than that noted in the December 1999 report.

Before we address the specific recommendations contained in the 2002 report, the WRD would like to focus on the important challenges that face the District in the upcoming years, challenges that the auditors expressly recognize in the 2002 report. For example, the quantity of groundwater stored in the Central and West Coast groundwater basins has declined by more than 110,000 acre feet over the last three years (p. 28)†. Exacerbated by the extraordinarily low rainfall experienced during the past winter, this precipitous decline in groundwater levels stands in stark contrast to the fifteen percent increase in total water use over the past years (p. 28)†. Yet, the District's financial state, arising from a low assessment rate and depleted reserves, makes the task of correcting this dangerous condition all the more difficult. In the words of the auditors, "the trend towards increased water use in the basins combined with the district's weakened financial condition should be a cause of concern." (p. 30)†. Thus, the District looks forward to completing its studies

* California State Auditor's comments appear on page 71.

† These page numbers refer to an earlier draft of the report.

as to the optimal level of groundwater stored in the basins and to reevaluating the amount of reserves that the District must maintain to achieve that groundwater level. The District will then work with stakeholders and, if necessary the Legislature, in implementing the necessary and appropriate action plan.

Another challenge that lies ahead for the WRD is the development and implementation of a refined and improved strategic plan for proposed capital projects. As noted in the 2002 report, these projects are aimed at "increasing the reliable supply of clean groundwater in the basins." (pp. 3-4.)[†] The successful development of such projects typically requires a variety of planning and financing tools. Some of those tools have not been available to the District over the past two years due to legislation that prohibited the District from incurring debt, raising its assessment rate to a level necessary to fund such projects, and employing other public financing mechanisms. These prohibitions have left the WRD in the precarious position of having to choose, for the upcoming fiscal year, between purchasing replenishment water and continuing existing groundwater quality and supply projects and programs. The District looks forward to beginning the long process of remedying this undesirable situation once these statutory restrictions expire at the end of 2002.

The 2002 report raises a number of administrative shortcomings on the District's part. The WRD will, in earnest and good faith, attempt to correct any such deficiencies and believes that it will enjoy greater success in that regard than has occurred over the past two years. The District holds this belief because, unlike past years, it should be able to devote its limited resources to improving its administrative systems as opposed to responding to the numerous lawsuits that a small group (eight) of its over 140 ratepayers litigated over the past three years. (Those lawsuits have all been dismissed or adjudicated in the District's favor.)

Finally, the District wishes to provide the most current data on two projects – the Goldsworthy Desalter project and the Alamitos Barrier Recycled Water project. To date, at the Goldsworthy Desalter, the chloride levels of water samples drawn from the project are 820 parts per million (see Exhibit 1), bringing the chlorides closer to the compromised operating level. Additionally, continuous conductivity data shows a consistent trend of increasing salt content. Based on this data, WRD anticipates that the 1,000 parts per million operating criteria can be achieved within the ensuing fiscal year, which would allow the Desalter to be operated with no additional capital costs or increased operating costs. Regarding the Alamitos Barrier Recycled Water project, the District has reached an oral agreement with the County of Los Angeles to resolve the third-party compensation issue, and anticipates a finalized agreement within three months.

The 2002 report makes ten summary recommendations (pp. 8-11)[†]. The WRD takes no exception to any of them. In fact, many of the recommendations are already in place and the District will seek to implement the balance of the recommendations within the upcoming fiscal year. Specifically,

1. A policy will be presented to the District's Board of Directors concerning the minimum reserve funds necessary to meet its statutory responsibilities. In addition, the District will determine what assessment rate is required to maintain an adequate reserve balance.
2. The District has established target groundwater levels for specific areas of the basins. As recommended, the District will develop optimum and minimum quantities of groundwater storage in the basins that correspond to these target levels.
3. The District agrees with the State Auditor that the Water Code should allow more flexibility to adjust assessment rates to match determined needs.
4. The District has already implemented a comprehensive process to develop the FY 02-03 budget. The improvements arising from this new process are listed in the 2002 report.
5. The District is in the process of updating its strategic plan from which a 5-year capital improvement plan will be developed with stakeholder involvement.
6. The District will develop a standardized approach to identify technical, legal, and financial risks related to proposed capital improvement projects.
7. The District remains committed to strengthening its contract management procedures. As suggested by the Auditors, the District will consider seeking legislative relief to amend the Water Code to allow more efficient contracting practices.
8. The District will continue to develop, update, and implement accounting policies as recommended in the report.
9. The District will further amend its Administrative Code to ensure consistency with relevant state Water Code provisions. In particular, the District will work to update its Code to provide clear guidelines on allowable expenses and define appropriate reimbursable lodging expenses. Furthermore, the District will apply these same reimbursement policies to its contractors.
10. The District is committed to ensuring accurate reporting in its independently audited financial statements.

The WRD values the input it has received from the audit team during the audit process. The team provided many useful suggestions that the District was able to implement even before the publication of this report. This has resulted in further refinement and improvement of our administrative, financial, and management processes and procedures.

As a regional groundwater management agency, the Water Replenishment District is committed to working cooperatively with our stakeholders including municipalities, water agencies, regulators, and the Legislature to ensure that the residents of south Los Angeles County continue to receive a reliable supply of safe drinking water. Please feel free to call WRD General Manager Bruce Mowry or me if we can be of any assistance.

Sincerely,

(Signed by: Leo J. Vander Lans)

Leo J. Vander Lans
President

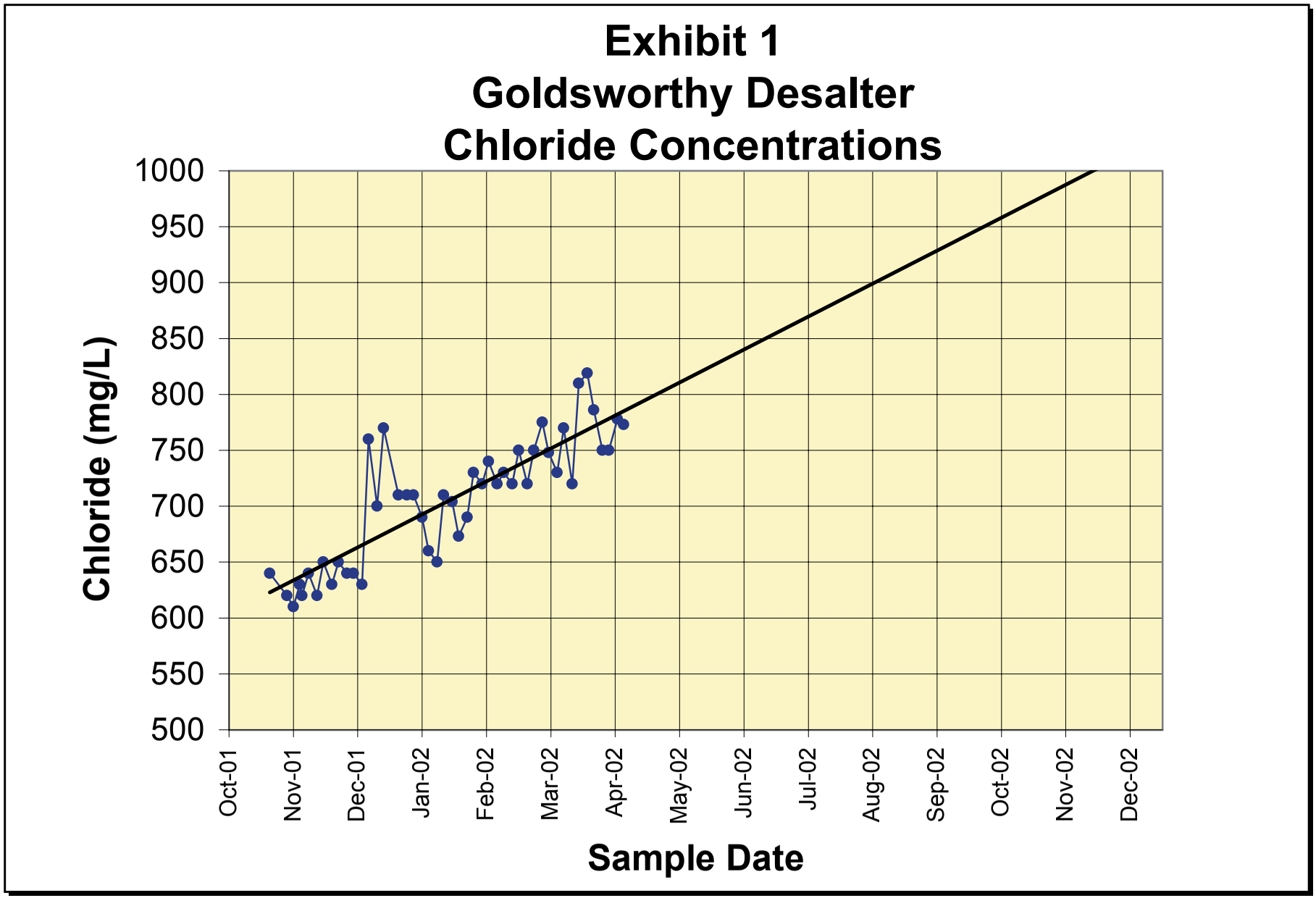
Exhibit 1
Goldsworthy Desalter
Chloride Concentrations
Chloride (mg/L)
1000
950
900
850
800
750
700
650
600
550
500
Oct-01
Nov-01
Dec-01
Jan-02
Feb-02
Mar-02
Apr-02
May-02
Jun-02
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Nov-02
Dec-02
Sample Date

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COMMENTS

California State Auditor's Comments on the Response From the Water Replenishment District of Southern California

To provide clarity and perspective, we are commenting on the Water Replenishment District of Southern California's (district) response to our audit report. The numbers correspond with the numbers we have placed in the response.

1. Although the district has made some improvements in its operations over the last two years, the findings and recommendations in this report share a common theme with our 1999 report. Specifically, the district continues to have weaknesses in its policies and procedures that affect its ability to appropriately set its assessment rate, plan and develop capital projects, and control its administrative costs.

2. The district overstates the role of restrictions on raising funds placed on it by legislation in creating its weakened financial outlook for the upcoming year, and understates its own role. As we state on page 17 of our report, the district's lack of a long-term vision for its finances has led to poor management of its reserve funds and of the replenishment assessment it charges ratepayers. The legislative restrictions which are set to expire after December 31, 2002, have prevented the district from immediately recovering financially from its past decisions.

cc: Members of the Legislature
Office of the Lieutenant Governor
Milton Marks Commission on California State Government Organization and Economy
Department of Finance
Attorney General
State Controller
State Treasurer
Legislative Analyst
Senate Office of Research
California Research Bureau
Capitol Press