California State Auditor

BUREAU OF STATE AUDITS

California's Independent Water Districts:

Reserve Amounts Are Not Always Sufficiently Justified, and Some Expenses and Contract Decisions Are Questionable

June 2004
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CALIFORNIA STATE AUDITOR

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June 24, 2004 2003-137

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 requested by the Joint Legislative Audit Committee, the Bureau of State Audits presents its audit report concerning our review of independent water districts—a type of special district—and their policies and procedures for accumulating and using cash reserves, for providing benefits and compensation to directors, and for conflicts of interest. This report concludes water districts do not always have sufficient policies guiding the accumulation and use of resources. As of the end of fiscal year 2002-03, the eight water districts we visited had accumulated resources, commonly known as reserves, totaling $485 million, an amount that would be sufficient to cover their total annual expenses for about 2.2 years. However, we acknowledge that water districts will ultimately use these resources for various purposes, not all of which will be to cover operating expenses. We did not conclude that these accumulations are excessive. However, five of the eight water districts might have trouble defending to ratepayers and taxpayers the need for some portion of their accumulated resources because either they had no reserve policies or the policies they do have are weak. Regarding reserves held by special districts, an opinion from the Office of the Legislative Counsel stated that the Legislature cannot lawfully enact a statute that would transfer to the State's General Fund money in a special district's reserve fund and allocate those moneys for a purpose other than that for which the special district was created.

Further, some directors' expenses did not appear to be a reasonable and necessary use of public funds. Our review of expense records found that three of the eight water districts paid attendance or similar fees for their directors' participation in events such as retirement, anniversary, and holiday celebrations; social mixers; and chambers of commerce functions. In some instances, these water districts paid their directors a stipend for attending the events and paid for the directors' spouses to attend. Moreover, one water district appeared to be overly generous in the amounts it paid for some directors' meals, paying almost $18,000 for meals on 15 different occasions attended by directors and others. Also, one water district did a much better job than did the others of disclosing reimbursements for individual expenses made by its directors as required by law, thus enabling ratepayers and taxpayers to more easily see the purposes and amounts of these reimbursements. Finally, we noted that one water district director made questionable decisions in which she had financial interests in apparent violation of the State's conflict-of-interest laws.

Respectfully submitted,

Elaine M. Howle

ELAINE M. HOWLE
State Auditor

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SUMMARY

Audit Highlights . . .

Our review of independent water districts revealed the following:

- ☑ *Five of the eight water districts we visited may have trouble defending to their ratepayers and taxpayers the need for some portion of their accumulated resources.*
- ☑ *The Office of the Legislative Counsel has opined that the Legislature cannot lawfully enact a statute that would transfer to the State's General Fund money in a special district's reserve fund.*
- ☑ *Three of the eight water districts paid attendance or similar fees for their directors' participation in events that the districts could not demonstrate were reasonable and necessary.*
- ☑ *One water district did a much better job than did the others of disclosing reimbursements for individual expenses by directors.*
- ☑ *A director at one water district made questionable decisions in which she had financial interests in apparent violation of the State's conflict-of-interest laws.*

RESULTS IN BRIEF

Water districts do not always have sufficient policies guiding the accumulation and use of resources. Lacking such policies, commonly referred to as reserve policies, water districts might have difficulty demonstrating to ratepayers and taxpayers how some of the accumulated resources serve public purposes. As of the close of fiscal years ending in 2003, the eight water districts we reviewed had accumulated resources totaling $485 million, an amount that would be sufficient to cover their total annual expenses for about 2.2 years. However, we acknowledge that water districts will ultimately use these resources for various purposes, not all of which will be to cover operating expenses. Resources held by the eight water districts to meet externally imposed restrictions would cover expenses for six months, while resources designated to meet specific district needs would cover expenses for about 17 months. The remaining balance would be sufficient to cover expenses for more than three months and could be used for other purposes, including rate reduction. We did not conclude that these accumulations are excessive. However, five of the eight water districts we visited might have trouble defending to ratepayers and taxpayers the need for some portion of their accumulated resources because either they have no reserve policies or the policies they do have are weak.

Regardless of how much resources water districts have accumulated, some people have asked whether the State could tap these resources to help it get through its current budget crisis. An opinion from the Office of the Legislative Counsel states that the Legislature cannot lawfully enact a statute to transfer money from a special district's reserve fund to the State's General Fund and allocate that money for a purpose other than that for which the special district was created.

After reviewing the expense records of the eight water districts we visited, we concluded that some expenses for the districts' directors did not appear to be reasonable and necessary uses of public funds. State law provides water districts only general guidance on spending for their directors. Therefore, water districts must enact and execute their own policies to ensure

that the funds they spend for their directors are reasonable and necessary. The policies addressing directors' expenses at some water districts are not always sufficiently specific or constraining.

The expense records of three water districts we visited showed that they paid attendance or similar fees for their directors' participation in dozens of events that the water districts could not demonstrate were reasonable and necessary. Questionable events included retirement, anniversary, and holiday celebrations; social mixers; and chambers of commerce functions. In some instances, water districts also paid their directors stipends for attending the events and paid for the directors' spouses to attend. One water district told us that attending such events gives directors the opportunity to informally discuss many issues with other agencies and community leaders. This water district also pointed out that it encouraged its directors to attend regular meetings of other entities important to its interests to achieve its goal of "maintaining consistent, effective, and open channels of communication." Although the goal appears to have some merit, we question whether the directors' attendance at the events previously described truly represents a reasonable and necessary means to achieve that goal.

We also observed that one water district appeared to be overly generous in the amounts it paid for some directors' meals. Specifically, this water district paid a total of almost $18,000 for 15 meals provided to its directors and others while away from the district. According to information provided by the water district, the number of people attending these 15 meals ranged from six to 29, the number of directors attending ranged from one to four, and the average cost per person for each meal ranged from $62 to $155. If the cost of each of the director's meals was equivalent to the average cost per person, then the estimated total cost to ratepayers and taxpayers for the 40 total instances when the water district paid the directors' share was $3,700.

Further, one water district we reviewed appears to do a much better job than do the others of disclosing the reimbursements it made to directors for individual expenses. Disclosing reimbursements, which is required by law, enables ratepayers and taxpayers to more easily see the purposes and amounts of the reimbursements. This water district periodically issues a document that describes a particular expense, the date the district incurred the expense, and the director who incurred it. The water district also reviews the disclosure document during

a public meeting of its governing board. In their efforts to meet the disclosure requirements, the other water districts use other practices, which include summarizing directors' expenses rather than listing individual expenses and making internal reports available only to those who request it.

Finally, we found that water districts provide their directors with varying levels of training regarding conflicts of interest. We noted that a director at one water district made questionable decisions regarding issues in which she had financial interests, in apparent violation of the State's conflict-of-interest laws. Further, directors from several water districts did not always properly complete the forms, as required by law or district policy, to disclose their personal investments, incomes, business positions, and interests in real property.

RECOMMENDATIONS

To demonstrate that they are using their accumulated public funds to cover reasonable and necessary expenses, water districts should ensure that they have comprehensive reserve policies in place that, at a minimum, do the following:

- Distinguish between restricted and unrestricted net assets.
- Establish distinct purposes for all reserves.
- Set target levels, such as minimums and maximums, for the accumulation of reserves.
- Identify the events or conditions that prompt the use of reserves.
- Conform with plans to acquire or build capital assets.
- Receive board approval and be in writing.
- Require periodic review of reserve balances and the rationale for maintaining them.

The Legislature should consider amending the California Water Code to require all water districts to develop and implement comprehensive reserve policies that include the key elements discussed in this report and outlined in our recommendation to the water districts.

To ensure that all payments to or on behalf of their directors are reasonable and necessary, water districts should adopt and implement policies that are sufficiently specific and constraining.

To clearly inform ratepayers and taxpayers about the nature and amounts of reimbursements paid to directors, water districts should adopt and implement policies to periodically report in public board meetings the specific amounts paid to or on behalf of their directors and the specific purposes of those payments.

To ensure that their directors are better aware of their responsibilities regarding conflict-of-interest requirements, water districts should do the following:

- Provide periodic training related to conflicts of interest.
- Guide directors in completing forms disclosing their economic interests and stress the importance of disclosing all economic interests as required by law or district policy.

WATER DISTRICT COMMENTS

Most of the water districts we visited generally agreed with the bulk of our recommendations. One water district—the Walnut Valley Water District—strenuously objected to nearly everything we mention in the audit report about it and believes that the Bureau of State Audits exceeded the scope of the audit, as determined by the Joint Legislative Audit Committee. ■

INTRODUCTION

BACKGROUND

Water districts are among the more than 50 types of special districts in California. Under the authority granted by various state laws, a local community can create a special district—a form of local government—to meet a specific need, such as mosquito abatement, sewer services and maintenance, highway lighting, or drinking water. Unlike general-purpose governmental entities that have broad powers to act on behalf of citizens, special districts act within limited boundaries and can only perform activities related to the specific purposes for which they were created.

To meet the needs for which they were created, special districts can perform activities that include constructing capital facilities, such as sewer or water systems. To pay for these capital facilities, a special district can use a variety of methods, including debt or pay-as-you-go. The primary factor driving the decision to use debt or pay-as-you-go is whether the special district will have its future customers or its current customers pay for the capital project.

When using debt, a special district can issue general obligation bonds or other types of financing instruments to obtain the money necessary to construct a capital facility. It then uses revenues from future ratepayers or taxpayers to make the debt payments. When a special district uses debt financing, it allocates some of its capital costs to those who will use the facility after it is built. This allows the special district to reduce or avoid tax or rate increases by spreading the facility's cost over the repayment period and, in a growing economy, to more people and to properties with higher assessed values. Special districts that want to avoid increasing their debt can pay for capital projects by using existing spendable assets. This pay-as-you-go approach helps special districts avoid the costs associated with debt, such as interest and debt administration fees. To pay for a capital project under pay-as-you-go, a special district could draw from cash reserves it has built over time or use current-year revenues.

Special districts can be classified in several different ways. In terms of revenue, special districts can be considered enterprise or nonenterprise. Enterprise special districts have customers who pay a rate for the quantity of goods or services they consume

(e.g., drinking water, waste disposal, etc.). Nonenterprise special districts typically are funded by general taxes and assessments and provide goods or services that indirectly benefit the communities they serve. Examples of services provided by nonenterprise districts are flood control and water conservation, street lighting and lighting maintenance, and fire protection.

In terms of governance, a special district can be either dependent or independent. A dependent special district is a subdivision of another government, normally a county or city. In some cases, a special district has a governing board (board) appointed by a county board of supervisors or a city council. An independent special district has its own board whose members, often called directors, are typically elected by voters from the community the district serves.

Special districts are autonomous government entities, accountable directly to the people who elect their leaders and the customers who use their services. The State plays only a minimal role in overseeing special districts. For instance, the State requires special districts to annually report information about their financial activities to the State Controller's Office (controller). The controller compiles the information from special districts and reports the results in the *Special Districts Annual Report*. If the controller believes that a special district has submitted inaccurate information, state law allows the controller to investigate to obtain the required information from that special district.

Water Districts Abound in California

California law authorizes the creation of more than 15 types of special districts that have water-related functions. For our audit, we included the nine types of special districts that have water in their names and which the controller groups under codes 41 to 49 in its *Special Districts Annual Report*. These types include California, County, and Municipal water districts. Appendix A briefly describes these nine types of water districts. According to data provided by the controller and used for compiling its *Special Districts Annual Report* for fiscal year 2001–02, there were 445 districts in these nine types as of December 2003. We excluded from the scope of this audit the 1,097 special districts that perform other water-related activities—for example, reclamation, flood control and water conservation, and levee districts—because we recognized that including too many diverse types of special districts could limit the conclusions we could draw from our analysis.

Water Districts Have Been Subject to Ongoing Criticism

In recent years, water districts have been subject to scrutiny from a variety of entities because of their perceived shortcomings. For example, from 2001 to 2004, several newspaper articles have criticized specific water districts, citing concerns about seemingly excessive spending for directors' stipends and travel, bribery investigations, inappropriate hiring practices, and other types of alleged corruption.

The Bureau of State Audits (bureau) has also been critical of individual water districts. In April 2001, the bureau concluded that the Central Basin Municipal Water District had ignored lower estimates of the cost of imported water for a recycled water project, resulting in the overstatement of the project's potential for self-sufficiency.[1] In a May 2002 report covering the Water Replenishment District of Southern California (replenishment district),[2] the bureau concluded that the replenishment district had so severely depleted its reserves that its ability to maintain the current quantity of groundwater in the basins was threatened. In 2004, the bureau issued audit reports concerning the Metropolitan Water District of Southern California[3] and the replenishment district.[4]

Further, the Milton Marks "Little Hoover" Commission on California State Government Organization and Economy (Little Hoover Commission) issued a report in May 2000 concluding that some special districts, including water districts, have banked unreasonably large, multimillion-dollar reserves.[5] Using data from the controller, the Little Hoover Commission concluded that water districts had reported to the controller more than $11.8 billion in retained earnings for fiscal year 1996–97, or 65 percent of the retained earnings of all enterprise special districts. In its report, the Little Hoover Commission recommended that the State appoint a panel of experts to propose guidelines to assist special districts in establishing and maintaining prudent reserves. As of May 2004, the Little Hoover Commission could cite no legislation implementing this recommendation.

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[1] *Central Basin Municipal Water District: Its Poorly Planned Recycled-Water Project Has Burdened Taxpayers But May Be Moving Toward Self-Sufficiency*, 2000–115, April 2001.

[2] *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*, 2000–016, May 2002.

[3] *Metropolitan Water District of Southern California: Its Administrative Controls Need To Be Improved to Ensure an Appropriate Level of Checks and Balances Over Public Resources*, 2003–136, June 2004.

[4] *Water Replenishment District of Southern California: Although the District Has Addressed Many of Our Previous Concerns, Problems Still Exist*, 2002–016, June 2004.

[5] *Special Districts: Relics of the Past or Resources for the Future?* Little Hoover Commission, May 2000.

Few Legal Restrictions Pertain to Water District Reserves

Although all special districts operate under statutory authority, few state provisions specifically govern their accumulation and use of reserves. With respect to the financial affairs of special districts, Article XIII B, Section 5, of the California Constitution merely states that each entity of government can establish contingency, emergency, reserve, or similar funds as it deems reasonable and proper. The State's Water Code does not generally impose any requirements or provide any guidance to water districts concerning the amounts that they can hold in reserves. One exception is the portion of the Water Code governing the activities of water replenishment districts. Specifically, Section 60290 imposes a cap of $10 million on replenishment district reserves beginning in fiscal year 2000–01. This statute also allows a water replenishment district to adjust the cap based on the cost of water from its supply sources. However, the data we obtained from the controller showed that the State has only two water replenishment districts. Therefore, all other types of water districts, including those we reviewed, generally have broad discretion in determining the number and character of reserves they choose to maintain. Nevertheless, as part of its fiduciary responsibility to the ratepayers and taxpayers that support its activities, each water district should be able to demonstrate how it deems its reserves to be reasonable and proper.

For its May 2000 report, the Little Hoover Commission focused its analysis of reserves on *retained earnings*, the term used at the time to reflect the equity—assets minus liabilities—of a government's enterprise activities. However, as we describe in Chapter 1 of this report, governmental accounting standards now require governments, including water districts, to report equity in terms of *net assets*. For a special district, like a water district, that operates an enterprise activity and whose customers pay a rate for the amount of goods or services they consume, retained earnings comprised the difference between its assets and its liabilities. However, some retained earnings represented a special district's investment in capital assets such as land, buildings, and pipelines. Therefore, retained earnings did not represent discretionary available resources because cash or other assets had already been used to acquire the capital assets. To make the resources available for alternative uses, a special district would have to sell the capital assets. Therefore, when analyzing the controller's data to identify which water districts may have accumulated excess available resources, we excluded the capital assets portion of total assets; we call the remainder potentially spendable resources. From potentially spendable resources,

special districts create reserves, which can include district-approved plans for the future use of resources to build or replace capital assets or to pay future debt service costs. External legal restrictions can also make some remaining spendable resources unavailable for discretionary uses.

We calculated the resources potentially available for future spending for each of the 445 districts within the nine water district types. We also calculated the annual expenses for each water district. Based on our calculations, 298 water districts had amounts of potentially spendable resources greater than zero. We present a profile of these water districts in Table 1.

TABLE 1

Profile of Water Districts With Potentially Spendable Resources

	Independent Water Districts	Dependent Water Districts	Total of Independent and Dependent Water Districts
Water Districts With Enterprise Activities Only			
Number of water districts	241	20	261
Total potentially spendable resources	$1,374,773,002	$68,208,203	$1,442,981,205
Average years of expenses covered*	4.2	8.0	4.5
Average potentially spendable resources	$5,704,452	$3,410,410	$5,528,664
Water Districts With Nonenterprise Activities Only			
Number of water districts	11	4	15
Total potentially spendable resources	$19,498,732	$60,953,320	$80,452,052
Average years of expenses covered*	2.1	1.1	1.9
Average potentially spendable resources	$1,772,612	$15,238,330	$5,363,470
Water Districts With Both Enterprise and Nonenterprise Activities			
Number of water districts	21	1	22
Total potentially spendable resources	$444,509,015	$53,569,752	$498,078,767
Average years of expenses covered*	0.9	1.5	0.9
Average potentially spendable resources	$21,167,096	$53,569,752	$22,639,944
Total: Enterprise and Nonenterprise Water Districts, and Those With Both Types of Activities			
Number of water districts	273	25	298
Total potentially spendable resources	$1,838,780,749	$182,731,275	$2,021,512,024
Average years of expenses covered*	3.8	6.6	4.0
Average potentially spendable resources	$6,735,461	$7,309,251	$6,783,597

Source: Bureau of State Audits' analysis of data provided by the State Controller's Office, as of December 2003, used for compiling its *Special Districts Annual Report* for fiscal year 2001–02.

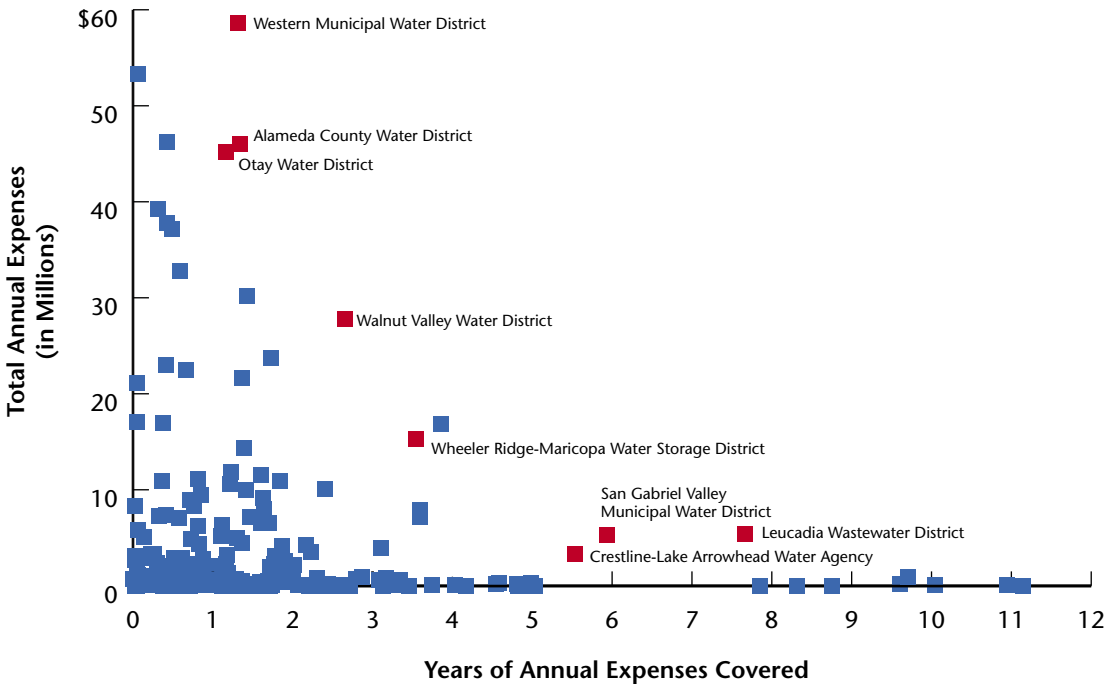
* To put potentially spendable resources in perspective, we calculated the average number of years of annual expenses that this amount could cover. However, we acknowledge that water districts will ultimately use these resources for a variety of purposes, not all of which will be to cover operating expenses.

As Table 1 shows, the 298 water districts had slightly more than $2 billion in potentially spendable resources. The table categorizes water districts based on whether they are independent or dependent water districts and whether they are enterprise, nonenterprise, or a mix of both. Table 1 also shows that the 241 independent enterprise water districts were the largest single group (representing 81 percent of the 298 water districts) with the most potentially spendable resources ($1.4 billion, or 68 percent of the total resources available to the 298 water districts).

To put potentially spendable resources in perspective, we also calculated the average number of years that these amounts could cover water districts' annual expenses. In total, the 298 water districts could cover roughly four years of expenses from their potentially spendable resources. The Figure is a scatter plot identifying which of the 241 independent enterprise water districts had relatively higher amounts of potentially spendable resources.

FIGURE

Scatter Plot Comparison of the Eight Water Districts We Visited and Other Independent Enterprise Water Districts



Source: Bureau of State Audits' analysis of data provided by the State Controller's Office, as of December 2003, used for compiling its *Special Districts Annual Report* for fiscal year 2001–02.

Note: This figure includes independent water districts that the State Controller's Office groups under types 41 to 49 in its *Special Districts Annual Report,* that conduct enterprise activities, and that have up to $60 million in expenses and up to 12 years of expenses covered.

To select the water districts we would visit, we reviewed districts appearing in the Figure on the right side of the horizontal axis and those at the top of the vertical axis. From along the horizontal axis, we selected three water districts that each had more than $3 million in annual expenses and more than five years of expenses covered by their amounts of potentially spendable resources. From along the vertical axis, we selected three water districts that each had more than $45 million in annual expenses and more than one year of expenses covered by their amounts of potentially spendable resources. We selected two additional water districts that represented types not included in our previous selections. The eight water districts we selected to visit for this audit are identified by name in the Figure.

State Access to Special District Reserves Impeded

Given the State's ongoing budget crisis, members of the Legislature and others might wonder whether the State can tap the potentially spendable resources held by special districts to help ease its fiscal woes. As mentioned on page 10, 298 water districts had slightly more than $2 billion in potentially spendable resources. In a legal opinion issued in April 2003, the Office of the Legislative Counsel (legislative counsel) addressed the Legislature's ability to enact a legally valid statute that would transfer money from a special district's reserve fund to the State's General Fund and allocate that money for a purpose other than that for which the special district was created. In short, the legislative counsel generally concluded that the Legislature cannot lawfully enact such a statute.

The legislative counsel acknowledged that the California Constitution has no provision that expressly prohibits the Legislature from transferring money in a special district's reserve fund and allocating that money for a purpose other than that for which the reserve fund was established. However, the legislative counsel stated in its opinion that several state provisions operate to deny the Legislature the authority to transfer money in this manner. For instance, with respect to a special district's reserve fund that may be derived from special taxes, Section 53724 of the Government Code requires that the revenue from any special tax must be used only for the purpose for which it was imposed. Section 53724 was added to statute by an initiative measure approved by voters at the November 1986 election and, as specified in the initiative, only a vote of the statewide electorate can amend it.

Although the specific statutory restrictions that apply to these special taxes do not apply to regulatory fees, the legislative counsel also opined that these revenues are special funds in the nature of trust funds that cannot be permanently diverted for a use other than that for which they were collected. In addition, the legislative counsel opined that a statute requiring the transfer of money from a special district's reserves to the State's General Fund and the allocation of that money for a use other than a public purpose of the special district might, depending on the facts, violate the state constitutional provision that prohibits gifts of public moneys.

California's Prohibitions Concerning Conflicts of Interest Apply to Water Districts

Two sets of statutory laws concerning conflicts of interest generally apply to government officials, including those of water districts. Section 1090 et seq. of the Government Code (Section 1090) prohibits a public official from having a financial interest in a public contract or purchase that he or she participated in developing, negotiating, or executing. The purpose of Section 1090 is to make certain that solely public, not personal, interests guide every public officer who enters into a contract in an official capacity. Violations of Section 1090 may be considered criminal offenses if willfully and knowingly committed; otherwise, violations may be considered civil offenses. Penalties can include fines of up to $1,000, incarceration in state prison, and being forever disqualified from holding any public office in the State.

Section 87100 et seq. of the Government Code, commonly known as the Political Reform Act of 1974, applies to decisions to form contracts and more generally to government decisions. The intent of the Political Reform Act is to set up a mechanism whereby public officials' assets and incomes, which could be materially affected by their official actions, are disclosed. Further, in appropriate circumstances, public officials are disqualified from acting so they might avoid conflicts of interest. The Political Reform Act does not prevent public officials from owning or acquiring financial interests that conflict with their official duties; rather, it prohibits a public official from participating in a government decision in which he or she has a disqualifying interest. Disqualification hinges on the effect the decision will have on the public official's financial interests. Violating the Political Reform Act can be considered an administrative, civil, or criminal offense and can result in penalties that include a cease-and-desist order, mandatory filing of any necessary documents, and a penalty of $5,000 per violation.

SCOPE AND METHODOLOGY

The Joint Legislative Audit Committee (audit committee) directed the bureau to review three specific areas concerning independent water districts. First, the audit committee asked the bureau to evaluate the financial status of water districts. The bureau was specifically asked to review the water districts' policies and procedures for accumulating and using cash reserves and for developing and setting rates to determine whether they met relevant statutory requirements. Second, the audit committee asked the bureau to evaluate the benefits and compensation packages that water districts offered their directors. The bureau was also asked to determine how often boards and their subcommittees met. Finally, the audit committee asked the bureau to review the policies and procedures that water districts had in place related to conflicts of interest and ethics.

Types of Water Districts Considered for Auditing

- California water
- County water
- County waterworks
- Metropolitan water
- Municipal water
- Water agency or authority
- Water conservation
- Water replenishment
- Water storage

To comply with the audit committee's requests, we first obtained and analyzed a data file containing financial information given to the controller by special districts for fiscal year 2001–02. From this data file, for each water district within the nine types shown in the text box, we were able to derive the annual expenses and estimates of the amounts of potentially spendable resources they held.

To determine which water districts we wanted to visit, we used the controller's data to help identify which water districts likely had relatively larger amounts of potentially spendable resources. We used the following formula to derive this amount for each water district:[6]

Total Assets – Total Liabilities – Net Fixed Assets = Potentially Spendable Resources

To validate the information in the controller's data file, we compared amounts from the annual audited financial statements of the eight water districts we visited and similar amounts in the controller's data file. Although key totals such as assets, liabilities,

[6] The controller's data does not provide enough information to identify the portion of debt that special districts incurred to acquire or build their capital assets. Therefore, our calculation of spendable resources described here is more conservative than a similar calculation we describe in Chapter 1, using data from districts' audited financial statements covering fiscal years ending in 2003. In the latter calculation, we deducted the debt incurred to acquire or build capital assets from the value of the capital assets. The formula in Chapter 1 results in a relatively higher measure of spendable resources.

and expenses materially agreed, we observed some differences in how fund equity was classified. The differences were primarily due to water districts' implementation of revisions to governmental accounting standards that require governments to split total equity into three categories of net assets, rather than simply listing equity as retained earnings. The new standards also require more detailed breakdowns of government assets and liabilities into current and noncurrent categories. Therefore, in describing our work at the water districts we visited, we refer to net assets instead of retained earnings and generally use terminology that is consistent with the new standards.

To determine the reasonableness of the net assets maintained by the eight water districts and the rates they charged, we determined the amount of net assets legally restricted (restricted net assets), reserved by the water district for specific purposes (reserved), or available for general purposes (unreserved). We also interviewed staff at each water district and reviewed applicable state laws and regulations, water district policies, financial reports, and annual budgets. To determine whether water districts maintained reasonable amounts of board-approved reserves, we identified applicable reserves and their balances and compared these to the water districts' reserve policies.

To evaluate the compensation and benefits packages that water districts offer their directors, we reviewed relevant state laws and each district's compensation policies. We observed that the daily stipend that each of the eight water districts pays its directors does not exceed the amount set by state law. Likewise, we noted that the number of meetings or days of service per month for which water districts pay their directors does not exceed the number allowed by state law. We also obtained and reviewed information for the 30-month period from July 1, 2001, through December 31, 2003, showing expenditure amounts that water districts paid to or on behalf of their directors to determine whether those expenditures were reasonable and necessary. Finally, to determine whether water districts properly disclosed director expenditures in compliance with state law, we reviewed each water district's policies and procedures. In Appendix B, we summarize the various types of compensation the eight water districts provide their directors.

To identify the mechanisms that water districts used to ensure that conflicts of interest and ethics violations did not occur, we reviewed state laws and regulations and water district policies and procedures. We also interviewed employees of the eight

water districts we visited. Further, we identified the types of training related to conflicts of interest or ethics that water districts offered their directors. We also performed other high-level analyses of certain information that water district directors disclosed on their statements of economic interests covering the most recent three years available. These analyses consisted of comparing information from the statements, such as business positions held and income sources, to information available from public sources, such as water district Web sites and candidate statements filed by the directors. We also compared applicable information from the statements to lists the water districts gave us that identified the names of contractors they used from July 1, 2001, through December 31, 2003. Additionally, we reviewed information the water districts provided to us concerning whether any of their directors had abstained or otherwise removed themselves during meetings of their boards because of financial interests. When water districts revealed this type of abstention to us, we probed the nature of the potential conflict to determine whether the director disclosed the relevant interest in a statement of economic interests, if required, and whether the director adhered to pertinent conflict-of-interest laws. Finally, we obtained information from the water districts about complaints against directors related to violations of conflicts of interest or ethics. ■

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CHAPTER 1

Poor Reserve Policies Impair the Ability of Many Water Districts to Demonstrate How Accumulated Resources Serve Public Purposes

CHAPTER SUMMARY

Our visits to eight water districts revealed that many water districts lack adequate policies guiding their accumulation and use of resources, commonly referred to as reserves. Consequently, these water districts might have difficulty demonstrating to ratepayers and taxpayers how some of the resources they have accumulated are necessary to serve the districts' public purposes. As of the close of fiscal years ending in 2003, the eight water districts we reviewed had $485 million in accumulated resources available for use in future years. This amount is enough to cover the annual expenses of the eight water districts for about 2.2 years.

However, we acknowledge that water districts will ultimately use these resources for a variety of purposes, not all of which will be to cover operating expenses. In addition, externally imposed restrictions dictate how water districts must use what equates to total expenses for six months, and the districts had designated reserves equaling 17 months of expenses. The balance, enough to cover more than three months of expenses, is unreserved and could be used for other purposes, including rate reductions. Therefore, we did not conclude that these accumulations are excessive. However, five of the eight water districts we visited might have trouble defending to their ratepayers and taxpayers the need for some portion of their accumulated resources because either they have no reserve policies or the policies they have are weak. Although water districts can maintain reasonable reserves, state law offers little specific guidance related to reserve policies. Therefore, water districts should establish and implement comprehensive reserve policies that create a strong link between rates and the reasonable accumulation and use of resources. In turn, comprehensive reserve policies can help water districts demonstrate to their ratepayers and taxpayers that they have adequate plans for any accumulated resources.

WATER DISTRICTS WE VISITED HAVE SUFFICIENT RESOURCES TO FUND FUTURE ACTIVITIES

We found that the eight water districts we visited have net assets sufficient to fund activities in future years. Table 2 breaks down the total net assets (assets minus liabilities) of the eight water districts we visited based primarily on information contained in the 2003 audited financial statements of the water districts. The component of net assets invested in capital assets, net of related debt, measures how much cash the water districts would have if they were able to sell all their facilities (capital assets), such as buildings or pipelines, for a price equal to book value and paid off the remaining balance of any debts they incurred to buy or build them (related debt). Because these net assets are tied up in facilities, we deducted them from total net assets to identify the resources available to pay future expenses (restricted and unrestricted net assets).

Restricted net assets measure the net resources that must be used for particular purposes because of legal, contractual, or other externally imposed requirements. Therefore, although the resources are available, water districts do not have discretion over the purposes for which these net assets must be spent. Nevertheless, water districts often have some control over how much of these net assets they accumulate because, in some cases, they set the rates for certain restricted charges and control the scheduling of projects that these charges will pay for. In contrast, water districts have complete discretion over how to spend unrestricted net assets.

Water districts have complete discretion over how to spend unrestricted net assets.

Table 2 reflects a final breakdown of unrestricted net assets into reserved and unreserved categories. Water districts frequently express their intentions to use some or all of their unrestricted net assets by establishing reserves for specific purposes—for example, to stabilize rates or to replace existing facilities. Some water districts do this more formally through policies or resolutions of their governing boards (boards); others simply use separate funds or accounts in their budgeting or cash management processes. The reserved category represents the sum of the water districts' intentions to use unrestricted net assets. We obtained many of the figures for reserves in Table 2 from the notes in the water districts' annual audited financial statements. When the audited statements did not have this information, we obtained the data from other sources as indicated in the notes to the table.

TABLE 2

Accumulations of Net Assets of Water Districts
Fiscal Years Ending in 2003 (Dollars in Thousands)

Line Number	Description	Alameda County Water District	Crestline-Lake Arrowhead Water Agency	Leucadia Wastewater District	Otay Water District	San Gabriel Valley Municipal Water District	Walnut Valley Water District	Western Municipal Water District*	Wheeler Ridge-Maricopa Water Storage District†	Totals
1)	Total Assets	$381,521	$45,601	$111,192	$417,802	$50,648	$157,936	$280,707	$101,202	**$1,546,609**
2)	Less: Total Liabilities	48,095	1,914	7,836	57,447	778	24,566	69,092	20,338	**230,066**
3)	Equals: Total Net Assets (line 1 minus line 2)	333,426	43,687	103,356	360,355	49,870	133,370	211,615	80,864	**1,316,543**
4)	Less: Invested in Capital Assets, Net of Related Debt	249,640	24,698	55,852	269,580	17,552	71,017	119,625	23,481‡	**831,445**
5)	Equals: Restricted and Unrestricted Net Assets§ (line 3 minus line 4) or (line 6 plus line 7 plus line 8)	83,786	18,989	47,504	90,775	32,318	62,353	91,990	57,383	**485,098**
6)	Restricted Net Assets	5,163	0	9,694	40,946	55‖	28,871	22,453	0	**107,182**
	Unrestricted Net Assets:									
7)	Reserved	78,623	8,200	37,810	38,288	20,318#	26,363	52,488**	56,484	**318,574**
8)	Unreserved	0	10,789	0	11,541	11,945	7,119	17,049	899‖	**59,342**
Percentage of Total Restricted and Unrestricted Net Assets:										
9)	Restricted Net Assets (line 6 divided by line 5)	6.2%	0.0%	20.4%	45.1%	0.2%	46.3%	24.4%	0.0%	**22.1%**
10)	Reserved (line 7 divided by line 5)	93.8%	43.2%	79.6%	42.2%	62.8%	42.3%	57.1%	98.4%	**65.7%**
11)	Unreserved (line 8 divided by line 5)	0.0%	56.8%	0.0%	12.7%	37.0%	11.4%	18.5%	1.6%	**12.2%**
Years of Expenses Restricted and Unrestricted Net Assets Could Fund:††										
12)	Expenses (operating and nonoperating)	$52,368	$4,272	$6,475	$47,875	$7,377	$25,935	$57,333	$22,542	**$224,177**
13)	Restricted Net Assets (line 6 divided by line 12)	0.1	0.0	1.5	0.9	0.0‖	1.1	0.4	0.0	**0.5**
14)	Reserved (line 7 divided by line 12)	1.5	1.9	5.8	0.8	2.8	1.0	0.9	2.5	**1.4**
15)	Unreserved (line 8 divided by line 12)	0.0	2.5	0.0	0.2	1.6	0.3	0.3	0.0‖	**0.3**
16)	Total (line 5 divided by line 12)	1.6	4.4	7.3	1.9	4.4	2.4	1.6	2.5	**2.2**

Source: Data obtained from the water districts' audited financial statements for fiscal years ending on June 30, 2003, unless otherwise indicated.

* Data is from the draft copy of Western Municipal Water District's financial statements as of June 30, 2003.

† Data for the Wheeler Ridge-Maricopa Water Storage District is as of December 31, 2003.

‡ The audited financial statements for the Wheeler Ridge-Maricopa Water Storage District included its investment in the Kern Water Bank Authority, totaling $7.8 million, as part of the unreserved net assets. Since this represents an investment in a capital asset, we reflect the amount in line 4.

§ This calculation is similar to our calculation of potentially spendable resources that we performed using data from the State Controller's Office (controller), described in the Introduction to our report. However, because of limitations in the data provided to the controller, we could not subtract the amounts of debt that water districts incurred to acquire or build the capital assets, resulting in amounts that are typically lower than we report on line 5.

‖ The dollar amounts are too small to affect a significant digit in the calculation.

\# The reserved balance was calculated based on the board-approved policy.

** The reserved balance is based on budget information and assertions of district staff.

†† We acknowledge that water districts will ultimately use these resources for a variety of purposes, not all of which will be to cover operating expenses.

It is important to note that we focused on the net assets of the water districts for two reasons. First, recent changes in governmental accounting standards now require all governments, including water districts, to report equity—assets minus liabilities—in terms of net assets. Second, as mentioned in the Introduction to this report, the Milton Marks "Little Hoover" Commission on California State Government Organization and Economy (Little Hoover Commission) reported concerns in 2000 about the size of special district *reserves*, including those of water districts. At the time the Little Hoover Commission was reviewing special district equity, accounting standards required governments to include a significant amount of what they had already spent on fixed (capital) assets for their enterprise activities as *retained earnings*, the term used to measure the equity of enterprise activities at that time. This parallels the way the State Controller's Office (controller) still gathers information from all special districts that report enterprise activities to compile its *Special Districts Annual Report*. However, as shown in Table 2, we found that more than half the accumulated equity possessed by the water districts we visited represented amounts that they had already spent for their capital assets, even after reducing these figures by any outstanding debts they incurred to build or acquire them. Because water districts typically would not choose to sell off the capital assets that allow them to deliver their goods and services, their net investment in capital assets should not be viewed as available to fund future activities, as may have been presumed when they were included in retained earnings. In addition, the new governmental accounting standards require governments, including water districts, to separately report the portion of their net assets over which they have less control because of externally imposed requirements such as laws, contract terms, or bond covenants. This helps to highlight the remaining unrestricted net assets over which governments have complete discretion.

We found that more than half the accumulated equity possessed by the water districts we visited represented amounts that they had already spent for their capital assets.

After indicating the total annual expenses the water districts incurred, Table 2 provides a measure of how many years the net assets could fund those expenses. Comparing the amounts in the various categories of net assets to annual expenses is intended to provide context regarding the relative size of net assets. However, we acknowledge that water districts will ultimately use these net assets for various purposes, not only to cover annual expenses. For example, water districts that maintain capital improvement or replacement reserves will likely use net assets to acquire or replace capital assets rather than to pay for annual expenses. As the table shows, the eight water districts had a total

Months of Annual Expenses That the Restricted and Unrestricted Net Assets of Eight Water Districts Could Fund

Category	Number of Months
Restricted	6
Unrestricted–Reserved	17
Unrestricted–Unreserved	3
Total	**26**

of $485 million in restricted and unrestricted net assets as of the close of fiscal years ending in 2003 and incurred annual expenses of $224 million for the period. Comparing the two figures reveals that the amount of restricted and unrestricted net assets would cover annual expenses for 2.2 years—or 26 months as detailed in the text box. The following sections describe what we found in analyzing the various components of net assets at each of the water districts.

MOST WATER DISTRICTS WE VISITED HAVE ADEQUATE PLANS FOR USING RESTRICTED NET ASSETS

The restricted net assets of six of the eight water districts we reviewed totaled about $107 million at the end of fiscal year 2002–03, as shown in Table 2. About $79 million (74 percent) of the total relates to net assets restricted for facilities growth projects at four of the six water districts: Leucadia Wastewater District (Leucadia), Otay Water District (Otay), Walnut Valley Water District (Walnut Valley), and Western Municipal Water District (Western). The other two districts with restricted net assets, Alameda County Water District (Alameda) and San Gabriel Valley Municipal Water District (San Gabriel), had smaller amounts of net assets restricted for debt service and State Water Project costs, respectively. The net assets restricted for growth projects were primarily funded by capacity charges the four water districts collected under the authority of Section 66013 of the California Government Code. This statute authorizes local agencies to collect capacity charges from persons or properties that benefit from existing facilities or will benefit from facilities to be constructed in the future. The law requires that water districts spend these charges solely for the purposes for which they were collected. Although the rate of the charge must bear a reasonable relationship to the cost of providing the service, water districts calculate the rates they charge for these services.

We generally found that the four water districts had a sufficient link between the capacity charges they collected under Section 66013 and the portion of their capital improvement plans for new facilities for which these charges were intended to pay. In particular, except for Walnut Valley, we found that the anticipated cost of planned growth projects equaled or exceeded the amount of net assets restricted for that purpose as of June 30, 2003. In addition, Western has not outlined the specific

projects that its accumulated capacity charges will fund beyond a one-year time limit, even though it has estimated that the total cost for the ultimate completion of its water delivery system will exceed these accumulations.

Walnut Valley manages its cash and short-term investments by maintaining 18 separate accounts, 11 of which it uses to track restricted assets.[7] According to its 2003 audited financial statements, the water district had about $29 million in restricted net assets related to these accounts at the end of the year. The largest of these, a restricted account for reservoir capacity charges, had a balance of $15.7 million as of June 30, 2003. Walnut Valley imposes capacity charges on developers to finance the construction of future water storage and pumping facilities. Although the water district appropriately performs an annual accounting of revenues and expenses related to this account, it has not established policies to address limits on the size of the account or to guide rate-setting decisions. The balance of the account grew steadily over the last three years from $13.2 million as of July 1, 2000, to $15.7 million as of June 30, 2003. During that period, revenues from capacity charges and interest income of $2.7 million exceeded expenses on growth projects of about $200,000, resulting in the $2.5 million increase in the account. In addition, Walnut Valley has not changed the rates related to capacity charges since 1980 according to the water district's general manager.

Walnut Valley's policies do not address what should happen when the cash and investments within the restricted account exceed planned expenditures.

Walnut Valley apparently experienced delays in completing projects from July 1, 2000, to June 30, 2003, because it had proposed spending $3.8 million in fiscal years 2001–02 and 2002–03 alone but spent only $200,000 over the entire three-year period. The water district's proposed expenditures for fiscal year 2003–04 and its list of projects planned through fiscal year 2007–08 indicate its intent to use about $11.8 million from the restricted account to fund growth projects through fiscal year 2007–08. Without factoring in additional revenues through fiscal year 2007–08 or the possibility that projects might continue to lag, this leaves an additional $3.9 million available in the reservoir capacity charge account. When we asked Walnut Valley's general manager about other plans for these restricted assets, she said the water district might use the funds to retire a portion of the $7.2 million in debt the water district's general fund incurred to finance certain reservoir capacity projects in the past. However, she also clarified that the board is considering this proposal but has not yet approved it.

[7] Although Walnut Valley designated one account as a reserve for employee sick leave and vacation pay, the district's audited financial statements reflect the balances in this account as restricted assets.

Although the plan appears reasonable, Walnut Valley's policies do not address what should happen when the account's cash and investments exceed planned expenditures. As a result, it is more difficult for the water district to defend to ratepayers and taxpayers the level of resources it maintains in this account.

Similarly, Western maintains separate restricted accounts for its capacity charges. For developers and others who connect to its system, the water district charges a fee to fund construction of the water supply, transmission, and storage facilities needed for future improvements. Western periodically hires engineering consultants to assess the maximum system capacity, capital needs for remaining growth, and an appropriate rate for the capacity charge. According to the latest studies completed in February 2004, the consultants projected a total cost of $81.2 million for the pumping, storage, and pipeline assets needed to complete the system. As of June 2003, Western had accumulated about $22.5 million in restricted net assets for this purpose. Therefore, the water district has demonstrated an ultimate need for these net assets. However, neither the consultants' reports nor other water district plans specify the anticipated time frame over which it intends to construct the additional facilities or a projected date for completing the system.

Western's board approves growth projects to be funded from restricted reserves during the annual budget process, but this represents only a one-year planning horizon. For example, in the fiscal year 2003–04 budget, the board approved $9.4 million in growth projects from the restricted accounts. The budget does not outline specific projects for the other $13.1 million that was available at the end of fiscal year 2002–03. When we asked Western's chief financial officer about its planning horizon, he said that water district staff are developing a five-year capital improvement plan beginning with fiscal year 2004–05. Having a capital plan for a period of several years could help Western justify the level of restricted net assets it maintains to ratepayers and taxpayers.

Western's budget does not outline specific projects for the other $13.1 million in restricted net assets that was available at the end of 2003.

MANY WATER DISTRICTS WE VISITED HAVE DIFFICULTY SUPPORTING THE NEED FOR SOME OF THEIR UNRESTRICTED NET ASSETS

In reviewing eight water districts' unrestricted net assets for fiscal years ending in 2003, we found that the districts employed several methods to indicate how they plan to use accumulated resources. Most water districts have some type of policy statement about

reserves, but some statements are more comprehensive than others. Whether formal policies exist or not, water districts maintain separate accounts or funds to track the revenues and expenses of key activities for budgeting or cash management purposes. We refer to these unrestricted net assets as reserved and any remaining net assets that water districts have not designated for a particular purpose as unreserved. As shown in Table 2, six of the eight water districts we visited designated a portion of their unrestricted net assets as reserved, while Alameda and Leucadia designated all such net assets as reserved.

The water districts also have varying numbers of separate reserves, ranging from only one at Crestline-Lake Arrowhead Water Agency (Crestline) to as many as eight at Wheeler Ridge-Maricopa Water Storage District (Wheeler Ridge). In analyzing these reserves, we found that Crestline, Leucadia, Walnut Valley, Western, and Wheeler Ridge may have difficulty defending to ratepayers and taxpayers the level of some of their reserves because of weak or nonexistent reserve policies. In contrast, we found that Alameda could defend the level of its reserves because it has a reserve policy and a comprehensive financial-planning model that combine to create a strong link between its rates and its use and accumulation of reserves. In addition, we found that Otay's reserve policy is out of date and does not incorporate many of its current strategies and practices for managing reserves. However, Otay had already begun a process to update its reserve policy before we began our audit. Finally, although San Gabriel had accumulated reserves in excess of levels established in its policy, it is taking action to reduce them.

Crestline Lacks a Comprehensive Reserve Policy and Has Commingled Funds

It is difficult for Crestline to demonstrate that it uses all its restricted assets for their legally intended purpose.

Crestline has not accounted for a portion of its net assets in a separate fund as required by its contract with the California Department of Water Resources related to the State Water Project (SWP). As a result, it is difficult for the water district to demonstrate that it uses all the restricted assets for the legally intended purpose. Further, despite having needs that could absorb its accumulation of unrestricted net assets, Crestline has not established a reserve policy to guide the management of its various funds. This makes it difficult for the water district to support the need for the net assets it has accumulated.

As shown in Table 2, Crestline had accumulated a total of $19 million in unrestricted net assets as of June 30, 2003. According to the water district's audited financial statements for

2003, the board designated $8.2 million as a reserve for capital improvements and reported the rest as unreserved net assets. However, in reviewing Crestline's finances, we found that the water district attempts to cover its projected annual costs for participating in the SWP by levying a special tax each year—and by law, a special tax can only be used for the specific purpose for which it was imposed.[8] Crestline deposits the special tax receipts into its general fund along with revenue from other sources even though it is contractually obligated to account for the collections in a separate fund.

According to the terms of its SWP contract, Crestline can levy a tax sufficient to provide for all payments currently due under the contract or that will be due within the tax year. The contract also stipulates that the tax collections must be accounted for in a separate fund. However, because Crestline commingles the special taxes with other revenues in its general fund, it is difficult for the water district to demonstrate that it only uses the tax to pay for SWP costs. The situation is troubling because the special tax revenues have exceeded SWP costs by a total of about $1.3 million over the last three years.

When we brought this to the attention of the water district's general manager, she referred us to Crestline's legal counsel and the auditor of its financial statements. The legal counsel agreed that these taxes should be accounted for in a separate fund and indicated that he has verbally advised the water district of this requirement. Crestline's auditor told us that, although the water district has separately accounted for the revenues and expenses related to the SWP each year, it has not historically distinguished the net assets related to these activities from the net assets of its general fund. He also indicated that any net assets related to the SWP would be reported separately as restricted in the future. To the extent that Crestline still has the historical data related to SWP revenues and expenses, it should be able to reconstruct the amount of restricted net assets related to this activity.

Because Crestline has no formal reserve policy, it is difficult to determine how the water district plans to use the amounts it has accumulated.

In addition, Crestline's board has approved the existence of one reserve for capital improvements and major maintenance projects. However, it has no reserve policy related to the existence of this reserve or any of its other unrestricted net assets. The level of the reserve has remained unchanged at $8.2 million since 1998. Because Crestline's capital improvement plan specifies $9.6 million in needed projects, and accumulated

[8] We acknowledge, however, that this special tax is not subject to the voter approval requirements of Articles XIII C and D of the California Constitution.

depreciation on its existing capital assets amounted to more than $12 million as of the end of fiscal year 2002–03, we are not concerned about the size of the reserve. However, Crestline's policies do not specify target levels to govern the size of the reserve or triggers to indicate when the reserve should be used.

Further, Crestline has no policy describing what it deems to be an appropriate level for its unreserved net assets. As shown in Table 2, the water district's unreserved net assets totaled $10.8 million as of the end of fiscal year 2002–03, enough to cover annual expenses for about 2.5 years. However, because Crestline has commingled its SWP revenues and expenses in its general fund, some portion of these remaining net assets may in fact be restricted. In addition, because Crestline has no formal reserve policy, it is difficult to determine how the water district plans to use the amounts it has accumulated or whether it should consider reducing any of its rates.

Leucadia Has Weaknesses in Its Reserve Policy

Leucadia maintains six separate reserves that account for all its unrestricted net assets. As shown in Table 2, the total balance of these reserves was $37.8 million as of the end of fiscal year 2002–03. Although we found that Leucadia had reasonable plans for using most of the reserves, weaknesses in its reserve policy may make it difficult for the water district to defend the size of its reserves to ratepayers and taxpayers.

Leucadia's policy does not establish sufficient limits or target levels that match the size of each reserve to its intended purpose.

Leucadia has a board-approved policy that indicates the purpose, source of funds, and intended use of each reserve. However, the policy does not establish sufficient limits or target levels that match the size of each reserve to its intended purpose. For example, the water district maintains a capital replacement reserve that provides funds for replacing or refurbishing old capital assets. We found that the balance in the capital replacement reserve ($23.1 million) matched the amount of accumulated depreciation on the related capital assets as of June 30, 2003. Because accumulated depreciation measures how much of a capital asset has been used, and replacement costs likely exceed the amount originally paid for the assets, we are not concerned about the size of the reserve. However, although the water district's current practice is to increase the reserve each year by 75 percent of the annual depreciation on the related assets, Leucadia does not include this or any other target level

to govern the size of the reserve in its reserve policy. As a result, the policy does not clearly indicate how much of its replacement needs the water district intends to fund from this reserve.

Further, Leucadia maintains two separate reserves that work in tandem to serve essentially the same purpose. The board established a contingency reserve to cover cash flow and unexpected operating needs and put a cap on the fund of $1.6 million. After allocating the results of its annual operations to other reserves, any remaining net income is initially applied to the contingency reserve. If this causes the balance to exceed $1.6 million, any excess is applied to the water district's rate stabilization reserve. However, Leucadia's policy provides no target level or limit on the size of the rate stabilization reserve. In addition, the only stated purpose for the rate stabilization reserve is to transfer funds to the contingency reserve to cover operating losses.

As of June 30, 2003, the combined balance in these two reserves was about $5 million, enough to cover expenses for roughly nine months. When we discussed these conditions with Leucadia's general manager, he acknowledged that the two reserves are closely related. He added that as part of its current financial-planning efforts, the water district has evaluated establishing an operating reserve equal to operating expenses for three or four months to help the water district meet cash flow needs. Finally, he stated that Leucadia's board might consider consolidating these reserves in the near future as part of an update to the water district's financial plan.

Walnut Valley Has Not Adopted a Comprehensive Reserve Policy

Walnut Valley's board has approved the use of 18 separate accounts for managing the water district's cash and short-term investments. As mentioned previously, Walnut Valley uses 11 of these accounts to track restricted assets.[9] According to the water district's 2003 audited financial statements, the board designated net assets totaling $26.4 million related to six other accounts as reserves. The water district uses the remaining account, with unreserved net assets totaling $7.1 million as of June 30, 2003, to account for assets that are not restricted or designated for particular purposes.

[9] Although Walnut Valley designated one account as a reserve for employee sick leave and vacation pay, the district's audited financial statements show the balances in this account as restricted assets.

It is difficult for an outside observer to fully understand Walnut Valley's intentions concerning its reserves.

Although the board has approved the use of separate accounts as indicated, it has not adopted a comprehensive reserve policy to guide the management of these funds. In particular, when we asked Walnut Valley officials for more information about the water district's plans for the use of funds accumulated in these accounts, Walnut Valley's director of finance prepared a memo to the district's general manager outlining the basic purposes for maintaining the separate accounts. Walnut Valley's general manager told us that this was an internal memo and was not intended to reflect a complete description of the water district's practices related to reserves. She further stated that the water district makes management decisions about the use of reserves through formal and informal discussions with water district staff and board members. However, because these discussions and decisions are not formalized in a written, comprehensive policy, it is difficult for an outside observer to fully understand the water district's intentions.

The largest of the six reserves, the replacement reserve, had net assets totaling $19.6 million as of June 30, 2003, according to the water district's audited financial statements. This reserve was established by Walnut Valley's board to provide funds to replace district assets and is adjusted annually at the end of the fiscal year to a level approximating half the accumulated depreciation on the water district's fixed (capital) assets, according to documentation on the water district's annual budget. Because accumulated depreciation on Walnut Valley's capital assets amounted to $47.5 million as of June 30, 2003, we do not think the amount of the reserve is excessive. However, documentation the water district provided us does not specify when the reserve should be used instead of other district funds. In fact, we found that Walnut Valley often included replacement projects in its general fund budget. In addition, documentation the water district provided us does not describe how Walnut Valley plans to fund the other half of its need to replace capital assets or the time frame over which it plans to replace them; nor does the documentation address any growth factor to account for the difference between original and replacement costs of these assets. Moreover, the balance in the account has grown by about $8 million from the end of fiscal year 2000–01 to the end of fiscal year 2002–03, primarily because of a $6.3 million transfer from the district's general fund in 2002, and Walnut Valley only used about $100,000 from the account over the two-year period. Therefore, the water district has not clearly linked the funds held in the replacement account to the district's plans for using the funds.

Walnut Valley has no policy to distinguish amounts it needs to maintain for operations from excess amounts that are available to reduce rates.

The lack of policies also makes it unclear how much in reserves Walnut Valley believes it should maintain to cover unforeseen increases in operating cost. Specifically, Walnut Valley maintains an operations reserve account, but it has no policy describing the desired size of the account or what events might prompt the district to use the funds. In addition, Walnut Valley accounts for its unreserved funds in its general fund. In total, the unreserved funds and the operations reserve amounted to about $8.2 million as of the end of its fiscal year 2002–03, enough to cover almost four months of expenses. Although maintaining net assets at this level may be appropriate, Walnut Valley has no policy to distinguish amounts it needs to maintain for operations from excess amounts that are available to reduce rates. This can raise questions about whether the water district needs the net assets it has accumulated.

Western Has No Formal Reserve Policy

Western maintains various reserve funds, but the district's board has not established a formal policy for managing them. Instead of a formal reserve policy, water district staff provided us with documents describing each reserve, estimates of reserve balances at June 2003, and certain budgetary and capital-planning documents as evidence of the district's intentions for using its reserve funds. We found that this information defined distinct purposes for each reserve. However, the documentation did not always indicate target levels for the amount to maintain in each reserve or the circumstances that would prompt the use of reserve funds. In addition, the levels maintained in certain reserves were not always consistent with other information about Western's capital needs. Coupled with the lack of a board-approved reserve policy, these weaknesses make it difficult for Western to justify the size of its reserves to ratepayers and taxpayers.

According to Western's chief financial officer, the board approves reserve levels in various funds as a part of the water district's annual budget process. In addition to the restricted account used to track capacity charges as described earlier, the water district maintains four reserve funds and indicates its annual plans for the use of these reserves in its annual budget. As shown in Table 2, the balance in reserve totaled $52.5 million as of June 2003, enough to fund about 11 months of expenses.

For example, the reserve for asset and vehicle replacement and major maintenance (replacement reserve) is the largest of the four reserves that Western holds, with a balance of $30.5 million as of June 2003. The water district uses the replacement reserve

to provide for refurbishment and replacement of the district's existing capital assets. According to Western's description of its purpose, the replacement reserve is funded each year in an amount equal to depreciation expense and interest earned on the balance. In November 2003, an engineering consultant estimated that Western would need to spend about $67 million to refurbish and replace its capital assets over the next five years. Therefore, we are not concerned that the balance of the reserve is too high. However, since the water district has not incorporated the consultant's recommendations into a long-range plan or outlined an alternative strategy, other than annually budgeting an amount to be spent on certain projects, it is unclear what target level Western intends for the reserve. It is also unclear what triggers the water district's use of the replacement reserve because the amounts it has recently budgeted for refurbishment and replacement fall far short of its needs, whether measured by the consultant's estimates of replacement costs or by the amount of accumulated depreciation on the water district's capital assets. Specifically, according to Western's chief financial officer, the water district's depreciation schedule indicated the need to replace $31 million in capital assets in fiscal year 2002–03 alone. However, the water district's budgets for fiscal years 2002–03 and 2003–04 included replacement projects totaling only $2.4 million and $2.1 million, respectively. These inconsistencies raise questions about how Western is managing the replacement reserve.

It is unclear what target level Western intends for the size of the replacement reserve.

When we discussed these issues with Western's chief financial officer, he explained that the water district does not expect to ever accumulate enough funds in the replacement reserve to meet the district's needs but will eventually need to borrow money to fund replacements. He also said that funding the reserve by the amount of depreciation is only a guide, adding that if an asset continues to function properly beyond the end of its estimated useful life, Western would not necessarily replace it right away. Therefore, the water district plans to inspect the capital assets that came up for replacement in fiscal year 2002–03 and will extend the timeline for their replacement into another period. Finally, Western's chief financial officer indicated that the water district is working on a five-year plan for all its capital assets that will include a section detailing anticipated costs by project for refurbishment and replacement needs. Although these actions may be appropriate, Western needs to incorporate such strategies into a written reserve policy that is approved by the board so it can better defend the need for and size of its reserves.

In addition to its designated reserves, Western had an additional $17 million in unreserved net assets. According to Western's chief financial officer, the water district's staff have informally reserved $13.6 million of that amount to cover risks related to natural disasters and droughts and to provide working capital. Each portion of this informal reserve has a clear target level tied to a key indicator. For example, the chief financial officer indicated that the working capital portion is based on two months of the total annual operating budget. Although there may be good reason to maintain this informal reserve, the water district could have difficulty defending it to ratepayers and taxpayers because no official policy or board action has sanctioned them. The remaining $3.4 million in unreserved net assets appears to be available for other purposes, including rate reduction.

Wheeler Ridge Has Not Developed a Comprehensive Reserve Policy

Wheeler Ridge could improve the reserve policy it has established. We observed that its reserve policy did not always set upper limits for its reserve funds and did not include written descriptions of the circumstances that would prompt the water district to use its reserve funds. Also, Wheeler Ridge has no written policy governing how frequently it reviews its reserves. Such weaknesses may make it difficult for Wheeler Ridge to adequately justify to ratepayers and taxpayers the size of its reserve balances.

Eight separate reserves totaling $56.5 million represented 98 percent of Wheeler Ridge's unrestricted net assets.

As of December 2003, Wheeler Ridge had $57.4 million in unrestricted net assets, enough to cover its annual expenses for 2.5 years. Eight separate reserve funds totaling $56.5 million represented 98 percent of its unrestricted net assets. Wheeler Ridge's reserve policy, which the water district last reviewed extensively in May 2002, identifies the following: (1) the general purpose of each reserve fund; (2) a recommended minimum dollar amount for the funds, which was subject to increase based on the amount of interest the water district earned on the investment of the amounts held in each reserve; and (3) for most reserves, a general description of how the water district calculated the recommended dollar amounts. However, for six reserve funds that totaled $41.1 million, Wheeler Ridge's policy imposed no maximum level to which these reserves could increase. For example, the district's operating reserve has no set cap and, as of December 2003, totaled $13.7 million, enough to cover its expenses for more than seven months. Without imposing some sort of size limit, Wheeler Ridge will have difficulty calculating how much of the operating reserve it

actually needs to cover anticipated increases in costs and how much of the reserve it could use for other purposes, such as reducing the amounts customers pay.

Also, Wheeler Ridge's reserve policy does not include written descriptions of the specific circumstances that would trigger the use of the money in its eight reserve funds. For example, the water district has an $8.3 million rate stabilization fund to defray water costs to customers when it does not receive its full water entitlement from the SWP and when the SWP's rate stabilization fund is insufficient to defray the costs. Wheeler Ridge's reserve policy, however, does not identify the extent of water shortages or deficiency of state funds that would prompt the water district to use the rate stabilization fund, nor does the policy describe the extent to which the district will draw down its rate stabilization fund during each year it is needed. Although general triggering circumstances for the water district's reserve funds can be deduced from descriptions in its policy, and Wheeler Ridge's engineer-manager described to us the general triggering circumstances for the reserve funds, clearly written descriptions of the specific circumstances that would prompt the water district to use its reserve funds and how the district would use them would improve Wheeler Ridge's ability to defend the reserve amounts it has accumulated.

Clearly written descriptions of the specific circumstances that would trigger the use of its reserve funds would enable Wheeler Ridge to better defend the reserve amounts it has accumulated.

Finally, Wheeler Ridge has no written policy governing the frequency of its reserve fund reviews. According to the water district's engineer-manager, Wheeler Ridge reviews the status of its reserve funds roughly every five years. The water district reviews the amounts in the various reserve funds, assesses the need for any adjustments to reserve amounts, and determines whether the water district should create new reserve funds or eliminate existing ones. The engineer-manager also stated that the water district's staff or the directors normally instigate the review. We believe that a written policy specifying the frequency of the reviews would help ensure that the water district does not fail to perform periodic reviews of its reserve funds.

Alameda Has Combined a General Reserve Policy With a Comprehensive Financial-Planning Model to Account for All Unrestricted Net Assets

Alameda has developed a mechanism to demonstrate its intentions for using all its unrestricted net assets, which totaled $78.6 million at the end of fiscal year 2002–03. As shown in Table 2, these net assets would be sufficient to cover about 1.5 years of annual

expenses. Alameda's reserve policy establishes three different reserves to account for its unrestricted net assets. One of these, the retiree health benefit reserve, had no balance at the end of fiscal year 2002–03. According to Alameda's finance and administration manager, the board established this reserve in anticipation of forthcoming governmental accounting standards that, if implemented, would require governments to account for the costs of providing health care benefits to retired employees in a different way. Specifically, the anticipated standard would require such costs to be recognized during the periods when employees earn the right to such benefits, rather than accounting for these expenses when the benefits are actually paid or provided years later. At this point, the water district has not defined target levels for the reserve or triggers for its use. However, it anticipates adding these to its policies if the accounting standards change as expected.

Alameda's reserve policy sets a target level for its emergency reserve at 10 percent of annual budgeted operating expenses.

Alameda accounts for the remaining two reserves through its general fund and facilities improvement fund. Specifically, the board established the emergency rate stabilization reserve (emergency reserve), maintained as an account within the general fund, to provide for unforeseen events such as a natural disaster. The water district's reserve policy sets a target level for the emergency reserve at 10 percent of annual budgeted operating expenses ($3.9 million at the end of fiscal year 2002–03) and requires specific board action to access the reserve. Alameda's board also established the capital projects and contingencies reserve to account for all of Alameda's capital and operating activities.

Although Alameda's reserve policy does not specify target levels for its reserves in its general and facilities improvement funds or specify triggers for the use of those reserves, the policy does require the district to manage all its unrestricted activities through a comprehensive financial-planning model. This cash basis model projects the water district's annual cash flow for all revenues, operating expenses, and capital expenses over a 25-year period. The model incorporates data from a host of internal and external sources, including the capital improvement plan, the annual budget, and information it receives from water providers, Alameda County, and the State. Alameda adds data to the model as information becomes available throughout the year and prepares a comprehensive update for its board to review at the end of each fiscal year. Through its financial-planning model, Alameda has created a strong connection between the various rates it charges and the cash reserves it accumulates because it considers the availability of cash reserves, along with its projections of cash basis revenues and expenses, when it determines the rates it will charge for the year.

Otay Has Not Adequately Formalized Its Reserve Policy

Otay's reserve policy has not been updated since 1999 to reflect changes in the district's strategies related to reserves.

As of June 30, 2003, Otay had $49.8 million in unrestricted net assets, enough to cover about one year of annual expenses. Otay's board designated $38.3 million of this amount as reserved for three different purposes, with $11.5 million remaining as unreserved. Although we found that Otay has adequate plans and policies to manage the use of these net assets, its reserve policy has not been updated since 1999 to reflect changes in the water district's strategies related to reserves. Because Otay's reserve policy does not reflect its current plans and practices, the district might have a hard time supporting its intended use of reserves and is at greater risk of disregarding its reserve strategies.

For example, Otay maintains a reserve to provide funds for replacing major capital equipment or facilities. The water district has identified $25.1 million in specific projects to be paid from this replacement reserve over the next five years and has set a target level of $13.8 million for the reserve balance at the end of 2008. In light of these plans, the reserve balance of $29.7 million at the end of fiscal year 2002–03 seems reasonable. However, its 1999 reserve policy does not link the balance in the reserve to a five-year planning horizon, as the water district's current plans do.

Similarly, although the 1999 reserve policy does not reference it, Otay established a separate policy related to its insurance reserve. The water district maintains this reserve to fund the cost of providing medical and dental benefits to retired employees and board members. As of June 2003, the water district had accumulated $4.4 million in the insurance reserve and, based on an actuarial study, determined that it would have an actuarial accrued liability of $16.7 million as of June 2004. Otay's separate policy also requires the water district's staff to report annually to the board on the condition of the insurance reserve.

Finally, Otay put a cap equal to 90 days of expenses on the size of its unreserved net assets to meet operating and cash flow needs. The water district has apparently been adhering to this practice because its unreserved net assets at the end of fiscal year 2002–03 were enough to cover about 88 days of expenses. However, the 1999 reserve policy does not mention this cap.

Otay has recognized that its reserve policy is old and needs to be revised. In fact, according to a 2003 report on the status of its strategic-planning efforts, the water district has started work on establishing and updating policies for reserve fund governance. Completing these efforts will enable Otay to justify to ratepayers

and taxpayers the size of its reserved and unreserved net assets and will provide greater assurance that its plans for using them will be followed.

San Gabriel Has Taken Action to Reduce Excess Reserves

Finally, although San Gabriel had accumulated more in unrestricted net assets than its reserve policy allows, it has taken action to reduce them. As shown in Table 2, San Gabriel had $20.3 million in reserves as of the end of fiscal year 2002–03, based on calculations in accordance with its reserve policy. Because the water district has an operations reserve to provide for its cash flow and operations needs, it considers the unreserved balance of $12 million to be an excess.

San Gabriel adopted a reserve policy in June 2003 that defines target levels to be maintained for cash flow, operations, rate stabilization, and capital replacement needs.

According to San Gabriel's general manager, the excess built gradually, and the water district was slow to recognize and react to the fact that it had accumulated too much money. San Gabriel engaged a consultant to review and advise on the levels of district reserve funding. Based on the consultant's findings, the water district adopted a reserve policy in June 2003 that defines target levels to be maintained for cash flow, operations, rate stabilization, and capital replacement needs. Because the target levels are defined in terms of annual expenses, it was easy for the water district to identify the excess at June 30, 2003. For example, the policy sets a target level for San Gabriel's cash flow reserve at 10 percent of annual expenses to cover imbalances in the timing of certain receipts and disbursements. Using this type of measure allows the water district to annually assess compliance with its reserve policy. To reduce the excess, San Gabriel provided several grants and no-interest loans for water projects to its member cities. In this way, it was able to reduce unneeded reserves while providing a direct benefit to water users and taxpayers. Finally, a clause in the reserve policy requires the water district to determine compliance with the policy during the annual budget approval process. To the extent that any excess is identified, San Gabriel has an opportunity to consider whether any adjustments to its rates are warranted.

COMPREHENSIVE RESERVE POLICIES HELP LINK WATER RATES AND THE ACCUMULATION OF RESERVES

Article XIII B of the California Constitution states that "each entity of government may establish such contingency, emergency, unemployment, reserve, retirement, sinking fund,

trust, or similar funds as it shall deem reasonable and proper." The California Water Code does not generally impose any requirements or provide any guidance to water districts concerning reserves. One exception is the portion of the Water Code governing the activities of water replenishment districts. Specifically, Section 60290 imposes a cap of $10 million on replenishment district reserves beginning in fiscal year 2000–01. This statute also allows water replenishment districts to adjust the cap based on the cost of water from a district's supply sources. However, the data we obtained from the controller showed that there were only two water replenishment districts in the State as of fiscal year 2001–02. Therefore, all other types of water districts, including those we reviewed, have broad discretion in determining the number and character of reserves they choose to maintain. Nevertheless, as part of its fiduciary responsibility to the ratepayers and taxpayers that support its activities, each water district should be able to demonstrate how it deems its reserves to be reasonable and proper.

Although the Water Code is generally silent on reserves, guidelines issued by the California Special Districts Association (CSDA) and the Government Finance Officers Association (GFOA), and a position paper written by certain members of the League of California Cities detail ways in which government entities can fulfill their fiduciary responsibility by documenting that their reserves are reasonable and proper. For example, the CSDA recommends that each special district formulate and adopt a reserve policy as an integral part of the prudent accumulation and management of reserves. Further, the CSDA states that a reserve policy should provide a clear and well-articulated rationale for the accumulation and management of reserve funds and should clearly identify the categories and purposes of all reserve funds. Similarly, in advocating the need for governments to maintain stabilization funds to protect against reducing service levels or raising taxes and fees, the GFOA recommends that governments establish policies regarding how and when a government builds up stabilization funds and should identify the purposes for which they may be used.

The California Special District Association recommends that districts should clearly identify categories and purposes of reserves.

The CSDA further recommends that a special district set target levels for reserves that indicate the desired size of each reserve and are consistent with a district's mission, its uniqueness, and the philosophy of the district's board and community. Similarly, regarding stabilization funds, the GFOA advises governments to develop a policy on minimum and maximum reserve levels and suggests that the minimum and maximum amounts to

be accumulated be based on the types of revenue, the level of uncertainty associated with revenues, the condition of capital assets, or the government's level of security with its financial position. Setting a target level for each reserve fund provides a strong mechanism for special districts to ensure that they accumulate an appropriate amount of reserves and can highlight when reserves are too large or too small.

It is also important that reserve policies be clear about when accumulated reserves should be used. A position paper on reserve policies by members of the League of California Cities contends that a city should adopt reserve policies that specify what funds it can set aside as reserves, define how it can use the funds, and establish triggers for their use. Among the triggers that the position paper suggests cities could put in place are changes in the consumer price index, a specified percentage decrease in revenue, a catastrophic event, or actions by the State. Cities need to consider carefully which triggers to establish, provide for the triggers in their policies, and specify when reserves can be drawn from and who has the authority to decide to do so. Similarly, the GFOA provides an example of some triggers that Portland, Oregon, established in 1990 to specify when it should access a portion of its general fund reserve. Portland's policy indicates that the reserve may be used when either revenue growth falls to below 5.5 percent for two consecutive quarters or revenue growth is projected to be below 5.5 percent for the next fiscal year, and when one or more of the following conditions occur in conjunction with slower revenue growth:

- Unemployment rate exceeds 6.5 percent.
- Property tax delinquency rate exceeds 8 percent.
- Business license revenue growth falls below 5.5 percent.

The CSDA also believes that reserve policies must be consistent with other financial and budgetary practices. As an example of this, it promotes the creation of a well-developed capital improvement plan as a critical element of regular strategic-planning efforts. The CSDA indicates that a capital improvement plan provides the framework for making decisions regarding the use of cash and debt to finance capital projects. The CSDA further views the development of and adherence to strong reserve policies as the means to greatly simplifying funding choices for the capital plan. However, the CSDA warns that blind adherence to arbitrary reserve levels can be just as inhibiting as no reserves at all. The key, the CSDA says, is to make the

accumulation or depletion of reserves work in harmony with the capital plan, the operating budget, and the risk management of the special district.

Based on guidance we reviewed and on our observations at eight water districts, we believe that effective reserve policies should, at a minimum, possess seven attributes.

As described earlier in this chapter, we believe that the failure to adopt and implement reserve policies exhibiting the previously described characteristics led five of the eight water districts to maintain reserve levels that they may not be able to strongly defend to ratepayers and taxpayers. Based on the guidance just described and our observations at eight water districts, we believe that, at a minimum, an effective reserve policy should do the following:

1. Distinguish between restricted and unrestricted net assets.

It is important that water districts deposit restricted revenue sources, such as SWP taxes and capacity charges, into restricted accounts and report these net assets separately. This ensures that water districts can demonstrate compliance with laws, regulations, and other externally imposed restrictions about the required use of such funds. In addition, for anyone using water district financial information, separate accounting and reporting clarifies that districts do not have discretion over how they use restricted funds.

2. Establish distinct purposes for all reserves.

After isolating the portion of net assets that is either invested in capital assets or restricted, water districts should identify the other unique needs they have for the remaining net assets. In making these determinations, water districts should take care to ensure that reserves do not have overlapping or duplicate purposes. For example, should a water district choose to establish two separate reserves, one for rate stabilization and another for contingencies, it should be sure that both reserves do not serve essentially the same purpose of absorbing operating cost increases. In this way, any unreserved balances that remain serve as a measure of amounts available for other purposes, such as rate reductions.

3. Set target levels for reserves, such as minimums and maximums.

Setting a target level for each reserve fund provides a strong mechanism for water districts to ensure that they accumulate an appropriate amount of reserves and can highlight when

reserves are too large or too small. These target levels should generally not be fixed dollar amounts. Rather, they should be tied to an indicator that fits with the purpose of the reserve. As examples, an operating reserve could be set at two to three months of annual expenses, a capital asset replacement reserve could be tied to a percentage of accumulated depreciation or replacement costs, and a reserve limit for capital improvement projects could be the anticipated cost of planned projects over a five-year planning horizon. In all these examples, the measure of the desired size of the reserve should change as the key indicator does. With such target levels in place, water districts can more easily determine if reserves become too large or too small and can react accordingly.

4. Identify the triggering event or scenario to prompt the use of reserve funds.

Water districts should ensure that reserve policies clearly indicate the circumstances under which the district will use each reserve. This is particularly important for reserves that are designed to mitigate some type of risk but are not used on an ongoing basis. For example, stabilization reserves are commonly used to offset rate increases. If a water district maintains such a reserve but does not specify what type or level of rate increase the funds are intended to offset, the district may never use the reserve, calling into question the need for the reserve.

5. Conform with capital asset planning.

Water districts should ensure that reserve policies are consistent with plans to expand or replace capital assets. Accumulations of reserves for capital projects should be based on both a water district's assessment of capital needs over a given time frame and its philosophy for financing the purchase or construction of capital assets. In this way, whether choosing to accumulate cash or issue debt to pay for capital projects, water districts can better demonstrate that such reserve levels are appropriate.

6. Receive board approval and be in writing.

Making water district boards accountable for reserve policies enhances public awareness of and participation in the business affairs of each district. In addition, through board approval, a policy becomes formal and put in writing, providing greater

assurance that the policy will be thorough and well thought out. Without official board approval, there is less assurance that water districts will consistently carry out their reserve strategies. Finally, boards should approve any amendments or revisions to reserve policies. This provides for a level of consistency from year to year in actions related to reserves.

7. Require periodic review of reserve balances and policies.

Water districts should regularly revisit the adequacy and necessity of their reserves, particularly when making rate-setting and budgeting decisions. This helps ensure that rates are consistent with reserves and that policies continue to reflect the long-term goals of the water districts as these goals evolve.

RECOMMENDATIONS

To demonstrate that they are using their accumulated public funds to cover reasonable and necessary expenses, water districts should ensure that they have comprehensive reserve policies in place that, at a minimum, do the following:

- Distinguish between restricted and unrestricted net assets.
- Establish distinct purposes for all reserves.
- Set target levels, such as minimums and maximums, for the accumulation of reserves.
- Identify the triggering events or conditions that prompt the use of reserves.
- Conform with plans to acquire or build capital assets.
- Receive board approval and be in writing.
- Require periodic review of reserve balances and the rationale for maintaining them.

The Legislature should consider amending the California Water Code to require all water districts to develop and implement comprehensive reserve policies that include the key elements discussed in this report and outlined in our recommendation to the water districts.

To ensure that special districts report information on their enterprise activities in a manner that is consistent with current governmental accounting standards, the controller should amend its instructions to special districts and the format of its *Special Districts Annual Report* for reporting special district equity. Specifically, the instructions and reporting format should reflect special district equity in terms of net assets for all of their enterprise activities. In addition, to ensure that anyone reading the *Special Districts Annual Report* understands clearly how special districts intend to use the unrestricted net assets from their enterprise activities, the controller should continue to ask special districts to separately identify the portion of their unrestricted net assets that their boards have reserved for specific purposes. ■

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CHAPTER 2

Strengthened Policies Could Help Ensure That Water District Expenses Are Reasonable and Necessary and That Directors Avoid Conflicts of Interest

CHAPTER SUMMARY

Leaders of governmental entities that hold funds in public trust are responsible for controlling those funds with care and ensuring that fund allocations benefit the public they serve. To help exercise this prudent control, governmental leaders must have reasonably specific and constraining policies to guide them. Our review of eight water districts revealed that guidance applicable to directors' expenses was weak in many cases and training on conflicts of interest was inconsistent. Improprieties such as imprudent spending and conflicts of interest can erode the trust of the public that governmental entities, such as water districts, are intended to serve.

State statutes governing directors' expenses provide only general direction, and the policies of some water districts appear to be overly generous about the types of expenses districts consider appropriate. Because policies and guidance are not sufficiently specific or constraining, some water districts have approved expenses for their directors that do not appear to be reasonable and necessary uses of public funds. Examples of these types of questionable expenses include paying fees or similar costs for directors to attend retirement and anniversary celebrations, holiday gatherings, and other types of social events; paying daily stipends to their directors for such attendance; and paying for directors' spouses to attend the events. Regarding conflicts of interest, inconsistent attendance at periodic training may have contributed to an apparent conflict of interest that arose when a water district director voted on contracts with companies with whom the consulting firm she owned had been doing business.

Further, we observed that the eight water districts we visited have varying approaches to complying with the state law requiring special districts to disclose reimbursements of $100 or more for each charge paid to a district director. Among the

approaches used by six water districts was making internal reports available to the public upon request. By contrast, one water district—San Gabriel Valley Municipal Water District (San Gabriel)—produces a quarterly report showing all payments it made to and on behalf of each director. We believe that San Gabriel's approach gives ratepayers and taxpayers a clearer picture of the nature and amount of each expense than do the methods used by the other six water districts. The remaining water district told us that its directors incurred no individual administrative expenses of more than $100 during the 30 months we reviewed, from July 1, 2001, through December 31, 2003.

USING WEAK POLICIES AND INADEQUATE GUIDANCE, WATER DISTRICTS HAVE REIMBURSED DIRECTORS FOR UNREASONABLE AND UNNECESSARY EXPENSES

State statutes covering districts' expenses provide only general direction, while policies for some water districts appear to be overly generous about the types of expenses districts consider to be appropriate.

Policies and guidance that control water districts' spending of public funds should be sufficiently specific and provide enough constraints to ensure that directors' expenses are reasonable and necessary for achieving the water districts' purposes. However, state statutes covering directors' expenses provide only general direction, and some water districts' policies appear to be overly generous about the types of expenses considered appropriate. Consequently, some water districts have approved expenses for their directors that do not appear to be reasonable and necessary for achieving the districts' purposes. Examples of these types of questionable expenses include paying fees or similar costs for attending retirement and anniversary celebrations, holiday gatherings, and other types of social events.

Our review of information on expenditure amounts for the 30-month period from July 1, 2001, through December 31, 2003, revealed that three of the eight water districts we visited paid a total of about $47,000 in expenses that did not seem reasonable and necessary. While these questionable expenses are relatively small compared with the districts' total spending, they are nonetheless troubling because of their apparent lack of a substantial relationship to the water districts' purposes. Directors' expenses that are not reasonable and necessary can undermine public confidence in the water districts' stewardship of their public funds.

Some Water District Policies and Guidelines Do Not Sufficiently Define or Constrain Directors' Expenses

State provisions and water district policies provide varying degrees of guidance concerning allowable expenses by water district directors. In carrying out their functions, water districts act as public agencies and are subject to various restrictions on the use of public funds within their possession. As special districts, water districts are limited-purpose local governments that deliver specific public services within defined boundaries. The water districts are limited to carrying out authorized purposes by law and do not possess the more general authority of the State and counties, which have broad governmental power to undertake activities that affect the general welfare of their citizens. Additionally, because they have limited powers, water districts must use their public funds to further their specific purposes, not to carry out more general purposes. Consequently, water districts can spend funds and use other sources within their possession only for the purposes expressly authorized by law or to carry out the powers necessarily implied to carry out the powers granted by law.

Regarding stipends, state statutes allow a water district to adopt an ordinance to compensate its directors up to $100 per day for each day's service at meetings of the district's governing board (board) or for each day of service by request of the board, to a maximum of 10 days per calendar month. State statutes allow special districts to increase the amount of their stipends by no more than 5 percent each calendar year following the operative date of the last adjustment. Because these statutes do not identify what constitutes a board meeting or a day of service for purposes of paying stipends, districts must rely on their own policies to provide the necessary specificity and constraints.

Water district policies varied in their specificity about the types of expenses deemed reasonable and necessary.

All eight water districts we visited have policies for paying for directors' expenses and for paying stipends for services as a director. Although all the policies state that the water districts reimburse directors for reasonable and necessary expenses, the policies vary in how they define expenses deemed reasonable and necessary. For instance, the policies in use at Alameda County Water District (Alameda), Leucadia Wastewater District (Leucadia), Otay Water District (Otay), and Western Municipal Water District (Western) identify the types of district services for which directors are preapproved for compensation. Some of these services include attendance at water association meetings; meetings of local, regional, statewide, or public officials; or any other service deemed

to be rendered as a director at the request of the board. The policies in place at Alameda, Leucadia, Otay, and the Walnut Valley Water District (Walnut Valley) identify types of expenses for which they do not reimburse their directors. Examples of prohibited reimbursements include expenses incurred by family members accompanying directors to events, entertainment or recreational expenses, and alcoholic beverages.

Some Water Districts Funded Events That Do Not Appear to Be Reasonable and Necessary Uses of Public Funds

Three water districts used public funds to pay attendance or similar fees for their directors' participation in events such as social mixers, retirement parties, anniversary celebrations, and chambers of commerce functions.

Absent sufficient direction from either state statutes or their own policies, three of the eight water districts we reviewed paid directors' expenses that do not appear reasonable and necessary. These three water districts—Western, Walnut Valley, and Otay—used public funds during our 30-month review period to pay attendance or similar fees for their directors' participation in events such as social mixers, retirement parties, anniversary celebrations, and chambers of commerce functions. In the 30 months, payments from the three water districts for 103 such events totaled about $4,400. Further, Walnut Valley and Otay used public funds to pay their directors daily stipends totaling $14,500 for attending these types of events. Moreover, we found that in a handful of instances, Western paid for the directors' spouses to attend certain events. We also have concerns about a $10,000 contribution by Western to a foundation and about Walnut Valley's spending of almost $18,000 for 15 meals.

Some of Western's Expenses Do Not Appear Reasonable and Necessary

Although the policies and practices Western uses allow for expense payments for events such as functions held by chambers of commerce, we question whether Western is using its public funds prudently by paying its directors to attend retirement and anniversary celebrations. For our 30-month review period, Western identified nearly $19,500 in expenses related to its directors for items such as travel and fees for participating in events. Our review of its expenses showed that Western paid about $1,600 in fees for its directors to attend functions that included two retirement parties and 28 installation ceremonies, lunches, or similar events put on by local chambers of commerce. Further, Western contributed $10,000 to the Water for the West Foundation (foundation) to sponsor a celebration of the 100th anniversary of the U.S. Bureau of Reclamation and the foundation's educational efforts. The event was held on June 17, 2002, at the Hoover Dam. For its $10,000 sponsorship, Western received two VIP seats to the celebration, two VIP reception tickets, eight main seating

tickets, two 11-inch commemorative pewter platters, and various collectable items. Finally, Western paid $360 for directors' spouses to attend four events, including inauguration or installation events for chambers of commerce and an awards banquet.

Western's written policies allow its directors to attend events at local agencies to dispense information relating to the water district and to serve as program speakers at community organizations. In response to our questions about the propriety of these types of expenses, Western stated that attending such events "afford an opportunity for Western to discuss many issues informally with other agencies and leaders of the community." Western also pointed out that to achieve its goal of "maintaining consistent, effective, and open channels of communication" with other entities, as stated in the water district's 1991 strategic plan, it encourages directors to attend regular meetings of public and private entities important to its interests.

Some water districts we visited do not pay for their directors to attend functions that are social activities.

Although we acknowledge that Western may find merit in any informal discussions that may occur at the events we have identified, and the water district might have the implied authority to promote good relations between itself and the community, we question whether spending public funds for events that are primarily social in nature is the most prudent way to achieve this goal. Some water districts we visited do not pay for their directors to attend similar functions. For instance, Alameda told us that it used to be a member of a chamber of commerce but decided to drop its membership because it did not believe that the chamber's purpose was closely related to Alameda's business. Alameda views chamber events like mixers and general membership luncheons as social activities.

Regarding its payments for directors' spouses, Western pointed to its reimbursement policy, which states that the water district will not reimburse a director's expenses for an accompanying spouse or family member unless the spouse's or family member's presence has a business purpose essential to the performance of the director's duties. According to Western, in the four instances we described here, such legitimate purposes existed.

However, we believe that a water district should not pay expenses incurred by a director's spouse or family member. In 1992, the attorney general issued an opinion about a situation that closely resembled the events at Western. Based on the State's prohibitions against conflicts of interest, the attorney general stated that a hospital district should not pay the travel and incidental expenses

incurred by the spouse of a district director who attends a conference on official business of the district when that public official participates in approving these services.

Walnut Valley and Otay Also Made Questionable Payments

Because of weak policies, Walnut Valley and Otay made questionable payments totaling approximately $2,800 for their directors to attend events similar to those we found at Western. These two water districts identified a total of $247,400 in expenses paid to or on behalf of their directors from July 2001 through December 2003 for items such as travel and fees for participating in events. In addition to these expenses, neither district could demonstrate that $14,500 in stipends they paid directors attending such events were reasonable and necessary.

Examples of questionable stipend payments include Walnut Valley's payment of $100 each to four of its five directors to attend a holiday luncheon hosted by a local manufacturers' council (council) in 2001. The fifth director also attended the 2001 luncheon but did not claim a stipend for it. Walnut Valley paid $140 to cover attendance expenses at the luncheon for the five directors and one other district employee. For the council's 2002 holiday luncheon, three Walnut Valley directors claimed stipends, and the water district paid $210 to cover attendance expenses for five directors and other district staff. For the council's 2003 holiday luncheon, four directors claimed stipends, and Walnut Valley paid $210 to cover attendance expenses for the five directors and other staff. We also found instances when Walnut Valley paid stipends to its directors for attending funerals and for social events such as farewell and retirement luncheons, and several social mixers hosted by the chambers of commerce.

Walnut Valley paid stipends to its directors for attending funerals and social events such as employee farewell and retirement luncheons, and several social mixers hosted by chambers of commerce.

We also observed that during our 30-month review period, Walnut Valley appeared to be overly generous in the amounts it paid for some directors' meals; it was the only water district at which we observed this condition. Specifically, Walnut paid a total of almost $18,000 for 15 meals provided to its directors and others while away from the district. For example, for a meal at an Anaheim restaurant attended by four directors and 24 others, Walnut Valley paid more than $2,500, an average of $91 per person. According to information provided by the water district, the number of people attending these 15 meals ranged from six to 29; the number of directors attending ranged from one to four. The average cost per person for each meal ranged from $62 to $155. If the cost of each of the director's meals was equivalent to the average cost per person, then the estimated

total cost to ratepayers and taxpayers for the 40 total instances when Walnut Valley paid the directors' share of these meals was $3,700, an average of $93 per director for each of the 15 meals.

Our review of expenses at Otay disclosed eight payments totaling $770 to its directors for expenses related to attending events not specifically related to water, such as an Asian Business Association dinner and various chambers of commerce events. In the 30-month review period, Otay paid stipends totaling approximately $3,300 to its directors for attending events such as holiday parties, Hispanic and Filipino American chambers of commerce meetings, and breakfasts with the mayor of Chula Vista.

Walnut Valley and Otay appear to have approved these types of expenses because of weak policies. Although Walnut Valley's expense policy states that the water district reimburses directors for expenses they incur for activities that benefit the district, it does not define what "benefit the district" means, nor does it identify the types of events that the district believes further its specific purposes. Walnut Valley stated that various events and activities hosted by local area chambers of commerce and other local associations (especially during water awareness month) provide a business/communication forum through which the public is provided the opportunity to personally speak to representatives and be kept informed about water-related issues, including rates and charges, costs of imported water and the effect on water rates, drought conditions, and current water supplies. Participation in chamber activities also provides the grassroots support for the district's commercial and industrial conservation programs that keep the district in compliance with mandatory requirements of the California Urban Water Conservation Council's Best Management Practices.

Otay's reimbursement policy states that activities such as chamber of commerce meetings are allowable "when applicable to issues involving the district." Further, Otay stated that under the district's strategic plan, the district emphasizes developing positive community relationships and educating community members about the provision of water services, water conservation, and water recycling. Otay also stated that participating in community events serves several of the district's goals and public purposes by establishing new relationships between the district and its customers and ratepayers; providing the district with an opportunity to educate the community about the services the district provides; strengthening positive ties between the district and the community it serves; engendering confidence and trust; broadening communications

We fail to see how participation in primarily social events bears a sufficiently direct link to achieving a district's purpose.

with key stakeholders; and helping to maintain effective communications with service area cities, neighboring special districts, state and government representatives, and community organizations. However, although a certain amount of participation in community events may promote the purposes of water districts, particularly when water-related issues are discussed, we fail to see how participation in primarily social events such as holiday parties and membership installations for chambers of commerce bears a sufficiently direct link to achieving the districts' purposes.

SOME DISTRICTS DISCLOSE DIRECTORS' REIMBURSEMENTS MORE EFFECTIVELY THAN DO OTHERS

One of the eight water districts we visited—Crestline-Lake Arrowhead Water Agency (Crestline)—did not provide disclosure reports to us, telling us that its directors incurred no individual administrative expenses exceeding $100. Each of the remaining seven water districts had some method of disclosing its directors' reimbursements. However, the method adopted by one water district—San Gabriel—enables ratepayers and taxpayers to see the nature and amount of each incurred expense more effectively than do the practices used by the other water districts.

State law, effective January 1995, requires special districts to disclose reimbursements at least annually for all individual charges of $100 or more that the special districts paid to directors within the preceding fiscal year. Individual charges include, but are not limited to, one meal, lodging for one day, transportation, or a registration fee paid to the director. The law states that the disclosure must include reimbursement information in a document published or printed at least annually and must be made available to the public. The analysis supporting the legislation enacting this law mentions that constituents of a water agency were "outraged" to discover that staff billed the district $160,000 over nine years for "fancy meals, limousines, and pricey accommodations."

San Gabriel periodically issues a document that describes a particular cost (for example, the name of a conference attended or the destination of a flight taken), the date the district incurred the cost, and the name of the director who incurred it. Directors for San Gabriel review this document and approve it during a board meeting open to the public. Further, San Gabriel discloses

on this document when it prepays expenses for a director (for example, when it purchases an airline ticket for a director rather than reimbursing the director who purchases a ticket personally), and the water district discloses all reimbursements it makes to its directors as required by law. We believe that the disclosure methods adopted by San Gabriel enable it to more clearly demonstrate to ratepayers and taxpayers the types of expenses it pays for its directors.

One of the water districts we reviewed is able to clearly demonstrate the types of expenses it pays for its directors; six of the other water districts took less obvious steps in their attempts to comply with the State's disclosure law.

Six of the other water districts we visited took less obvious steps in their attempts to comply with the State's disclosure law. Alameda provides its board with a quarterly report detailing the expenses directors incurred for items like conference registration fees, lodging, and air travel. Although it does not discuss this report in an open meeting, Alameda makes the internal report available to those who request it. Otay produces an annual report that summarizes the expenses each director incurred by month, and Otay's directors vote on the report in an open board meeting. Further, rather than limiting its report to just expenses of $100 or more, Otay discloses expenses as low as $5. However, Otay does not disclose individual reimbursements as state law requires; it simply provides the monthly totals for each director for items like mileage, seminars and conferences, and travel. As noted earlier, the law requires special districts to disclose individual charges.

Leucadia, Walnut Valley, and Western indicated that they disclose director expenses simply as part of their periodic lists of warrants paid or to be paid that they bring before the board. Also, Wheeler Ridge told us that its directors incurred no disclosable expenses during our 30-month review period. It added, however, that if its directors did incur any disclosable expenses, it would include them in the overall list of accounts payable distributed monthly to directors at board meetings. None of the four water districts produces a distinct report that separately identifies administrative expenses for their directors. Therefore, if concerned ratepayers or taxpayers wish to identify the directors' expenses, they must hunt for them among all the other warrants or payables listed. Further, Walnut Valley does not disclose individual reimbursements as state law requires. We believe that the practices used by these four water districts to disclose directors' expenses through warrant registers or payables lists are clearly weaker than if they had produced a separate document for consideration during board meetings.

TRAINING CAN INCREASE DIRECTORS' AWARENESS THAT THEY MUST DISCLOSE AND AVOID CONFLICTS OF INTEREST

Among the eight water districts we visited, some offered directors comparatively comprehensive training in the State's conflict-of-interest requirements, and others could not provide evidence that their training pertained to conflicts of interest. An example of some directors' lack of awareness of state conflict-of-interest laws occurred at Leucadia, where a director appears to have participated in making decisions in which she had financial interests. Additionally, water districts do not always ensure that directors appropriately disclose their economic interests. We believe that the kinds of violations we found are more likely to occur when water districts fail to ensure that directors attend periodic training on conflicts of interest and ethics.

Conflict-of-interest laws are based on the belief that government officials owe paramount loyalty to the public and that the personal or private financial considerations of government officials should not be allowed to enter the decision-making process. By prohibiting directors, or the governing boards of which they are members, from making contracts in which they have financial interests, the State's conflict-of-interest laws are designed to prevent, or at least limit, the possibility of public officials' personal interests tainting their decision-making processes and distracting them from exercising loyalty and allegiance to the best interests of the citizens they serve.

State Law Defines Conflict-of-Interest Requirements

The central law pertaining to public officials and conflicts of interest in California is the Political Reform Act of 1974.

Various state laws are designed to ensure that public officials carry out their official duties free from personal financial conflict. The central law pertaining to public officials and conflicts of interest in California is Section 81000 et seq. of the Government Code, known as the Political Reform Act of 1974. This law imposes various obligations on public officials, including requirements related to the public disclosure of private financial assets and a requirement that public officials who have financial interests in government decisions disqualify themselves from any participation in those decisions. As the Political Reform Act states, its intent is to set up a method for disclosing public officials' assets and incomes that could be materially affected by their official actions and disqualifying officials from acting when necessary to avoid conflicts of interest.

The Political Reform Act requires public officials whose decisions in public office could affect their economic interests to file statements disclosing their investments, income, business positions, and interests in real property shortly after assuming public office, each year thereafter, and shortly after leaving public office. These disclosure statements, commonly known as Form 700s, are public records. The public officials covered under this requirement include constitutional officers, members of the Legislature, county supervisors, city council members, mayors, judges, and other high-ranking officials; candidates for any of these offices; and public officials who manage public investments.

An Eight-Step Analysis to Determine Whether an Individual Has a Disqualifying Conflict of Interest Under the Political Reform Act

1. Determine whether the individual is a public official.
2. Determine whether the official is participating in or attempting to influence a governmental decision.
3. Identify the public official's economic interests.
4. Determine whether each economic interest has a direct or indirect effect on the governmental decision.
5. Determine if the effect is material.
6. Determine if the effect is reasonably foreseeable.
7. Determine if the effect is distinguishable from the effect on the public generally.
8. Determine if the official's participation is legally required.

Source: Fair Political Practices Commission, *Can I Vote? An Overview of Public Officials' Obligations Under the Political Reform Act's Conflict-of-Interest Rules.*

Under the Political Reform Act, a public official's disqualification from the governmental decision-making process hinges on the effect a decision will have on the public official's financial interests. The Fair Political Practices Commission—the primary entity charged with advising officials on compliance with the Political Reform Act—has established an eight-step analysis to assist individuals in determining whether they have disqualifying interests (see the text box). If an official's governmental decision would have the requisite financial effect, the official is prohibited from making, participating in making, or using his or her official position to influence the making of that governmental decision at any level of the decision-making process. The public official must publicly announce the financial interest that is the subject of the possible conflict of interest and disqualify himself or herself from any participation in the decision.

Another important conflict-of-interest law is Section 1090 et seq. of the Government Code (Section 1090). Section 1090 prohibits public officials, including water district directors, from entering into contracts in their official capacities in which they have personal financial interests. The intent of Section 1090 is to prohibit public officials from engaging in "self-dealing" when they participate in making public contracts. Although Section 1090 does not expressly define the circumstances under which a public official is considered "financially interested" in a contract, the courts have broadly construed the prohibition to apply to any financial interest that might interfere with the official's unqualified devotion to his or her public duty, whether

the interest is direct or indirect, and includes any monetary or proprietary benefits, or gain of any sort, or the possibility of these benefits. As one court stated, "However devious and winding the chain may be which connects the officer with the forbidden contact, if it can be followed and the connection made, the contract is void." Prohibited financial interests include a public official being employed by or acting as a supplier of goods or services to the contracting party, unless specific conditions are met. The public official with the proscribed financial interest cannot avoid the prohibition contained in Section 1090 by merely abstaining from participating in the decision-making process. Rather, the public agency as a whole may not enter into a contract when one of its members has a prohibited financial interest.

Prohibited financial interests include a public official being employed by or acting as a supplier of goods or services to the contracting party, unless specific conditions are met.

Under various circumstances, however, the prohibition contained in Section 1090 does not apply. The Legislature has defined several remote interests that, if present in a contracting situation, do not prevent the public agency from entering into the contract. If the public official discloses to the public agency his or her remote interest in the contract, if the interest is noted in the public agency's official records, and if the public official completely abstains from any participation in the making of the contract, then the public agency can lawfully execute the contract. For example, supplying goods or services to a party that contracts with a public agency is considered a remote interest as long as the public official has supplied the goods and services to the contracting party for at least five years before his or her election or appointment to the current term of office. In other words, although acting as the supplier of goods and services to a party that contracts with a public agency is generally a prohibited financial interest, if the business relationship has existed for at least five years before the public official's current term of office, it is considered to be a remote interest.

Further, in Section 1091.5 of the Government Code, the Legislature defines various noninterests. One example of a noninterest is a public official owning less than 3 percent of the stock in a for-profit corporation while meeting various other related requirements. If the public official's interest falls within the definition of noninterest, the public agency can legally enter into the contract, without any disclosure on the part of the public official with the noninterest.

It is important to note that when public officials participate in making and approving public contracts, they must comply with both the Political Reform Act and Section 1090. As discussed earlier, the Political Reform Act contains a general requirement that a public official disqualify him or herself from

a governmental decision, including the decision to enter into a contract, when he or she has a disqualifying interest. Under Section 1090, however, the requirements may be more stringent and might actually require the public agency to refrain from entering into a contract altogether if one of its members has a financial interest. The Political Reform Act plainly states that nothing prohibits the Legislature from imposing additional requirements beyond those imposed by the Political Reform Act, as long as the additional requirements do not prevent a person from complying with that law. In the case of a governmental decision to approve a contract, Section 1090 imposes such additional requirements by requiring the public agency to refrain from entering into a contract when one of its members has a prohibited financial interest.

Water Districts Take Different Approaches to Training Directors in the Requirements Related to Conflicts of Interests

While some water districts provided directors with comparatively comprehensive training, other districts could not provide evidence that their training pertained to conflicts of interest.

One method that water districts can use to help ensure that their directors comply with the State's conflict-of-interest requirements is to provide them with training. All eight of the water districts we visited claimed to provide some level of training on conflicts of interest. However, although some water districts give their directors fairly comprehensive training, other districts could not show us evidence that their training pertains to conflicts of interest. For example, as part of Crestline's orientation for new directors, the water district's legal counsel gives a presentation that contains a summary of conflict-of-interest laws, including the Political Reform Act and Section 1090. On the other hand, the general counsel for San Gabriel told us he offered to provide similar training to San Gabriel's directors but, as of April 2004, the directors had not yet taken advantage of his offer.

Five of the eight water districts we visited told us they offer their directors training from the Special District Institute (institute) or the California Special District Association (association). The institute provides a series of three seminars that includes special district governance, conflict-of-interest laws, and ethics, and the association has a special district governance academy that includes sections on conflicts of interest.

Even when water districts make training available to their directors, the extent to which directors participate in the training varies significantly among water districts. At seven of the eight water districts we visited, at least one director took advantage of available training opportunities. For example, four of the five current directors at Alameda have attended the

association's training seminar. Staff at Alameda told us that the fifth director is a former city councilman who had previously participated in seminars for new council members conducted by the League of California Cities and had additional orientation in conflict-of-interest laws through his former employment. Also, Walnut Valley sent letters to its directors recommending and encouraging their attendance at association and institute training sessions related to conflicts of interest and ethics.

None of San Gabriel's directors have attended training as recommended by the water district's legal counsel.

On the opposite end of the spectrum, however, is San Gabriel. Although the water district has recommended various training courses to its directors, including some administered by the Association of California Water Agencies, none of its directors has attended any course. San Gabriel's general manager told us that directors are well informed about conflicts of interest and ethics and the district's legal counsel frequently discusses these issues at board meetings. He also indicated that four directors are professional engineers and follow ethics codes of the profession, which are not too different from political ethics codes. Additionally, Leucadia makes association and institute training available to its directors, but not all directors attend the training courses consistently. Also, Western does not appear to offer consistent training, relying heavily on on-the-job experience to build directors' knowledge of ethics and conflict of interest.

Finally, each water district has, from time to time, supplied its directors with various informational handouts related to conflicts of interest. These handouts include, but are not limited to, a pamphlet titled *Pocket Guide to Conflict of Interest Laws* and the association's handbook for directors of special districts. These handouts appear to be useful references and would complement more comprehensive training focused on conflicts of interest and ethics. However, the interactive approach used in formal training to familiarize directors with applicable conflict-of-interest and ethics requirements is probably more effective than handing busy directors a guide on the subject and expecting them to read and understand its contents.

Though regular training on conflicts of interest and ethics cannot prevent directors from making willful departures from statutory requirements, it can serve to keep such requirements at the forefront of directors' minds and help directors hold one another accountable for fulfilling their responsibilities as public officials. Issues related to conflicts of interest and ethics led the Legislature to expand the requirement for biennial training on the subjects from just state agency directors to all state employees who file statements of economic interests. Compliance with this biennial

training requirement can be satisfied in part by participating in the on-line ethics orientation offered by the Office of the Attorney General. This requirement might provide water districts with a means of holding their elected officials accountable and ensuring that directors are more aware of their responsibilities regarding conflicts of interest and ethics.

Apparent Violations of Conflict-of-Interest Requirements Exist at Leucadia

Of the 49 current and former directors at the eight water districts we visited, we identified one director who may have violated state conflict-of-interest laws when participating in the approval of various contracts. A director at Leucadia is the sole owner and manager of a private consulting firm that offers public relations services. For one of its clients, an engineering company, the director's firm contracted in August 2002 to produce a monthly newsletter. The director's consulting firm receives $2,740 per month to produce the newsletter. In February 2003, six months after the director's consulting firm formed this business relationship with the engineering firm, the director voted to approve at least two agreements between Leucadia and the engineering firm for design services: an amendment to an existing contract worth $67,000 and a new contract for $35,900.

A Leucadia director's participation in the approval of agreements may have violated both Section 1090 and the Political Reform Act.

We believe that this director's participation in the approval of these agreements may have violated both Section 1090 and the Political Reform Act. As discussed earlier, the prohibition contained in Section 1090 is broadly construed. A public official who, outside his or her official capacity, provides goods or services to a party that contracts with a public agency will generally be considered to have a financial interest within the meaning of Section 1090, unless the public official started providing the goods and services to the contracting party at least five years before the public official's current term of office. In the Leucadia case, the director had already started her current term of office when her consulting firm began providing a service to the engineering firm. Although the director's participation in Leucadia's agreements with the engineering firm did not appear to directly affect the amount she received from the engineering firm in compensation for producing the monthly newsletter, we think it reasonable to suggest that when she participated in approving the agreements that awarded a public contract to one of her private clients, she promoted the financial well-being of that client, thereby causing her to have an indirect financial interest.

Leucadia's legal counsel asserts that the director's vote was permissible.

According to Leucadia's legal counsel, the director did not have a prohibited financial interest within the meaning of Section 1090 because she believes that no financial benefit, either direct or indirect, flowed to the director as a result of these agreements. Therefore, Leucadia's legal counsel asserted that the director's vote was permissible under Section 1090. Even if there was a financial interest, the legal counsel argued, the provisions of law contained in Section 1091.5 of the Government Code apply in the case of the Leucadia director and make that interest a noninterest. As previously mentioned, Section 1091.5 states that a noninterest exists when a public official owns less than 3 percent of the shares of a corporation for profit, provided that the public official also meets other related conditions. Leucadia's legal counsel stated that although the director did not own any stock in the engineering firm, she met the other related conditions and consequently had a noninterest. According to our legal counsel, Section 1091.5 requires some amount of corporate stock ownership, as well as meeting the other related conditions. Therefore, because the director does not own stock in the engineering company, Section 1091.5 does not apply. However, the final decision about whether the application of this section is appropriate rests with any resolution that may ultimately occur if this instance is pursued in the courts.

We also believe that participating in the approval of water district agreements with the engineering firm violated the Political Reform Act. Under this act, a public official has a disqualifying interest if he or she received more than $500 in income from a contracting party in the 12 months preceding contract execution. As previously mentioned, the director's consulting firm received $2,740 per month from the engineering firm and had received nearly $16,500 in the six-month period before Leucadia approved the firm's contracts.

The director consulted with Leucadia's legal counsel and was advised in July or August 2002 to abstain from voting on contracts related to this engineering firm and to disclose the reason for the abstention. Although the director abstained from a vote involving a $232,000 contract with the engineering firm 14 months later in October 2003, the minutes for this meeting do not indicate the reason why she abstained. Further, the director voted to approve agreements between Leucadia and the engineering firm in February 2003, despite the advice of the district's legal counsel in mid-2002. Further, despite the director's absence from a November 2002 meeting and her abstention from a vote during an October 2003 meeting, the contract agreements

made at those meetings might also violate Section 1090 because the director is presumed to have entered into any contract that the board, of which she is a member, entered into. If the only legal requirements at issue were those contained in the Political Reform Act, then the advice of Leucadia's legal counsel to abstain from voting would have been the appropriate course of action, assuming that the legal counsel also informed the director that she needed to publicly disclose the interest as the basis for the disqualification and that she is required to leave the room until any discussion or voting on the issue is completed. However, Section 1090 also applies in this case because contracts were involved. Therefore, given the director's financial interest in the engineering firm, the appropriate course of action for Leucadia to take was to refrain from entering into any agreement with the engineering firm.

By voting on a contract within 12 months from when she had received income from the contractor, the director appears to have violated the Political Reform Act.

In addition, the director may have violated the Political Reform Act when she voted to approve a contract with a second engineering company. In February 2003, the director voted with other board members to approve a contract with the second engineering company for $64,300. The director's private consulting firm had a written contract with this engineering firm to provide public relations services between May and July 2002, and her firm received approximately $19,000 in payment for its services during that period. As described earlier, the Political Reform Act prohibits a public official from participating in a government decision, such as the one at issue here, if he or she received more than $500 from that party within the 12 months preceding the government decision. By voting on this contract between seven and nine months after she had received this income, the director appears to have violated the Political Reform Act. The director did not seek advice from Leucadia's legal counsel on this issue. However, according to Leucadia's legal counsel, to the extent that the Bureau of State Audits contends that this instance constitutes noncompliance with the Political Reform Act, it was technical and inadvertent.

Some Water District Directors Failed to Appropriately Disclose Their Economic Interests

In reviewing records from eight water districts, we found that three water district directors did not include information related to business positions they held or income they earned in their economic disclosure statements as required by state law, state regulation, and district policy. Despite having owned her consulting firm for at least 10 years, the Leucadia director

previously mentioned did not disclose on her statements covering 2000 through 2002 either her income from or her business position with her consulting firm.[10] We saw another instance of this type of omission on an economic disclosure statement for one director at Walnut Valley and one at Otay.[11] When describing why they omitted their business positions from their economic interest statements, the directors told us either that they believed such disclosure was not required or that they simply did not think to include their positions or incomes.

If directors do not properly disclose their economic interests, it reduces the likelihood that they will be able to identify potential conflicts of interest.

Water district directors are required by the Political Reform Act to annually disclose their economic interests. These interests typically include income from or business positions with private firms, especially those doing business with the water district or in the water district's territory. Further, we noted that the policies of some water districts impose more stringent disclosure requirements on their directors, including the requirement to disclose income from or business positions with firms that perform the types of services that the water district uses. Examples of these types of services include financial, legal, and engineering services. By failing to properly disclose their economic interests, directors limit their ability to identify any potential conflicts of interest as they consider contracts and other district decisions. We believe that a better understanding of disclosure requirements and periodic reminders received through training could help prevent improper nondisclosures.

RECOMMENDATIONS

To ensure that all payments to or on behalf of water district directors are reasonable and necessary, water districts should adopt and implement policies that identify the types of events that they believe serve their statutory purposes as water districts and that explain how these events serve their statutory purposes.

To clearly inform ratepayers and taxpayers about the nature and amounts of reimbursements paid to directors, water districts should adopt and implement policies to periodically report in public board meetings the specific amounts paid to or on behalf of directors and the specific purposes of those payments.

[10] Shortly after we brought this omission to Leucadia's attention, the director filed an amended disclosure statement covering 2002.

[11] The Otay director holds a business position at a company whose subsidiary provides services to the district. Shortly after we brought the omission to Otay's attention, the director filed an amended disclosure statement covering 2003.

To ensure that their directors are fully aware of their responsibilities regarding conflicts-of-interest requirements, water districts should do the following:

- Provide periodic training related to conflicts of interest.
- Guide directors in completing economic disclosure forms and stress the importance of disclosing all economic interests as required by law.

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: June 24, 2004

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APPENDIX A

Services That Nine Types of Water Districts Can Provide, as Defined by State Law

Table A.1 summarizes the types of services that each of the nine types of water districts we reviewed can provide. Specific water districts may provide all or only some of the allowable services.

TABLE A.1

District Type	Water Code Section	Allowable Services
California Water	34000 et seq.	California water districts can produce, store, and distribute water for irrigation, domestic, industrial, and municipal purposes; drain and reclaim lands incidental to the districts or connected with them; grant to owners of water rights the right to use district storage and conduits upon approval at election or after notice and hearing; acquire, construct, operate, and furnish facilities and services to collect, treat, and dispose of sewage, waste, and storm water; and generate hydroelectric power. They can also allocate water according to crops and acreage in certain situations. Additionally, they have the authority to protect from contamination groundwater given to water replenishment districts.
County Water	30000 et seq.	County water districts can furnish water for any present or future beneficial use; acquire, appropriate, convey, conserve, store, and supply water; control and use sewage and storm waters; drain and reclaim lands; generate and sell at wholesale hydroelectric power; use any land or water under district control for recreational purposes; acquire, construct, and operate sewer and sanitation facilities; and provide fire protection services.
County Waterworks	55000 et seq.	County waterworks districts can supply inhabitants of districts with water for irrigation, domestic, industrial, or fire protection purposes; acquire and conserve water from any source; and treat or reclaim saline water and sewage. They can also construct and operate sewage collection and treatment facilities.
Metropolitan Water	Act 9129b et seq.	Metropolitan water districts can develop, store, and distribute water for municipal and domestic purposes; acquire, construct, and operate power facilities; and provide, generate, deliver, and use electric power. They can blend water from different sources to supply their member agencies. They can also furnish water outside district boundaries for generation of electric power, subject to conditions and restrictions.

continued on next page

District Type	Water Code Section	Allowable Services
Municipal Water	71000 et seq.	Municipal water districts can acquire, control, distribute, store, spread, sink, treat, purify, recycle, recapture, and salvage any water, including sewage and storm water, for beneficial uses of the districts, and their inhabitants or owners of rights to water in the districts; undertake water conservation programs; sell water to cities, public agencies, and persons in the district only, unless there is a surplus; construct and operate recreational facilities; acquire, construct, and operate facilities to collect, treat, and dispose of sewage, waste, and storm water; collect and dispose of garbage, waste, and trash; and provide fire protection services.
Water Agency or Authority	Uncodified Special Acts	Water agencies and authorities are created by special acts of the Legislature for various specific purposes and to address a variety of needs.
Water Conservation	74000 et seq.	Water conservation districts can appropriate, acquire, and conserve water and water rights for any useful purpose; construct and operate works, facilities, and operations to protect land or property from floods; store and distribute surface waters to district lands; replenish underground water; acquire water from underground sources; and generate hydroelectric power and sell it at wholesale.
Water Replenishment	60000 et seq.	Water replenishment districts can replenish groundwater supplies of the district and protect groundwater from contaminants.
Water Storage	39000 et seq.	Water storage districts can provide for the acquisition, appropriation, diversion, storage, conservation and distribution of water; drainage and reclamation; and the incidental generation and distribution of power.

APPENDIX B

Levels of Compensation and Benefits Water Districts Provide to Their Directors

We were asked to evaluate the benefits and compensation packages water districts offer their directors. During our visit at each water district, we determined the number of directors at each district, the daily stipend amount each director received to attend meetings, the maximum number of meetings each district allows per month, and the type of benefits the water districts offer their directors. Table B.1 on the next page shows that the directors for Western Municipal Water District receive the highest daily stipend amount—$229.21—while the directors for the Crestline-Lake Arrowhead Water Agency (Crestline) and the Walnut Valley Water District (Walnut Valley) receive the lowest—$100. Six of the eight water districts provide their directors with medical, dental, and vision insurance, while Crestline offers its directors only life insurance. In addition, the Otay Water District is the only one to offer its directors a monthly telephone allowance and workers' compensation, while Walnut Valley is the only one that offers its directors access to an Employee Assistance Program.

TABLE B.1

District	Number of Directors	Allowable Director Stipend Amount for Meetings	Maximum Number of Paid Meetings Allowed per Month	Benefits Provided										
				Medical	Dental	Vision	Life	Accidental Death & Dismemberment	Workers' Compensation	Employee Assistance Program	Public Employees Retirement System*	Deferred Compensation	Medicare Contribution	Telephone Allowance
Alameda County Water District	5	$175	6	X	X	X						X	X	
Crestline-Lake Arrowhead Water Agency	5	100	10				X							
Leucadia Wastewater District	5	130	10	X	X	X	X				X			
Otay Water District	5	145	10	X	X		X†	X	X					X
San Gabriel Valley Municipal Water District	5	140	10	X	X	X	X				X			
Walnut Valley Water District	5	100	6	X	X	X	X			X		X	X	
Western Municipal Water District	5	229.21‡	10	X	X	X	X†	X						
Wheeler Ridge-Maricopa Water Storage District	9	125	10	X	X	X	X	X						

Source: Information provided by the water districts.

* As of July 1, 1994, newly elected board members are excluded from Public Employees' Retirement System membership.

† These two water districts also provide dependent life insurance.

‡ The Western Municipal Water District was the only water district we visited whose adopted policy automatically increases the stipend paid by 5 percent on January 1 of each year. Directors have to actually vote down an increase to not receive one. Since 1994, Western's directors have rejected only one stipend increase.

Agency's comments provided as text only.

Alameda County Water District
P.O. Box 5110
Fremont, California 94537-5110

June 8, 2004

Elaine M. Howle
State Auditor
555 Capitol Mall, Suite 300
Sacramento, CA 95814

Dear Ms. Howle:

Enclosed please find the Alameda County Water District's response to the Audit of California's Independent Water Districts which was recently conducted by your office. The District's responses have been formatted on the attached diskette as requested. I have also enclosed a hard copy of this document for your review. Should you have any questions regarding the responses provided, please contact me at (510) 668-4251.

Sincerely,

(Signed by: William J. Zenoni)

William J. Zenoni
Finance and Administration Manager

Enclosures

Recommendations of California State Auditor
Audit of California's Independent Water Districts
June 2004

1) Develop/Maintain Comprehensive Reserve Policy which
   - Distinguishes between restricted and unrestricted reserves
   - Establishes distinct purpose for all reserves
   - Sets target levels for accumulation of reserves
   - Identifies triggering events/conditions for the use of reserves
   - Is consistent with plans to acquire/build capital assets
   - Is a written document which is approved by Board of Directors
   - Provides for periodic review of reserve balances and rationale for maintaining these reserves

   Response: *The Alameda County Water District concurs with this recommendation. The Board of Directors of the Alameda County Water District, in February 2002, approved a Reserve Fund Policy. That written document identifies the District's reserve funds, states the purpose of each reserve, sets a target level for accumulation of certain reserve funds and identifies the triggering events for use of the reserves. The Reserve Fund Policy states that reserves will be maintained to allow for funding of the District's operating, capital and debt service obligations as well as providing funding for unforeseen events and that reserves will be accumulated and managed in a manner which allows the District to fund costs consistent with the Capital Improvement Plan, Long Range Financial Plan and Integrated Resources Management Plan while avoiding significant fluctuations in water rates. The District's Reserve Fund Policy will be reviewed during the coming months and updated bi-annually in conjunction with the two year budget process.*

2) Adopt and Implement Specific/Constraining Policies to ensure that director expenses are reasonable and necessary

   Response: *The Alameda County Water District concurs with this recommendation and does have in place comprehensive policies to ensure that director expenses are reasonable and necessary.*

3) Adopt and Implement Policies to periodically report in public meetings of the governing board the specific amounts paid to or on behalf of directors and the specific purpose of those payments

Response: *The Alameda County Water District concurs with this recommendation. A report identifying amounts paid to board members is distributed to the Board of Directors on a quarterly basis. In addition, a report identifying all costs in excess of $100 paid in any calendar year is prepared, submitted to the Board of Directors annually and is made available for public inspection. In order to make this information more readily available for public review, these items will, in the future, be agendized for review at a regularly noticed meeting of the Board of Directors.*

4) Provide Periodic Training to Directors which
- Makes them aware of conflict-of-interest requirements
- Provides guidance in accurately completing economic disclosure forms

Response: *The Alameda County Water District concurs with this recommendation. The District does make training on conflict-of-interest requirements available to all Board members. As is indicated in this report, all of the District's Board members have, at one time, participated in these training programs. Staff does also provide guidance to Board members on an as needed basis to assist with completing economic disclosure forms.*

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Agency's comments provided as text only.

Best Best & Krieger LLP
Post Office Box 1028
Riverside, California 92502-1028

June 7, 2004

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

Dear Ms. Howle:

Pursuant to your letter of June 3, 2004 to the Crestline-Lake Arrowhead Water Agency, the Agency has reviewed the draft report entitled "California's Independent Water Districts: Reserve Amounts Are Not Always Sufficiently Justified While Some Expenses and Contract Decisions Are Questionable," and offers the comment set forth in the enclosed letter to you from the Agency dated June 7, 2004. We have arranged for the text of this letter to be downloaded onto the enclosed diskette, which we are also transmitting along with the Agency's comment letter in accordance with your request. All of this is being transmitted to you by overnight mail on June 7, 2004 to meet your deadline of June 9, 2004, for receipt of comment. Please let us know if you have any questions.

Sincerely yours,

(Signed by: Michael T. Riddell)

Michael T. Riddell
of BEST BEST & KRIEGER LLP

Encs.

* California State Auditor's comments appear on page 73.

Crestline-Lake Arrowhead Water Agency
P.O. Box 3880
Crestline, California 92325

Elaine M. Howle
State Auditor
555 Capitol Mall, Suite 300
Sacramento, CA 95814

Re: Report Following Audit of Crestline-Lake Arrowhead Water Agency

Dear Ms. Howle:

Thank you for this opportunity to comment on your report entitled "California's Independent Water Districts: Reserve Amounts Are Not Always Sufficiently Justified While Some Expenses and Contract Decisions are Questionable." This Agency appreciated the extensive review performed by your staff and is pleased to see that the audit produced no evidence of unauthorized, unreasonable, unnecessary or excessive expenditures by Directors, conflicts of interest, prohibited interests in contracts, or unethical activity. We are also pleased to be recognized in the report for the training provided by the Agency to ensure adherence to high ethical standards, and are likewise pleased to see that your auditors are not concerned about the size of the Agency's reserve.

The report recommends that this Agency revise its financial reporting to separately identify restricted funds which can be expended only for particular purposes. The Agency will be happy to do so. This information is maintained by the Agency annually, and therefore it will only require a revision in the reporting format.

The report also recommends adoption of a written reserve policy designed to achieve certain objectives identified in the report. The Agency's current reserve policy is the product of many years of discussion and has not been reduced to a single written document. We see merit in producing such a document, even if not required by law, and therefore the Agency will follow that recommendation as well.

Again, we thank you for this opportunity to comment on the report, and we commend you and your staff for their courteous and professional conduct in performing the audit.

Very truly yours,

(Signed by: Roxanne M. Holmes)

Roxanne M. Holmes
General Manager

COMMENTS

California State Auditor's Comments on the Response From the Crestline-Lake Arrowhead Water Agency

To provide clarity and perspective, we are commenting on the response to our audit report from the Crestline-Lake Arrowhead Water Agency (Crestline). The numbers below correspond to the numbers we have placed in the margin of Crestline's response.

1. While Crestline was reviewing our draft audit report for comment, we amended slightly the report's title.

2. Crestline's plan to simply revise its reporting format does not sufficiently address our concern. As we point out on pages 24 and 25 of our audit report, according to the terms of its State Water Project (SWP) contract with the California Department of Water Resources, Crestline must use a separate fund to account for the taxes it collects to cover its projected costs in the SWP. Further, these collections must be used for the specific purposes for which the tax was imposed. Because Crestline deposits its SWP tax receipts into its general fund along with revenue from other sources and has not historically distinguished the net assets related to the SWP from the net assets of the general fund, there is reduced assurance that Crestline has used these collections for the specific purposes for which the tax was imposed. Therefore, Crestline must not only establish a separate fund, it should also, to the extent that it still has historical data related to SWP revenues and expenses, reconstruct the amount of restricted net assets applicable to the SWP.

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Agency's comments provided as text only.

Leucadia Wastewater District
1960 La Costa Avenue
Carlsbad, CA 92009

June 9, 2004

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

Subject: Draft Bureau of State Audits Report: 2003-137

Dear Ms. Howle:

Attached is the Leucadia Wastewater District (LWD) response to the subject draft report. In accordance with your request, we are providing this hard copy and an electronic version (Word document) on the diskette provided by your office. Additionally, LWD's response was emailed to John Collins, Audit Principal, prior to 5 p.m. on Wednesday, June 9, 2004.

If you wish to discuss this response or have any questions, you may contact me at 760.753.0156, ext. 3014 or via emial at mbardin@lwwd.org.

Very truly,

(Signed by: Michael J. Bardin)

Michael J. Bardin
General Manager

Attachment

* California State Auditor's comments begin on page 85.

LEUCADIA WASTEWATER DISTRICT
RESPONSE TO BUREAU OF STATE AUDITORS DRAFT REPORT 2003-137
June 9, 2004

General Comments

1) The Bureau of State Audits (BSA) Report 2003-137 (Report) summary states that the accumulated resources of water districts audited totaled $485 million, and concluded that these accumulations are not excessive. The Leucadia Wastewater District (LWD) concurs with this finding and we believe this demonstrates that special districts provide sound and prudent planning for the replacement of present and future infrastructure. Prudent planning for infrastructure replacement is critical especially considering the infrastructure funding gap that exists both in California and nationally.

2) The scope of the audit's financial screening criteria and analysis is misleading and does not evaluate or assess other important elements of a water district's financial condition, practices or accountability to its ratepayers. For example, the report does not consider charges, types of service provided, level or quality of service provided, or the number of service accounts. LWD believes that inclusion of these items would provide a more meaningful perspective of water districts and how they are accountable to their respective ratepayers.

Chapter 1

1) The manner in which financial data is presented in Table 2 is misleading and does not accurately represent the financial condition, practices or policies of LWD. We offer the following table to clarify LWD's financial condition.

Leucadia Wastewater District
Unrestricted Net Assets Summary

Line Number	Description	Totals
1	Unrestricted Net Assets	$37,810
2	less Debt Service Reserve (dedicated to economic defeasance of Phase IV Revenue Bonds debt service)	$6,769
3	less Solids Mgmt. Reserve	$1,274
4	less Water Recycling Reserve	$1,720
5	less Capital Replacement	$23,136
6	Unrestricted Net Assets Not Dedicated to Future Capital Improvements (line 1 less lines 2+5)	$4,911
7	Annual Operating Expenses (FY 2004)	$5,497
8	Years of Expenses Unrestricted Net Assets not Dedicated to Future Capital Improvements Could Fund (line 6 divided by line 7)	**0.89**

Line 1 of the table above begins with an unrestricted net asset level of $37.8, which is identical to the Report's Table 2 line 7. However, Table 2 fails to account for several items such as LWD's outstanding bonded indebtedness and dedicated capital reserves. The table above illustrates that 87% of LWD's unrestricted net assets of $37.8 million are dedicated to capital facility reserves and the economic defeasance of outstanding debt. In fact, 23.1 million (61%) is dedicated to the Capital Replacement Fund that the Report recognizes as equating to LWD's accumulated depreciation of capital assets. Applying the Report's comparative methodology to LWD financial data as presented above indicates that LWD could fund less than 1 year (0.89%) of operating expenses from its unrestricted net assets. We believe the table presented above provides a more accurate depiction of LWD's financial condition.

LWD's unrestricted net assets not dedicated to future capital improvements or bonded indebtedness total $4.911 million. This figure represents the sum of the balance of LWD's Contingency ($1.6 million) and Rate Stabilization ($3.3 million) Reserves. These two reserves are operating reserves and combined could fund less than one year of operating expenses. These funds have been set aside to cover unexpected operating expenses or emergencies and offset potential abrupt rate increases. LWD believes the establishment and funding of these reserves is prudent, necessary and reasonable and serves the best interest of the LWD ratepayers.

2) The June 30, 2003 LWD Financial Statements prepared by independent certified public accountants, and provided to the BSA, includes data (the Combining Schedule of Changes in Net Assets) that clearly identifies the intended use of the District's unrestricted net assets. The LWD Reserve Policy, a written policy adopted by the Board of Directors, clearly identifies each of the District reserves, its purpose and source of funds.

   With respect to guidelines on reserve target levels, the LWD Financial Plan monitors reserve levels, sources and expenditures of funds. The Financial Plan does not establish fixed dollar amounts for reserves; however, it incorporates capital cost projections identified in the District's Master Plan to establish future reserve levels. The Financial Plan guides the District in setting rates and charges sufficient to fund current operational as well as future non-operational needs. The Financial Plan and Master Plan are updated on a five year basis.

Chapter 2

1) LWD complies with the disclosure requirements of GC Section 53065.5 as follows: LWD discloses on a monthly basis in the Board of Directors meeting agenda (on the demands list) all reimbursements paid to individual Board members and employees. In addition, LWD prepares and maintains separate, detailed expense reports that itemize all reimbursements paid. These detailed reports are available for public review.

2) LWD provides conflict of interest training, as well as training on a variety of other subjects, to its Board members through participation at professional associations' conferences, seminars and workshops. These professional associations include the California Association of Sanitation Agencies (CASA), California Special District Association (CSDA) and the Special District Institute (SDI). These training opportunities are available on an ongoing basis and Directors attend regularly.

In addition, the Board of Directors regularly receives training material and informational material regarding conflict of interest law training and updates. These materials are distributed to Board members at regularly scheduled Board meetings.

The LWD Board members are informed when annual Form 700's are distributed that the District's General Counsel is available to assist Directors in completing the forms and to answer any questions they might have. In addition, the Board members are informed that they may seek assistance or obtain information from the FPCC directly via the FPCC telephone hotline and website.

3. With respect to the BSA's concerns regarding apparent noncompliance with conflict of interest requirements, LWD's response is as follows:

I. <u>There Was No "Financial Interest" Within the Meaning of Section 1090.</u>

A. <u>Section 1090.</u>

Government Code section 1090 states:

Members of the Legislature, state, county, district, judicial district, and city officers or employees shall not be financially interested in any contract made by them in their official capacity, or by any board of which they are members. (Emphasis added.)

The interest prohibited is in the contract acted on by the public agency. It is not in the company that made the contract. Section 1090 is not a blanket prohibition against interests in companies that do business with public agencies.

In this instance, the Bureau of State Audits is questioning whether a Director violated Section 1090 because the Director's independent business provided monthly newsletter services to a corporation during a period in which the corporation entered into contracts with the District for unrelated engineering services.

The contract for newsletter services began in August, 2002. Prior to entering into the contract, the Director sought General Counsel's advice. General Counsel informed the Director to abstain from voting on contracts related to the engineering firm and to disclose the reason for the abstention during the period of the contract and for 12 months following termination of the contract. The newsletter contract provided for a set monthly fee that is not based, in any

way, on business the corporation does with the District. The Director does not have any stock or shares in the corporation and is not an employee. The monthly newsletter services were provided to the corporation on an independent contractor basis.

Since August 2002, the District approved three separate engineering contracts with the corporation. The Director voted to approve only one of the contracts. The Director disclosed the contractual relationship with the corporation and abstained from voting on one occasion and was absent on another.[1] Except for the Director's disclosure and abstinence from voting on the one occasion, the votes to approve the engineering contracts were unanimous. The Director did not participate in contract negotiations or take any action to influence any other Director with respect to approval of the engineering contracts before the Board.

The question in this instance is whether the Director's interest in the newsletter services contract created a prohibited Section 1090 financial interest in the three, unrelated engineering contracts between the District and corporation. The answer is no. The Director did not have any direct or indirect financial interest in the engineering contracts approved. The newsletter services were not tied, in any way, to the engineering contracts. The making of the contracts for engineering services did not affect the agreement for monthly newsletter services. Whether or not the corporation was awarded the engineering contracts, the Director's business would have had the same work and have been paid the same fixed amount each month for the newsletter services. There was no monetary or proprietary benefit of any sort which flowed to the Director or Director's company as a result of the District contracts and therefore no "self dealing" on the part of the Director in violation of Section 1090.

It is clear from cases interpreting Section 1090 that the purpose of the statute is to prohibit self dealing and interests in contracts that lead to personal gain. In the cases where courts have found a Section 1090 prohibited interest, the facts demonstrated that the public official was in a position to gain or actually received some financial benefit as a result of a contract made by the official in his or her official capacity or a contract entered into by his or her member agency. There was a clear connection between the contracts at issue and improved financial circumstances for the public official. There was a change of circumstance that benefited the public official, a financial benefit which flowed, directly or indirectly from a public contract to the public official. In this instance, the contracts at issue did not result in additional income, proprietary gain, or any change of circumstance for the Director. The newsletter contract with the corporation was not directly or indirectly affected by the unrelated engineering contracts between the corporation and District for purposes of Section 1090 application. It follows that the newsletter contract does not qualify as a financial interest prohibited by Section 1090.[2]

---

[1] Although the Minutes for the October 8, 2003 Board meeting do not specifically indicate that the Director disclosed the contractual relationship with the engineering firm, the Director did in fact so disclose before abstention.

[2] Additionally, because the Director did not have a Section 1090 "financial interest" in the District contracts at issue, it is not necessary that the "remote interest" provision of Gov. Code Section 1091 apply to the Director's participation in each instance.

B. The Newsletter Contract Qualifies As a Section 1091.5(a)(1) "Noninterest".

As discussed above, the newsletter contract at issue does not qualify as a financial interest within the meaning of Section 1090. However, even if it were interpreted to be a financial interest, it qualifies as a "noninterest" defined by Section 1091.5(a)(1). Section 1091.5(a)(1) states:

1091.5. Interests not constituting an interest in a contract

(a) An officer or employee shall not be deemed to be interested in a contract if his or her interest is any of the following:

(1) The ownership of less than 3 percent of the shares of a corporation for profit, provided that the total annual income to him or her from dividends, including the value of stock dividends, from the corporation does not exceed 5 percent of his or her total income, and any other payments made to him or her by the corporation do not exceed 5 percent of his or her total annual income.

The newsletter contract qualifies as a Section 1091.5(a)(1) noninterest. First, the Director owns 0 percent of the corporate stock, (ipso facto, less than 3%), and receives no dividend income. The second requirement of Section 1091.5(a)(1) is met as well because the income received by the Director from the newsletter contract amounted to less than 5 percent of the Director's total annual income for the years 2002 and 2003. Therefore, the Director's interest is categorically a "noninterest" for purposes of Section 1090 application. This is consistent with the California Attorney General's interpretation of Section 1091.5(a)(1).

In 81 Op. Atty. Gen. Cal. 169 the issue was whether a City Council could execute a contract with a corporation for the purchase of equipment where a council member and her spouse (1)owned corporate stock, but less than 3%, and (2) the spouse was employed by the corporation. Dividends received from the corporation amounted to less than 5% of the total income of the council member and his spouse. However, separate from dividends, the spouse received a salary from the corporation that exceeded 5% of the joint income. In that case, the Attorney General determined that the City Council could not execute the contract, and concluded that the financial interest at issue was twofold: the council member owned stock and received a salary from the corporation, which, "standing alone," amounted to a prohibited interest under Section 1090. The AG Opinion went on to explain:

However, the prohibition of Section 1090 does not stand alone. In two instances the Legislature has attempted to ameliorate the harsh consequences of its application. In section 1090, the Legislature has described various "remote interests," which, if applicable, allow the making of the contract...[Citations]. The other situation is found in section 1091.5, which describes "noninterests," where, if applicable, the contract may be executed because the Legislature has determined that the interest is insufficient to merit application of the prohibition. (81 Op. Atty. Gen. Cal. At 8-9).

The Attorney General determined that the interest at issue was not a Section 1091.5(a)(1) noninterest because not all of the Section 1091.5(a)(1) elements were met. Even though the stock ownership by the council member was less than 3% and the stock dividends less than 5% of the council member's and spouse's total income, the spouse's salary was an "other payment" pursuant to section 1091.5(a)(1) which exceeded 5% of the council member and spouse's total income.

In the instant case, however, all of the Section 1091.5(a)(1) elements are satisfied. The Director's stock ownership and dividend shares are zero. And, the "other payment" received by the Director from the corporation, that is, the total income received under the newsletter contract, was less than 5 percent of the Director's total income for the years 2002 and 2003. Therefore, even if, "standing alone," the Director's interest in the newsletter contract is an "interest" within the meaning of Section 1090 (which it is not, for the reasons enunciated hereinabove), it qualifies as a noninterest under Section 1091.5(a)(1) and thereby, categorically insufficient to merit application, as well as the harsh consequences of application, of the Section 1090 prohibition.

The only credible interpretation of Section 1091.5(a)(1) is that it is not solely applicable to cases where a public official owns stock, and also addresses situations where a public official has zero stock ownership in a corporation and receives "other payments" from the corporation which do not exceed 5% of the public official's total annual income. First, there is no legal precedent which requires stock ownership in a corporation before the 1091(a)(1) exception is applicable. Second, to require such would result in an absurdity - i.e. in this case, it would be an absurd result, and certainly not one envisioned by the Legislature, to require that the Director own at least some stock in the engineering firm in order to be eligible for the Section 1091.5(a)(1) exception. Requiring such would mean that the Director's interest in the subject contracts would be a Section 1091.5(a)(1) "noninterest" if the Director owned some stock in addition to the income received for newsletter services but would not qualify as a "noninterest" if the Director received the same income without owning shares. Requiring some amount of corporate stock ownership before application of Section 1091.5(a) would essentially require the Director in this case to have more of a financial interest in order to qualify for the "noninterest" exception.

The Director did not have a Section 1090 prohibited financial interest in the engineering contracts that were before the District Board as the Director had no financial stake in those contracts. The only financial interest the Director had was in the unrelated newsletter contract. In addition, the income received by the Director for the newsletter contract amounted to less than 5 percent of her total annual income for the applicable years. The Director's " interest" therefore fits squarely within the Section 1091.5(a)(1) exception for noninterests and it is not a Section 1090 prohibited interest for this reason as well.

C. The Director Acted In Good-Faith And Relied On the Advice of Counsel.

In this case, the Director relied on the advice of General Counsel for the District before entering into the newsletter contract. The law with respect to the application of Government Code Section 1090 and the rules relating to 1090 conflict of interest violations are highly technical, complex and confusing. They typically involve issues over which the most competent experts can and frequently do, disagree. The record is clear that the Director had no intent to violate section 1090 or any of the rules governing conflicts of interest. She in fact sought the advice of counsel before entering into the engineering contract and relied in good faith on counsel's advice in this regard.

II. Potential PRA Noncompliance.

The Bureau of State Audits is also concerned there may have been noncompliance with the Political Reform Act (Gov. Code Sec. 87100 et. seq; hereinafter, "PRA"), with respect to the Director's participation in votes by the LWD Board on February 12, 2003 to award contracts for engineering services to the same engineering firm discussed above and to another engineering firm with which the Director had a previous business relationship (hereinafter referred to as "second engineering firm").

With respect to the second engineering firm, in the prior year (2002), the Director's business provided public relations services to the City of Corona as a subcontractor of the second engineering firm. Although the services provided by the Director's business were to the City of Corona, it was part of a prime contract between the second engineering firm and the City. Under the prime agreement, the second engineering firm provided preliminary design of a proposed recycled water system for the City of Corona. As the second engineering firm's subcontractor, the Director's business provided public outreach services for the City of Corona's proposed recycled water facility. The Director's business provided these services under the subcontract with the second engineering firm from approximately May 2002 until July 2002 – a two month period. After July 2002, the Director's business provided the services directly to the City of Corona under a contract with the City of Corona.

It should be noted that the public relations services by the Director's business were requested by the City of Corona, not the second engineering firm. Neither the Director nor the Director's business sought to secure a subcontract with the second engineering firm. The Director's business had provided similar services for the City of Corona approximately three years earlier and the City of Corona requested the Director's business for the public outreach services related to the proposed recycled water facility. Initially, the Director's business and the City attempted to contract for the public relations services directly; however, primarily because of timing and convenience, the Director's business provided the services for the first two months for the City of Corona as the second engineering firm's subcontractor. After two months, the Director's business worked directly for the City of Corona.

In February 2003, approximately 8 months after the contract between the Director's business and the second engineering firm terminated, the LWD Board considered award of contracts to both the first and second engineering firms. With respect to the Director's vote on award

of contract to the second engineering firm, the contract between the Director's business and the second engineering firm was a two month contract which ended 8 months prior, and the Director was unaware of any potential conflict of interest and participated in the vote. With respect to the Director's vote on the contract award to the first engineering firm, it is clear the Director on this occasion simply forgot to disclose and abstain and inadvertently voted.[3] It is also clear that with respect to the contract awards to both engineering firms, (1) the Director's presence at the board meeting was not necessary for a quorum; (2) the Director's votes were not necessary to award the contracts; and (3) the votes to award the contracts were unanimous. In both cases, there is no evidence whatsoever that the Director discussed the proposed contracts with any other Director or member of LWD staff, or that the Director lobbied or solicited any other member of the Board to vote one way or the other on the contracts.

The facts clearly establish that to the extent there was noncompliance with the PRA, in both cases, it was technical and entirely inadvertent.

[3] As discussed hereinabove, the Director previously sought General Counsel's advice and disclosed and abstained from voting to approve award of contract to the first engineering firm at a subsequent Board meeting (October 2003).

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COMMENTS

California State Auditor's Comments on the Response From the Leucadia Wastewater District

To provide clarity and perspective, we are commenting on the response to our audit report from the Leucadia Wastewater District (Leucadia). The numbers below correspond to the numbers we have placed in the margin of Leucadia's response.

1. Leucadia's response does not address the audit report's recommendations pertaining to water districts. Therefore, Leucadia provides no indication of its plans for addressing issues related to it that we identified in our audit report, including weaknesses in its reserve policies as we discuss on pages 26 and 27, shortcomings in its disclosure of its directors' expenses on page 51, inconsistent attendance by its directors at training related to conflicts of interest on page 56, and a director's omission of information from economic disclosure statements on pages 59 and 60.

2. Contrary to Leucadia's assertion, our screening criteria and analysis are not misleading. As we note on pages 8 through 11 of our audit report's introduction, using financial data that water districts provided to the State Controller's Office, we calculated the resources potentially available for future spending for each district within nine water district types. Those water districts that had amounts of potentially spendable resources greater than zero had slightly more than $2 billion in those resources. Further, as we show on Table 1 of our audit report, the 241 independent water districts with only enterprise activities had an average of $5.7 million in potentially spendable resources, enough to cover their annual expenses for an average of 4.2 years. By selecting for review some water districts that had relatively higher amounts of annual expenses, some that had relatively higher numbers of years of expenses covered, and some that were types of water districts that did not appear in either of the first two categories, we achieved a broad selection of water districts from which to draw the conclusions we reached.

Further, we made no conclusions about the sufficiency of any water district's reserves based on this data or our analysis of it. Rather, using information we obtained primarily from each of the eight water districts' audited financial statements as shown in Table 2 of our report, we performed in-depth analyses of the amounts the water districts accumulated as restricted net assets, unrestricted reserved net assets, and unrestricted unreserved net assets.

- The manner in which we present the financial data in Table 2 of our audit report is neither misleading nor inaccurate, despite Leucadia's statements to the contrary. As we point out on page 19, the source of Table 2's information is data we obtained primarily from the water districts' audited financial statements for the fiscal year ending in 2003. We believe that it serves no useful purpose to describe each and every account water districts have that make up the amounts we show in lines 6, 7, and 8 of Table 2. For example, as we point out on page 24, the eight water districts we reviewed have varying numbers of separate reserves, ranging from one to as many as eight. Therefore, we believe it is more appropriate for comparison purposes to reflect the total amount that each water district reserved in line 7 on Table 2. Further, we clearly state on page 20 that comparing the amounts in the various categories of net assets to annual expenses is intended to provide context regarding the relative size of net assets. We also state on page 20 and in a footnote to Table 2 that we acknowledge that water districts will ultimately use these net assets for a variety of purposes, not all of which will be to cover annual expenses. In the text, we point out the example that water districts that maintain capital improvement or replacement reserves will likely use these net assets to acquire or replace capital assets rather than to pay for annual expenses. Consequently, the financial data we present in Table 2 is both fair and accurate.

- Leucadia is incorrect when it states that Table 2 of our audit report does not account for several items. We point to, most notably, that the amount of unrestricted reserved net assets that we report for Leucadia on Table 2 ($37,810,000) agrees precisely with the sum of the amounts of unrestricted reserved net assets that Leucadia shows on lines 2 through 6 of the table on page 1 of its response. Therefore, we fail to see how Leucadia can conclude that we do not account for several items.

  Further, on line 12 of Table 2 of our audit report—which shows the amounts of water districts' expenses—we clearly state that we include operating and nonoperating expenses as part of

this amount. In Leucadia's case, these amounts are $5,915,000 and $560,000, respectively, as reported in its audited financial statements as of the end of fiscal year 2002–03.

Moreover, we believe Leucadia included misleading information as part of the table on page 1 of its response. Specifically, for line 7, Leucadia states that it includes fiscal year 2003–04 expense data; it uses this amount as part of its calculation of line 8, Years of Expenses Unrestricted Net Assets not Dedicated to Future Capital Improvements Could Fund. Using expense data from one fiscal year—2003–04—and unrestricted net assets data from another—2002–03—may lead to incorrect conclusions about the status of Leucadia's reserves.

- Leucadia's table on page 1 of its response does not depict its financial position more accurately as the water district states. As we noted in comment 4, the amount of unrestricted reserved net assets that we report for Leucadia on Table 2 ($37,810,000) agrees precisely with the sum of the amounts of unrestricted reserved net assets that Leucadia shows on lines 2 through 6 of its table. However, we acknowledge that the table in Leucadia's response lists the detail of its unrestricted reserved net assets. Nevertheless, as we mentioned in comment 4, for line 7 of its table, Leucadia states that it includes fiscal year 2003–04 expense data; it uses this amount as part of its calculation of line 8, Years of Expenses Unrestricted Net Assets not Dedicated to Future Capital Improvements Could Fund. Using expense data from one fiscal year—2003–04—and unrestricted net assets data from another—2002–03—may lead to incorrect conclusions about the status of Leucadia's reserves.

- We do not dispute that Leucadia complies with the disclosure requirements of Section 53065.5 of the Government Code. However, Leucadia does not acknowledge a key point we make in our audit report. Namely, on page 50, we state that the disclosure method adopted by the San Gabriel Valley Municipal Water District enables ratepayers and taxpayers to see the nature and amount of each incurred expense more effectively than do the practices used by the other water districts we visited, including Leucadia.

- Leucadia overstates its point; it may give the impression that all its directors regularly attend conferences, seminars, and workshops related to conflicts of interest. According to information Leucadia provided to us, during our 30-month review period from July 1, 2001, through December 31, 2003,

at least one of its five directors attended eight separate conferences or seminars at which requirements pertaining to open meetings, ethics, or conflicts of interest were discussed. Two directors attended at least seven of these events, one attended four events, and one attended two events. Leucadia's information shows that the final director, who may have violated the state's conflict-of-interest laws as we mention on pages 57 through 59 of our report, did not receive any training on conflicts of interest or ethics during our 30-month review period. This director attended only one conference. A topic discussed at this conference was open meeting requirements; Leucadia did not list either conflicts of interest or ethics as being discussed at any event attended by this director.

- Similar to comment 6 earlier, Leucadia missed a key point we make in our audit report. Specifically, on page 56, we point out that each water district we visited has, from time to time, supplied its directors with various informational handouts related to conflicts of interest and ethics. We also acknowledge that these handouts appear to be useful references and would complement more comprehensive training focused on conflicts of interest. However, the interactive approach used in formal training to familiarize directors with applicable conflict-of-interest and ethics requirements is probably more effective than handing directors a guide on the subject and expecting them to read and understand its contents.

- As our report indicates on pages 53 and 54, the prohibition contained in Section 1090 et seq. of the California Government Code has been construed very broadly in order to avoid financial interests that are both direct and indirect. This approach is supported by several court decisions. ["The certainty of financial gain is not necessary to create a financial interest. The object of the [statute] is to remove or limit the possibility of any personal influence, either directly or indirectly which might bear on an official's decision . . ." (*People v. Gnass* (2002) 101 Cal.App.4th 1271, 1298, quoting from *Stigall v. City of Taft* (1962) 58 Cal.2d 565, 569.) "The fact that the officer's interest 'might be small or indirect is immaterial so long as it is such as deprives the [state] of his overriding fidelity to it and places him in the compromising situation where, in the exercise of his official judgment or discretion, he may be influenced by personal considerations rather than the public good.'" (*People v. Gnass* (2002) 101 Cal.App.4th 1271, 1298, quoting from *People v. Honig* (1996) 48 Cal.App.4th 289, 325.)]

As to whether the definition of a remote interest contained within paragraph (1) of subdivision (a) of Section 1091.5 applies to the situation at hand, our legal counsel advised us that well-accepted rules of statutory construction require that significance should be attributed to every word and phrase of a statute, and a construction making some words unnecessary should be avoided (*People v. Woodhead* (1987) 43 Cal.3d 1002, 1010; *Moyer v. Workmen's Comp. Appeals Bd.* (1973) 10 Cal.3d 222, 230). Moreover, a statute is to be given a reasonable and commonsense construction in accordance with the apparent purpose and intention of the lawmaker (*County of Alameda v. Kuchel* (1948) 32 Cal.2d 193, 199; see also *Select Base Materials Inc. v. Board of Equalization* (1959) 51 Cal.2d 640, 645). These well-accepted rules of statutory construction require that the definition contained within that section be construed in a way that gives meaning to every word and that results in a commonsense construction based on the apparent purpose of the provision. The relevant provisions of Section 1091.5 of the Government Code read as follows:

> *The ownership of less than 3 percent* of the shares of a corporation for profit, *provided that* the total annual income to him or her from dividends, including the value of stock dividends, from the corporation does not exceed 5 percent of his or her total annual income, and any other payments made to him or her by the corporation do not exceed 5 percent of his or her total annual income. [Emphasis added.]

These provisions state plainly that a public official will have a remote interest when he or she owns less than 3 percent of the shares of a corporation for profit, provided that the official also meets the other related conditions within that definition. To suggest that a public official who does not own stock in a corporation but who meets the other related conditions has a noninterest under Section 1091.5 is, in our view, a construction that is entirely inconsistent with well-accepted rules of statutory construction. However, as we point out on page 58 of our report, the final decision about whether application of this section is appropriate rests with any resolution that may ultimately occur if this instance is pursued in court.

- Leucadia, in fact, approved *four* separate agreements since August 2002 with the engineering firm. The first instance occurred when Leucadia approved a contract for $56,000 in November 2002. The second and third instances occurred when Leucadia approved a contract amendment for $67,000 and a

new contract for $35,900, both in February 2003. The fourth instance occurred in October 2003, when Leucadia approved a contract for $232,000.

Agency's comments provided as text only.

Otay Water District
2554 Sweetwater Springs Boulevard
Spring Valley, California 91978-2096

June 9, 2004

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

Dear Ms. Howle:

Otay Water District (District) is in receipt of the State Auditor's draft findings and recommendations. The District has compiled the following comments to the audit:

- Overall, the reserve findings and recommendations are consistent with the District's reserve practices. The recommendations, however, provide enhanced accountability for the management of public funds.

- The District has acted in a responsible manner and is proactive with its reserve practices. Consistent with the spirit of the audit report and recommendations, the District performed a Rate Study in 2003. That study was a comprehensive review of rates and reserves, and provided a five-year strategic approach to the finances of the District. This study addresses the purposes of each of the District's reserves and targets funding levels. The District recently updated this Rate Study and is in the second year of reserve governance in which it is consistently applying the Rate Study's recommended practices. These practices were accepted by the Board on June 4, 2003 and reaffirmed through the 2004 budgeting process.

- The District's Strategic Plan calls for the District to update its reserve policies. This objective was formalized in the District's Strategic Plan through an update adopted by the Board of Directors on March 29, 2003. The State Audit also identifies this update as a recommendation. The District is committed to completing this update within the next year. In formulating the changes, the District will use the Audit's recommendations.

- With respect to the District's disclosure and reporting of Director's expenses, the District is in compliance with state law and regulations. Nevertheless, the Audit recommendations provide enhanced accountability for the expenditure of public funds through more detailed disclosure

and reporting of expenses. In accordance with the Audit recommendations, the District will implement a more detailed annual report on Director expenses. Moreover, consistent with the Audit's recommendations, staff will recommend an amendment to existing policy to institutionalize the enhanced disclosure and reporting of these expenses.

- The Audit identified issues as to the rationale and necessity of certain events and expenditures. The Audit recommends the improvement and clarification of Board policies that govern these activities. While the District has complied with the law as it relates to these expenditures, it values the Audit's recommendations and will consider the proposed modifications.

- While the Audit lists benefits provided to the Directors, it does not identify any improvements or recommendation for change. Likewise, the District has no comment as these benefits, as they are customary and not unreasonable.

- The District provides the Directors with training on an ongoing basis. Directors also receive Director training at the various water conferences that they attend throughout the year. The District does not take issue with the Audit recommendations relative to formalizing the training, but notes that the training continues to take place. The District will continue to evaluate ways to improve director training.

The Otay Water District is committed to improving the governance of the District. The Board of Directors has repeatedly expressed this commitment at various meetings of the Board. The Audit recommendations provide the District with productive guidance on ways to continue this improvement.

We appreciate the opportunity to respond and provide our input. Should you have any questions, please contact me at 619-670-2210.

Sincerely,

(Signed by: Robert Griego)

Robert Griego,
General Manager

Agency's comments provided as text only.

San Gabriel Valley Municipal Water District
P.O. Box 1299
Azusa, California 91702-1299

June 8, 2004

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

Dear Ms. Howle:

The San Gabriel Valley Municipal Water District has reviewed the document entitled "California's Independent Water Districts" and has the following comments:

In response to Table 2, page 23a; the audit should not attempt to compare reserve levels without a better understanding of each district's reserve policy, otherwise, it is rash to make any comparison. Each policy should detail the rationale for maintaining certain levels. In this regard, the States analysis should be done on a case-by-case basis and should focus on the reserve policy. The audit report's metric of "years of expenses restricted and unrestricted net assets could fund" as a comparison measure is not suitable. Moreover, since it is presented as a bottom line comparison in Table 2, it can potentially mislead the uninformed reader. As an example, districts have varying levels of capital infrastructure which, in turn, have various levels of criticality to their operations. For this district, our very existence hinges upon our 37-mile pipeline which is used to deliver water from the State Water Project to its customers in the Main San Gabriel Basin. Because this is the District's sole source of supply, the District has decided to retain capital replacement reserves of its accumulated depreciation. This accounts for the majority of our unrestricted reserves. The district feels this is a prudent decision to reserve full accumulated depreciation for the very backbone of its existence, and should not be scrutinized for doing so.

Thank you for the opportunity to comment on this report.

Very truly yours,

(Signed by: Darin J. Kasamoto)

Darin J. Kasamoto
General Manager

* California State Auditor's comments begin on page 95.

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COMMENTS

California State Auditor's Comments on the Response From the San Gabriel Valley Municipal Water District

To provide clarity and perspective, we are commenting on the response to our audit report from the San Gabriel Valley Municipal Water District (San Gabriel). The numbers below correspond to the numbers we have placed in the margin of San Gabriel's response.

1. While preparing our draft audit report for publication, page numbers shifted. Table 2, to which the general manager refers, now appears on page 19 of our audit report.

2. This statement by San Gabriel's general manager indicates that he does not fully understand the scope of our review and the methodology we employed to achieve that scope. As we mention on page 13 of our audit report, the Bureau of State Audits was specifically asked to review the water district's policies and procedures for accumulating and using cash reserves. On page 14 of our report, we identify the methodology we used; specifically, to determine the reasonableness of the net assets maintained by the eight water districts we visited, we interviewed staff at each water district and reviewed applicable state laws and regulations, water district policies, financial reports, and annual budgets. We also identified applicable reserves and their balances and compared these to the water districts' reserve policies. Thus, we developed a sufficient understanding of each water district's reserve policies on a case-by-case basis and drew appropriate conclusions therefrom.

3. San Gabriel is incorrect when it asserts that the audit report's metric of "years of expenses restricted and unrestricted net assets could fund" is not suitable and that its use can potentially mislead an uninformed reader. We clearly state on page 20 that comparing the amounts in the various categories of net assets to annual expenses is intended to provide context regarding the relative size of net assets. Furthermore, we state in the text and in a footnote to Table 2 that we acknowledge that water districts will ultimately use these net assets for a variety of purposes, not all of which will be to cover annual expenses. In the text, we point out the example that water districts that maintain capital improvement

or replacement reserves will likely use these net assets to acquire or replace capital assets rather than to pay for annual expenses. Hence, we believe that our use of "years of expenses restricted and unrestricted net assets could fund" as a relative measure is entirely suitable and is not misleading.

Agency's comments provided as text only.

Walnut Valley Water District
P.O. Box 508
Walnut, California 91789-3002

June 8, 2004

Ms. Elaine M. Howle*
California State Auditor
555 Capitol Mall, Suite 300
Sacramento, California 95814

Dear Ms. Howle:

Re: Walnut Valley Water District Response to Draft Audit Report

Following is the District's formal response to your letter received on June 3, 2004.

COMMENTS

Walnut Valley Water District challenges the title of the report and the District disputes the claim that its "reserve accounts are not always sufficiently justified" or that "some expenses and contract decisions are questionable." The District submits there is absolutely no evidence to support these broad general allegations. While there is some discussion in the text of the report regarding reserves and expenses, in the case of Walnut Valley Water District there is absolutely no reference to any contract decision that could be classified as "questionable". The text relating to the District states that policies are "weak." Such an adjective is a relative term and there is no indication of what would constitute a "strong" policy. The term "weak" is an adjective used throughout the Report. If the Auditor means "not written" that's what should be stated. The District believes that a policy of its Board of Directors need not always be written to be clear, unambiguous and enforceable.

Contrary to the claims in the Report title, there is no evidence in the summary or in the full Report that would support the claim that the District has failed to sufficiently justify its reserve amounts as contended at pages 26 and 27 of the draft Report. The only criticism is a failure to have a predetermined plan for the utilization of funds which exceed expenditures for which reserves have been established. It should be noted that, in the first place, the law constrains and restricts the use of funds without the need for any specific Board policy and second, it is impossible to make informed judgments regarding the use of any excess funds until first it is determined that an excess is going to exist and then contemporary needs are then identified, evaluated and prioritized.

* California State Auditor's comments begin on page 103.

On page 28 of the Report, the Auditor states, "the District apparently experienced delays in projects from July 1, 2000, to June 30, 2003, because it had proposed spending $3.8 million in fiscal years 2001-02 and 2002-03 alone but spent only $200,000 over the whole three year period." In reality, the District intentionally postponed a reservoir project so that an updated Water System Master Plan could be prepared. As a result of the WSMP (December 2002) the District was able to reduce the size of the reservoir from 3.8 million gallons at an estimated cost of $3.3 million to a 2.0 million gallon reservoir at an estimated cost of $1.9 million, a cost savings of $1.4 million.

In addition, the $200,000 spent during the period of July 1, 2000 to June 30, 2003 does not include the approximately $1.8 million spent on the construction of the Districts 1.0 MG E.P. Carrey Addition/Upgrade Project completed in October 2003, which audit staff was advised of during the on-site audit. The required fund transfer from the Reservoir Capacity Charge Fund to the General Fund is scheduled to be made this month as a result of the recent closing of the work order for the project.

Further, on this same page, the Auditor implies the District has not taken any steps to establish a use for any potential excess restricted assets. Clearly this is not the case. During the on-site audit, information and documentation was provided to the audit team in support of the use of $2 million (set aside in April 2001 and shown on the District's monthly financial reports) to defease debt when first legally allowed in 2008.

Pages 35-37 of the draft Report purport to support the claim that the District has no comprehensive reserve policy. This is difficult to understand when all of the reserve accounts are specifically earmarked and restricted for particular permitted uses. There is no evidence that the District's Reserves are either inadequate or excessive with respect to the demands of unspecified contingencies, nor was this within the Auditor's assigned tasks. Whether the restriction on the use of funds is appropriate depends on factors not always within the control of the District. For example, the District imports substantially all of its water supplies from a wholesale water purveyor which is a customer of a regional water agency. The rates and charges for the acquisition and delivery of such water supplies to the District is outside the control of Walnut Valley.

In the recommendations on page 51 of the draft Report it is suggested that there should be comprehensive reserve policies to accomplish certain specific objectives, including the distinction between restricted and unrestricted reserves, establishing distinct purposes for the reserves, setting target levels, identifying triggering events and require Board approval and periodic review. It is submitted that tested against these criteria, the District's current policies meet or exceed the recommendations of the Auditor.

Once again the author of the Report seems enamored by the adjective "weak." After referring to the reserve plans as "weak" on page 3, the expense plans and ethics training are also classified as "weak" on pages 53, 54, 60 and 61. The District has policies which are clear and impose certain limitations and restrictions on the conduct of the Board and the Staff. Maybe these policies are not what the Auditor would have put in place if it were the elected Board of the District, but all of the policies established by the District are consistent with the law.

With respect to page 57, there is a claim that unreasonable and unnecessary expenses have been paid from public funds. The District challenges the Auditor to identify any instance where disbursements of public funds have been made contrary to the authority granted by the statues under which the District has been formed and is operating. The Report's inference to the contrary is unfair.

With respect to page 60, the Report describes some stipends paid to District Directors as being questionable. The payments identified are within the authorization of the expense policy and permissible under law. In addition, the opinions of the Auditor in this portion of the Audit Report are beyond the scope of the charge given to the Auditor by the Joint Legislative Audit Committee. The Auditor has not been asked to impose its independent judgment on what the Auditor thinks might be an appropriate expense reimbursement policy.

With respect to page 61, the Auditor reasons that the District approves "questionable" expenses because of "weak policies." On the contrary, the District approves expenses which are permitted under its policies and authorized by law. Also on page 61, the complaint that the policies of the District fail to identify what expenses are incurred for the "benefit of the District" does not stand the test of reason or logic. The District challenges the Auditor to develop a definition sufficiently comprehensive to be meaningful in all circumstances for the determination of what particular activity or expense benefits the District and its inhabitants.

With respect to page 64, the claim that the District fails to disclose individual reimbursements as the State law requires, is a factual error. The District complies with Government Code §53065.5 and has since the initial adoption of that statute. This is done by the filing of reports of expenditures in excess of $100 which are to be reimbursed by the District. Copies of the reports have been and now are on file with the District.

On page 75 the Report indicates some directors have "failed to appropriately disclose their economic interest." On page 76, reference is made to a director of the District who allegedly filed an incomplete economic disclosure statement. The District challenges that characterization of the conduct of the director and points out that the action by the Director was consistent with the District Conflict of Interest Code which had been reviewed and approved by the County of Los Angeles, as the Code reviewing body, and which enables a director to rely on the advice of counsel with respect to disclosures, which is what was done in this particular instance.

In response to the Auditor's comment in Appendix B-1, on March 20, 1992, the Internal Revenue Service (IRS) issued a clarification letter regarding the classification of elected public officials. As a result of the IRS ruling, the District was required to provide certain benefits to its directors, including access to its EAP plan.

By way of summary, the District points out that if the Auditor had followed the scope and methodology identified in pages 17 and 18, it would have restricted it inquiries to the question of whether or not the conduct of the Districts being investigated "met relevant statutory requirements." In addition, the Audit Committee asked the Auditor to review policies of the Districts. It did not, however, ask the Auditor for recommendations for the Auditor's proposed changes in the legislative authority granted to water districts. Despite this lack of authorization, it appears that the Auditor has undertaken this project with the idea that it is the function of the Auditor to reform the enabling statutes of the water districts it investigated. That is not the Auditor's role.

The District understands that its comments will be included in the final Report and further assumes that the redacted material in the draft Report provided did not relate to the District.

The District also wants to clarify that while the June 3, 2004 transmittal from you refers to "expense information we requested" the Auditor has acknowledged that no such request was made that was not responded to prior to the June 3, 2004 letter of transmittal.

Not having a point of reference, the District's response to the additional language provided via facsimile this morning, June 8, is attached hereto as a separate item.

Very truly yours,

WALNUT VALLEY WATER DISTRICT

(Signed by: Karen Powers)

KAREN POWERS
General Manager

Attachment

Supplemental Response to Walnut Valley Water District Letter Dates June 8, 2004

Following is additional draft language provided by Dale Carlson on June 8, 2004, for inclusion in the State Auditor's Report:

"We also observed that during our 30-month review period, Walnut Valley appeared to be overly generous in the amounts it paid for some directors' meals; it was the only water district at which we observed this condition. Specifically, Walnut paid a total of almost $18,000 for 15 meals provided to its directors and others while away from the district. For example, for a meal at an Anaheim restaurant attended by four directors and 24 others, Walnut Valley paid more than $2,500, an average of $91 per person. According to information provided by the water district, the number of people attending these 15 meals ranged from six to 29; the number of directors attending ranged from one to four. The average cost per person for each meal ranged from $62 to $155. If the directors' share of the costs of these meals was equivalent to the average cost per person, then the estimated total cost to ratepayers and taxpayers for the 40 total instances when Walnut Valley paid the directors' share of these meals was $3,700, an average of $93 per director for each of the 15 meals."

District response to additional draft language:

The District received the preceding paragraph at 11:00 a.m. on June 8 and was instructed to respond by noon the following day. This is hardly enough time to investigate the allegation that the District was "overly generous" in its payment for meals for Directors. The auditor reached its conclusions by arbitrarily dividing the number of attendees at meals into the total meal payments and assuming that each director's meal expense was a proportionate share of the total. This "magic formula" fails to take into account what the actual cost was for each Director meal. Therefore, there is no basis to claim the payments were "overly generous." The auditor's statements also fail to take into account the benefits the District received from expenditures for guests of the Board, including other public officials and consultants. In addition, the District notes that it has not had an opportunity to validate the auditor's claim that the District was the only water district so generous.

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COMMENTS

California State Auditor's Comments on the Response From the Walnut Valley Water District

To provide clarity and perspective, we are commenting on the response to our audit report from the Walnut Valley Water District (Walnut Valley). The numbers below correspond to the numbers we have placed in the margin of Walnut Valley's response.

1. In its response, Walnut Valley provides no indication of its plans for addressing issues related to it that we identified in our audit report, including weaknesses in its reserve policies as we discuss on pages 27 through 29, the payment of questionable expenses on pages 48 through 50, shortcomings in its disclosure of its directors' expenses on page 51, and a director's omission of information from an economic disclosure statement on page 60.

2. Walnut Valley apparently failed to recognize during its reading of our audit report that it was only one of several water districts that we reviewed and failed to understand that our report title encompasses the results of the work we performed at all the water districts we visited. Its lack of recognition is troubling because we informed Walnut Valley of our scope at several points during the audit. The evidence we obtained from all eight water districts we visited completely supports the title of our final report.

3. Once again, Walnut Valley has failed to understand our audit report. As used in the title of our audit report, *questionable contract decisions* is a reference to the section in Chapter 2 concerning instances when a director at another water district may have violated the State's conflict-of-interest laws when participating in the approval of various contracts. Because this section applied to another water district, we redacted it from the draft audit report that we sent to Walnut Valley for comment as required by state law—we did not allow the water district to review that section. We informed the water district that a section of our audit report pertaining to conflicts of interest did not apply to it.

- The comments made by Walnut Valley clearly show that it has read only selective portions of our audit report and has taken certain words or phrases completely out of context. On pages 35 through 40, we describe the specific attributes that we and other entities believe comprise a comprehensive, or strong, reserve policy.

- Walnut Valley's belief that a policy "need not always be written to be clear, unambiguous and enforceable" indicates that the water district does not completely grasp common management practices. Concerns about verbal policies include that they are subject to changes in application and interpretation by management or others without notice. For instance, we fail to see how Walnut Valley can hold either itself or its employees uniformly accountable for complying with policies that are not recorded in writing. We also fail to see how Walnut Valley can demonstrate to ratepayers and taxpayers that it can effectively manage district affairs without written reserve policies.

- Once again, it appears that Walnut Valley has read only selective portions of our audit report. We clearly state on page 17 of our audit report that we do not conclude that accumulations of resources by water districts are excessive. However, because of weaknesses in reserve policies, some water districts may have trouble defending to ratepayers and taxpayers the need for some portion of their accumulated resources. As we clearly point out on pages 27 through 29 of our audit report, Walnut Valley has not adopted a comprehensive reserve policy. For instance, we state that Walnut Valley's reserve policy is not in writing, does not always specify the desired size of reserves, and does not always identify what events might prompt the use of the reserves. Given the above statements, Walnut Valley's assertion is incorrect.

- While preparing our draft audit report for publication, page numbers shifted. Therefore, the page numbers that Walnut Valley cites throughout its response do not correspond to the final page numbers in our report.

- Walnut Valley has missed entirely the point we make on page 21 of our audit report; namely, because state law specifically restricts the use of certain funds, it is essential that water districts create a clear link between the accumulation of restricted net assets and plans for using them. Further, as we point out on page 18 of our audit report, water districts maintain some control over the accumulation of restricted net assets because they set the rates for certain charges and control the scheduling of projects that these charges will pay

for. Moreover, as we describe on pages 22 and 23, Walnut Valley has not established policies to address limits on the size of its restricted account for reservoir capacity charges or to guide rate-setting decisions. As a result, we fail to see how Walnut Valley can determine whether or not funds held in this restricted account are adequate or excessive.

- Once again, Walnut Valley missed our point. As described on pages 22 and 23 of our audit report, we did not question Walnut Valley's plans for its use of the $3.9 million it had accumulated in the reservoir capacity charge account as of June 2003. Further, we do not imply that Walnut Valley has not taken any steps to establish a use for any potential excess restricted assets; in fact, we acknowledge that the general manager's assertions about additional plans appear reasonable, despite the lack of board approval of those plans. However, we do take issue with the fact that Walnut Valley's policies do not address what should happen when the reservoir capacity charge account's cash and investments exceed planned expenditures. Thus, it can be more difficult for Walnut Valley to defend to ratepayers and taxpayers the level of resources it maintains in the account.

- Walnut Valley's comments aside, we obtained sufficient, competent, and relevant evidence that clearly shows that the water district's reserve policies fall short of being comprehensive. We elaborated on this point in comments 4, 5, 6, 8, and 9 earlier. We stand by the conclusions we drew from that evidence.

- The comment by Walnut Valley is misleading; on page 17 of our report we mention that we did not conclude that the amounts of net assets accumulated by the eight water districts we visited were excessive. However, Walnut Valley incorrectly asserts that it was not within our assigned tasks to determine whether reserves are excessive. In the scope and methodology section of our report, we describe the work we performed to achieve that very goal and related this work to the request from the Joint Legislative Audit Committee.

- Walnut Valley's statement shows that it does not understand clearly the meaning of the term *restricted net assets*. For future reference, we suggest that Walnut Valley refer to page 18 of our audit report where we explain that restricted net assets measure the net resources that an entity must use for particular purposes because of *legal, contractual, or other externally imposed*

requirements [emphasis added]. Further, Walnut Valley does not explain how the rate that it pays to its water purveyor affects the appropriateness of restrictions on the use of funds.

- Contrary to Walnut Valley's statement, we more than merely *suggest* that comprehensive reserve policies are necessary; we state clearly that, to demonstrate that they are using public funds in a reasonable and necessary manner, water districts should ensure that they have comprehensive reserve policies in place that, at a minimum, have the seven attributes we describe on pages 38 through 40 of our report.

- Its assertions notwithstanding, Walnut Valley did not provide us with sufficient, competent, and relevant evidence to support the claims it makes here, primarily because the water district apparently does not see the need to reduce policy decisions to writing as evidenced by its response (see also comment 5 earlier); Walnut Valley believes that a policy of its board does not always need to be written to be clear, unambiguous, and enforceable. As a result, we determined that Walnut Valley's current reserve policies fall short of the recommendations we make on page 40 of our audit report. Moreover, we note that Walnut Valley ignores the 'in writing' and 'conform with capital plans' attributes of our recommendation.

- Based on its comments here, Walnut Valley again demonstrates that it appears to have selectively read our draft report, taken those sections out of context, and missed the key points we made. To clarify, at no point in our text do we state that expenses paid by Walnut Valley for its directors violate California statutes. In fact, Walnut Valley seems to confuse the phrase *reasonable and necessary* with the word *legal*. Specifically, although some expenses may be entirely legal, these same expenses may not be a reasonable and necessary use of water district funds. For example, even if tickets to an amusement park are legal purchases by the water district, they certainly raise questions about whether they are a reasonable and necessary use of public funds. As we state on page 44, policies and guidance that control spending of public funds by water districts should be sufficiently specific and provide enough constraints to ensure that directors' expenses are *reasonable and necessary* [emphasis added] for achieving the water district's purposes. We hope that Walnut Valley would find—as we do—that, while perhaps being legal, paying directors expenses for attending holiday luncheons, and paying them stipends for such attendance, are not a reasonable and necessary use of public funds.

Walnut Valley's assertion here and on page 4 of its response that the Bureau of State Audits has either exceeded or not followed the audit scope given us by the Joint Legislative Audit Committee is baseless. The scope and methodology section of our report clearly links the work we performed to the audit request from the Joint Legislative Audit Committee.

Further, the fact that Walnut Valley would make such accusations without providing proof demonstrates that it lacks even a minimal understanding of the auditing standards with which we are legally obligated to comply. Specifically, Section 8546.1 of the Government Code requires the Bureau of State Audits to complete any audit in accordance with *Government Auditing Standards*—also known as the *Yellow Book*—published by the Comptroller General of the United States. According to the *Yellow Book*, professional judgment is to be used in performing the audits and reporting the results. This standard "requires auditors to exercise reasonable care and diligence and to observe the principles of serving the public interest and maintaining the highest degree of integrity, objectivity, and independence in applying professional judgment to all aspects of their work." Moreover, the standard requires that we apply professional judgment in performing the tests and procedures and in evaluating and reporting the results of the work. We have fully complied with this and all other standards applicable to our audit of water districts. Therefore, we stand completely behind all findings and conclusions in our audit report.

The district errs again; it does, in fact, fail to disclose individual director reimbursements as required by law. As we mention on page 50 of our audit report, state law requires special districts to disclose reimbursements at least annually for each *individual charge* of $100 or more paid to directors within the preceding fiscal year. We also state that *individual charges* include, but are not limited to, one meal, lodging for one day, transportation, or a registration fee. When we asked it to describe how it complied with Section 53065.5 of the Government Code, Walnut Valley told us that it includes these reimbursements in a list of warrants that it provides monthly to its board. Our review of the November 2002 and May 2003 warrant lists, which the water district provided to us as examples of its compliance, showed warrants issued to directors simply for expense *reimbursement*; Walnut Valley did not identify individual charges. Consequently, based on the evidence provided to us by Walnut Valley, we stand by our conclusion that it fails to disclose individual director reimbursements as required by law.

- Walnut Valley is incorrect. Despite Walnut Valley's challenge that we incorrectly characterized the director's disclosure statement as incomplete, the evidence we obtained clearly shows that the director did not comply with water district policy when he omitted his business position. As the water district should know, its conflict-of-interest policy states that persons meeting requisite criteria—which includes directors in this case—shall disclose, among other things, all positions with businesses that produce or provide services of a type used by the water district, including but not limited to money management and law. According to Walnut Valley's Web site, the director at issue here is a certified financial planner and an associate in a financial planning and law firm (law firm). Further, the director's resume discloses that the director works for the law firm and the law firm's Web site lists the director as an associate. The director did not report this business position on his disclosure statement. Therefore, contrary to Walnut Valley's statements, the director's omission of his business position was not, in fact, consistent with the water district's conflict of interest policy. Therefore, we stand by our conclusion.

- Walnut Valley exhibits its lack of familiarity with the general body of work performed by the Bureau of State Audits. When we obtain sufficient, competent, and relevant evidence that supports the issues and conclusions we include in our report and when correction of those issues merits statutory changes, we have and will indeed recommend changes to existing laws.

- To clarify, we informed Walnut Valley at the exit conference in early June 2004 that the material we redacted from the draft report that we sent to the water district for comment pertained to water districts other than Walnut Valley; state law prohibits us from sharing that information with it.

- Walnut Valley is incorrect; the Bureau of State Audits made no such acknowledgement. In fact, Walnut Valley did not provide all documents that the audit team requested to support events attended by Walnut Valley's directors that appear questionable such as chambers of commerce breakfast or dinner meetings. In late April 2004, we verbally requested that Walnut Valley provide us with documents supporting certain directors' expenses it paid that we did not obtain when we visited the water district in March 2004. On May 21, 2004, we made a similar request in writing. This information was necessary to complete our audit work concerning directors' expenses for Walnut Valley. On June 3, 2004—the day we delivered a copy

of our draft audit report to the water district for comment—we received a package of information from Walnut Valley. This package did not respond to our request; rather, it included supporting documentation for events that the audit team had already reviewed during its site visit. In other words, Walnut Valley provided documents that the audit team already had in its possession. We then informed Walnut Valley that we still needed the documents related to the remaining potentially questionable events. As of June 18, 2004, Walnut Valley had not yet provided those documents.

- Walnut Valley mischaracterizes our report's description of, and the events surrounding our request for information about, the 15 meals paid for by the water district. Although it provided to us the credit card statements that showed the total cost of each of the 15 meals and the number of directors who attended each meal, Walnut Valley was unable to provide the break out of individual meals and their related costs for each director. Absent this essential information from the water district, we calculated the average cost per person for each meal, as we show on page 48 of our audit report. Therefore, based on the evidence provided by Walnut Valley pertaining to these 15 meals, our calculation is sound and cannot be reasonably characterized as *arbitrary*.

  As for the Bureau of State Audits not providing Walnut Valley sufficient time to respond to our discussion of director meals paid by the water district, it was in fact Walnut Valley's lack of timely cooperation that drove our request for a quick response. Specifically, on April 30, 2004, we asked Walnut Valley for information concerning directors' meals paid using the water district's credit card. Walnut Valley gave us that information on June 3, 2004, almost five weeks later. After analyzing the credit card information, we informed Walnut Valley about the 15 meals that we were questioning and, on June 8, 2004, we told it that we would like to include in our report its perspective about why it believes these meal expenses were a reasonable and necessary use of public funds. To ensure that we could include Walnut Valley's perspective in the body of our audit report, we gave the water district one day to provide its response. Given Walnut Valley's slow response to our request for the meal information, the nature of this issue, and the information we provided to the water district, we believe that 24 hours was more than sufficient time for Walnut Valley to have responded adequately to our request.

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Agency's comments provided as text only.

Western Municipal Water District
P.O. Box 5286
Riverside, California 92517-5286

June 9, 2004

Ms. Elaine M. Howle
State Auditor
555 Capitol Mall, Suite 300
Sacramento, California 95814

AUDIT OF CALIFORNIA'S INDEPENDENT WATER DISTRICTS

Dear Ms. Howle:

Thank you for the opportunity to review and provide comment to the document "California's Independent Water District Audit" of June 2004.

First, on behalf of Western, I would like to commend the audit team on the professional manner in which the audit was conducted. Although we may not agree with some of the conclusions reached in the audit report, we do agree with the recommendations and appreciate the professional method in which the audit was conducted and the opportunity to submit commentary for consideration.

While we recognize that the audit, by its very nature, is performed at arm's length, we are confident that Western, as an organization, its Directors, and employees fully carry out the mission of the District – that is "to provide water supply, wastewater disposal, and water resource management to the public in a safe, reliable, financially-responsible, and environmentally-sensitive manner."

Each of the District's Board members are directly elected by the public he or she serves. This results in accountability at the most basic level of democracy – to those who directly benefit from the service. Therefore, we look forward to implementing the audit reports recommendation to clarify reserve policy, provide training and create additional avenues for the public to review and provide input regarding our expenditures.

Western's water resource management responsibilities include an extensive effort to educate present and future generations on water issues. This is particularly critical in Western's service area due to the limited imported water supplies and exploding growth. Unlike other areas of the state that may have ready local supplies or are completely built-out, Western must not only meet supply demand, but has responsibility for managing the resource. We need the cooperation of our local communities to do this. One way to reach these communities is through educational efforts. This education process takes many forms, not the least of which is outreach through local organizations such as chambers of commerce. However, again, we will take the audit committee's recommendation to heart and develop further reporting and authorization policies in order to make clear the nexus between these activities and our mission.

Again, thank you for your efforts in this process.

Sincerely,

(Signed by: John V. Rossi)

JOHN V. ROSSI
General Manager

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Agency's comments provided as text only.

Wheeler Ridge-Maricopa Water Storage District
Post Office Box 9429
Bakersfield, CA 93389-9429

June 8, 2004

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

File: 7.2.0

Subject: **Comments on Draft Report on California's Independent Water Districts**

Dear Ms. Howle:

This is to provide our comments on those portions of the subject draft report which pertain to this District. In particular our comments are focused on your conclusions respecting the District's Reserve Policy. While we would agree that the reserve policy used by Wheeler Ridge-Maricopa Water Storage District can be improved as you suggest, we do not agree with the initial conclusion that the District has not developed a Comprehensive Reserve Policy. The District's reserve policy is supported by Resolutions of the Board and staff memoranda detailing the purpose and scope of each of the District's reserves.

The report's conclusion that for six of the eight reserve funds Wheeler Ridge's policy imposed no limits on the maximum size to which these reserves could increase is not correct. For each of these six reserve funds established by Resolution of the Board of Directors, an upper limit was established equal to the fund balance of the reserve as of January 1, 2002. The Board Resolution also provides that the upper limit of each of the Reserve funds was to be increased periodically by the amount of accumulated interest earned on the fund. It is the District's position that this procedure provides appropriate limits on the size of reserves when combined with the periodic reviews which have historically been conducted by the District, in that it has been the District's experience that the cost of the items to be covered by the respective reserves generally increase at a rate in excess of such interest earned.

We acknowledge the report findings that the District's reserve policies do not include written description of the specific circumstances which would trigger use of certain reserve funds, and that the District does not have a written policy specifying the frequency of the reviews of its reserves. I will recommend to our Board that its policies be modified to address these concerns.

Thank you for the opportunity to comment on the draft report.

Sincerely,

(Signed by: Wm. A. Taube)

Wm. A. Taube
Engineer-Manager

* California State Auditor's comments begin on page 115.

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COMMENTS

California State Auditor's Comments on the Response From the Wheeler Ridge-Maricopa Water Storage District

To provide clarity and perspective, we are commenting on the response to our audit report from the Wheeler Ridge-Maricopa Water Storage District (Wheeler Ridge). The numbers below correspond to the numbers we have placed in the margin of Wheeler Ridge's response.

1. Wheeler Ridge's assertion that its reserve policy is comprehensive is puzzling. As we describe on pages 31 and 32 of our audit report, Wheeler Ridge's reserve policy did not always set upper limits for its reserve funds, did not include written descriptions of the circumstances that would prompt the water district to use its reserve funds, and has no written provisions concerning how frequently Wheeler Ridge would review its reserves. We point out on pages 38 through 40 that these three elements are part of a comprehensive reserve policy.

   Further, in the last paragraph of the water district's response to our audit report, Wheeler Ridge's engineer-manager acknowledges that the water district's reserve policies do not include written descriptions of the specific circumstances that would trigger the use of certain reserve funds and that the water district does not have a written policy specifying the frequency of its reviews of its reserves. He also states that he will recommend to the board that the water district's policies be modified to address these concerns. Therefore, we stand by our conclusion that Wheeler Ridge's reserve policy is not comprehensive.

2. Wheeler Ridge's belief that six of its eight reserve funds have upper limits is mistaken. Evidence that it provided to us during our audit supports our conclusion that Wheeler Ridge's reserve policy imposed no maximum level to which these six reserve funds could increase. In its response, Wheeler Ridge asserts that "an upper limit was established equal to the fund balance of the reserve as of January 1, 2002," and that a board resolution "provides that the upper limit of each of the reserve funds was to be increased periodically by the amount of accumulated interest earned on the fund." Despite Wheeler Ridge's assertion, we do not believe that a reserve fund's upper limit that routinely

increases by the amount of interest that the fund earns functions as a true upper limit on the size to which the reserve can grow. Accordingly, we stand by our conclusion.

Agency's comments provided as text only.

Office of the State Controller
P.O. Box 942850
Sacramento, CA 95814

June 9, 2004

Ms. Elaine Howle
State Auditor
555 Capitol Mall, Suite 300
Sacramento, California 98514

Dear Ms. Howle:

Enclosed please find our response to the Bureau of State Audits' (BSA) recommendation to the California State Controller's Office regarding its California's Independent Water Districts report. As requested, we are providing this response by 5:00 p.m. on Wednesday June 9, 2004.

The audit report recommends the State Controller's Office should amend its instructions to special districts and the format of its *Special District Annual Report* for reporting special district equity. Specifically, the instructions and report format should reflect special district equity in terms of net assets for all enterprise districts.

We concur with this recommendation. By December 2004, the phased-in implementation of Governmental Accounting Standards Board Statement No. 34 will effectively require all enterprise special districts to implement a net assets presentation of equity on their financial statements. We also agree that a further breakdown of the equity section will provide more useful information to the users of the *Special Districts Annual Report*.

However, because some governmental agencies have until December 2004 to implement the new accounting standards, we do not have a current assessment of how many enterprise districts have already converted their reporting systems to comply with this standard. Therefore, we want to evaluate whether this recommendation could result in unintended state mandated costs.

The Controller's various annual reports on local governments serve as a centralized source of specific financial transactions data that has evolved over many years. These reports are not meant to duplicate local governments' audited financial statements. Consequently, we plan to consult with the Controller's Advisory Committee on Financial Transactions to evaluate the impact of the BSA's recommendation, and if feasible, implement it by the 2005-06 reporting year.

We appreciate the courtesy extended by your staff throughout their audit. If you have any further questions, please contact John Korach, Chief of the Division of Accounting and Reporting at 327-4144.

Sincerely,

(Signed by: John Korach for)

VINCENT P. BROWN
Chief Operating Officer

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