# Review of the FY 2005-06 Santa Clara Valley Water District Operating and Capital Budget

Prepared by the

Board of Supervisors
Management Audit Division

For the

Board of Supervisors
Of the
County of Santa Clara
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July 12, 2005

Chairperson Liz Kniss
Members of the Board of Supervisors
County of Santa Clara
70 West Hedding Street
San Jose, CA 95110

Dear Chairperson Kniss and Members of the Board of Supervisors:

The Board of Supervisors Management Audit Division is pleased to submit this *Review of the FY 2005-06 Santa Clara Valley Water District Operating and Capital Budget.* This report was prepared in response to an October 24, 2004 Board of Supervisors directive instructing the Management Audit Division to prepare an independent analysis and recommendations for budget modifications to the District's FY 2005-06 recommended budget. That budget was submitted by the Santa Clara Valley Water District (SCVWD) for consideration by the Board of Supervisors on May 2, 2005, in accordance with requirements contained in the *Santa Clara Valley Water District Act.*

For FY 2005-06, the SCVWD has presented a $311.0 million Operating and Capital Budget. The net budget, after accounting for $46.5 million in expenditure offsets from intradistrict transfers, amounts to $264.5 million. Included in the $311.0 million recommended budget is approximately $205.3 million in operating expenditures, of which $105.6 million is for salaries and benefits that will be paid to the District's 825 Full Time Equivalent (FTE) employees. Additional appropriations of $105.7 million have been recommended for debt service and capital projects, excluding approximately $123.9 million that will be carried forward from prior years for capital project activities. Lastly, the recommended budget identifies $122.5 million in projected reserves as of June 30, 2006. This amount does not include an additional $180.2 million of unbudgeted reserve balances that are projected to be available at the end of FY 2005-06. Therefore, at the time of this review, the District was projecting total budgeted and unbudgeted reserves amounting to approximately $302.7 million as of June 30, 2006.

This report examines the budgeted operating and capital appropriations for FY 2005-06, as well as estimated operating fund balance for FY 2004-05, unexpended prior year capital project appropriations, and both budgeted and unbudgeted reserves. It includes 18 recommendations for budget adjustments, amounting to a net increase in resources available for appropriation of $147.7 million. This report also includes a series of 18 additional recommendations that will improve management oversight of the budget, ensure greater budget integrity and enhance reporting to the Santa Clara Valley Water District Board of Directors and the Board of Supervisors. A matrix displaying these recommended budget adjustments and other recommendations is attached to this letter. A listing of the 18 management recommendations are provided below.

The District Board of Directors should direct the Chief Executive Officer to:

1. Develop an annual budget process and expedited calendar that will meet the requirements of the County Board of Supervisors;

2. Develop a process and regularly report to the Directors and Board of Supervisors, on changes to estimated fund balances throughout the budget review and approval process;

3. Clearly and concisely report estimated fund balances in the Budget Outlook and Financial Summaries section of the budget document;

4. Regularly track and report on salary savings so that a portion of annual expenditure savings may be recognized at the beginning of the fiscal year;

5. Prepare and include in future budgets, comprehensive listings of classifications, positions and labor costs by functional organization unit, linked to financial summaries that spread labor hours and costs across the various funds;

6. Provide and present budget schedules that compare the recommended budget for the coming fiscal year to current year estimated actual revenues and expenditures;

7. Produce financial management reports on a quarterly basis, that will permit the Director's and the Board of Supervisors to more effectively monitor budget compliance by fund;

8. Fully fund a Post-Employment Health Care Benefits reserve fund from surplus self-insurance reserves, capital project reserves and other sources, and establish pension-type investment policies for this reserve fund as permitted by State law;

9. Retain the services of private investment firms that have been pre-qualified by PERS to manage Post-Retirement Health Care Benefits Reserve Fund investments;

10. Provide the District's 15-Year Capital Improvement Plan and annual updates, the Water Utility Enterprise Report and other key planning studies to the Board of Directors for review and approval;

11. Formally transmit the District's 15-Year Capital Improvement Plan and annual updates, the Water Utility Enterprise Report and other key planning studies to the Board of Supervisors to be considered during Santa Clara Valley Water District budget deliberations;

12. Formalize the District's capital planning process, with a shorter time horizon for funding purposes, through a public and legislative process;

13. Modify the District's management audit workplan to include an organizational assessment and span of control analysis; and,

14. Engage the services of an external consultant to conduct a salary and benefit survey for all classifications, including the 144 exempt positions discussed in this report.

In addition, the Board of Director's should:

15. Review and modify its budgetary control authorities to reduce its risk exposure; and,

16. Establish a policy of funding liability, property and workers' compensation reserves at the 50 percent confidence, or expected level of expenditure for existing and IBNR claims.

The County Board of Supervisors should:

17. Annually consider the District's 15-Year Capital Improvement Plan and annual updates, the Water Utility Enterprise Report and other key planning documents during Santa Clara Valley Water District budget deliberations; and,

18. Direct the County Executive, County Counsel and the Finance Director to review existing policies and practices, and develop budget policies in relation to the SCVWD budget review that would appropriately protect the Board of Supervisors from unnecessary risk.

We are available to discuss the contents of this report and to respond to any questions from the Board of Supervisors or County administration.

Sincerely,

Roger Mialocq

Roger Mialocq, Manager
Management Audit Division

# Recommended Budget Adjustments

| | One Time | | Ongoing | | | Total |
|---|---|---|---|---|---|---|
| | Revenue Increase | Expenditure Decrease | Revenue Increase | Expenditure Decrease | Reserve Modification | Additional Resources |
| ***OPERATING RESERVES*** | | | | | | |
| Ending Unreserved Fund Balance | - | - | - | - | 6,004,282 | 6,004,282 |
| Rate Stabilization Reserve | - | - | - | - | 3,000,000 | 3,000,000 |
| Equipment Service Fund | - | - | - | - | 494,849 | 494,849 |
| Contingent Insurance Liability Reserve | - | - | - | - | 6,640,176 | 6,640,176 |
| Total Operating Reserve Modifications | | | | | 16,139,307 | 16,139,307 |
| | | | | | | |
| ***CAPITAL PROJECTS*** | | | | | | |
| Almaden & Winfield Campus | - | 6,053,366 | - | - | - | 6,053,366 |
| Almaden Campus Gas Generator & Heat | - | 647,605 | - | - | - | 647,605 |
| Information Systems - CMMS | - | 819,734 | - | - | - | 819,734 |
| Information Systems - WRIS | - | 1,152,494 | - | - | - | 1,152,494 |
| Information Systems - EDMS | - | 605,149 | - | - | - | 605,149 |
| Watershed Funds - Various | - | 49,793,197 | - | - | - | 49,793,197 |
| Security Improvements | - | 715,617 | - | - | - | 715,617 |
| Capital Projects Reserves | - | - | - | - | 67,882,949 | 67,882,949 |
| Total Capital Projects | - | 59,787,162 | - | - | 67,882,949 | 127,670,111 |
| | | | | | | |
| ***REVENUES*** | | | | | | |
| Property Tax | - | - | 2,919,407 | - | - | 2,919,407 |
| Interest Income (1) | - | - | 1,161,876 | - | - | 1,161,876 |
| Total Revenues | - | - | 4,081,283 | - | - | 4,081,283 |
| | | | | | | |
| ***EXPENDITURES*** | | | | | | |
| Retirement Contributions | - | - | - | 392,590 | - | 392,590 |
| Salaries Regular | - | - | - | (288,302) | - | (288,302) |
| Fed & State Taxes/Benefits | - | - | - | (5,156) | - | (5,156) |
| Retirement Contributions | - | - | - | (333,165) | - | (333,165) |
| Total Expenditures | - | - | - | (234,033) | - | (234,033) |
| | | | | | | |
| **Grand Total** | **$ -** | **$ 59,787,162** | **$ 4,081,283** | **$ (234,033)** | **$ 84,022,256** | **$ 147,656,668** |

(1) Includes $1,344,134 in additional interest income from changes in earnings rate, and a $182,258 loss in interest income from reductions in the District's investment balance due to the prepayment of PERS retirement contributions. The loss in interest income from pre-paying the PERS contribution is offset by $392,590 in expenditure savings, for a net benefit of $210,332.

# Table of Contents

# Introduction

In October 2004, the Board of Supervisors directed the Management Audit Division to conduct a review and submit a report on the Santa Clara Valley Water District's (SCVWD) recommended budget. The purpose of this report is to fulfill that directive by providing the Board of Supervisors with an independent analysis and recommendations for budget modifications that it may wish to consider, in accordance with the mandates included in *Santa Clara Valley Water District Act,* Section 20. That section of the SCVWD Act states:

> "The Board of Supervisors of Santa Clara County shall, at the time and place established by said board of supervisors for hearing and adopting the budget for said county, hear and adopt the budget submitted by the district, making such additions thereto or deletions therefrom as said board of supervisors deems to be in the best interest of the district."

On May 2, 2005, the SCVWD Board of Directors Chair transmitted the District's FY 2005-06 Operating and Capital Budget to the County Board of Supervisors. That document, which was approved by the Water District Board of Directors on April 19, 2005, provided descriptive information and summary schedules of the SCVWD $264.46 million budget by major fund, expenditure category and revenue account.

In his transmittal letter, the Chair described some of the challenges facing the District and steps that had been taken by the SCVWD Board of Directors to meet losses in property tax revenue of approximately $25.5 million in FY 2004-05 and $25.5 million in FY 2005-06 (for a combined total of approximately $51.0 million for the two fiscal years). Chief among these were the following:

- Deleting 90 regular staff to save approximately $9.5 million annually;
- Reducing administrative support costs by 15 percent, or $1.2 million;
- Using $23.0 million in reserves to offset a portion of the property tax loss and fund increased operating costs projected for FY 2005-06; and,
- Agreeing with employee unions to forego an annual cost-of-living increase that the District projected would save approximately $835,000 for each one percent cost-of-living increase that would be withheld in FY 2005-06.

The Chair also noted that earlier plans to increase water rates by 8.0 percent in North County and 20 percent in South County had been dramatically modified. Instead, the Board of Directors approved rate increases amounting to 3.5 percent in North County and 7.5 percent in South County. The Chair stated that, "These lower rates will help fund critical asset management projects, as well as some necessary capital programs and projects; however, less urgent infrastructure and operations projects will be delayed or not implemented."

Despite these actions, our review indicates that the SCVWD continues to operate with a considerable amount of immediate operating and capital expenditure flexibility, and has significant reserves in some areas. However, to assist the Board of Supervisors with its review, this report summarizes the financial organization of the District before providing recommendations for adjusting the budget that was approved by the Board of Directors and submitted to the Board of Supervisors on May 2.

The SCVWD provides three direct service functions to the residents and communities within its service boundaries:

1. Wholesale water supply;

2. Flood protection; and,

3. Stream stewardship.

Accordingly, the District's finances are organized around these direct service functions, as well as various support service activities that are collectively funded by the direct service programs in an attempt to provide lower cost and more efficient support services for all of the District's organizational units.

Like the County, the District's finances have therefore been segregated by fund, including the:

- General Fund, which includes the office of the Chief Executive Officer and the administrative functions of the District.

- Service Funds, which include the *Equipment Service Fund* (vehicles, field equipment and information technology) and the *Risk Insurance Fund* (the District's safety program, and the general liability, property and workers compensation insurance programs).

- Water Enterprise Fund, which has been established to fund activities related to the wholesale water supply activities of the District.

- Watershed and Stream Stewardship Funds, which include the *Lower Peninsula Watershed, the West Valley Watershed, the Guadalupe Watershed, the Coyote Watershed, the Uvas/Llagas Watershed, the Watershed and Stream Stewardship Program,* and the *Clean, Safe Creeks Program* funds, established for flood control and water quality purposes.

Each of these funds have unique characteristics that affect budget perspective. For example, the General Fund and Service Funds receive the major portion of their income from intra-District reimbursements, while the Watershed and Stream Stewardship Funds receive the major portion of their income from property taxes, special parcel taxes and benefit assessments. On the other hand, the Water Enterprise Fund receives most of its income from user charges. These different characteristics and laws surrounding the sources of funds dictate the types of services provided and the uses for available funding.

While we have organized this report by the general budget categories of Reserves, Capital Projects, Revenues and Expenditures, each finding and recommendation provides data and information on the impact by fund. In addition, each section includes a brief summary of the budget category being discussed, followed by each of our more specific budget findings and detailed recommendations to the Board of Supervisors. In the final section of the report, we have provided a series of recommendations that we believe will strengthen the Board of Supervisors' ability to fulfill the budget oversight responsibilities that have been defined in the *Santa Clara Valley Water District Act.*

## SCVWD Operations and Budget Process

The SCVWD Board of Directors has granted broad administrative authority to the Chief Executive Officer (CEO) to manage the District's operations and capital program. Board of Director's Policy 4.1 states that "The Board will develop policies instructing the CEO to achieve certain results, for certain recipients at a specified cost." Policy 4.3 states that "As long as the CEO uses any reasonable interpretation of the Board's Ends and Executive Limitations policies, the CEO is authorized to establish all further policies, make all decisions, take all actions, establish all practices and develop all activities." These "Ends Policies" are intended to provide broad guidance to the CEO. Current policies established by the Directors allow the CEO to exercise significant latitude on staffing, capital planning and resource allocation decisions that impact the budget. In addition, core budget review and oversight duties typically retained by governing boards in other public jurisdictions, have also been delegated to the CEO.

The Directors state that financial planning and budgeting will be monitored annually, as part of the budget review process; and, that financial conditions and activities will be monitored quarterly, using internally prepared reports; and annually, by an external auditor. In addition, the Directors policies state that the Board may "monitor any policy at any time by any method."[1] We were advised during this review that the Directors regularly request additional budget and financial information from the CEO during the course of the year.

Nonetheless, there appear to be three primary tools used by the Board of Directors to monitor the budget and financial activities of the District:

- The Operating and Capital Budget, which covered a two-year period in prior years, but only covers one year for FY 2005-06. This change reportedly occurred because of the District's concerns regarding State budget actions that have reduced property tax revenues, and because of the need to implement an accelerated budget development process to respond to the Board of Supervisors' request for this independent budget review.

[1] June 2004, *Governance Policies of the Board of Directors of the Santa Clara Valley Water District*, Policy Number BL-5, Section 5.4

- The <u>Ends Quarterly Monitoring Reports</u>, which the CEO provides to the Directors on the District's accomplishments with meeting the intent of established Ends Policies. A review of a sample report from Quarter 1, Fiscal Year 2005, indicates that financial information included in these reports is at a very high summary level and the reports are not an effective tool for measuring budget compliance.

- The <u>Comprehensive Annual Financial Report (CAFR)</u>, which includes the District's financial statements after they have been audited by an external accounting firm.

Other regularly prepared reports to the Board of Directors on the District's financial operations were not brought to our attention during this review, although we noted that the Board receives periodic reports on water enterprise rates and charges, and other special purpose reports.

While we did not conduct a thorough review of Board of Directors activities, certain matters came to our attention which bear mentioning. First, we were advised that the Board of Directors did not review or approve the District's $1.68 billion 15-year capital improvement plan when it was initially developed, nor do the Directors review quarterly or annual updates to this plan. While select information on the capital improvement plan has been presented, to varying degrees, to the Board of Directors in budget workshops, the information provided has not been sufficient to fully evaluate the capital improvement program. Because capital activities drive much of the District's costs, as well as the rates charged to the District's water customers, we believe it is a critical document that should have been thoroughly reviewed and approved when created, reevaluated when substantially modified, and annually considered by the Directors and the Board of Supervisors in a budget context. Our comments regarding capital plan review and approval are more fully described in a later section of this report.

Second, the Directors have delegated considerable authority to the CEO for the creation of positions, position control and, in some cases, salary setting. The Directors do not establish an annual salary ordinance or closely define the types and numbers of personnel that may be hired by the District. In fact, during this review, the District was unable to provide certain basic information regarding the construction of the salary and benefit expenditure budget with the ease or in the amount of time that we would expect for an organization with only 825 full time equivalent positions. Again, our comments regarding employee salary and benefit expenditure budgeting practices are discussed more fully in a later section of this report.

Capital plans, salary ordinances and other subsidiary planning and control documents are critical tools for budget development and monitoring purposes. They contain key information regarding the assumptions and context upon which a budget is based. Accordingly, in order to conform with the spirit and intent of Section 20 of the *Santa Clara Valley Water District Act,* these documents should be appropriately reviewed and adopted by the SCVWD Board of Directors and transmitted to the Board of Supervisors for consideration prior to District budget deliberations. This recommendation is discussed more fully in Section 6 of this report, which provides observations and recommendations on budget reporting and process concerns that came to our attention during this review.

## Impact of Budget Adjustments on Water Rates

Included in this report are many recommendations that would reduce costs or increase the amount of undesignated resources available within the Water Enterprise Fund. Although we have not evaluated the direct impact from these recommendations on water rates, the District is clearly required to adjust such rates to reflect the budget decisions that are made by the Board of Supervisors. The Santa Clara Valley Water District Act, Section 26.7 (a) (3) (D) requires the Santa Clara Valley Water District Board to adjust water rates to conform with the budget approved by the Board of Supervisors, as follows:

> "The rates shall be established each year in accordance with a budget for that year submitted by the district to the Board of Supervisors of Santa Clara County pursuant to this act, or amendments or adjustments to that budget . . ."

At the conclusion of these budget deliberations, the Santa Clara Valley Water District Board should evaluate the impact on water rates that might result from any budget adjustments affecting the Water Enterprise Fund. Changes would likely be warranted if the Board of Supervisors makes: (1) adjustments directly to the Water Enterprise Fund budget, or (2) adjustments to the General Fund, the Risk and Insurance Fund, or the Equipment Services Fund, for which the District allocates costs to the Water Enterprise Fund and its other operating funds. Based on the FY 2005-06 projected revenue from water sales of $120.0 million, a 1.0 percent adjustment to the rates would be required for each $1.2 million in savings or additional resources recognized by the District for the Water Enterprise Fund.

The following sections of the report discuss our specific budget findings.

# 1. Reserves

The Santa Clara Valley Water District has accumulated total reserves that it projects will amount to $374.9 million by the end of FY 2004-05. Some of these reserves are required by various agreements or debt covenants that bind the District, while others have been set aside by policy of the District Board of Directors. Depending on the source and intended use of funds, the District may be able to flexibly allocate some money for purposes other than reserves. In other cases, flexibility is more limited or does not exist.

A review of District financial statements and budget documentation indicates that reserves have been declining over the past three fiscal years. As of June 30, 2003 the District had restricted and unrestricted fund balance, including reserves, of approximately $547.9 million. This declined to $484.4 million by June 30, 2004[2] and, as mentioned above, the District anticipates that total reserves will decline to $374.9 million by June 30, 2005. The FY 2005-06 Operating and Capital Budget anticipates that the reserves will decline further to $302.7 million by June 30, 2006, as the District draws on available resources to replace lost property tax revenue, finance operations and proceed with its $1.68 billion capital improvement program.

The anticipated reserves at the end of the FY 2005-06 fiscal year are displayed by fund in the table on the following page. As shown, approximately $109.4 million will be restricted in use for encumbrances, debt service and contractual obligations associated with previous debt covenants, a contract with the U.S. Department of the Interior, and other obligations. We verified the District's classification of these amounts by reviewing source documentation for each obligation and validating the computation of budgeted amounts.

The balance of $195.4 million is unrestricted.[3] Within each fund, the District Board of Directors has designated these unrestricted funds for the following general purposes.

- Approximately $158.3 million has been budgeted for current and future year capital projects, as well as fixed asset purchases;

[2] The $484.4 million amount is stated in the SCVWD *Comprehensive Annual Financial Report for the Year Ended June 30, 2004.* This figure does not agree with a 5/09/2005 table which shows an amount of $446.0 million (a difference of $38.4 million, due to adjustments which omit the value of water rights purchased by the District), entitled "Summary Comparison of Changes from FY 2002-03 to FY 2005-06 Based on Prior Board Presentations and Discussions," which was provided to Management Audit Division staff in an attempt to describe changes to the District's reserve levels.

[3] In some funds, such as the Water Utility and Clean, Safe Creeks funds, unrestricted fund balance can only be used for the legal purposes specified for the funding source. For example, most revenue received by the Water Utility Fund is generated from user fees and water sales. Therefore, these funds can only be used to support Water Utility activities. Similarly, fund balance in the Clean, Safe Creek Fund is generated from a special, voter approved parcel tax (Measure B) that is restricted for flood control and stream stewardship activities. Therefore, these funds can only be used for purposes defined in the original voter approved measure.

- Nearly $11.8 million has been budgeted for accrued liabilities for employee sick leave, vacation and other leave benefits that have been earned by the workforce;
- Over $11.9 million has been budgeted for workers compensation, general liability and property liability self insurance reserves; and,
- Approximately $11.4 million has been budgeted for designated and general contingencies.

A schedule of the District's projected June 30, 2006 reserves by classification, purpose and fund is provided in the table below.

## Table 1

## Schedule of SCVWD Projected Reserves By Classification, Purpose and Fund As of June 30, 2006

**(In Millions)**

| Classification & Purpose | General Fund | Risk and Insurance | Equipment | Water Utility | Watershed | Clean, Safe Creek | TOTAL |
|---|---|---|---|---|---|---|---|
| ***Restricted*** | | | | | | | |
| Encumbrances | 3,000 | - | - | 27,000 | 27,000 | 3,000 | 60,000 |
| Debt Service | - | - | - | 7,000 | 16,000 | - | 23,000 |
| Debt Proceeds | - | - | - | - | 10,000 | - | 10,000 |
| Contractual | - | - | - | 16,527 | - | - | 16,527 |
| **TOTAL RESTRICTED** | 3,000 | - | - | 50,527 | 53,000 | 3,000 | 109,527 |
| ***Unrestricted*** | | | | | | | |
| Capital/Fixed Assets | 12,932 | - | 1,066 | 36,760 | 63,113 | 44,162 | 158,033 |
| Compensated Absences | 11,752 | - | - | - | - | - | 11,752 |
| Self Insurance | - | 11,945 | - | - | - | - | 11,945 |
| Water Supply/Banking | - | - | - | 1,510 | - | - | 1,510 |
| Contingency | 211 | 53 | 49 | 6,232 | 618 | 2,722 | 9,885 |
| **TOTAL UNRESTRICTED** | 24,895 | 11,998 | 1,115 | 44,502 | 63,731 | 46,884 | 193,125 |
| **GRAND TOTAL** | 27,895 | 11,998 | 1,115 | 95,029 | 116,731 | 49,884 | 302,652 |

It is important to note that the District's FY 2005-06 Operating and Capital Budget only identifies approximately $122.5 million of the $302.7 million in reserves that have been estimated for FY 2005-06. The balance of $180.2 million is not appropriated within the budget. For example, the budget only appropriates $7.8 million of the $38.9 million the District has reserved for capital/fixed assets within the Water Enterprise Fund. This unbudgeted portion includes appropriations from prior years that have not been expended. Further, the FY 2005-06 Operating and Capital Budget does not show reserves for encumbrances or debt. To provide a more comprehensive perspective, this report looks at all reserves -- both budgeted and unbudgeted -- and makes recommendations for reallocation of available resources where appropriate.

We separately comment on capital project reserve policies in the section of this report that discusses the District's capital project budget. This section of the report therefore focuses on our analysis of the remaining categories of unrestricted reserves, including (1) Compensated Absences, (2) Self Insurance, (3) Fixed Assets, (4) Water Supply and Banking, and (5) Contingency. In total, these five categories of reserves equal approximately $35.1 million of the District's $302.7 million in total reserves that will be available at the end of FY 2005-06, or merely 11.5% percent. Our findings relate primarily to five budget areas:

- Fund balance that results from unanticipated revenues and operating expenditure savings;
- The Water Utility Rate Stabilization Reserve;
- Amounts that have been designated by the Board of Directors for equipment reserves;
- Amounts that have been designated by the Board of Directors for workers compensation, general liability and property liability self insurance reserves; and,
- Unfunded liability for post-retirement health insurance benefits.

Our discussion of each of these areas begins in the sections below.

## All Funds — Page IV-10 to IV-11

**Ending Unreserved Fund Balance**

| | | Recommended By Water District | Audit Division Proposed | Surplus Balance |
|---|---|---|---|---|
| **General Fund** | **Page IV-10** | **$0** | **$5,779,679** | **$5,779,679** |
| **Watershed Funds** | **Page IV-10** | **0** | **5,954,909** | **5,954,909** |
| **Water Enterprise** | **Page IV-11** | **0** | **(5,730,306)** | **(5,730,306)** |
| **Total** | | **$0** | **$6,004,282** | **$6,004,282** |

Fund balance occurs when the actual results of operations result in differences between budgeted revenues and budgeted expenditures at the end of the fiscal year. These variances can result in a positive fund balance, when revenues are higher than expected and/or expenditures are lower than expected; or, in a negative fund balance when the opposite occurs. In the County, fund balance is estimated as part of the budget process. If there is a positive fund balance, the County Executive recognizes the balance as a resource to fund operations and/or capital projects in the following year. If there is a negative fund balance, the County Executive must access reserves or other resources, or make program cuts to fill the prior year funding gap. These procedures are the generally accepted budget methodologies used by cities, counties and special districts throughout California and prescribed by State law pursuant to Government Code Section 29089.

Although we were advised that some estimates of fund balance were made by the Santa Clara Valley Water District when developing the FY 2005-06 recommended budget, we were also advised that the District does not routinely make projections of fund balance as part of the annual budget development process. In fact, according to the District, a year-end budget adjustment accounting for the variance in budgeted fund balance is not completed until November or December, five or six months into the next fiscal year. Further, there is no section of the Santa Clara Valley Water District budget document that fully discusses fund balance or prominently displays estimates of revenue and expenditure variances from the prior year budgeted amounts. This is key information, since the ending fund balance can provide additional resources for appropriation. In addition, when a negative ending fund balance occurs, budget adjustments may be needed to respond to funding shortfalls.

As part of this review, we conducted an analysis of FY 2004-05 actual revenues and expenditures to determine the net financial position of the District by major fund. The following table displays the summary results of this analysis.

## Table 2

## Estimated FY 2004-05 Fund Balance By Revenue and Expenditure Category and Fund

| *Revenues* | Adjusted Budget | Estimated Actual | Surplus (Deficit) |
|---|---|---|---|
| General Fund | 3,428,500 | 4,222,094 | 793,594 |
| Watershed Funds | 71,328,280 | 72,894,103 | 1,565,823 |
| Water Enterprise | 150,471,828 | 137,975,939 | (12,495,889) |
| Total Revenues | 225,228,608 | 215,092,136 | (10,136,472) |
| ***Expenditures*** | | | |
| General Fund | 46,919,147 | 41,933,062 | 4,986,085 |
| Watershed Funds | 59,205,150 | 54,816,063 | 4,389,087 |
| Water Enterprise | 127,881,746 | 121,116,163 | 6,765,583 |
| Total Expenditures | 234,006,043 | 217,865,288 | 16,140,755 |
| ***Fund Balance*** | | | |
| General Fund | | | 5,779,679 |
| Watershed Funds | | | 5,954,909 |
| Water Enterprise | | | (5,730,306) |
| Total Fund Balance | | | 6,004,282 |

As shown in the table, the District will collect approximately $10.1 million less in revenue than assumed in the FY 2005-06 budget. Although the General Fund and the Watershed Funds will realize $2.4 million more than anticipated in the budget, the Water Enterprise Fund will realize nearly $12.5 million less than anticipated. However, this net reduction in revenues will be offset by approximately $16.1 million in expenditure savings. In total, the District will end FY 2004-05 with approximately $6.0 million more than anticipated, which includes (a) a positive fund balance of $5.8 million for the General Fund, (b) a positive fund balance of nearly $6.0 million for the Watershed Funds, and (c) a negative fund balance of approximately $5.7 million for the Water Enterprise Fund.[4] Based on this analysis, the projected additional resources should be recognized as available within the General Fund and the Watershed Funds, while the loss of available resources should be recognized in the Water Enterprise Fund.

During this review, the District's financial management staff indicated that fund balance is difficult to estimate for the SCVWD because of the unique budgeting and financial management characteristics of the District. For example, it was suggested that expenditure patterns can be difficult to determine because management has the authority to move funds between projects, disrupting expenditure patterns. In addition, it has been the District's practice in prior years to move fund balance into reserves, when they occur. For example, we were advised that the District intended to move any unanticipated FY 2004-05 General Fund and Watershed Fund expenditure savings into the PERS Stabilization Reserve. The District also expected that any unanticipated Water Enterprise Fund expenditure savings could be used to offset anticipated losses in revenue from water sales.

These kinds of general approaches are indicative of an organization that has significant funding and expenditure flexibility. For example, the $5.8 million unanticipated General Fund balance equals approximately 13.9 percent of the District's General Fund budgeted operating expenditures of $41,443,137 in FY 2005-06. This is a considerable surplus for the fund, and the additional resources could have been used to reduce intra-district charges to the other operating funds for the year, which have been budgeted at $39.3 million. To the extent such intra-district charges reduced Water Enterprise Fund costs, net losses in income experienced by that fund could have been further offset, potentially affecting water rates. Yet the District's management chose to not develop or update its earlier fund balance estimates, or advise the Directors and the Board of Supervisors of the significant variances from budget that will occur due to the actual results of operations. As recommended in Section 6 of this report, fund balance should be routinely analyzed and prominently reported in the annual budget document. As is the practice in the County, such estimates should be updated and refined prior to budget adoption.

It should also be noted that the District does not estimate salary savings as part of the salaries and benefits budget. This is a commonly used tool that the County of Santa Clara employs to recognize a portion of expenditure savings that will occur during the year, due to normal attrition and other factors. In FY 2004-05, the District's savings was higher than in previous years due to

[4] These amounts exclude $1,453,684 in expenditure savings for the Risk and Insurance and the Equipment Services funds, which are discussed elsewhere in this report.

changes in procedures requiring executive management approval prior to filling vacancies. For FY 2005-06, the level of savings will likely decline because the District eliminated 90 vacant positions that had accumulated during the prior fiscal year.

However, an analysis of vacancies as of April 26, 2005 indicates that approximately 2.4 percent of all positions authorized in the FY 2005-06 budget were vacant, representing 2.3 percent of the Districts total salary and benefit costs. It is therefore likely that some level of salary and benefit savings will again occur in FY 2005-06. Because we did not review prior year data, and because of the hiring anomalies that occurred in FY 2004-05, we have not made an estimate of salary savings for FY 2005-06. However, such savings will likely occur and again result in unanticipated fund balance at the end of the fiscal year. As in the County, the District should begin to track salary and benefit savings for its $105.6 million salary and benefit budget. A two percent savings would result in annual District-wide resources of over $2 million for all funds.

## Water Utility Fund — Page IV-123

**Rate Stabilization Reserve**

| Recommended By Water District | Audit Division Proposed | Surplus Reserve |
|---|---|---|
| **$3,000,000** | **$0** | **$3,000,000** |

The District has established a Rate Stabilization Reserve within the Water Utility Enterprise Fund to "1) mitigate fluctuations in water rates by providing funding during periods of extraordinary operating expense or water revenue shortfalls, and 2) to supplement District revenues to meet debt service coverage requirements."[5] In its budget explanation, the District states, "The budgeted reserve level *should not be less than* 10% of annual debt service on all Parity Obligation" (emphasis added). In FY 2005-06, the District has budgeted $3.0 million in this reserve. The reserve has been funded at this level since at least FY 2003-04. In its Ten Year Water Utility Plan, the District has assumed that the reserve will remain at this level through FY 2007-08. Beginning in FY 2008-09, the reserve is projected to increase to $4.0 million.

The authority to create a Rate Stabilization Reserve is established in the Water Utility System Master Resolution, which was approved by the Board of Directors in June 1994 to secure payments for debt obligations from Water Utility System revenues. Section 2.1 of that resolution states that "The District hereby establishes and agrees to maintain, so long as any Parity Obligations or Subordinate Obligations remain outstanding . . . (a) Rate Stabilization Reserve Fund." However, other sections suggest that the amount of funds transferred into the Rate Stabilization Reserve are discretionary. Section 2.2 states that "the District agrees and covenants that all Current Water Utility Revenues received by it *shall* be deposited when and as received in the Water Utility System Revenue Fund. The District *may* transfer amounts in the Water Utility

[5] *FY 2005 -2006 Operating and Capital Budget,* Page IV-38.

System Revenue Fund to the Rate Stabilization Reserve Fund or from the Rate Stabilization Reserve Fund to the Water Utility System Revenue Fund." Section 2.3 states "From time to time the District *may* deposit in the Rate Stabilization Reserve Fund from Current Water Utility System Revenues or from any other available funds of the District such amounts the District shall determine" (emphasis added).

It is clear that the 1994 Master Resolution provides the Board of Directors with broad discretion regarding the amount of Current Water Utility System Revenues that can be deposited into the Rate Stabilization Reserve Fund. In addition, the amount of reserve that has been established by the District significantly exceeds the "10% of annual debt service on all Parity Obligation" that the District says "should be" held in reserve. In fact, total Water Enterprise Fund debt payments will equal only $5,589,823 in FY 2005-06. A 10 percent reserve on this amount would equal only $558,983. Therefore, the reserve is presently holding at least $2,441,017 more than the District's recommended minimum reserve funding level.

Lastly, it appears the Rate Stabilization Reserve Fund provision included in the 1994 Master Resolution was established to provide a certain level of operating flexibility to the District during periods when revenues and/or expenditures unexpectedly fluctuate. Yet these funds were not accessed for FY 2005-06 when the District reportedly chose to lower Water Utility Rates below amounts initially proposed. Nor has the District convincingly demonstrated a need to maintain the reserve over the next 10-year Water Utility Rate horizon, when ground water charges are projected to increase by 48.1 percent in North County and 72.5 percent in South County.

Therefore, because the Rate Stabilization Reserve Fund (1) can be set at discretionary levels, (2) is set at levels which far exceed levels established in the 1994 Master Resolution, and (3) has not typically been accessed by the District to stabilize rates when unexpected fluctuations in expenditures or revenues occur, the funding in the reserve should be removed, recognized as a discretionary resource in the Water Enterprise Fund and applied toward a water rate reduction.

## Equipment Service Fund — Page IV-163

**Total Year End Reserves**

| Recommended By Water District | Audit Division Proposed | Surplus Reserve |
|---|---|---|
| **$1,114,849** | **$620,000** | **$494,849*** |

***Excludes projected fund balance of an additional $2.6 million in surplus which the District has rebated to operating units in FY 2004-05.**

The Santa Clara Valley Water District has established an Equipment Service Fund for the purposes of funding the acquisition and maintenance of vehicles, field equipment and computers for the different operating units within the District. In FY 2005-06, the District has budgeted operating expenditures of $3,768,544 and intends to purchase $910,298 in equipment, for total operating and acquisition costs of $4,678,842. The major portion of the $910,298 in capital expenditures will be made for computer equipment, amounting to approximately $833,300.

To finance Equipment Service Fund operations and these capital acquisitions, the District is anticipating that it will receive approximately $183,400 in interest and other income, as well as $4,072,854 in intra-fund reimbursements. In total, this $4,256,254 in current year resources will finance a major portion of the anticipated expenditures of $4,678,842. The $422,588 in expenditures that exceed the $4,256,254 in anticipated resources will be funded from Equipment Service Fund balance. A review of the District's prior year financial statements indicates that the entire projected capital reserve plus contingency amounts of $1,553,937 as of June 30, 2005, and $1,114,849 as of June 30, 2006, represent retained earnings.

Internal service funds are designed to operate on a break-even basis and should not accumulate retained earnings or maintain such surpluses on an ongoing basis. Further, charges in excess of actual costs violate Federal OMB A-87 Accounting Standards. Therefore, retained earnings cannot be accumulated from any federal or State funded program or grant. Nonetheless, in violation of these standards, the District has had a history of accumulating significant retained earnings in the Equipment Services Fund. This history is displayed in the table below.

## Table 3

## History of Budgeted and Actual Year End Reserves Equipment Service Fund - FY 00 through FY 06

**(In Thousands)**

| | 06/30/00 | 06/30/01 | 06/30/02 | 06/30/03 | 06/30/04 | 06/30/05 | 06/30/06 | Note |
|---|---|---|---|---|---|---|---|---|
| Budgeted Year-End Reserves | 2,036 | 2,352 | 896 | 1,713 | 1,759 | 1,525 | 1,115 | (1) |
| Actual Year-End Reserves | 3,765 | 2,911 | 3,686 | 4,925 | 5,799 | 3,375 | UNK | (2) |
| | | | | | | | | |
| Over (Under) Budget Estimate | 1,729 | 559 | 2,790 | 3,212 | 4,040 | 1,850 | UNK | |
| | | | | | | | | |
| Available Cash | 4,362 | 3,261 | 4,182 | 6,115 | 6,297 | UNK | UNK | (3) |
| Percent of Actual in Cash | 115.9% | 112.0% | 113.5% | 124.2% | 108.6% | UNK | UNK | |

(1) Budgeted year-end reserves represent the annual budget estimates made by District staff in FY 2000-01 through FY 2005-06 budget approved by the Board of Directors. The figures exclude carryforward appropriations from previous fiscal years.

(2) Actual year-end reserves represent the unrestricted net assets, less encumbrances, reported in the District's audited financial statements for June 30 of each year. These figures include carry forward amounts designated for projects approved in prior fiscal years and classified as Unrestricted-Designated by the District's financial auditors. Actual year-end reserves for FY 2004-05 represent our projection of operating surplus plus the reported unencumbered balance available as of May 31, 2005. It should be noted that the District intends to use a portion of this anticipated surplus to rebate $2.6 million in costs to the purchasing operating units at the end of FY 2004-05 (shown in the budget). This will effectively generate $2.6 million of surplus in the District's operating funds. The FY 2004-05 estimate is therefore provided for illustrative purposes, demonstrating the significant difference between the initial projection made at the beginning of the year and the actual results of operations.

(3) Available cash represents the amount of cash and investments reported in the District's audited financial statements for June 30 of each year.

As shown in the table, the District's annual budget has historically under reported the net resources available in the Equipment Service Fund. As of June 30, 2001, the fund had actual reserves that exceeded the current year budget estimate by $559,000. This was the year with the lowest amount of surplus difference. As of June 30, 2004, actual unrestricted surplus reserves exceeded the budget estimate by $4.0 million. A review of the District's financial reports for Accounting Periods 1-11 (as of May 31, 2005), indicate that the Equipment Service Fund will have a probable fund balance that will again exceed the budget estimate. As of that date the District had expended or encumbered only $1.9 million of the $5.6 million appropriated for fixed asset purchases from prior year carry forward and current year budgeted resources. Accordingly, the Fund may hold as much as $3.7 million in unexpended fixed asset appropriations as of June 30, 2005, which is nearly $2.2 million more than was estimated in the initial budget for that year. Estimated additional operating savings of $687,144 will increase this surplus fund balance to the $2,859,000 shown in the table, above. Recognizing this surplus, the District refunded $2.6 million of this amount to the operating departments as a rebate in FY 2004-05.

The District argues that year end designations that have been established for current authorized projects and future projects should not be compared with the amount that has been budgeted for future projects only. Normally, we would agree. However, as shown by the data in Table 3, the District has historically carried forward balances for current authorized projects amounting to several million dollars each fiscal year, meaning that there are regularly large, ongoing surplus appropriations in every fiscal year that are normally not expended. This expenditure pattern suggests that the carry forward amount of unrestricted fund balance that has been designated for future projects actually equates to surplus.

The District anticipates future year vehicle and equipment replacement expenditure levels that it believes will require its estimated current fund balance to "smooth out overhead charges" in the two years immediately following FY 2005-06. According to an explanation provided by the District, recent decisions to extend the vehicle replacement cycle will create a need to make vehicle and equipment purchases of $1.5 million in FY 2006-07 and $2.0 million in FY 2007-08. These amounts exceed the FY 2005-06 budgeted level of $910,298.

However, financing the acquisition of internal service fund capital assets by charging user rates in excess of actual costs in order to generate retained earnings is also a direct violation of OMB A-87 and State Controller accounting requirements. Consequently, except for 60-days working capital of approximately $620,000, all of the Equipment Service Fund surplus balance that is in the form of retained earnings should be returned to the funds from which they were obtained through refund processes recommended by the State Controller. Such refunds are accomplished by adjusting future charges to user departments to incur an offsetting operating loss that will eventually absorb any surplus balance. Therefore, on a budget basis, $494,849 should be immediately returned to the operating departments in the form of a rate reduction in FY 2005-06. This ongoing violation of OMB A-87 accounting requirements should have been identified and reported by the District's financial auditor.

Following receipt of this report, District staff requested its financial auditor to review the District's State and federal grant claims and reimbursement requests for the past two fiscal years, to determine if any violations of OMB A-87 had occurred. At our exit conference meeting with District staff, it was reported that no equipment charges had been made to any State or federal program, therefore it was concluded that OMB A-87 accounting requirements had not been violated. The fact that no illegal charges had been made in these prior reimbursement claims does not mean that the Equipment Internal Service Fund accounting procedures are not in violation of OMB A-87 accounting requirements. If the District does not change its accounting procedures to comply with OMB A-87, no Equipment ISF charges can legally be made against any future State or federal program. In addition, it is quite possible that prior State and federal grant claims and reimbursement requests for personnel costs included overhead charges that <u>did</u> include an equipment component, which would make such charges excessive and a violation of OMB A-87. The District should either bring its internal service fund accounting procedures into compliance with OMB A-87, develop two sets of internal service fund rates (including one that is in compliance with OMB A-87), or audit all State and federal grant claims and reimbursement requests prior to submittal to ensure no equipment charges are directly or indirectly included through overhead charges.

| **Risk Insurance Service Fund** | **Page IV-167** |
|---|---|

**Contingent Liabilities Reserve**

| **Recommended By Water District** | **Audit Division Proposed** | **Surplus Reserve** |
|---|---|---|
| **$11,945,176** | **$5,305,000** | **$6,640,176** |

Each year, the Santa Clara Valley Water District designates fund balance within the Risk Insurance Service Fund as a reserve to pay for future obligations related to workers compensation, general liability and property liability claims against the District. In part, the amount of this reserve is determined based on actuarial evaluations of the District's current and future cost of existing liabilities, calculated at the 50 percent confidence level, or expected cost to settle all reported and Incurred But Not Reported (IBNR) claims against the District. The expected cost is based on an analysis of claims data, and is affected by the amount of coverage provided by purchased insurance and self-insurance exposure.

The District has chosen to fund the self-insurance reserve amounts at levels which exceed the 50 percent confidence levels, or expected current and future costs of reported and IBNR claims. In FY 2005-06, the District has funded self-insurance for general liability, property liability and workers compensation at the 95 percent confidence level, which is very conservative and exceeds the funding level established by most public agencies with which we are familiar. For comparison purposes, the County funds its insurance reserves at the 50 percent confidence level. In addition to the decision to establish a conservative self-insurance funding threshold, the District has chosen to establish the following supplemental self-insurance reserves.

- Because the actuarially determined reserves are based on claims experience below a $500,000 threshold, there is an additional $1.5 million reserve that the actuary has recommended for "catastrophic" general liability and property liability claims settlements above $500,000 and below $2,000,000 (over $2.0 million, commercial insurance provides coverage). This catastrophic reserve was recommended by the actuary because although "the expected loss for this layer is low due to the small probability of a loss in this layer . . . the dollar value of any loss that does occur in this layer is likely to be large."

- Additional catastrophic loss reserves of $4,181,315 have been established to provide immediate resources and local emergency funding prior to receiving other emergency relief, in the event of a major disaster involving uninsurable assets (e.g., dams and other major infrastructure).[6]

In total, the District has budgeted approximately $8.2 million in reserves that exceed the self-insurance reserve requirements established at an expected level of loss for FY 2005-06. At the expected level, the District would require self-insurance reserves of only $3,805,000 instead of the $11,998,315 that has been budgeted.

We agree that the District should establish prudent self-insurance reserves. However, we believe that these reserves should be more closely aligned with expected losses (i.e., 50 percent confidence), with a smaller supplemental reserve for catastrophic claims. Our perspective is based, in part, on an analysis of the annual cost of commercial insurance, self-insurance claims and administration, which shows that actual annual expenditures have been relatively stable in recent years, and are projected to continue at approximately the same levels through FY 2005-06. In fact, the reserves established by the District have historically been more than 500 percent of actual annual expenditures for claims costs and administration since at least FY 2003-04 and have been budgeted to remain at those levels through FY 2005-06. The following table shows the stability of these expenditure trends for the General Liability, Property Liability and Workers Compensation insurance programs over the past three fiscal years.[7]

[6] It should be noted that the self-insurance claims reserve shown in the District's summary budget worksheets shows a projected claims reserve amount of $6,822,000 and catastrophic loss self-insurance reserves of $5,123,000 as of June 30, 2006. The $6,822,000 claims reserve amount shown in these worksheets is the amount established by the actuary at the 95 percent confidence level for FY 2004-05. In our analysis we increase the claims reserve to the 95 percent confidence level for FY 2005-06, or $7,817,000 consistent with the District's stated policy, and reduce the catastrophic reserve amount by a corresponding difference between the years. The total self-insurance reserve shown in our analysis conforms with the District's proposed budget.

[7] The District was requested to provide 10-years of insurance program expenditure data but reported that older records had been archived and would be difficult to retrieve. Therefore, only five years of data was provided.

# Table 4

## FY 2003-04 through FY 2005-06 Actual and Budgeted Insurance Program Costs Compared with Insurance Reserves

| ANNUAL RISK PROGRAM COSTS | Actual FY 1999-00 | Actual FY 2000-01 | Actual FY 2001-02 | Actual FY 2002-03 | Actual FY 2003-04 | Budget FY 2004-05 | Budget FY 2005-06 |
|---|---|---|---|---|---|---|---|
| *General and Property* | | | | | | | |
| Commercial Insurance | 336,493 | 372,541 | 545,834 | 652,800 | 693,829 | 972,050 | 847,050 |
| Self-Insurance | 70,583 | 297,155 | 170,081 | 149,579 | 426,634 | 250,000 | 250,000 |
| Legal Services | 171,538 | 158,064 | 248,966 | 257,425 | 318,059 | 350,000 | 350,000 |
| Administration | 3,862 | 241 | 14,579 | 285 | 9,111 | 48,000 | 30,000 |
| Total General and Property Liability | 582,476 | 828,001 | 979,460 | 1,060,089 | 1,447,633 | 1,620,050 | 1,477,050 |
| *Workers Compensation* | | | | | | | |
| Commercial Insurance | 29,878 | 33,197 | 56,261 | 77,362 | 112,955 | 140,000 | 115,000 |
| Self-Insurance | 44,895 | 345,751 | 336,795 | 421,339 | 647,758 | 498,000 | 573,000 |
| Legal Services | - | - | - | - | - | 40,000 | - |
| Administration | 49,699 | 61,576 | 93,429 | 180,219 | 234,464 | 173,615 | 206,807 |
| Total Workers Compensation | 124,472 | 440,524 | 486,485 | 678,920 | 995,177 | 851,615 | 894,807 |
| Total Insurance Program | 706,948 | 1,268,525 | 1,465,945 | 1,739,009 | 2,442,810 | 2,471,665 | 2,371,857 |
| Budgeted Reserves | 14,628,017 | 15,983,000 | 15,165,000 | 12,621,000 | 12,867,119 | 12,638,489 | 11,998,315 |
| Funding Ratio | 2069% | 1260% | 1034% | 726% | 527% | 511% | 506% |

As shown in Table 4, the District has been retaining self-insurance reserves that exceed 500 percent of the annual cost of the entire insurance program since at least FY 1999-00. These reserves have been maintained despite the District's policy of charging its operating funds for the full current year cost of the insurance program, as well as substantial portions of the District's various discretionary risk management activities that are intended to reduce the District's claims exposure. For example, in FY 2005-06, the District's Risk Insurance Service Fund is budgeted to receive $3.5 million in intra-district reimbursements and interest income to fund approximately $2.4 million in insurance program costs.[8] As in previous years, the fund will generate over 100 percent of the annual cost of the insurance program through these intra-district charges and interest earnings, and use the balance of the reimbursements to fund more discretionary risk management activities.

## Budgeting for Future Expenditures

The District believes the significant increases in claims costs that have been projected by the actuaries require the more conservative reserve policies that have been established by the Board

[8] The District has budgeted insurance and risk management program expenditures of $4.1 million in FY 2005-06. Of this amount, $2.4 million will be expended on the insurance program and $1.7 million will be expended on risk management activities. After offsetting total costs by $3.5 million in anticipated interest earnings and intra-district reimbursements, the District anticipates that it will need to draw approximately $637,174 from fund balance to finance its budgeted risk management activities.

of Directors. In a response to inquiries regarding the rationale for these more conservative policies, the District's Deputy Administrative Officer for Finance stated:

> "While the 95th percentile may be higher compared to other agencies, the actual dollar amount applied is not high when compared to the potential cost of a single liability and/or workers comp claim. Given the volatility experienced over the last few years, there is greater uncertainty as to the adequacy of the reserves, which justifies the higher funding level."

We believe this characterization overstates the District's more immediate needs, and that the District could substantially reduce its reserve levels while still providing sufficient coverage for estimated losses at the expected levels. For example, if the District lowered its reserve policies to the expected, or 50 percent confidence levels, and maintained a $1.5 million reserve for catastrophic losses, it would require a self-insurance reserve of only $5,305,000. At this policy level, the District (a) would still have sufficient resources to fund expected losses, (b) would have sufficient resources to fund the "small probability" of a catastrophic loss that might occur within the $500,000 to $2,000,000 exposure layer, and (c) would maintain reserve levels that would be equivalent to over 200 percent of its actual annual cost of insurance.

<u>Additional Reserve for Catastrophic Losses</u>

As mentioned previously, the District has established an additional reserve of $4,181,315 for losses that might occur in the event of a dam failure or some other major catastrophic event. We believe that such a reserve is not required because of the substantial financial liquidity and flexibility that the District has with the use of its other resources.

For example, the District has anticipated that it will have over $160 million in total unrestricted capital project reserves by the end of FY 2005-06. Of this amount, more than $63 million will be reserved for watershed and flood control purposes; and, much of this funding will not be required for several years. In the event of a major catastrophe, such funds could be accessed as an immediate resource for infrastructure repair and meeting the disaster assistance needs of the community. Other resources would likely be made available over time, including emergency assistance from the federal and State governments, and the District would be able to borrow funds against future property tax receipts that it will generate. Therefore, we question the necessity of establishing a separate reserve of over $4.1 million for catastrophic events, and believe that this reserve layer should be eliminated.

The County of Santa Clara has established more realistic reserve policies in recent years. For both the General and Automobile Liability Self Insurance Fund and the Workers Compensation Fund, the Board has established reserves at the expected, or 50 percent confidence level. This has allowed the County to discount rates charged to departments in recent years, while maintaining prudent, actuarially based reserves that will be sufficient to smooth any dramatic fluctuations in actual annual costs.

Based on this analysis, we recommend that the District fund insurance reserves at the expected, or 50 percent confidence levels determined by its independent actuaries, plus a $1.5 million catastrophic reserve for low probability claims that would fall between the $500,000 and $2,000,000 layer, discussed above. We do not believe the District should fund other catastrophic reserves. Therefore, the District should reduce its self-insurance reserves, through intradistrict rate adjustments, by $6,640,176 over the course of the next two fiscal years. This would allow the District to reduce intra-district costs by over $3.1 million in FY 2005-06 and additional amounts in following fiscal years, depending on actual program requirements and interest earnings. These reserve reductions and policy changes would produce one-time and annual savings for all funds, and could result in water rate reductions for District customers.

## Unfunded Liability for Post-Employment Health Care Benefits

The Santa Clara Valley Water District provides post-employment health care benefits for employees who have completed at least 10 years of service with the District. For the year ended June 30, 2004, the District spent $1,295,000 for these benefits for 215 former employees. This expense represented the current year cost of claims. None of this expense was incurred to fund the future liability for benefits to be paid to previous or existing employees, and no funding was previously set aside for these purposes in prior years. Accordingly, the District has a significant unfunded liability for its post-employment health care benefit program.

The District reports that it has not completed an actuarial evaluation to determine the amount of this unfunded liability, although it intends to complete such a review in FY 2005-06. Therefore, we cannot reliably report the amount of the unfunded liability at this time. However, our experience in the County of Santa Clara and in other large jurisdictions throughout the State that have completed actuarial evaluations of post employment health care benefit programs, suggests that the total liability may be as much as 35 times the annual payment for the program. While the actuarially determined liability estimate will be subject to various factors, including the specific attributes of the program and the assumptions used by the actuaries, applying this factor will provide a good first estimate of the scale of the unfunded liability. In FY 2005-06, the District is budgeting $2,417,049 to fund the current year cost of the post-employment health care benefits for previous employees. Multiplying this projected expense by 35 results in an estimate of unfunded liability amounting to approximately $85.0 million. This is substantial, and should be funded by the District as soon as practical.

Within this study, we have identified significant reserves and other resources which we have recommended be moved into unappropriated fund balance. We believe that the District should consider moving some of these funds into a special fund for post-employment health care benefits. Doing so would (1) provide funding for all or a portion of the unfunded liability, and (2) allow the District to take advantage of higher yield investments typical for pension funds, thereby offsetting all or a portion of its annual outlay for post-employment health care benefits. The financial benefit from doing so could be substantial.

We are projecting that the District will earn an average of approximately 3.61 percent on its commingled pool of investments during FY 2005-06. If the District were able to invest approximately $85.0 million in higher yield instruments typically purchased by retirement funds, the earnings differential could be significant.[9] For example, the California Public Employees Retirement System (PERS) assumes a return on investments of 7.75 percent, a level which it has significantly exceeded in the past 25-year history of the fund. If the District could earn additional income equivalent to approximately 4.14 percent on an estimated $85.0 million fund balance, which is the approximate difference between the District's projected commingled earnings rate of 3.61 percent in FY 2005-06 and the PERS assumed rate of 7.75 percent, additional annual investment income of approximately $3.5 million could be earned by the District. This amount would effectively eliminate the need for annual contributions and provide resources for discounting future contributions, increasing these discounts as the funded balance grows.

Should the District choose this strategy, it should employ the services of private investment firms that have been pre-qualified by PERS to invest retirement funds. As indicated in our 2002 *Management Audit of the Controller-Treasurer Department of the Finance Agency,* "PERS has a rigorous screening and qualification program for firms applying to participate. External (investment) management firms are divided between domestic equities, international equities, fixed income, real estate and other specialties, and are further specialized within these areas. Once qualified, each firm is given a benchmark investment goal that is carefully monitored by PERS staff and reported quarterly to the PERS Board. If a firm fails to meet its investment benchmark, it is placed on probation for a period of time and terminated pursuant to its contract if the benchmark is not attained within a fixed period of time." At the time of the report, "PERS reported that its domestic equity active manager program had earned an average of 2.0 percent over PERS benchmarks since inception."

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[9] As shown in the May 12, 2005 *Review and Analysis of FY 2005-06 State Budget Issues,* prepared by the Board of Supervisors Management Audit Division, PERS has earned an actual average net return on investments of 10.96 percent over the last 25 years. Although there were investment losses in FY 2000-01 and FY 2001-02, PERS investment performance has significantly improved since that time. In FY 2003-04, PERS earned an average net return on investments of 16.70 percent and in the first seven months of FY 2004-05, PERS earned an average net return on investments of 13.45 percent (annualized). As further shown in the *State Budget* report, the PERS assumed earnings rate of 7.75 percent is among the lowest of the rates used by retirement systems within the 30 most populous U.S. Cities, California Counties, and States. For these jurisdictions, investment earnings rates range from a low of 7.0 percent to a high of 9.0 percent. The PERS assumed rate is the fourth lowest of the jurisdictions surveyed.

# 2. Capital Projects

Capital activities are a significant function for the District. In fact, approximately 109 of the District's 813 employees, or 13.4 percent, are assigned to the Capital Program Services division. In FY 2003-04, capital expenditures were approximately $248.4 million or 53.3 percent of the District's total expenditures.

The annual Capital Budget is developed from the District's 15-year capital improvement plan. Capital projects are added to the plan through a process of project initiation, assessment and planning. Capital projects are also reviewed by various advisory committees, the Water Commission, and by water retailers through the development of the Water Utility Enterprise Report. While the Board of Directors has not formally approved the 15-year capital improvement plan, individual projects are authorized through the annual appropriations and contract approval processes. Further, select information on the capital improvement plan has been presented, to varying degrees, to the Board of Directors in budget workshops in the spring of 2005, 2003, and 2002. Finally, Directors also receive monthly capital project status reports by District. However, these reports do not contain any financial or budgetary information.

As of March 31, 2005, the 15-year capital improvement plan has identified $1.68 billion in capital projects funding needs through FY 2015-16. However, projects in the plan are in various stages of assessment, planning and development and, therefore, the estimate is not necessarily indicative of the actual costs to implement the 15-year capital improvement plan.

While it is the intent of the District to appropriate funding for capital projects in the year that the funds will be expended, because individual capital projects often span multiple years, capital appropriations that are not spent in a given year are "carried forward" to the next year. Some of these funds may be contractually obligated or otherwise encumbered. Therefore, all previously appropriated funds are not available to the Board of Directors for new appropriations, unless the Directors take action to release the existing appropriations. Accordingly, in any given year, the capital program can be funded from a variety of sources: (a) appropriations from the current year funded by operating surpluses or capital reserves, (b) prior year unexpended capital encumbrances, or (c) prior year unexpended (and unencumbered) appropriations.

Table 5 on the next page presents historical capital appropriations and actual expenditures by fund for FY 2001-02 through FY 2003-04, and estimated for FY 2004-05. The table shows that since FY 2001-02, the District has gradually reduced its carry forward of appropriations from a 59 percent variance between appropriations and actual capital expenditures in FY 2001-02 to an estimated 33 percent in FY 2004-05. However, there is considerable variability between the funds. In FY 2004-05, the General Fund is projected to carry forward approximately 52 percent of its capital appropriations, the Watershed Management special revenue funds are projected to carry forward approximately 37 percent, and the Water Enterprise Fund is projected to carry forward 26 percent. While the appropriations carried forward are decreasing, the balance is substantial, totaling an estimated $123.9 million in FY 2004-05. Some of these capital appropriations, which are carried forward, may include encumbered funds which have not been spent at year-end.

# Table 5

## Comparison of SCVWD
## Capital Budget to Actual Expenditures
### (in Thousands)

| | FY 01-02 | | | FY 02-03 | | | FY 03-04 | | | FY 04-05 | | | % |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | Budget | Actual | Variance | Budget | Actual | Variance | Budget | Actual | Variance | Budget | Est. Act | Variance | Bud |
| General Fund | 22,376 | 5,423 | 16,953 | 35,098 | 15,148 | 19,950 | 27,719 | 14,261 | 13,458 | 19,074 | 9,074 | 10,000 | 52% |
| Watershed & Stream Stewardship | - | - | - | | | - | 7,682 | 5,664 | 2,018 | 19,780 | 8,380 | 11,400 | 58% |
| Lower Peninsula Watershed | 26,244 | 12,456 | 13,788 | 31,448 | 26,580 | 4,868 | 36,373 | 23,323 | 13,050 | 24,184 | 15,284 | 8,900 | 37% |
| West Valley Watershed | 8,562 | 1,464 | 7,098 | 9,366 | 1,719 | 7,647 | 7,777 | 491 | 7,286 | 7,670 | 6,170 | 1,500 | 20% |
| Guadalupe Watershed | 106,270 | 34,563 | 71,707 | 90,927 | 55,115 | 35,812 | 68,311 | 52,905 | 15,406 | 48,959 | 43,459 | 5,500 | 11% |
| Coyote Watershed | 91,419 | 36,762 | 54,657 | 94,402 | 46,374 | 48,028 | 72,369 | 40,670 | 31,699 | 49,727 | 30,727 | 19,000 | 38% |
| Uvas/Llagas Watershed | 1,113 | 95 | 1,018 | 1,266 | 323 | 943 | 729 | 253 | 476 | 506 | 206 | 300 | 59% |
| CSC and NFP | 7,640 | 4,865 | 2,775 | 24,073 | 9,393 | 14,680 | 38,486 | 13,538 | 24,948 | 54,258 | 24,058 | 30,200 | 56% |
| Subtotal Watershed Funds | 241,248 | 90,205 | 151,043 | 251,482 | 139,504 | 111,978 | 231,727 | 136,844 | 94,883 | 205,084 | 128,284 | 76,800 | 37% |
| Water Enterprise | 112,346 | 56,998 | 55,348 | 129,560 | 93,358 | 36,202 | 129,560 | 95,438 | 34,122 | 141,937 | 104,837 | 37,100 | 26% |
| Equipment | 6,162 | 2,829 | 3,333 | 6,347 | 3,329 | 3,018 | 4,999 | 1,870 | 3,129 | 5,636 | 5,636 | - | 0% |
| **Total** | **382,132** | **155,455** | **226,677** | **422,487** | **251,339** | **171,148** | **394,005** | **248,413** | **145,592** | **371,731** | **247,831** | **123,900** | **33%** |
| **% Variance** | | | **59%** | | | **41%** | | | **37%** | | | **33%** | |
| Source: | CAFR | CAFR | | CAFR | CAFR | | CAFR | CAFR | | Financial Reports 3/31/05 | FY 05-06 Capital Budget | | |

Note: Budgeted amounts are adjusted budgets at the end of the fiscal year and include prior year carry forward of appropriations.

Areas of Concern Related to the Capital Budget

Our budget review noted several areas of general concern. These areas include use of the 15-year capital improvement plan as an information source for the Capital Budget, the legal level of budgetary control maintained over capital appropriations, and identification of additional available resources that were not considered in the development of the FY 2005-06 Operating and Capital Budget, or in the Water Utility Enterprise Report and water rate development.

*15-Year Capital Improvement Plan*

During this review, we identified several concerns pertaining to the 15-year capital improvement program, which is entering its fifth year of existence. First, the plan, as a comprehensive document, has never been presented to or approved by the District Board of Directors, which is a recommended practice by the Government Finance Officers Association and the National Advisory Council on State and Local Budgeting. Second, as indicated in many of our recommendations below, appropriations do not necessarily correspond to funding needs and expenditure patterns.

Sometimes this variation is significant. We noted inconsistencies within the 15-year capital improvement plan summaries and supporting project detail that made it difficult to identify actual funding requirements for projects, specifically related to projects occurring in, but not necessarily funded by, the General Fund. And, because the 15-year capital improvement plan is a dynamic document and the projects within it are at various stages of development, the estimated funding requirements of the plan are generally inexact. The cost estimates for individual projects are not refined to reasonable accuracy before the projects are included in financing models and annual appropriations, and the plan does not provide criteria for prioritizing capital projects. A detailed review of the budget indicated that the District has funded significant projects that have not been defined, for which cost estimates have not been fully developed, and for which a clear priority and need has not been established.

The 15-year capital improvement plan is a good planning and management tool. However, District management described the plan as a staff planning document. We were advised that the Board of Directors did not review or approve the District's $1.68 billion 15-year capital improvement plan when it was initially developed, nor have the Directors reviewed quarterly or annual updates to the plan in the first five years of its existence. As a result, budgetary controls are weakened.

Several of the capital projects where we found insufficient or non-existent cost estimates are discussed below. Indeed, with respect to projects delayed due to the current budget reductions, the Water Utility Enterprise Report of March 2005 notes that "it is not clear that there is demand among our customers for the District to invest in these projects."[10]

[10] *Water Utility Enterprise Report*, March 2005, page 5.

Because of the issues identified in this budget review, the capital planning process should be formalized, potentially with a shorter time horizon for funding purposes, through a public and legislative review process, in order to ensure that capital projects and related costs are reasonable and are appropriately prioritized.

*Legal Level of Budgetary Control*

Another area of concern is the legal level of budgetary control maintained by the District Board of Directors. In accordance with Ends Policies, the CEO can reallocate appropriations between capital projects without seeking Board of Directors' authorization. Therefore, there is very limited legislative or public oversight or review of capital projects. For example, District management has transferred extensive appropriations from other capital projects to a project for a new water quality laboratory in FY 2004-05. The transferred appropriations totaled $5,640,000, which came from the Rinconada Water Treatment Plant, Treatment Improvement Stage 2 project ($4,040,000), the Waste Stream Separation project ($150,000), the Penitencia Water Treatment Plant Maintenance Building project ($1,100,000), and the Treated Water Distribution Flow Meter project ($350,000). This transfer occurred without the Directors being provided an opportunity to review the transfers and ask pertinent questions, such as: Are those funds needed in the near- term? (If not, surplus appropriations should be returned to fund balance.) Is the project over budget or ahead of schedule? (The transfer of funding implies one of these.) Why are there surplus appropriations in the other capital projects and what is the status of each project? (The surplus funding indicates either the projects were over-budgeted, had a change in project scope, or were deferred due to shifting priorities.) These are important questions that aid in the oversight and management of capital projects to ensure that the Directors' goals and objectives are met and the public's interest is protected.

*Additional Available Resources*

Finally, this past year, the District conducted a review of every capital project and anticipates closing 34 projects in FY 2004-05. The residual unspent appropriations in these projects were estimated to be $4,780,661, but were considered expended when the FY 2005-06 budget was developed. Therefore, these funds were not considered available as fund balance in the development of water rates and funding needs in the FY 2005-06 budget. In fact, the District shifted some of these surplus balances to other capital projects. Two additional projects with unencumbered appropriation balances totaling $4,326,456 as of January 19, 2005, were suspended, but the appropriations were also considered expended in FY 2004-05, for budget development purposes. These surplus funds should have been returned to fund balance and incorporated into the projection models as available funding sources, especially with regard to rate development in the Water Enterprise Fund. The 12 closed projects in the Water Enterprise Fund totaled $1,589,000 which, if returned to fund balance, would have reduced the District's revenue requirements from water rates. Further, a portion of the $751,132 in capital project appropriation reductions in the General Fund would also have been allocated to the Water Enterprise Fund and reduced the District's revenue requirements.

The following sections discuss our specific recommendations related to the District's capital budget appropriations.

| General Fund, Project 60204023, Almaden and Winfield Campus Project | Page IV-153 |
|---|---|

| Recommended By Water District* | Audit Division Proposed | Surplus Appropriations |
|---|---|---|
| **$6,076,366** | **$23,000** | **$6,053,366** |

* Includes prior year appropriations estimated to be carried forward to FY 2005-06.

According to the 15-year capital improvement plan, the Almaden and Winfield Campus Project (Administrative offices and facilities) was established to "maximize the utilization" of various District facilities and includes development of a needs assessment, an updated Master Plan, and any necessary environmental reviews. The project has been categorized into four segments: Almaden Winfield Campus Master Plan, Seismic Upgrades Almaden Campus, Off-Campus Corporation Yard, and Almaden Campus Expansion. As of March 31, 2005, the capital improvement plan estimated future funding needs for the entire project of $64.2 million. However, according to the capital improvement plan, only $23,000 in funding is required during FY 2005-06.

The Almaden and Winfield Campus project has carried forward over $6.4 million in appropriations since at least FY 2001-02. In FY 2004-05, $6,407,756 was carried forward into the current year and was augmented by an additional $241,047 in appropriations. As of March 31, 2005, the remaining unexpended balance was $6,427,920, not including an additional $101,279 in open encumbrances. While the preliminary draft of the needs assessment was completed in early 2004, the District reports that the Master Plan will not be completed until September 2005, at which time staff will present various options to the Board. The District intends to transfer the residual appropriations, originally allocated to the Master Plan and estimated by the District to be $6,076,366, to the other three project segments. The Almaden Campus Expansion is projected to receive the majority of this funding totaling approximately $5,945,412.

Because the Master Plan has not been completed, expenditure plans and budget requirements for the remaining segments have not been refined or informed by the Master Plan. In addition, significant activity related to these segments are not projected until FY 2006-07 in the 15-year capital improvement plan. Therefore, $6,053,000 in appropriations for the Almaden and Winfield Campus Project should be released to unrestricted fund balance for use in the General Fund. Additionally, this project, and its segments, should be evaluated in relation to the other District capital needs through a formal process of capital planning, prioritization and authorization, before the project receives future appropriations. This assessment should include the possible purchase of existing office space at current favorable prices, in lieu of expanding existing District buildings or constructing new ones. As noted previously, the entire project is estimated to cost $64.2 million and the District can only reasonably evaluate whether this project is a District priority when evaluated along with all other capital needs. The proposed reduction in appropriations will continue to leave approximately $23,000 in the Almaden and Winfield Campus Project budget for expenditures currently anticipated in the 15-year capital improvement plan, so that the District can complete the Master Plan process.

**General Fund, Project 60204025, Almaden Campus Gas Generator and Heat Project** **Page IV-153**

| Recommended By<br>Water District | Audit Division<br>Proposed | Surplus<br>Appropriations |
|---|---|---|
| **$1,729,542** | **$1,081,937** | **$647,605** |

This project was fully funded in FY 2002-03 at an estimated cost of $2,450,000 as provided for in the original project plan. However, the District reports that there has been a 34.0 percent increase in estimated project costs of $831,937 to $3,281,937, consisting of the following: $271,433 for the design consultant, $377,294 for "District P/R", and $183,210 for construction and equipment. An additional appropriation of $1,729,542 has been included in the FY 2005-06 budget to cover the estimated cost increase as well as another $250,000 in appropriations that were transferred from this project in FY 2003-04 to the Almaden Campus Solar project. However, these funding needs total $1,081,937, or $647,605 less than the FY 2005-06 budgeted appropriation. The District reports that the variance is an error identified after the Board had approved the budget. Therefore, the FY 2005-06 appropriation should be reduced by $647,605 to $1,081,937.

**General Fund, Project 60274054, Information Systems Master Plan - Computerized Maintenance Management System (CMMS) Project** **Page IV-153**

| Recommended By<br>Water District* | Audit Division<br>Proposed | Surplus<br>Appropriations |
|---|---|---|
| **$819,734** | **$0** | **$819,734** |

* Includes prior year appropriations estimated to be carried forward to FY 2005-06.

According to the District, this project is in the planning stages and expected to be completed in FY 2007-08. This project has been substantially funded since FY 2002-03, but has incurred minimal expenditures. The District estimates that $819,734 in appropriations will be carried forward to FY 2005-06 and because only $58,800 is anticipated in expenditures in FY 2005-06, there are no new appropriations. The 15-year capital improvement plan estimates the total project costs to be $1,056,000.

In the project plan, the District notes that this project is to upgrade the Computerized Maintenance Management System. However, the District upgraded this software in February of 2005. The District believes that the new upgrade "may be able to enhance the system if the features are understood and used." The project scope includes evaluating the current version of the system which was installed only four months ago and determining "whether the newer version...would better serve the District needs and if all the functionality of the current version are used." The project plan notes that the functionality of the current version of the system is not fully utilized and that it should be expanded and standardized. Additionally, the project plan states: "Use of the system and the value of the data collected has been limited from the lack of policies and guidelines." Thus, it appears that the implementation of the current version of the system has significant issues that have not yet been resolved.

The District reports that the upgrade in February was not considered a major upgrade and had little disruption to District users. Because of the disruption that is expected with the next major upgrade of the Computerized Maintenance Management System, the District now reports that it is waiting for the system vendor to release a more advanced version.

Therefore, the District does not have an established need for an imminent upgrade to its Computerized Maintenance Management System. Further, at this time, increased functionality of a new version does not justify spending an additional $1,056,000 when the existing system is not being fully utilized. Therefore, this project should be unfunded and the estimated $819,734 in prior year appropriations returned to unrestricted fund balance. Because this project is funded 50 percent by the Water Enterprise Fund and 50 percent by the Watershed Funds, the funding should be returned proportionately to these funds, $409,867 to the Water Enterprise Fund and $409,867 to the Watershed Funds. In the Water Enterprise Fund, this could impact both current year and future year water rates.

**General Fund, Project 60274057, Information Systems Master Plan - Water Resources Information System (WRIS) Project** **Page IV-153**

| Recommended By Water District* | Audit Division Proposed | Surplus Appropriations |
|---|---|---|
| **$1,731,507** | **$579,013** | **$1,152,494** |

* Includes prior year appropriations estimated to be carried forward to FY 2005-06.

This project has been fully funded since at least FY 2002-03 although no significant expenditures have been incurred to date. The estimated appropriations carried forward from FY 2004-05 of $1,386,254, plus the FY 2005-06 appropriation of an additional $345,253, total $1,731,507 in appropriations. However, the 15-year capital improvement plan estimates project costs to total $1,498,000. Therefore, the total project is over-budgeted by $233,507.

In addition to over-funding the total project costs, a significant amount of project appropriations are not required in FY 2004-05 and FY 2005-06. For financial management purposes, the District should aim to appropriate project funding in the year such funding is anticipated to be expended. Thus, total project appropriations should be reduced to the current (FY 2004-05 and FY 2005-06) project funding needs of $579,013 as estimated in the 15-year capital improvement plan. Because this project is funded 100 percent by the Water Enterprise Fund, the funding should be returned to the Water Enterprise Fund, which would impact current year and future year water rates. Of the $1,152,494 returned, $233,507 would be a permanent return in funding and $918,917 would be temporary, but would spread the costs to the Water Utility over the life of the project.

**General Fund, Project 60274058, Information Systems Master Plan - Electronic Document Management System (EDMS) Project** **Page IV-153**

| Recommended By Water District* | Audit Division Proposed | Surplus Appropriations |
|---|---|---|
| **$605,149** | **$0** | **$605,149** |

* Includes prior year appropriations estimated to be carried forward to FY 2005-06.

According to the District summary of this project, while the project plan will be completed in July 2005, the project scope is currently being evaluated and will be potentially modified to leverage existing District software. Because this project with an estimated year-end balance of $605,149 is not yet developed and clearly defined, all project appropriations should be eliminated until such time as the District has developed a project scope and project costs, and is ready to proceed. Because this project is funded 50 percent by the Water Enterprise Fund and 50 percent by the Watershed Funds, the funding should be returned proportionately to these funds, $302,575 to the Water Enterprise Fund and $302,575 to the Watershed Funds. In the Water Enterprise Fund, this could impact current year and future year water rates.

**Watershed Funds, Various Projects** **Page IV-57 through IV-113**

| Recommended By Water District* | Audit Division Proposed | Surplus Appropriations |
|---|---|---|
| **$63,923,370** | **$14,130,173** | **$49,793,197** |

* Includes prior year appropriations estimated to be carried forward to FY 2005-06.

The District has funded several capital projects in the Watershed Funds above identified funding needs. Because funding of capital projects should parallel capital project expenditures to not restrict available funding, these appropriations should be released until such time as specific funding is needed. Otherwise, the extent of resources available for all purposes related to the Watershed Funds is not readily transparent. Further, given the long-term time horizon of the 15-year capital improvement plan, and because the plan is a dynamic document and the projects within are at various stages, the estimated funding requirements especially in later years are likely to be inexact. Therefore, the appropriations also may not be representative of reasonable project cost estimates. Using recent expenditure projections prepared by the District in March of 2005, we identified 17 different projects in five Watershed Funds that were significantly over-funded in the near-term. Table 6 on the following page provides detail on these funds.

# Table 6

## SCVWD Watershed Funds
## Appropriations Exceeding Current Requirements

| Fund Page | Project Number | Project Title | Available Appropriations | FY 05-06 Estimates | Over Appropriation |
|---|---|---|---|---|---|
| **Lower Peninsula Watershed** | | | | | |
| IV-60 | 10104011 | Adobe Creek Upper Reach | 1,803,600 | 853,609 | 949,991 |
| IV-60 | 10214009 | Matadero Barron Creek | 1,675,000 | 158,820 | 1,516,180 |
| IV-61 | 10284007 | San Francisquito Creek | 3,994,587 | 1,700,000 | 2,294,587 |
| | | | 7,473,187 | 2,712,429 | 4,760,758 |
| **Guadalupe Watershed** | | | | | |
| IV-80 | 30154016 | Guadalupe DT - St Clara Park | 2,286,146 | 242,015 | 2,044,131 |
| IV-80 | 30154017 | Guadalupe DT - Woz Way to I280 | 2,030,733 | 525,065 | 1,505,668 |
| | | | 4,316,879 | 767,080 | 3,549,799 |
| **Coyote Watershed** | | | | | |
| IV-90 | 40174004 | Berryessa-L Penit to Calaveras | 7,900,000 | 397,218 | 7,502,782 |
| IV-91 | 40264001 | Lower Silver Creek R3 McKee/I680 | 1,600,000 | 821,673 | 778,327 |
| IV-91 | 40264009 | Lower Silver Creek Reimbursement | 900,000 | 174,737 | 725,263 |
| IV-91 | 40264011 | Lake Cunningham Improvements | 1,460,000 | - | 1,460,000 |
| IV-91 | 40324003 | U Penitencia Creek - Corp Coord | 1,675,000 | 937,191 | 737,809 |
| IV-91 | 40324004 | U Penitencia Creek - Bypass | 1,210,000 | - | 1,210,000 |
| IV-91 | 40324005 | U Penitencia Creek - Coyote-Dorel | 3,700,000 | 86,298 | 3,613,702 |
| | | | 18,445,000 | 2,417,117 | 16,027,883 |
| **Watershed and Stream Stewardship** | | | | | |
| IV-116 | 62184001 | Stream Watershed Land | 7,386,412 | 172,602 | 7,213,810 |
| IV-116 | 62214001 | Thompson Creek Stabilization | 2,200,000 | 45,194 | 2,154,806 |
| | | | 9,586,412 | 217,796 | 9,368,616 |
| **Clean Safe Creeks and Natural Protection** | | | | | |
| IV-107 | 26154004 | Guadalupe River, Reach 7-12 | 17,536,938 | 4,677,933 | 12,859,005 |
| IV-107 | 26174042 | Berryessa Calav/Old Pied LERRD | 2,175,000 | 86,298 | 2,088,702 |
| IV-107 | 26174051 | Upper Llagas Creek Reimburse | 4,389,954 | 3,251,520 | 1,138,434 |
| | | | 24,101,892 | 8,015,751 | 16,086,141 |
| Total All Funds | | | 63,923,370 | 14,130,173 | 49,793,197 |

In total, these projects had appropriations of $63,923,370 in current year and prior year appropriations, but current funding needs of only $14,130,173. Therefore, $49,793,197 in appropriations are recommended for release. While these funds will likely be utilized for the Watershed Fund projects eventually, for financial management and project planning and control purposes, these projects should not maintain appropriation balances that are artificially high.

**Water Enterprise Fund, Project 94084005, Security Improvements Project — Page IV-136**

| Recommended By Water District* | Audit Division Proposed | Surplus Appropriations |
|---|---|---|
| **$715,617** | **$0** | **$715,617** |

* Includes prior year appropriations estimated to be carried forward to FY 2005-06.

According to the District, a project plan has not yet been developed for these funds, but will be developed after community input is received from the visual screening project team. As of March 31, 2005, the unexpended appropriations totaled $1,115,617. However, the District reallocated $400,000 of these appropriations in FY 2004-05 to another project. Because there is no project plan, the remaining appropriations of approximately $715,617 should be eliminated until such time as a project plan is completed and reasonable and accurate cost estimates have been developed. Because this project is funded 100 percent by the Water Enterprise Fund, the release of these appropriations could impact current year and future year water rates.

These recommended reductions in surplus appropriations are spread across District funds and will, therefore, have different impacts. For the Water Enterprise Fund, a release of appropriations would provide additional current resources that should be factored into available funding resources and current year and future year water rate calculations. While some of these appropriations may eventually be expended on the specified project, at issue is that the appropriations, and therefore cash requirements, are not smoothed-out over-time. Further, because of the imprecise nature of the 15-year capital improvement plan cost estimates, it does not provide a reasonable basis for determining appropriations, especially if funds are appropriated years before anticipated expenditure requirements.

The following is a summary table of individual capital project appropriations reductions by fund:

## Table 7
## Schedule of Surplus Capital Appropriations Recommended for Release

| | General Fund | Watershed Funds | Water Enterprise | Total |
|---|---|---|---|---|
| Almaden and Winfield Campus | $6,053,366 | | | $6,053,366 |
| Almaden Campus<br><br>Gas Generator and Heat | 647,605 | | | 647,605 |
| Computerized Maintenance Management System | | $409,867 | $409,867 | 819,734 |
| Water Resources Information System | | | 1,152,494 | 1,152,494 |
| Electronic Document Management System | | 302,575 | 302,575 | 605,149 |
| Watershed Funds | | 49,793,197 | | 49,793,197 |
| Security Improvements | | | 715,617 | 715,617 |
| **Totals** | **$6,700,971** | **$50,505,639** | **$2,580,553** | **$59,787,162** |

## Capital Reserves

While typically governmental agencies finance significant capital projects and acquisitions with long-term debt in order to spread the expense across the useful life of the asset, the District has developed a policy of funding certain capital projects and acquisitions as funding is accumulated – often called "pay-as-you-go." The District has established capital reserves in all of its funds to accumulate resources for capital needs. As described in the budget document, the District's capital reserve policies are as follows:

**Future Years' Capital Reserves** – Funds reserved for future capital needs as provided for in the 15-year capital improvement plan. Reserves are funded from annual surplus revenues which exceed funding requirements in other operating, contingent liability or capital reserves.

**Capital Replacement Reserves** – Funds reserved for fixed asset routine purchases. However, the reserve is also available for unanticipated fixed asset needs. Reserves are funded at the amount of annual fixed asset deprecation in each fund.

Budgeted reserve balances for FY 2005-06 are as follows:

| Fund | Future Years' Capital Reserves | Capital Replacement Reserves |
|---|---|---|
| General Fund | $4,358,808 | $1,224,000 |
| Watershed Funds | 56,448,429 | |
| *Watershed and Stream Stewardship* | *1,735,494* | |
| *Lower Peninsula Watershed* | *5,143,045* | |
| *West Valley Watershed* | *7,010,639* | |
| *Guadalupe Watershed* | *742,225* | |
| *Coyote Watershed* | *12,159,054* | |
| *Uvas/Llagas Watershed* | *2,132,964* | |
| *CSC and NFP* | *27,525,007* | |
| Enterprise Fund | 6,009,855 | 1,816,000 |
| Equipment Fund (1) | 1,065,858 | |
| **Total Reserves** | **$67,882,949** | **$3,040,000** |

(1) Equipment Fund Reserves are addressed specifically in the Reserves section of this report.

While the District justifies both of these reserve categories as those required to fund future capital needs, there is no clear policy on appropriate levels for these reserves nor are there any policies which provide guidance on when these capital reserves are to be used. In fact, according to the District's *Ten-Year Water Utility Plan*, Future Years' Capital Reserves for the Water Utility are fairly stable through FY 2013-14 and Capital Replacement Reserves remain at a constant $1.8 million. Thus, the funding of reserves is not tangibly linked to capital funding requirements. For example, District policy designates all residual fund balances to the Future Years' Capital Reserve so that the District maintains no unreserved, undesignated fund balances. While the reserve is earmarked for the 15-year capital improvement plan, the monies in this reserve are not dedicated to any particular capital project or acquisition. Further, as previously noted, the 15-year capital improvement plan is a dynamic document with imprecise capital project definitions and cost estimates. The reserve is also not linked to any formal policies on debt financing or pay-as-you-go financing for capital projects.

Because of these weaknesses in the capital reserve policies, coupled with the substantial capital appropriation balances carried forward from year to year, we recommend that these reserves be eliminated until such time as a formal capital improvement plan can be developed and authorized. At that time, capital reserve policies should be developed to support the financing of the capital improvement plan. The capital reserve policies should include how funds are to be accumulated, for what purposes, maximum thresholds, and when reserves are to be spent.

# 3. Revenues

The scope of Water District activities and services are determined and constrained by its revenues and any legal restrictions placed upon those revenues by the individual revenue sources. Overall, District revenue of $227.7 million that has been budgeted for FY 2005-06 is projected to increase $1.9 million, or 0.9 percent over FY 2004-05 budgeted revenues. However, FY 2005-06 budgeted revenues are $19.1 million or 7.7 percent less than FY 2003-04 actual revenues. As discussed in detail below, the decrease is largely the result of decreased property tax revenues that have resulted from the State's decision to shift local property taxes to school districts. The following is a description of major revenue sources in order of significance.[11]

- Water charges are the largest revenue source for the District and are projected to total $120.0 million in FY 2005-06 and 52.7 percent of total District revenues. The District's Operating and Capital Budget classifies water charges into three categories: treated water charges (56.8 percent of total water charges), groundwater charges (42.2 percent) and surface water and recycled water charges (1.0 percent). While water charges are not a discretionary revenue source, water charges can be increased or decreased by the Board of Directors, based upon its assessment of the District's funding needs for the Water Enterprise Fund. The FY 2005-06 Operating and Capital Budget incorporates an increase in water rates of approximately 3.7 percent in the North County and 7.5 percent in the South County. Water demand is projected to be constant. Actual water charge revenues did not vary significantly from budgeted revenues in either FY 2002-03 (-3.4 percent variance) and FY 2003-04 (+1.0 percent variance). The District is projecting that FY 2004-05 water charge revenues will be less than budgeted amounts by approximately $4.6 million or 4.0 percent.

- Property taxes are a distant second largest revenue source for the District and are projected to total $36.7 million in FY 2005-06 and 16.1 percent of total District revenues. Property taxes are comprised of two components: (1) the countywide 1.0 percent ad valorem levy totaling $20.2 million in FY 2005-06 and (2) ad valorem levies for voter approved debt service totaling an additional $16.5 million in FY 2005-06. The 1.0 percent levy is a discretionary revenue source and can be used for any purpose within the limitations set forth by the respective fund for which the revenue was levied. Levies for voter approved debt service are restricted to paying debt service obligations.

  Property tax revenue of $36.7 million budgeted for FY 2005-06 is a decrease of $0.7 million, or 1.9 percent less than FY 2004-05 budgeted revenues. However, FY 2005-06 budgeted revenues are $22.0 million or 37.5 percent less than FY 2003-04 actual revenues. As noted previously, the significant reduction is due to the State's decision to shift $25.5 million in annual District property tax revenues to school districts in FY 2004-05 and FY 2005-06. The District is pursuing financial relief from the FY 2005-06 property tax shift through the State's

[11] Not included as District revenues are intradistrict charges, such as from the Risk Insurance or Equipment Service funds, because these monies originate from the revenue sources detailed and are then allocated based on the internal services provided.

legislative process. The District reports that Assembly Bill (AB) 1590 sponsored by Sally Lieber (D – Mountain View) would restore $18.3 million in property tax revenues to the District. As of May 25, 2005, AB 1590 is being held in the Assembly Committee on Appropriations. However, because of the significant uncertainties associated with the passage of this legislation and any potential amendments to the bill, the District has not included the additional $18.3 million in the FY 2005-06 Operating and Capital Budget nor has the District considered the revenues when developing water rates for FY 2005-06.

- A 15-year special parcel tax was approved by voters in November 2000 for stream stewardship and flood protection to fulfill the District's Clean, Safe Creeks and Natural Flood Protection Program. The special parcel tax, which will be in its fifth year, is projected to increase $1.5 million or 5.4 percent to $28.5 million in FY 2005-06 due to a rate increase of 3.0 percent, the maximum increase allowed by the voter approved Measure B, and growth in the number of parcels assessed.

- Benefit assessments are levied in the District's five flood control zones to pay for each zone's long-term debt obligations related to flood protection projects and facilities. The levies total approximately 1.25 times the annual debt service requirements in the respective watershed funds. Benefit assessment revenues, which are 8.5 percent of total District revenues, are projected to decrease $130,000 or less than 1 percent to $19.4 million in FY 2005-06.

- Intergovernmental revenues for both operating and capital activities are received from other local, State and federal agencies and, in FY 2005-06, are estimated to total $12.0 million or 5.3 percent of total District revenues. This is a $3.1 million or 34.8 percent increase over amounts budgeted in FY 2004-05. A significant component of FY 2005-06 intergovernmental revenues is an estimated $7.8 million reimbursement from the City of San Jose for the Downtown Guadalupe Project.

- Interest income is earned on the District's cash balances and is projected to total $8.6 million in the FY 2005-06 Operating and Capital Budget, which is a decrease of $0.6 million or 6.3 percent from FY 2004-05 budgeted amounts. The decrease is due to projected lower cash balances in FY 2005-06 as a result of the District using operating reserves.

Because certain revenues are limited by legal restrictions, District activities and services are segregated into a number of different funds. A schedule of revenue sources by fund is provided in the following table.

# Table 8

## Schedule of Revenue Sources by Fund
## FY 2005-06 Operating and Capital Budget
**(In millions)**

| | General Fund | Watershed Funds | Water Enterprise | Service Funds | Total |
|---|---|---|---|---|---|
| Water Charges | | | $120.0 | | $120.0 |
| Property Taxes | $1.7 | $17.1 | 17.9 | | 36.7 |
| Special Parcel Tax | | 28.5 | | | 28.5 |
| Benefit Assessments | | 19.4 | | | 19.4 |
| Intergovernmental | | 7.8 | 4.2 | | 12.0 |
| Interest Income | 1.0 | 4.7 | 2.5 | $0.4 | 8.6 |
| Other | | 1.6 | 0.8 | 0.1 | 2.5 |
| Total | $2.7 | $79.1 | $145.4 | $0.5 | $227.7 |

**Property Tax Revenues** **Page IV-8**

| | | Recommended By Water District | Audit Division Proposed | Revenue Increase |
|---|---|---|---|---|
| **General Fund** | **Page IV-149** | **$1,741,456** | **$2,235,609** | **$494,153** |
| **Watershed Funds:** | | | | |
| **Lower Peninsula** | **Page IV-57** | **2,597,428** | **2,916,346** | **318,918** |
| **West Valley** | **Page IV-67** | **2,861,436** | **3,222,554** | **361,118** |
| **Guadalupe** | **Page IV-77** | **2,624,728** | **2,997,334** | **372,606** |
| **Coyote** | **Page IV-87** | **3,317,781** | **3,828,960** | **511,179** |
| **Uvas/Llagas** | **Page IV-97** | **694,483** | **781,724** | **87,241** |
| **Stream Stewardship** | **Page IV-113** | **4,991,885** | **5,565,404** | **573,519** |
| **Water Enterprise*** | **Page IV-123** | **1,361,607** | **1,562,280** | **200,673** |
| **Total** | | **$20,190,804** | **$23,110,211** | **$2,919,407** |

* Water Enterprise property tax presented in the table as recommended by the Water District excludes voter approved debt service obligations totaling $16,542,000, which includes $15,000,000 for the State Water Project and $1,542,000 for Zone W-1 debt service. See page IV-15 for detail.

The District projected FY 2005-06 property tax revenues early in 2005 and, at that time, estimated a 3.0 percent increase district-wide in the 1.0 percent ad valorem levy over FY 2004-05 estimated property tax revenues. The projected increase is comprised primarily of a 3.0 to 4.0 percent growth rate in secured property taxes. Unsecured property taxes were projected to remain constant, while supplemental or SB813 property taxes were projected to decrease 10.0 percent.

The most recent and revised property tax growth estimates provided by the County Controller-Treasurer project a countywide increase in assessed values and secured property taxes of 9.0 percent, based on actual tax roll growth reported by the Assessor. Because of the uncertainties surrounding both unsecured and supplemental assessed values and property taxes, we are conservatively projecting unsecured property tax revenues to decrease 3.7 percent and supplemental property tax revenues to decrease 4.0 percent based on our discussions with the County Controller's Office. Additionally, since the District's FY 2005-06 recommended budget was prepared, current year property tax revenues are now projected to be approximately $1.0 million greater than the estimates used in the development of the FY 2005-06 property tax revenues.

The revised assessed value growth rates coupled with an increase in current year property tax revenues result in a net increase in projected property tax revenues of $2,919,407 in FY 2005-06. While the District does not budget property tax revenues by its components, the increase in property tax revenues is comprised of $2,613,452 in secured property taxes, $73,623 in unsecured property taxes, and $232,332 in supplemental property taxes across all funds.

## Interest Income Revenues Page IV-8

| | | Recommended By Water District | Audit Division Proposed | Revenue Increase |
|---|---|---|---|---|
| **General Fund** | **Page IV-149** | **$952,000** | **$1,101,490** | **$149,490** |
| **Watershed Funds:** | | | | |
| **Lower Peninsula** | **Page IV-57** | **653,000** | **756,117** | **102,617** |
| **West Valley** | **Page IV-67** | **289,000** | **334,959** | **45,459** |
| **Guadalupe** | **Page IV-77** | **912,100** | **1,055,324** | **143,224** |
| **Coyote** | **Page IV-87** | **1,532,000** | **1,772,565** | **240,565** |
| **Uvas/Llagas** | **Page IV-97** | **81,000** | **93,719** | **12,719** |
| **Clean Safe Creeks and Natural Flood Prot.** | **Page IV-105** | **1,011,500** | **1,170,333** | **158,833** |
| **Stream Stewardship** | **Page IV-113** | **211,000** | **244,133** | **33,133** |
| **Water Enterprise** | **Page IV-123** | **2,487,000** | **2,877,526** | **390,526** |
| **Service Funds:** | | | | |
| **Equipment** | **Page IV-163** | **108,400** | **125,422** | **17,022** |
| **Risk Insurance** | **Page IV-167** | **321,900** | **372,447** | **50,547** |
| **Total** | | **$8,559,900** | **$9,904,034** | **$1,344,134** |

The District has projected that $8,559,900 will be collected from interest earned on investments within the District's commingled pool of funds. This estimate was made using current investment yields on January 10, 2005 which resulted in an annual average interest rate of 3.13 percent projected for FY 2005-06. However, more recent analysis of interest rate trends indicates that estimated interest rates are understated, assuming a consistent investment strategy by the District and in light of the continuing increase in interest rates. The Federal Reserve Board has increased the federal funds rate by 25 basis points in each of its last nine meetings, including a recent increase to 3.25 percent on June 30, 2005. According to the Governor's Budget, May Revision for 2005-06, the State is anticipating the Federal Reserve Board to continue increasing its target interest rates at its remaining meetings this year and projects the federal funds rate to average 3.2 percent in 2005 and 4.2 percent in 2006.

At our request, the District compiled new yields as of June 3, 2005, which resulted in an annual average interest rate of 3.61 percent. For comparative purposes, the County's Controller-Treasurer is also projecting an annual interest rate of 3.61 percent for its own commingled investment pool. However, the County's current average days to maturity for its investments is 280 days, substantially less than the District's average days to maturity on March 31, 2005 of 711 days. While we recommend a lower yield of 3.36 percent for the County's commingled investment pool to be conservative, because longer-term investments have higher yields, the District is expected to earn a higher yield than the County in FY 2005-06. Accordingly, an interest rate of 3.61 percent continues to be a conservative, non-speculative estimate for the District, which is based on prevailing interest rates at this time.

# 4. Operating Expenditures

In FY 2005-06, the District has budgeted $205,339,046 in operating expenditures. This includes $105,620,353 in salaries and benefits for 825 FTE employees (including 813 FTE regular employees and 12 FTE overtime employees), and $99,718,693 in other non-personnel expenses. This operating budget has declined by $15,084,570 from the FY 2004-05 budgeted level of $220,423,616. Salaries and benefits represent $3,939,162 of the budget reduction, or 26.1 percent.

As part of this study, we conducted a review of the technical accuracy of salary and benefit computations included in the budget. Except as noted in this report, we found that these computations were well constructed and tied to the information contained in the budget document. However, we also made the following general observations:

- The Santa Clara Valley Water District's average salary and benefit cost per budgeted position is $128,025 in FY 2005-06. As a comparison, the average salary and benefit cost for County employees in FY 2005-06 is projected to be $101,453 or 26.2 percent less than for the District. To some extent, this occurs because of the high proportion of professional staff positions within the District (e.g., engineers). However, there are other significant factors that contribute to these higher salaries and benefits. Some of these factors are discussed below.

- Even though the District reportedly has not granted cost of living salary increases to employees in FY 2005-06, the average hourly salary cost – excluding benefits – is projected to increase by 4.7 percent. For regular employees, the average hourly salary cost is budgeted to increase by 5.7 percent. The District indicates that this average hourly salary cost growth may be resulting from (1) automatic step increases required for salary scheduled employees, and (2) changes in the mix of employees, as a result of a FY 2004-05 hiring freeze and budgeted personnel reductions.

- Of the 813 budgeted positions within the District, 144 positions, or 17.7 percent, are "exempt." Within this group are 32 unclassified employees for whom the salaries and benefits are subject to the CEO's discretion within broad pay bands. The average salaries and benefits paid to the District's exempt employees in FY 2005-06 are projected to be approximately $176,960. For unclassified positions, the average salaries and benefits is projected to be $211,981.

- Of the 813 budgeted positions within the District, 93 positions, or approximately 11.4 percent of all District employees, are assigned to mid-level and executive management duties (e.g., unit manager and above).[12] An additional 252 positions, or 31.0 percent of the District workforce, are assigned to administrative and support functions. Therefore, a total of 42.4 percent of all employees are assigned to management, administration and support functions. The remaining 57.6 percent of all positions provide direct services to the community.

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[12] This excludes Senior Project Managers, who may be assigned to manage small groups of professional staff or significant capital project activities.

- The number of mid-level to executive management positions within the District appears to be driven, in part, by the District's organizational structure. At the time of this report, the District had 95 organizational units for 813 regular positions, averaging 8.6 employees per organizational unit. Eighty-seven of these organizational units were led by a Unit Manager level position or above. The annual salary and benefit cost for these individuals ranged from $125,503 (Unit Manager) to $292,576 (Chief Executive Officer), excluding District matching funds for deferred compensation and compensation for vehicle allowance. For those individuals receiving the maximum amount of income for these additional benefits, the District pays an additional $9,500 per year.

Due to the limited scope of this budget review, we cannot comment on the appropriateness of the organizational structure, mix of staff or compensation paid to the employees of the District. However, such analysis would appropriately be included in a management audit. Nonetheless, these are critical factors that can directly drive the budgeted cost of services.

On May 3, 2005, the Board of Directors approved a contract with Red Oak Consulting for $745,041 to conduct a performance audit of the Santa Clara Valley Water District. The consultant's workplan that was approved by the Directors, includes several tasks related to conformity with the Directors' Ends Policies, an evaluation of District operations, the management of financial operations, and other similar activities. The workplan does not evaluate (1) the District's organization structure, (2) management span of control, or (3) mix of staff and related administrative efficiency. In addition, we are not aware of recent efforts made by the District to compare employee compensation with that which is paid to employees in other similar organizations.

Such analyses are clearly beyond the scope of a budget review. However, we believe that the District would benefit by including an organizational assessment and span of control analysis in the pending management audit of the District. In addition, we believe the District should engage the services of an external consultant to conduct a salary and benefit survey for all classifications, including the 144 exempt positions mentioned previously. The results of these analyses should be reported to the Board of Supervisors prior to FY 2006-07 budget deliberations.

## Contract Services

In addition to salaries and benefits, the District expends a significant portion of its operating budget on contractual services. Listings by the District indicate that approximately $24.1 million will be expended in FY 2005-06 on consultant and legal services, software licenses and support service activities. While we could not conduct a detailed review of these contract services as part of this budget review, we reviewed the reported expenditure appropriation bases for some of the larger contracts and examined the contracts for some of the more significant service agreements (i.e., janitorial and security services). Based on this limited review, we did not identify any major budget findings.

The following discussion provides budget findings in two operating expenditure areas.

**Retirement Contributions**

| Recommended By Water District | Audit Division Proposed | Expenditure Decrease |
|---|---|---|
| $10,323,991 | $9,931,401 | $392,590 |

**Interest on Deposits - Revenue Account 4301100**

| Recommended By Water District | Audit Division Proposed | Revenue Increase |
|---|---|---|
| $8,559,900 | $8,377,642 | $(182,258) |

**Net Benefit to the Santa Clara Valley Water District: $210,332**

The FY 2005-06 Santa Clara Valley Water District's required contribution to the PERS pension fund for its employees amounts to $10,323,991. Because this contribution is normally paid bi-weekly throughout the fiscal year, the $10,323,991 charge includes interest at the rate of 7.75 percent based on one-half of the annual payment amount, which is the equivalent of the average unpaid balance during the fiscal year. Based on an analysis of the District's recent cash balance and projected cash flow throughout FY 2005-06, the District could afford to prepay the PERS employer contribution at the start of the fiscal year.

The prepayment of FY 2005-06 PERS retirement contributions was discussed with the PERS actuary assigned to Santa Clara County. Based on this discussion, the reduction in the required FY 2005-06 PERS contribution would amount to approximately $392,590 if the District were to prepay the FY 2005-06 employer contribution at the beginning of the fiscal year. However, this savings would be offset by a lesser reduction of interest income that would have otherwise been earned on the $10.3 million while available for investment in the District's Commingled Fund. Based on a projected rate of return on investments of 3.61 percent in FY 2005-06, the loss of interest revenue to the District would amount to approximately $182,258. As a result, the net benefit to the District from prepaying its FY 2005-06 PERS retirement contribution would be approximately $210,332.

It should be noted that the District evaluated the savings that would result from prepayment of its annual PERS contribution when developing the budget for FY 2005-06. However, the District reports that it decided to discontinue pursuing this alternative because of other needs.

**All Funds** **Page IV-37**

**District Salaries and Benefits**

| | Recommended By Water District | Audit Division Proposed | Expenditure Decrease |
|---|---|---|---|
| Salaries Regular | $74,958,463 | $75,246,765 | ($288,302) |
| Fed and State Taxes/Benefits | 1,340,569 | 1,345,725 | (5,156) |
| Retirement Contributions | 10,323,991 | 10,363,699 | (39,708) |
| Total | $86,623,023 | $86,956,188 | ($333,165) |

The Santa Clara Valley Water District pays employees bi-weekly, resulting in the need to pay employees on either 26 paydays or 27 paydays each year, depending on how the payroll calendar falls. However, unlike other jurisdictions with which we are familiar, the District budgets salaries and benefits on a cash basis. Therefore, in years with 26 paydays, the District budgets 26 payrolls. In years with 27 paydays, the District budgets 27 payrolls. For FY 2005-06, the District has budgeted 26 payrolls, understating the actual payroll obligations that will be incurred by the District for the year.

This practice is problematic for a number of reasons. First, the current practice does not conform with the District's annual financial report, creating discrepancies between the District's budget and the annual financial statements that are prepared according to Generally Accepted Accounting Principles (GAAP). More importantly, this practice causes periodic spikes in the District's budgetary needs for salary and benefit costs when years with 27 paydays occur.

The District's current practice is also inconsistent with that which is used in the County of Santa Clara and in other large California jurisdictions with which we are familiar. In most jurisdictions, salaries and benefits are budgeted based on the actual number of weekdays that occur within a year (most years have 261 weekdays and 104 Saturdays and Sundays). In years where 26 pay days occur, the funding for the additional day is accrued and encumbered for the next payroll that occurs in the following year. In years when 27 pay days occur, the expenditures are fully funded from current and prior year appropriations. This more typical practice more precisely defines the amount of a jurisdiction's payroll obligations, smoothes salary and benefit budget appropriations between years and reduces the likelihood that budgeting errors will occur during 27 payday years.

In a response to inquiries made during this review, representatives from the District explained that "the last 27 pay period year was Fiscal Year 1998/99. The next one will occur in FY2009/10 at which time the District will budget and charge for 27 pay periods for that fiscal year." Based on our analysis, at current costs, the District will be required to budget approximately $3.3 million more in salaries and benefits in FY 2009-10 than it has in FY 2005-06. The District should modify its salary and benefit budgeting practices to smooth annual appropriation needs. If implemented in FY 2005-06, approximately $333,165 would need to be added to the regular salaries and payroll driven tax and benefit accounts, as shown above.

# 5. Appropriations (Gann) Limit

Local government annual appropriations are limited pursuant to a formula first established in 1979 with the passage of Proposition 4, Limitation of Government Appropriations, and codified in the California State Constitution as Article XIII B. The requirement is commonly referred to as the Gann Limit after the Proposition's main sponsor. Local governments are restricted to spending tax proceeds at the prior year appropriations level, increased for changes in population and cost of living. However, several significant items are excluded from the appropriations limit, including debt service and capital outlay expenditures. If actual appropriations exceed the limit for two successive years, the excess tax proceeds must be refunded or rebated to taxpayers. While the annual appropriations limit is not reviewed by any State agency, the State Constitution requires that the calculation be reviewed as part of a local government's annual financial audit.

Santa Clara Valley Water District calculates the appropriations limit for only three of its six special revenue funds that receive a share of 1 percent ad valorem property tax. According to District records, the other special revenue funds are exempt from the calculation because the tax rates in FY 1977-78 were less than the minimum threshold required by the provisions of Article XIIIB. Additionally, an appropriations limit is not calculated for the District's General Fund or the Water Enterprise Fund. The General Fund also did not have a tax rate that exceeded the minimum threshold in the base year. For the Water Enterprise Fund, the District's position is that the 1 percent ad valorem property tax is, in substance, a special assessment, which has been levied in lieu of a user fee and, therefore, is not considered proceeds of taxes for purposes of determining compliance with the appropriations limit. County Counsel has reviewed the District's interpretation of Article XIIIB and relevant case law and has indicated that the District's position is reasonable.

To determine compliance with the provisions of Article XIIIB, the District calculates the limit for those funds subject to the limit and compares the result to total tax proceeds for the year. The three appropriations limits for FY 2004-05 were reviewed as part of the FY 2003-04 financial audit and the District's independent auditor provided an attestation report of District compliance with the FY 2004-05 appropriations limit increment. For these three funds, the limit totaled $79,464,055, whereas proceeds of taxes totaled $15,224,975. Due to the expedited budget process this year, the appropriations limits for FY 2005-06, which are based on population and cost of living increase factors provided by the State Department of Finance in early May, had not been calculated before the FY 2005-06 Operating Budget was approved by the District's Board of Directors in late April. However, based on prior year calculations and the current year budget constraints, it appears that the District's FY 2005-06 Proposed Budget will clearly be less than the limit.

Because the District's most significant expenditures are for capital outlay, which is excluded from the calculation pursuant to Proposition 111, passed in 1990 as an amendment to Proposition 4, it is unlikely that the appropriations limit will ever be reached.

# 6. Budget Reporting and Process

During the course of this review, several opportunities to improve the Santa Clara Valley Water District budget development; budget reporting and monitoring processes; and, expenditure control policies were identified. Although these opportunities are discussed in relation to budget findings presented in previous sections of this report, this section summarizes the current conditions and makes recommendations for improvement.

Conversion to One-Year Budget Process and Expedited Budget Calendar

Prior to FY 2005-06, the Santa Clara Valley Water District developed two-year budgets. These documents were approved by the District Board of Directors and then forwarded to the Board of Supervisors for consideration and approval. Modifications to the two year budget typically came in the form of budget addenda.

In FY 2005-06, the District prepared a one-year budget. During interviews, we were advised that this change occurred due to two primary factors.

- The State of California decided to shift a total of approximately $51.0 million in property tax revenues from the District to fund education in FY 2004-05 and FY 2005-06. As a result, major adjustments in the budget for both the current fiscal year (included in the FY 2003-04 and FY 2004-05 two year budget) and planned fiscal year were required to meet the funding reductions imposed by the State.

- The Board of Supervisors indicated its intention to conduct a more thorough budget analysis in FY 2005-06 by assigning the Management Audit Division to conduct a detailed review of the Santa Clara Valley Water District Budget.

In addition, these factors reportedly caused the District to implement an expedited budget process for FY 2005-06. The Board of Directors approved the CEO's recommended budget on April 19 and that document was transmitted to the Board of Supervisors on May 2, 2005.

The longer the budget horizon, the more difficult it is to accurately project the resources and needs of a governmental organization. Major changes in the economic outlook, external decisions by the federal and State governments, and other unforeseen factors can cause assumptions and projections to change dramatically. For these reasons alone it is advisable for government organizations to annually produce a budget which is based on a thorough analysis of all economic, financial and programmatic factors.

In addition, the Board of Supervisors has indicated its intention to involve the Management Audit Division in a more thorough analysis of the District Budget each fiscal year. Accordingly, the District will be increasingly called upon to update and justify its budget choices to the Board of Supervisors. This annual review will create a demanding environment that will require continuous attention to the details of the budget. For these reasons, the Board of Directors should direct the CEO to develop an annual budget process and expedited calendar that will meet the demands of the Board of Supervisors.

Annual Budget Report Content

The Santa Clara Valley Water District's budget document includes a significant amount of summary financial, policy and program information, and is a good source for understanding the general budget approach of the District. However, there is a significant amount of key information and data that is excluded from the document and apparently is not readily available elsewhere within the organization. The following listing provides a description of key elements of the budget, which are currently omitted or provided in insufficient detail.

- The District does not prepare a comprehensive analysis or estimate of current year fund balance and changes in available resources to fund operations and its capital program. Discussions with the Deputy Administrative Officer for Finance indicates that such analysis is difficult to perform due to the flexibility provided to the administration and its decision to exercise authority to move funding between projects, the timing of certain financial reporting and other factors. As a result, he believes that accurate projections of fund balance are difficult to make when the budget is being developed and prone to inaccuracy. Based on our review and understanding of the financial reporting capabilities of the District, we disagree and believe that efforts should be made to estimate fund balance based on the actual results of operations and variations in expected revenue. The District's estimate of changes in fund balance should be clearly and concisely reported in the Budget Outlook and Financial Summaries section of the budget document.

- The District's budget is organized by fund, and personnel and cost information is generally presented by project, rolled up to the fund level. Staff who report to one organizational unit may have their hours allocated across the District to various projects in different funds. Although this method of project budgeting is useful for many reasons, it does not provide sufficient detail to gain an understanding of the functional organization of staff resources or the changing personnel demands of the District. Accordingly, it would be useful for the District to annually prepare a comprehensive listing of classifications, positions and costs by functional organization unit, linked to financial summaries that spread labor hours and costs across the various funds. Such information should be prepared and discretely presented in future budget documents.

- Because the District does not prepare estimates of fund balance, information on anticipated year-end revenues and expenditures is generally not developed or presented in the budget. Instead, the District compares the recommended budget to the actual results of operations that occurred two years prior to the budget year and to the current year adjusted budget. The comparison from adjusted budget to recommended budget does not provide a sound basis for displaying planned changes in service levels, revenue expectations or planned expenditures. As the District develops its capacity for projecting current year-end revenues and expenditures, a comparison of the recommended budget to current year estimated actual revenues and expenditures should be presented.

Periodic Reporting on Budget Status

Santa Clara Valley Water District End Policy BL-5, 5.3 states that the Board of Directors should receive a quarterly report on "Financial Conditions and Activities." We requested copies of these reports for FY 2004-05, and were provided with a copy of the "Ends Quarterly Monitoring Report Quarter 1, Fiscal Year 2005." We were advised that no other financial reports are provided to the Board of Directors.

The Ends Quarterly Monitoring Report provides information and data on a number of performance metrics that link to the Ends Policies established by the Board of Directors. These metrics span operational, financial and service quality measures that have been developed by the CEO for the purpose of providing high level monitoring tools for management and the Directors. For example, Ends Policy E-2.1.1 requires that "The water supply meets or exceeds all applicable water quality regulatory standards in a cost effective manner." The reporting focuses on quality (number of drinking water regulatory violations found by the State Department of Health Services) and the average cost of water treatment operations. The cost metric is at a high level, shows trending for multiple years and is compared to a CEO "interpretation" of an acceptable performance standard. In the report that we reviewed, the cost was at or below the standard in all but one year. From the report, it is difficult to determine (a) whether the standard is reasonable, (b) whether there might be opportunities to reduce or better control costs, or (c) the extent to which the economy, supply conditions or other factors might affect costs. The metric provides no clear linkage to cost information that is critical for measuring compliance with budget policy dictated by the Directors or the Board of Supervisors.

The District should develop a financial management tool that permits the Directors and the Board of Supervisors to effectively monitor budget compliance by fund. These reports should be produced at least quarterly, beginning in FY 2005-06 and copies should also be provided to the Board of Supervisors.

Formal Review of Capital Plan and Water Utility Enterprise Report

The District's budget is driven by several subsidiary analyses that provide the foundation for revenue and expenditure assumptions. Key among these are (1) the 15-year capital improvement plan, which is used to define the substantial capital project budget for the District; and, (2) the Water Utility Enterprise Report, which is used to estimate water rates to support Water Enterprise Fund operations and the capital projects needs defined by the CEO.

As we discuss in previous sections of the report, the following weaknesses were identified with the development and use of this information in a budget context. Specifically,

- The $1.68 billion 15-year capital improvement plan is considered a staff report, and has never been submitted to the Directors for approval or to the Board of Supervisors for consideration as part of budget deliberations. In FY 2005-06, the District has budgeted over $81.1 million in capital project expenditures, not including substantial continuing appropriations for capital project expenditures that were authorized in prior years.

- The 15-year capital improvement plan is not formally updated, and changes are not effectively communicated to the Directors. Only 10 years remain on the original plan, although the funding horizon for some projects will likely exceed this window.

- The Water Utility Enterprise Report that is used to project revenues, expenditures and fund balance for the Water Enterprise Fund is not formally provided or presented to the Board of Supervisors, even though it has significant budget implications.

To meet mandates related to fiduciary responsibility over the District, the Board of Directors should review and approve these and other key planning studies produced by staff (e.g., the annual actuary studies on workers compensation and liability self insurance funding needs, memoranda of understanding with employee bargaining groups, other rate and fee schedules, etc.). These reports and other key financial and budget documents should be formally transmitted to the Board of Supervisors, and be considered during Santa Clara Valley Water District budget deliberations.

<u>The Capital Planning Process</u>

There were several issues pertaining to the use of the 15-year capital improvement plan as a source for establishing annual and project appropriations. First, historical capital project appropriations do not necessarily correspond to funding needs and expenditure patterns. Inconsistencies within the 15-year capital improvement plan summaries and supporting project detail make it difficult to identify actual funding requirements, specifically related to projects occurring in, but not necessarily funded by, the General Fund. Finally, because the 15-year capital improvement plan is a dynamic document and the projects within it are at various stages, the estimated funding requirements of the plan are inexact.

The capital planning process should be formalized, potentially with a shorter time horizon for funding purposes, through a public and legislative process. A more formalized process and a more constricted capital improvement plan would ensure that capital projects are defined, project scopes established, estimated costs are reasonable, and projects are evaluated relative to all capital needs, prior to funding and granting appropriation authority.

<u>Budgetary Controls Over Spending</u>

One of the primary purposes of a budget is to provide control and oversight over a public agency's taxing and spending. Through its Ends Policies, the Board of Directors has given the CEO substantial latitude to meet the District's goals and objectives, including the authority to move funding at the project and object level. The CEO may also establish positions within the broad appropriation authority granted in the budget. The CEO is not required to go to the

Directors to obtain authorization to move funds, and it is these budgetary decisions which ultimately impact funding requirements and water rates. In addition, significant modifications to the budget are not brought to the Board of Supervisors for review and approval.

As a result, the Directors and the Board of Supervisors have relinquished considerable budgetary control authority to staff. This could expose the District Board of Directors and Board of Supervisors to substantial risk. The District should review its budgetary control authorities and modify them as appropriate. The Board of Supervisors should request the County Executive, County Counsel and Finance Director to review existing policies and practices, and develop budget policies that would appropriately protect the Board from unnecessary risk.