

## Southeastern Los Angeles County

Various Reasons Affect the Rates Water Suppliers  
Charge and the Rate Increases They Have Imposed

January 2013 Report 2012-104



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January 29, 2013

2012-104

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

Dear Governor and Legislative Leaders:

As requested by the Joint Legislative Audit Committee, the California State Auditor (state auditor) presents this audit report concerning the cost of water delivery in southeastern Los Angeles County. This report concludes that various reasons affect water rates and why these rates have increased. Such reasons include water suppliers budgeting for increasing costs to purchase water or to make capital improvements to their water treatment facilities or other infrastructure. In other cases, certain suppliers have increased their water rates because they stopped using reserve funds to help lower consumer water rates or have wanted to promote water conservation by increasing the cost for a given amount of water.

In general, water suppliers set their water rates in a manner to recover their anticipated costs for the upcoming fiscal year. As water flows to consumers in southeastern Los Angeles County, various entities play a role in its management and, as a result, contribute costs that are ultimately passed on to consumers. A significant portion of the water used in Los Angeles is imported from outside the county and is distributed by the Metropolitan Water District of Southern California (MWD), the regional wholesaler. MWD's water rates are expected to increase by 75 percent from 2008 to 2014. Key factors that drive MWD's water rate increases are its increasing budget for capital improvements—such as improving its water treatment facilities—and the higher costs of purchasing imported water through the State Water Project.

Our review also found that local wholesalers and retailers have faced increasing costs for various reasons. The Central and West Basin municipal water districts—the two local wholesalers we reviewed—have roughly doubled their water rates during the past five years. Budget documents at both wholesalers revealed that they have been facing increasing costs to finance and build infrastructure to provide recycled water to their customers and thus rely less on imported water. Similarly, water retailers we reviewed have planned for additional costs to make improvements to their infrastructure while also using higher prices as a means to promote conservation.

Despite the water rate increases, we found that mechanisms exist for the public to provide input into rate increases, including the transparency of proposed actions and the ability to use the electoral process if not satisfied with specific outcomes, but such mechanisms could be more effective. Our review noted that the city of Los Angeles recently began using an independent ratepayer advocate to consider water rate increases proposed by the Los Angeles Department of Water and Power before higher rates are approved by the city council. Depending on the effectiveness of this advocacy, the Legislature may want to consider requiring all publicly operated water suppliers to use a similar ratepayer advocate.

Respectfully submitted,



ELAINE M. HOWLE, CPA  
State Auditor

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# **Southeastern Los Angeles County**

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## Summary

### Results in Brief

In July 2008 a family of four living in southeastern Los Angeles County<sup>1</sup> could have purchased 20 units of water<sup>2</sup>—about a month’s supply—from the City of Downey Department of Public Works (Downey) for \$23.48. As of July 1, 2012, that same family of four would pay \$38.57, or 64 percent more than it did in 2008. If the same family lived elsewhere, it could have purchased an equal amount of water from the City of Los Angeles Department of Water and Power (LADWP) for \$60.64 in 2008 but \$84.05—or 39 percent more—as of July 1, 2012. The purpose of our audit was, in part, to examine why water rate increases have occurred since 2008 and why the price for buying the same quantity of water from different suppliers can vary significantly.

As part of our audit of water suppliers in southeastern Los Angeles County, we identified the different types of agencies involved in supplying water to consumers (for example, the regional wholesaler, local wholesalers, and retailers), and we examined the rates suppliers charged and the reasons for any significant year-to-year rate increases. We also identified the processes suppliers used to approve proposed rate increases, the mechanisms in place to help ensure that consumers are protected from unreasonable rate increases, and the impact on water rates attributable to specific categories of expenses, such as litigation and administration.

Several reasons contributed to increases in water suppliers’ rates in effect on July 1 of each year from 2008 through 2012. Chief among these is that the suppliers’ costs increased. Because suppliers base the rates they charge on the amount of annual revenue they believe is necessary to cover their annual water-related costs, when costs increase, so do rates. For instance, one retailer—LADWP—budgeted a cost increase of \$47.7 million, or 26 percent, from fiscal years 2008–09 to 2012–13 for the cost of purchased water. According to LADWP’s water executive managing engineer, the increase in the cost of purchased water was caused by increases in the water rates charged by the Metropolitan Water District of Southern California, the regional wholesaler. Other reasons suppliers cited for rate increases include improving water conservation by implementing tiered rate structures in which

### Audit Highlights . . .

*Our audit of water suppliers in southeastern Los Angeles County highlighted the following:*

- » *Water suppliers attributed rate increases to the increasing cost of purchasing water, improving water conservation, and no longer relying on reserves to help cover annual costs.*
- » *We questioned the legality of almost \$1 million in fee revenues that the city of Downey transferred from its Water Fund because it could not sufficiently substantiate that the funds were used for water-related purposes.*
- » *Because a consumer’s physical location determines the retailer that will provide water, there is a lack of competition and consumers cannot select among retailers to obtain the lowest rate.*
- » *We found that spending at each of the seven water suppliers was generally consistent with their respective policies and procedures and seemed reasonable.*

<sup>1</sup> We defined southeastern Los Angeles County as the area roughly bounded by Highway 72 on the north, the Orange County line on the southeast, the Pacific Ocean on the south, and Highway 110 on the west.

<sup>2</sup> A unit of water is 100 cubic feet, or approximately 748 gallons.

customers pay higher per-unit rates when their water usage exceeds certain levels, and no longer relying on reserves to help cover the annual costs of providing water.

When examining water rates, we observed that portions of Downey's water rates may not be allowable under the California Constitution. Because Downey could not substantiate that almost \$1 million in revenues that it transferred from its Water Fund to other funds were actually for specific water-related purposes, we question whether these transfers comply with the provisions of Article XIII D of the California Constitution, added by Proposition 218 in 1996. Under these provisions, revenues derived from a fee or charge cannot exceed the funds required to provide the service, revenues cannot be used for purposes other than those for which the fee or charge was imposed, and the local agency imposing the fee bears the burden of proving the fee complies with the article. We found that during fiscal years 2007–08 through 2010–11, Downey transferred almost \$1 million from its Water Fund to other funds. Although Downey staff told us that the transfers to the Sewer and Storm Drain Fund paid for costs incurred by the stormwater engineering division, they were unable to provide sufficiently detailed evidence to convince us that the transfers were for water-related purposes. Our legal counsel advised us that court decisions interpreting Article XIII D have not prohibited local governments from charging its customer water fees that would recoup the costs of the government's water department on other departments, as long as these fees reasonably represent such costs. Because Downey did not provide evidence sufficient to make such a conclusion, we questioned the legality of these transfers.

We also identified several mechanisms that exist to help ensure that consumers are protected from unreasonable rate increases. Because a consumer's physical location determines the one retailer that will provide water, the lack of competition means that the consumer cannot choose among retailers to obtain the lowest rate. The mechanisms protecting against unjustifiable rates include transparency, the electoral process, and the use of consumer advocates. To provide transparency, government-operated suppliers consider water rates and proposed rate increases at public hearings or meetings held by their governing boards. The public has the right to attend and participate in these meetings or hearings and can voice opinions about proposed rate increases. Also if consumers do not like the decisions made by public water agencies, they can use the electoral process to replace members of their governing boards. Finally, two entities—the California Public Utilities Commission (CPUC) and LADWP—use consumer advocate positions to independently analyze proposed rate increases.

When faced with increasing water rates, some customers may blame poor spending decisions by water suppliers—for instance, spending on litigation involving other water suppliers, administrative overhead, or other factors—or more direct costs, such as maintenance or the treatment necessary to make water drinkable. Our review of 141 transactions at the seven water suppliers we examined revealed that spending was generally consistent with the water suppliers' policies and procedures and seemed reasonable. We also found that legal and administrative expenses constituted relatively modest proportions of the overall costs for the seven water suppliers, and that the suppliers typically maintained approximately six months' to a year's worth of operating costs in reserves.

### **Recommendations**

To ensure that it can meet the burden of proof that its water fees comply with Article XIII D of the California Constitution, Downey should be able to provide, upon request, documentation that all transfers out of the Water Fund are for water-related purposes. Such documentation should be sufficiently detailed and understandable to the layperson.

If it believes that the mechanisms available to consumers in southeastern Los Angeles County to protect against unreasonable rates or rate increases are not sufficient, the Legislature should consider enacting additional consumer protection mechanisms. Mechanisms to consider include ratepayer advocacy positions similar to those used by the CPUC and LADWP.

### **Agency Comments**

Downey did not agree with our finding and its response did not address how it would implement the recommendation we made to it.

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# Introduction

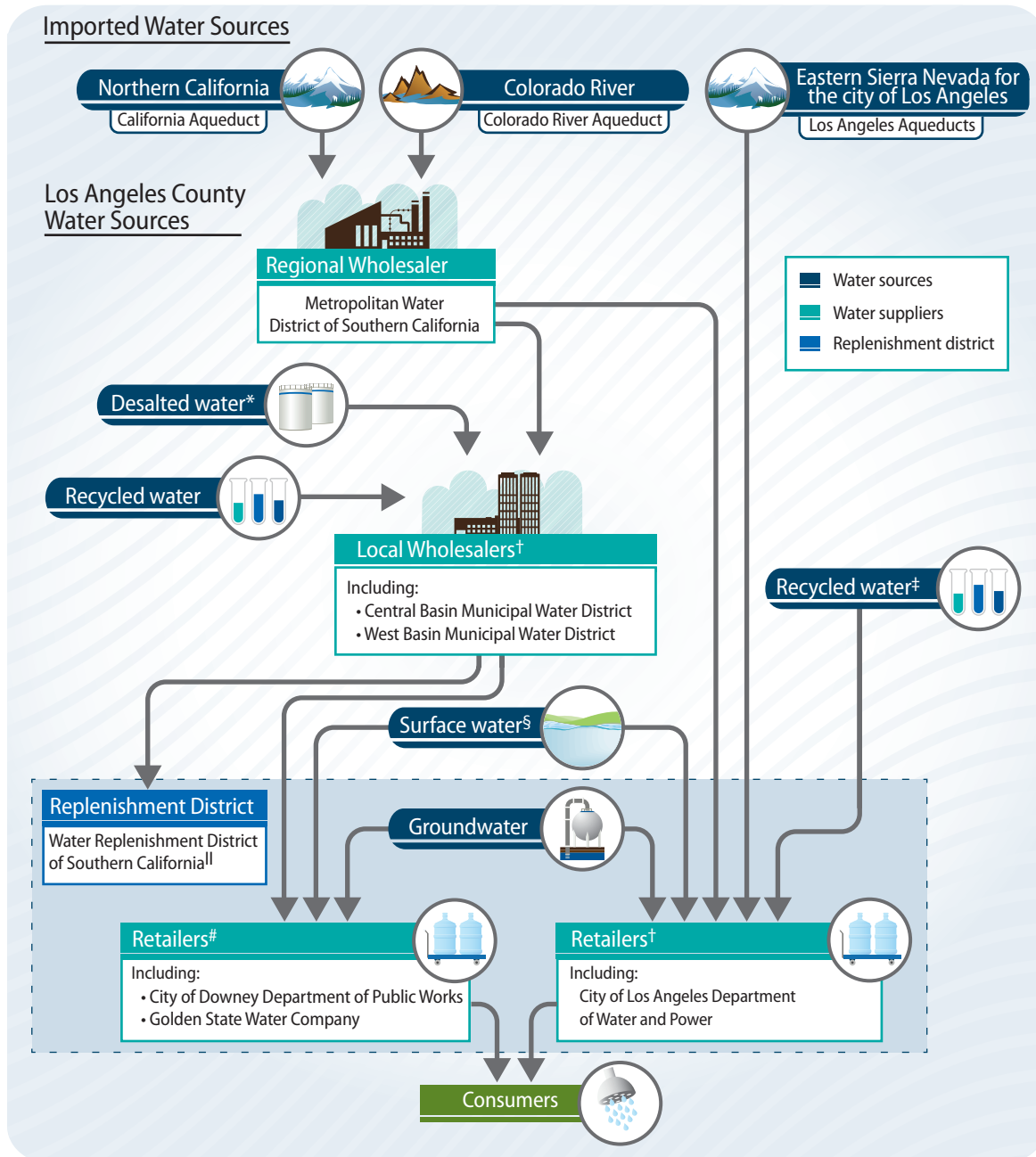
## Background

Different entities, including different types of water suppliers, are involved in the water delivery system serving southeastern Los Angeles County. Figure 1 on the following page summarizes this delivery system. Retail water suppliers provide water directly to consumers. Retailers include both investor-owned companies and government entities, such as cities. If it is available, retailers can get their water by extracting it from underground by using wells. Retailers can also buy water imported from outside Los Angeles County. We focused most of our audit work on three retail water suppliers—the City of Los Angeles Department of Water and Power (LADWP), the City of Downey Department of Public Works (Downey), and the Golden State Water Company (Golden State Water).

Local wholesalers, the second type of water supplier, sell imported water to those retailers whose groundwater supplies are not sufficient to meet customer demand and who do not have direct access to imported water. To help minimize the use of imported water, local wholesalers can also sell recycled water to retailers for landscaping and other uses. Local wholesalers are government entities, such as municipal water districts. Our audit focused on the Central Basin Municipal Water District (Central Basin District) and the West Basin Municipal Water District (West Basin District). The West Basin District was created in 1947 and the Central Basin District in 1952 to provide additional water supplies to retailers to supplement groundwater sources. Each of these two local wholesalers is governed by its own five-member board of directors elected by the public from its service area. Figure 2 on page 7 shows the respective service areas for the Central Basin District and West Basin District.

The third type of water supplier, the regional wholesaler, provides imported water to local wholesalers and to certain retailers. The regional wholesaler for southeastern Los Angeles County is the Metropolitan Water District of Southern California (MWD), which is a government agency. MWD was created in 1928 to develop, store, and distribute water to Southern California. Its mission is to “provide its service area with adequate and reliable supplies of high-quality water to meet present and future needs in an environmentally and economically responsible way.” Through an infrastructure that includes five treatment plants, 242 miles of canals, and 819 miles of pipeline, MWD imports water into Southern California for resale to its 26 members. MWD members include retailers and local wholesalers and consist of 14 cities, 11 municipal water districts, and one county water authority. Currently, a 37-member board of directors governs MWD. Each member agency has at least one member on the board, while larger suppliers, as determined by assessed property values within a member agency’s district, may have more. MWD acquires the imported water it supplies from two main sources: Northern California, via the State Water Project’s California Aqueduct, and the Colorado River, via the Colorado River Aqueduct. MWD can provide either treated or untreated water to its member agencies.

**Figure 1**  
**Water Delivery System for Southeastern Los Angeles County**



Sources: Urban water management plans for the entities named or other documents the entities provided.

\* All local wholesalers do not have access to desalted water.

† Members of the Metropolitan Water District of Southern California (MWD).

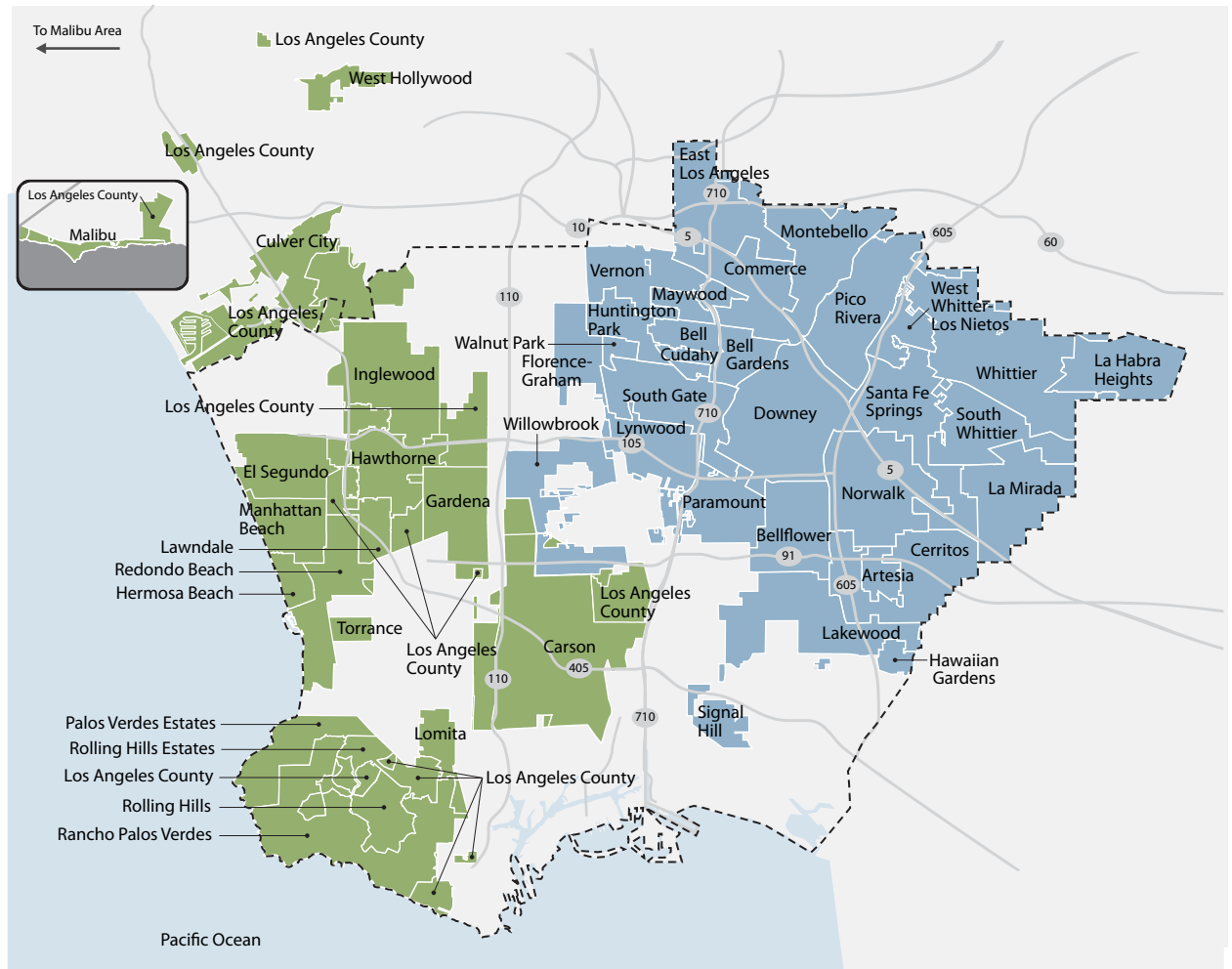
‡ The city of Los Angeles operates its own recycling program.

§ All retailers do not have access to surface water.

|| The Water Replenishment District of Southern California purchases water from various sources to recharge the groundwater basins beneath southern Los Angeles County.

# Nonmembers of the MWD.

**Figure 2**  
Service Areas for Local Wholesale Water Suppliers and the Water Replenishment District of Southern California



Sources: Web sites for the Water Replenishment District of Southern California (replenishment district), the Central Basin Municipal Water District (Central Basin District), and the West Basin Municipal Water District (West Basin District).

- = Service area for the Central Basin District.
- = Service area for the West Basin District.
- = Service area for the replenishment district.

Besides water suppliers, other entities also play roles in southeastern Los Angeles County's water delivery system. One such entity is the Water Replenishment District of Southern California (replenishment district). The replenishment district was formed in 1959 to replenish and maintain the Central and West Coast groundwater basins<sup>3</sup> by

<sup>3</sup> According to the California Department of Water Resources, a groundwater basin is a set of one or more aquifers with reasonably well-defined boundaries.



purchasing imported and recycled water, recharging<sup>4</sup> the basins, and halting seawater intrusion.<sup>5</sup> The mission of the replenishment district is “to provide, protect and preserve high-quality groundwater through innovative, cost-effective and environmentally sensitive basin management practices for the benefit of residents and businesses of the Central and West Coast Basins.” To accomplish its mission, the replenishment district purchases imported and recycled water from several sources to replenish the Central and West Coast groundwater basins and for injection into barriers to help prevent seawater intrusion into the groundwater basins. To help cover its costs, the replenishment district collects an assessment for each acre-foot of water pumped from its service area. Figure 2 shows the replenishment district’s service area, which generally includes the areas overlying the Central and West Coast groundwater basins.

The rates that consumers pay to retailers help cover the costs of the different water agencies along the water supply chain. However, each retailer pays different proportions of its rate to the other water agencies. Based on the rates that the regional wholesaler, local wholesalers, retailers, and replenishment district charge their customers, and based on the proportions of imported water and groundwater used by each of the three retailers we examined, we estimated the proportions of the water rates paid by consumers that go to other water agencies. Each retailer obtains its water using a different supply route. Golden State Water relies on a mix of groundwater and imported water to meet its demand and obtains its imported water from local wholesalers. LADWP also relies on a mix of groundwater and imported water but obtains its imported water directly from MWD and via its own aqueducts. Downey relies entirely on groundwater to meet its potable needs.

Figure 3 shows that the proportion paid to the replenishment district varies among the retailers we examined, and the proportion of the retailers’ rates that goes to local wholesalers is relatively small. For example, 56 cents, or 52 percent, of Downey’s \$1.08 rate per unit,<sup>6</sup> would go to the replenishment district. In comparison, 32 cents (8 percent) of Golden State Water’s rate would go to the replenishment district, and only 1 cent, or 0.1 percent, of LADWP’s rate would go to the replenishment district. For LADWP, the percentage is small because only a small proportion of the water that LADWP provides to its customers within the replenishment district’s service area is groundwater. Also, the combined costs that Golden State Water pays to local wholesalers is only 10 cents, or 3 percent of its rate, even though 43 percent of its water comes from local wholesalers.

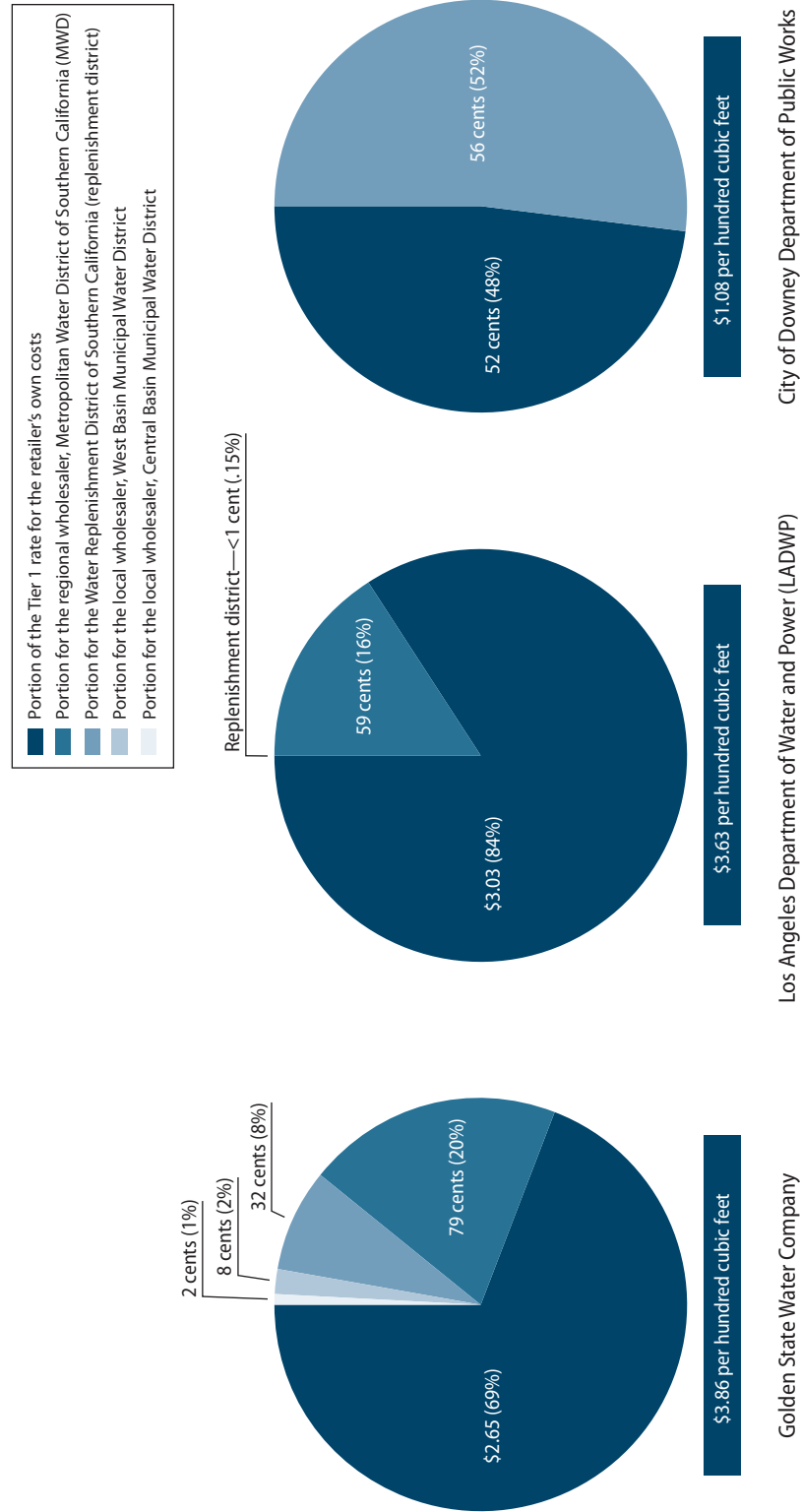
<sup>4</sup> According to the replenishment district, recharging involves putting water back into a groundwater basin via manual methods such as injection or percolation (placing freshwater on the ground and allowing it to seep into the basin). Recharging is used when natural replenishment (for example, percolation from storm runoff or inflow from other basins) is not sufficient to replace groundwater that is removed from the basins.

<sup>5</sup> Seawater can enter groundwater basins near the coast when levels of groundwater drop below a certain point.

<sup>6</sup> A unit of water is 100 cubic feet, or approximately 748 gallons.



**Figure 3**  
Estimated Portions of Retailer Rates That Cover the Costs of Other Agencies



Sources: California State Auditor's estimation based on water supply data provided by the California Department of Water Resources, water retailers' rate sheets, and water retailers' internal water reports. Notes: Various entities play a role in providing water to the residents of Los Angeles County or ensuring such water continues to be readily available. Depending on the source of water, different entities are involved and their costs are ultimately passed on to consumers. The amounts shown in the figure represent an estimation of the relative proportion of a retailer's water rate that is attributable to other entities besides the water retailer. To perform the estimation, we began with each water retailer's total volumetric rate for its Tier 1 water. For example, LADWP's Tier 1 rate for June 1, 2012, was \$3.63 per hundred cubic feet. We then estimated what portion of that \$3.63 water rate was attributable to MWD and to the replenishment district based on the amount of imported water from MWD and groundwater from the replenishment district's service area LADWP obtained, and the applicable rates charged by those entities respectively. The amounts shown only consider the volumetric cost of water and do not consider additional fixed costs imposed by the various water agencies involved.

Another entity involved in southeastern Los Angeles County's water delivery system is the California Public Utilities Commission (CPUC), a state agency. The CPUC is responsible for the regulation and oversight of Golden State Water and other investor-owned utility companies in California. Large investor-owned water utilities (10,000 water service connections or more) are required to submit a formal application every three years with the CPUC for consideration and approval before implementing rate changes. The CPUC rate-setting process is an adversarial process in which the investor-owned water utility submits evidence and makes its case for higher rates before an administrative law judge. Representing consumers, the CPUC's Division of Ratepayer Advocates reviews the evidence and challenges the utility's justification for the rate increases. The CPUC rate-setting process also includes public participation hearings in the affected local jurisdictions so that consumers can participate. Ultimately, the administrative law judge makes a recommendation to the commissioners of the CPUC as to whether the water rates should be increased, and the CPUC commissioners make the final decision. According to Golden State Water's vice president, these rate-setting cases can take as long as 18 months to complete and they include thousands of pages of evidence.

The service areas for Los Angeles County's numerous water retailers can be confusing, as geographic or political boundaries are not always reliable indicators of which retailer supplies water to a particular address (the physical location receiving the water determines which retailer provides water services). In some areas of southeastern Los Angeles County, neighbors living across the street from each other can have different water retailers. For example, according to Downey's utilities manager, depending on their location, consumers in the city of Downey will be served by one of three retailers: Downey, the city of Santa Fe Springs, or Golden State Water. Also, according to the city of Bellflower's Web site, consumers will purchase their water from one of four retailers: the Bellflower Municipal Water System, the Bellflower-Somerset Mutual Water System, the Bellflower Home Garden Water Company, or the Park Water Company (Park Water).

Conversely, the same retail suppliers can provide water to different areas of the county. For example, according to its Urban Water Management Plans,<sup>7</sup> Golden State Water provides water to all or portions of numerous cities in Los Angeles County, including Artesia, Bell, Bell Gardens, Carson, Cerritos, Compton, Cudahy, Downey, Hawaiian Gardens, Huntington Park, Lakewood,

<sup>7</sup> The California Department of Water Resources requires each of the State's urban water suppliers to submit an Urban Water Management Plan every five years to assess the reliability of its water sources over a 20-year planning horizon given different possible scenarios. The department requires this plan to ensure that supplies are available to meet existing and future water demands.

La Mirada, Long Beach, Norwalk, Santa Fe Springs, South Gate, and Vernon. Further, according to its Urban Water Management Plans, Park Water provides water to portions of six cities in southeastern Los Angeles County: Artesia, Bellflower, Compton, Lynnwood, Norwalk, and Santa Fe Springs. Both companies also provide water to portions of unincorporated Los Angeles County.

### Water Sources and Costs

As Figure 1 on page 6 shows, consumers in southeastern Los Angeles County buy their water through water retailers. When local water sources are not sufficient to meet demand, retailers must acquire water imported from outside Los Angeles County. Retailers buying MWD's imported water to meet consumer demand will acquire that water through one of two supply routes. If the retailer is an MWD member, it can buy imported water directly from MWD. If the retailer is not an MWD member, it can buy MWD's imported water through a local wholesaler that is an MWD member. LADWP is a unique retailer in that it imports its own water from Northern California via the Los Angeles Aqueducts to help meet customer demand. However, LADWP still relies on MWD's imported water to meet a significant portion of its needs.

Figure 1 also shows that local water sources include groundwater, recycled water, and desalted water. Recycled water, sometimes called *reclaimed* water, essentially is sewer water that has been sufficiently treated to make it usable for certain nonpotable purposes, such as landscape irrigation.

Groundwater can be less expensive than imported water. For instance, retailers purchasing treated imported water in 2012 from local wholesalers paid \$915 (Central Basin District) or \$1,036 (West Basin District) per acre-foot.<sup>8</sup> In contrast, a water supplier that pumped groundwater out of the Central or West Coast basin paid the replenishment district an assessment of \$244 per acre-foot. If well operation and maintenance costs were \$200 per acre-foot, the total cost of groundwater would be \$444 per acre-foot, or \$471 less than imported water purchased from the Central Basin District and \$592 less than imported water purchased from the West Basin District.

### Court Judgments Related to Groundwater

Courts have set limits on the amount of groundwater that entities such as retailers can pump from the Central and West Coast groundwater basins. According to the California Department of

<sup>8</sup> An acre-foot of water is approximately 325,800 gallons.

Water Resources (Water Resources), in the early 1900s, increases in industry and agriculture caused demand for groundwater to exceed the basins' natural replenishment. This overpumping led several entities to file suit to set groundwater rights for the West Coast Basin, resulting in a court judgment that limited pumping from that basin in 1961. Other entities similarly filed suit to set their rights to groundwater from the Central Basin, resulting in a separate judgment in 1965 that set restrictions on pumping groundwater from that basin.

To assist the courts in the administration and enforcement of their judgments, each court appointed Water Resources as watermaster. To help Water Resources track the amount of groundwater extracted, pumpers, which includes retailers, report amounts pumped monthly. Water Resources tracks the monthly amounts pumped throughout the fiscal year and calculates the amounts that pumpers can legally pump during the remainder of that fiscal year.

### Scope and Methodology

The Joint Legislative Audit Committee (audit committee) directed the California State Auditor (state auditor) to perform an audit to evaluate the cost of water delivery in southeastern Los Angeles County. Specifically, the audit committee directed the state auditor to focus on the significant factors that contribute to a water customer's bill to identify the reasons for the rising cost of water, as well as methods to improve the cost-effectiveness of water delivery. The audit analysis the audit committee approved contained six separate objectives. We list the objectives and the methods we used to address them in Table 1.

**Table 1**  
**Audit Objectives and the Methods Used to Address Them**

AUDIT OBJECTIVE	METHOD
1 Review and evaluate the laws, rules, and regulations significant to the audit objectives.	With the assistance of legal counsel, we reviewed provisions of the California Constitution, state statutes and regulations, and judicial decisions relevant to water suppliers and the California Public Utilities Commission (CPUC). We also reviewed local charters and codes.
2 Identify the roles—related to the delivery and sale of water in Southern California—of the Metropolitan Water District of Southern California (MWD), the Water Replenishment District of Southern California (replenishment district), wholesale water suppliers (such as the Central Basin Municipal Water District [Central Basin District]), and retail water suppliers.	We interviewed key staff and obtained documentary evidence, such as annual budget documents and mission statements, to understand the roles of these organizations and where they fit into the water supply chain for Los Angeles County.
3 Identify the regulatory role of the CPUC with respect to overseeing the rates set by the area's privately owned water suppliers.	We interviewed staff from the CPUC and reviewed the state statutes that establish the CPUC's authority and powers. Further, we reviewed documents submitted to the CPUC for certain rate cases.

AUDIT OBJECTIVE	METHOD
<p>4 Select two wholesale water suppliers (the Central Basin District and another wholesale water supplier that receives water from the MWD) and three retail water suppliers that supply water to Los Angeles County. To the extent possible, for each water wholesaler and retailer selected:</p>	<ul style="list-style-type: none"> <li>• In addition to the Central Basin District, which was specifically identified in the audit request, we selected the West Basin Municipal Water District (West Basin District) based on the geographic size of its service area and our judgment regarding the needs of our report's users.</li> <li>• After considering the size, water sources, ownership type (that is, government operated or investor owned), and other information, we selected the City of Los Angeles Department of Water and Power (LADWP), the City of Downey Department of Public Works (Downey), and the Golden State Water Company (Golden State Water) as the retail water suppliers for review.</li> </ul>
<p>a. Review and evaluate the process and basis each water supplier uses for establishing its water rates.</p>	<ul style="list-style-type: none"> <li>• Because some water suppliers have different rates for different classes of water, we focused our review on single-family residential rates because we thought these rates would be the most meaningful to our report's users.</li> <li>• For the three wholesalers and three retailers we examined, we reviewed budget and accounting documents to understand how increasing costs drove the need for a rate increase. We also identified the extent to which the public was informed of the rate increases and whether the public was afforded an opportunity to provide input into proposed rate changes.</li> </ul>
<p>b. Identify the significant factors that contribute to the water rates each supplier charges its respective customers and any major differences in water rates charged by each water supplier.</p>	<ul style="list-style-type: none"> <li>• We established different consumer usage levels and determined the water bills paid by consumers purchasing each of the amounts of water from each of the three retailers we reviewed.</li> <li>• We reviewed budget documents that water providers used when increasing their rates to better understand what costs have a significant effect on water rates and the extent to which these costs have increased over time.</li> </ul>
<p>c. Review and assess any changes in rates over the most recent five-year period and the reasons for any major changes in the water rates.</p>	<ul style="list-style-type: none"> <li>• For the water suppliers we selected, we identified, documented, and summarized the water rates charged and rate structures in effect on July 1 for 2008 through 2012.</li> <li>• We identified and documented changes in water rates over the audit period and examined certain major changes to determine whether suppliers sufficiently justified them.</li> </ul>
<p>d. Review a sample of expenditures over the last five years, including expenditures for infrastructure projects, bonds, and general operations. Determine whether those expenditures were allowable and reasonable.</p>	<ul style="list-style-type: none"> <li>• We reviewed 141 transactions—at least 15 per water supplier—and determined the reasonableness of the transaction. In general, our review of transactions involved determining whether the expenses were consistent with suppliers' internal policies and procedures.</li> <li>• We judgmentally selected the 141 expenditures instead of selecting a random sample because we assessed varying levels of risk both among the different water suppliers and among their respective spending accounts. In selecting transactions for testing, we chose expenditures based on a number of factors, including dollar amount, risk level, and any reported concerns of inappropriate spending. Because we judgmentally selected items for testing, the results of our testing cannot be projected to the population of transactions from the water suppliers.</li> </ul>
<p>e. Examine any increases in each water supplier's respective administrative costs and reserve amounts over the last five years. Identify the reasons for any major increases and whether they were reasonable and necessary.</p>	<p>Based on our review of budget documents and other accounting records, we reviewed each of the five water suppliers' administrative costs and reserve amounts for fiscal years 2007–08 through 2011–12. If administrative costs or reserve amounts had increased significantly, we interviewed key staff to understand the reasons for these increases. Finally, for water suppliers that maintained large unrestricted reserve amounts, we inquired as to the planned uses for those unrestricted reserves.</p>

continued on next page...

AUDIT OBJECTIVE	METHOD
5 Identify any best practices for streamlining and making water delivery more cost-effective for the residents in Los Angeles County.	During our review of the water suppliers and their policies, we looked for practices that promoted greater transparency or accountability to the public for proposed water rate increases. We also looked for instances in which water suppliers had instituted policies that minimized the effects of rate changes. We identified no such best practices. According to the manual <i>Principles of Water Rates, Fees and Charges</i> , 6 <sup>th</sup> edition, 2012, published by the American Water Works Association, different rules for formulating water rates exist that are based on local conditions and requirements. These varying conditions allow each supplier to determine a unique set of practices that cannot always be applied to other water suppliers.
6 Review and assess any other issues that are significant to the cost and delivery of water to Los Angeles County residents and businesses.	No other issues came to our attention.

Sources: California State Auditor's analysis of Joint Legislative Audit Committee audit request number 2012-104, planning documents, and analysis of information and documentation identified in the column titled *Method*.

In performing audit work at the water suppliers and the CPUC, we obtained numerous financial records, budget documents, and other evidence that were generated from computer-processed data maintained by the eight auditees that were included in our audit. The U.S. Government Accountability Office, whose standards we follow, requires us to determine whether we need to test the effectiveness of the auditees' information system controls in order to obtain sufficient and appropriate evidence for our conclusions. In our judgment, we did not need to test these information system controls for the purpose of answering the audit objectives. The audit objectives focused on explaining water suppliers' justification and rationale for their rate increases, not whether water suppliers had reliable cost data with which to reach their conclusions. As a result, we make no conclusions in our audit report regarding the accuracy of these financial data. When presenting budget and cost information in our report, we disclose that these are unaudited data so as not to mislead our report's users.

## Audit Results

### **Different Reasons Contribute to Water Rate Increases Among Wholesalers and Retailers**

As part of our audit, we examined the rates water suppliers had in effect on July 1 of each year from 2008 through 2012. Suppliers we examined included:

- The regional wholesale supplier—the Metropolitan Water District of Southern California (MWD).
- Two local wholesale suppliers—the Central Basin Municipal Water District (Central Basin District) and the West Basin Municipal Water District (West Basin District).
- Three retail suppliers—the City of Los Angeles Department of Water and Power (LADWP), the City of Downey Department of Public Works (Downey), and the Golden State Water Company (Golden State Water).

We also examined the rates charged by the Water Replenishment District of Southern California (replenishment district).

Specifically, we identified increases in the rates each entity charged and determined why significant increases occurred from one year to the next. Although we identified several reasons for these rate increases, the most prevalent one was that the suppliers' own costs increased. Because suppliers base the rates they charge on the amount of annual revenue they believe necessary to cover their annual costs, when costs increase, so do rates. For example, LADWP rates for 20 units of water increased 39 percent from July 2008 through July 2012, while the cost of the water it buys from MWD increased by 26 percent and the interest expense pertaining to capital-related debt increased by 69 percent from fiscal years 2008–09 to 2012–13. Other reasons for rate increases included improving water conservation by implementing a tiered rate structure in which those consumers who use more water pay higher rates, and eliminating deficits when annual revenues are not sufficient to cover the costs of providing water.

### ***The Regional Wholesaler's Rates Have Increased Since 2008 Due to Increased Costs and Lower Water Sales***

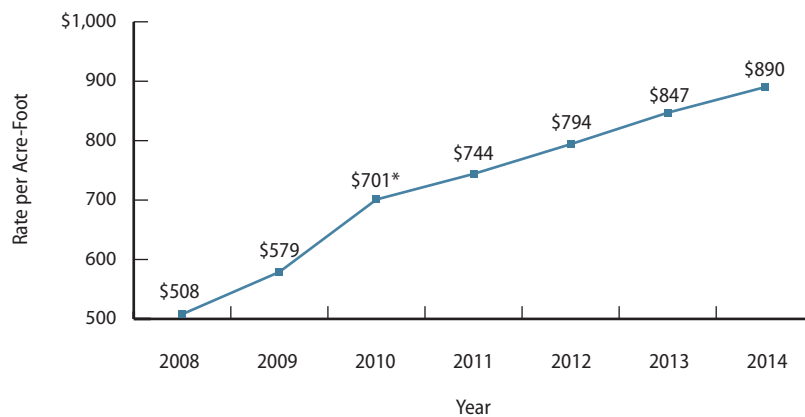
As we mentioned in the Introduction, MWD is the regional wholesaler for southeastern Los Angeles County. Since fiscal year 2007–08, MWD's water rates and costs have increased, even as water sales have declined. The rates MWD charges for



its water generate sufficient revenue from water sales to cover most of its costs.<sup>9</sup> The Tier 1 rate is MWD's rate for a certain amount of water; deliveries beyond this amount are charged at a higher Tier 2 rate. As shown in Figure 4, MWD incrementally increased its Tier 1 rate for treated water from \$508 per acre-foot as of January 1, 2008, to \$794 per acre-foot as of January 1, 2012, or by 56 percent over this period. MWD's Tier 1 rate increased an additional \$53 per acre-foot on January 1, 2013, and it will increase a further \$43 per acre-foot on January 1, 2014.

MWD's sales of treated water, which make up over half of its total water sales, declined by more than 328,000 acre-feet, or 25 percent, from fiscal years 2007–08 through 2011–12, from 1.3 million acre-feet to almost 981,000 acre-feet. MWD's total water sales also decreased 20 percent over the same period. As we elaborate later, economic and weather conditions affect MWD's water sales.

**Figure 4**  
**Metropolitan Water District of Southern California's Rate for Full-Service, Treated Water**  
**2008 Through 2014**



Source: Metropolitan Water District of Southern California's (MWD) approved water rates.

Note: MWD provides water to its member agencies for a variety of purposes, ranging from fully treated water for drinking purposes to untreated water for other purposes, including treatment by member agencies and groundwater replenishment. The amounts shown in the figure pertain only to MWD's full-service, treated Tier 1 water deliveries, which includes drinking water. Deliveries of water beyond a certain amount are charged at a higher Tier 2 rate not shown in the figure. MWD also imposes additional fixed charges not reflected in the figure.

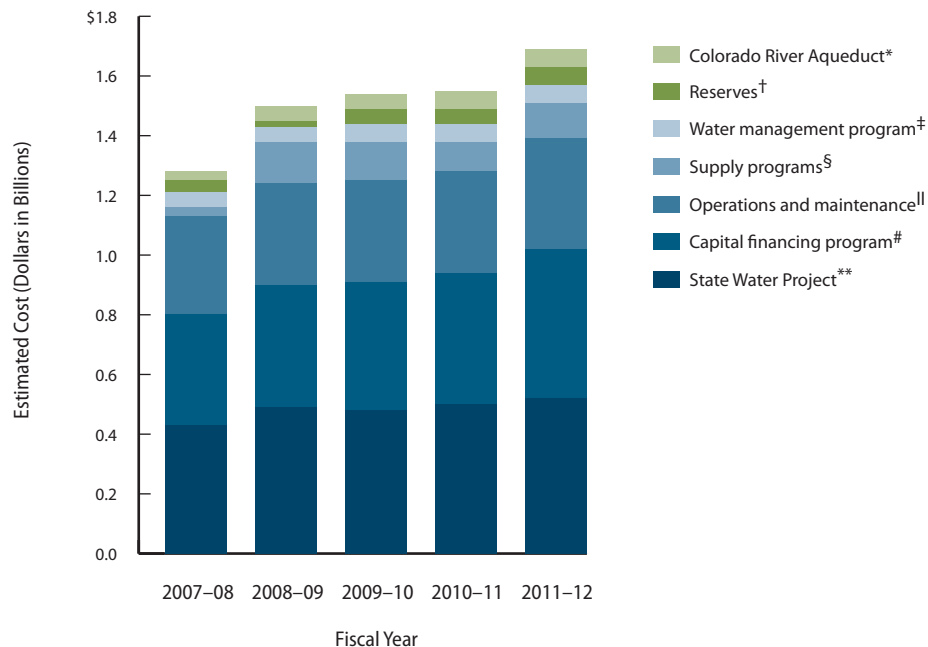
\* MWD Tier 1 water rates are generally effective January 1 of each year, but the 2010 rate went into effect on September 1, 2009.

<sup>9</sup> When designing its different water rates and charges for fiscal year 2011–12, MWD planned to recover \$1.51 billion, or 90 percent, of its total \$1.68 billion in expected costs. MWD planned to obtain the remaining \$168 million from property taxes, hydroelectric power sales, and other miscellaneous income.



MWD's four largest cost areas, as seen in Figure 5, relate to the State Water Project, capital financing, operations and maintenance, and supply program costs. These four cost components constitute approximately 90 percent of MWD's total costs and together increased by \$356.4 million, from \$1.15 billion in fiscal year 2007–08 to \$1.51 billion in fiscal year 2011–12.

**Figure 5**  
**Metropolitan Water District's Estimated Costs Used to Determine Water Rates**  
**Fiscal Years 2007–08 Through 2011–12**



Sources: Metropolitan Water District of Southern California (MWD) cost-of-service studies.

Note: We did not audit these amounts.

\* Colorado River Aqueduct costs incorporate power costs associated with pumping water from the Colorado River.

† The reserves amount reflects reserve fund transfers required by bond covenants and the MWD's administrative code.

‡ Water management program costs reflect payments made to member agencies in support of local resource development and active conservation efforts.

§ Supply program costs reflect the costs of entering into agreements with water agencies to store and transfer water to MWD to augment deliveries from the State Water Project and the Colorado River Aqueduct.

II Operations and maintenance costs include, among other things, labor and benefit costs; chemical, electricity, and sludge disposal costs incurred in the water treatment process; costs for operating equipment; and professional service payments to outside consultants for specialized skills.

# Capital financing program costs include debt service and capital expenditures funded from revenues or reserves to finance MWD's capital projects.

\*\* State Water Project costs reflect MWD's allocable portions of the costs associated with the State Water Project system, as well as variable power costs associated with pumping water from the system.

MWD's budget for its capital financing costs had the largest increase, as measured in dollars, during the five-year period we reviewed. These budgeted costs increased by \$133.8 million (37 percent), from \$364 million in fiscal year 2007–08

***MWD is the largest contractor of 29 water suppliers that have long-term contracts with the State for the State Water Project, a system to provide water throughout much of California.***

to \$497.8 million in fiscal year 2011–12. According to MWD documents, one reason for the increase is significant capital improvements at MWD’s five water treatment plants. Some of these improvements were necessary to ensure that treated water continues to meet regulatory standards.

MWD is also pursuing other capital improvement projects to maintain its infrastructure. For example, MWD has active projects aimed at rehabilitating or replacing aging equipment at pumping plants, upgrading electrical and power systems at water treatment plants, and constructing a new pipeline from a treatment plant to the boundary of a member agency. Further, as the owner and operator of the 242-mile Colorado River Aqueduct, MWD must perform ongoing maintenance on equipment that pumps water over mountainous terrain, lifting it by a total of approximately 1,600 feet. Budget documents indicate that MWD’s infrastructure expenditures are expected to grow as more facilities reach the end of their service life.

Another major area of MWD cost increases is the State Water Project. MWD is one of 29 water suppliers that have long-term contracts with the State for the State Water Project, a system to provide water throughout much of California. MWD is the State Water Project’s largest contractor and is allocated approximately 46 percent of the State Water Project’s total amount of water allocated to contractors in any given year. Under the terms of its contract with the State, MWD is obligated to pay certain allocated expenses associated with the operation, maintenance, power, and replacement cost of the State Water Project’s transportation facilities through at least the year 2035, regardless of the quantities of water available. This means that MWD is required to pay these costs even if it obtains no water.

MWD’s budgeted costs related to the State Water Project increased by \$86.1 million (20 percent), from \$431 million in fiscal year 2007–08 to \$517.1 million in fiscal year 2011–12. The State Water Project is operated by the California Department of Water Resources (Water Resources), which we did not audit. A program manager in MWD’s budget and financial planning section stated that Water Resources is identifying and undertaking significant repair and rehabilitation projects on the State Water Project. According to MWD documents, some of the increase was used to finance the environmental and preliminary engineering for the long-term infrastructure necessary to improve reliability in the Sacramento-San Joaquin River Delta, along with actions to help address concerns regarding endangered species in the delta. Water Resources bills its contractors, including MWD, for their share of the costs associated with the State Water Project. However, MWD engages an independent auditor annually to audit the charges that

Water Resources submits to MWD, to ensure that the amounts charged to MWD are correct. This audit was performed for every year we examined, and MWD's auditor determined that the statements of charges submitted to MWD by Water Resources were fairly presented in all material respects in each year.

Another major source of MWD's costs is expenditures related to its water supply programs. MWD's water supply programs increase the availability and reliable delivery of water throughout MWD's service area. The manager of MWD's Water Resource Management Group stated that the costs of the water supply programs are incurred when MWD enters into agreements with other water agencies to store and transfer water to MWD. This water can then be used to augment other water deliveries from the State Water Project and Colorado River Aqueduct. Budgeted supply programs costs paid by operating revenues increased by \$90.1 million (311 percent), from \$29 million in fiscal year 2007–08 to \$119.1 million in fiscal year 2011–12. The largest increase occurred from fiscal years 2007–08 to 2008–09, when supply programs costs increased by \$110.4 million (381 percent). According to MWD, this increase was due to the substantial costs of additional water transfers<sup>10</sup> to augment supplies from the State Water Project because of critically dry conditions and a federal court ruling that restricted pumping on the State Water Project.

The last large area of expenditures is for operations and maintenance. MWD's operations and maintenance costs include, among other things, labor and benefits costs; costs incurred for chemicals, electricity, and sludge disposal during the water treatment process; operating equipment costs; and professional service payments to outside consultants for specialized skills. Budgeted operations and maintenance costs increased by \$46.4 million (14 percent), from \$327.5 million in fiscal year 2007–08 to \$373.9 million in fiscal year 2011–12. The largest increase occurred between fiscal years 2010–11 and 2011–12, when budgeted operating and maintenance costs increased by \$36.5 million (11 percent). This increase occurred for a variety of reasons. For instance, budgeted labor costs included a \$6.6 million increase to cover projected merit increases and benefit cost increases, budgeted costs for retirement benefits increased by \$10 million, budgeted costs for operating equipment increased by \$4.9 million, and budgeted costs for water treatment chemicals increased by \$1.6 million.

*The largest increase occurred from fiscal years 2007–08 to 2008–09, when supply programs costs increased by \$110.4 million (381 percent), which was due to the substantial cost of additional water transfers to augment supplies from the State Water Project.*

<sup>10</sup> A water transfer occurs when an entity with water rights sells or leases surplus water to another entity.

*When setting its rates for fiscal year 2011–12, MWD estimated that more than 80 percent—roughly \$1.2 billion—of its anticipated expenditures were fixed costs.*

Even though certain areas of MWD's budgeted costs are increasing, we observed that MWD took some actions to control its costs.

One of these actions was to defer certain capital projects.

For instance, budget documents for fiscal year 2009–10, which coincides with the largest percentage increase in MWD's Tier 1 treated water rates since 2008, indicate that MWD deferred nearly 20 projects totaling \$240 million in that fiscal year, including projects related to upgrading and improving water treatment facilities. MWD's budget documents also indicate that it took other steps, such as deferring the replacement of operating equipment by optimizing the use of equipment that has experienced lower utilization. The budgeted amount for operating equipment decreased by \$2.7 million (28 percent) from fiscal years 2007–08 to 2011–12. In addition, MWD's budget documents indicate it has eliminated 148 positions, a reduction of 7 percent, from 2,069 positions in fiscal year 2007–08 to 1,921 in fiscal year 2011–12.

MWD has a high percentage of fixed costs that are independent of the amount of water it sells. Examples of these fixed costs include portions of its State Water Project expenses, as well as debt service costs related to bonds issued to help fund capital projects. When setting its rates for fiscal year 2011–12, MWD estimated that more than 80 percent—roughly \$1.2 billion—of its anticipated expenditures were fixed costs, while water sales typically account for approximately 90 percent of its operating revenues.

In addition to increasing costs, MWD has faced declining water sales, which resulted in more of its costs being spread over a given unit of water sold. As stated earlier, MWD's total water sales declined by 20 percent from fiscal years 2007–08 through 2011–12. The manager of MWD's Water Resource Management Group stated that demands for deliveries from MWD are quite volatile from year to year and indicated that a 20-percent decline or increase over a few years is not uncommon. The manager stated that the single largest variable that changes demand for MWD water and its use, largely outdoor water use, from year to year is weather. The manager also stated that weather alone can swing retail demands by almost 10 percent in a given year and that recent weather has been remarkably cool in MWD's service area, which has led to lower demands overall. MWD documents also indicate that the economic recession and its associated impacts such as job losses, income losses, and housing foreclosures affect MWD's sales and that it anticipates demands for water will increase if economic conditions return to pre-recession levels.

***Local Wholesalers Have Increased the Portions of Their Rates Not Tied to Imported Water, in Large Part Because of Efforts to Develop Alternate Water Sources***

Rates charged by local wholesalers—specifically the West Basin District and Central Basin District—to their retail customers have increased since fiscal year 2007–08 for several reasons. As local wholesalers, the Central Basin and West Basin districts spend a significant portion of their budget to purchase imported water from MWD; however, they are also spending large amounts to develop alternative sources of water, such as systems to provide access to recycled or desalted water, and these activities currently add to the cost of the imported water that consumers use. Customers of retailers that acquire their water from local wholesalers rather than directly from MWD feel the impact of these added costs.

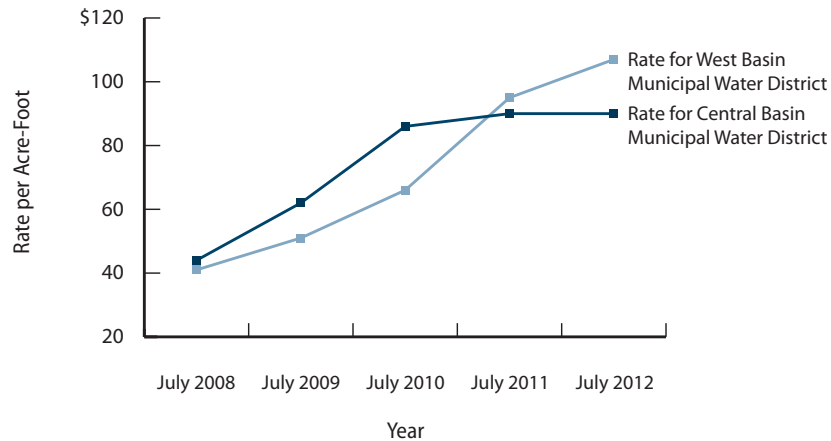
Like other water suppliers we examined, local wholesalers set their rates in order to generate revenue sufficient to cover their projected expenses in the coming budget year. The volume-based rates that local wholesalers charge their retail customers include two basic components:<sup>11</sup> an amount the wholesalers describe as passed through from MWD for the cost of imported water (MWD component), and amounts the wholesalers add to cover their own costs (wholesaler component). The Central Basin District's wholesaler component includes two charges: an administration surcharge and an infrastructure surcharge. According to the Central Basin District's management team, the infrastructure surcharge covers some of the costs of debt used to develop water recycling capacity, and the administration surcharge covers the district's operational costs. The West Basin District's wholesaler component includes a single charge: a reliability service charge. Budget documents for the West Basin District stated that the reliability service charge covers its operational costs, such as those associated with its water recycling operations. The wholesaler component makes up about 10 percent of the rates the Central Basin and West Basin districts charge retail customers for imported water.

As Figure 6 on the following page shows, the wholesaler components charged by the Central Basin and West Basin districts have more than doubled since July 2008. The Central Basin District's wholesaler component increased by \$46 (105 percent) per acre-foot, from \$44 in fiscal year 2007–08 to \$90 in fiscal year 2011–12. The West Basin District's wholesaler component increased by \$66 (161 percent) per acre-foot, from \$41 in fiscal year 2007–08 to \$107 in fiscal year 2011–12.

***The wholesaler components charged by the Central Basin and West Basin districts have more than doubled since July 2008.***

<sup>11</sup> The wholesalers also have fixed costs, but we did not include these in our discussion of overall rates because they are based on customer-specific variables such as past usage and water capacity.

**Figure 6**  
Local Wholesalers' Components of Rates for Treated Water  
July 2008 Through July 2012



Sources: Water rates and charges tables provided by the local wholesalers.

Notes: The rates shown represent the additional costs local wholesalers add to the cost of treated water imported from the Metropolitan Water District of Southern California. Specifically, the amounts shown for the West Basin Municipal Water District (West Basin District) pertain to its reliability service charge. Similarly, the amounts shown for the Central Basin Municipal Water District (Central Basin District) pertain to its infrastructure surcharge and its administrative surcharge. Finally, the amounts shown do not reflect any additional fixed charges, such as capacity charges and monthly service charges, which are dependent on the specific circumstances of each water retailer receiving water from the West Basin District or the Central Basin District.

Because the local wholesalers base their proposed rate increases on the expenses they expect to incur in an upcoming fiscal year, we examined how their budgeted expenses have increased since 2008 to better understand why their water rates increased. The largest category of budgeted expense for both local wholesalers is imported water from MWD. As Table 2 shows, the cost of MWD's imported water and the readiness-to-serve (RTS) charge made up 73.2 percent of the Central Basin District's budget for fiscal year 2012–13. According to MWD, the RTS charge reflects the cost of MWD providing standby services, such as emerging storage. Similarly, Table 3 on page 24 shows that the cost of MWD's imported water made up 57.1 percent of the West Basin District's budget for fiscal year 2012–13.

To identify areas of expense added by the local wholesalers, we looked specifically at the expenses that are not a direct cost of imported water. When we subtracted the cost of MWD's imported water, four remaining categories made up more than 70 percent of the budget for the Central Basin District: debt service, water recycling operations, public/external operations, and district administration. Similarly, debt service and recycling operations made up more than 75 percent of the remaining budget for the West Basin District.



**Table 2**  
**Central Basin Municipal Water District's Budgeted Expenditures**  
**Fiscal Years 2008–09 Through 2012–13**

	FISCAL YEAR					PERCENTAGE OF FISCAL YEAR 2012–13 TOTAL	PERCENTAGE INCREASE SINCE FISCAL YEAR 2008–09
	2008–09	2009–10	2010–11	2011–12	2012–13		
Imported water purchase readiness-to-serve (RTS)	\$31,613,200	\$41,372,211	\$42,281,070	\$47,549,800*	\$50,857,600*	73.2%	61%
Debt service	3,854,499	3,945,427	3,912,023	4,798,735	4,752,390	6.8	23
Public/external affairs	2,578,754	2,172,070	2,001,079	3,117,692	3,172,524	4.6	23
Water recycling operations	2,493,231	2,495,945	2,502,768	3,173,998	2,708,153	3.9	9
District administration	1,750,667	2,431,202	3,303,059	2,726,408	2,538,329	3.7	45
Designated funds	1,376,902	1,251,709	1,539,061	2,276,718*	1,592,470*	2.3	16
Water Quality Protection Project (WQPP) operations	1,176,270	1,197,069	1,246,574	1,226,112	1,190,042	1.7	1
Capacity charge	1,027,556	917,000	943,200	833,230*	833,230*	1.2	(19)
Water resource planning	389,135	230,647	340,154	1,209,833	1,565,194	2.2	302
District Local Resources Program (LRP) rebate	199,356	265,600	265,600	265,600*	265,600*	0.4	33
<b>Totals</b>	<b>\$46,459,570</b>	<b>\$56,278,880</b>	<b>\$58,334,588</b>	<b>\$67,178,126</b>	<b>\$69,475,532</b>	<b>100%</b>	<b>50%</b>

Sources: Central Basin Municipal Water District's (Central Basin District) approved budgets for fiscal years 2008–09 through 2012–13.

Notes: The amounts shown in the table are based on the Central Basin District's budgeted expenses for the fiscal years shown. We did not audit these amounts. The table focuses on budgeted expenses as opposed to actual expenses, since the Central Basin District establishes its water rates concurrently with its budgeted (or projected) costs. Some key terms shown in the table are defined below:

*Imported water purchase/RTS:* These are amounts the Central Basin District expects to pay the Metropolitan Water District of Southern California (MWD) for imported water as well as MWD's RTS charge. According to MWD, the RTS charge reflects the cost of MWD providing standby service, such as emergency storage.

*Designated funds:* Planned revenues in excess of the Central Basin District's budgeted expenditures are placed in certain funds that can be allocated by the Central Basin District's board of directors at its discretion.

*WQPP operations:* The WQPP is intended to protect local groundwater from certain contaminants by extracting impaired water and treating it to meet drinking water standards.

*Capacity charge:* MWD charges the Central Basin District this fixed amount annually based on the Central Basin District's peak water usage over a three-year period.

*District LRP rebate:* Under its LRP, the Central Basin District issues rebates to certain water retailers that have undertaken construction efforts to expand the Central Basin District's recycled water system.

\* The Central Basin District's budget documents for fiscal years 2011–12 and 2012–13 did not provide data for certain cost elements. As a result, certain amounts are based on the assertions of the Central Basin District's management.

Regarding debt service, both districts incurred a significant portion of their debt to fund the construction of facilities necessary to deliver recycled water to industrial, commercial, and irrigation sites, thereby reducing the districts' reliance on imported water. The Central Basin District funded the Southeast Water Reliability Project, which delivers recycled water to the cities of Pico Rivera and Montebello. The district currently has three bond issues outstanding to fund its recycled water efforts.

For the West Basin District, recycling operations make up more than 40 percent of the district's non-MWD budget. According to the West Basin's operating budget, the costs of recycling operations include payments to the contractor operating the recycling

facilities. West Basin, like Central Basin, sells recycled water for industrial and irrigation uses. However, West Basin also sells recycled water for injection into the local groundwater basin to prevent seawater intrusion and replenish groundwater supplies.

**Table 3**  
**West Basin Municipal Water District's Budgeted Expenditures**  
**Fiscal Years 2007–08 Through 2011–12**  
**(Dollars in Thousands)**

	FISCAL YEAR					PERCENTAGE OF FISCAL YEAR 2012–13 TOTAL	PERCENTAGE INCREASE SINCE FISCAL YEAR 2008–09
	2008–09	2009–10	2010–11	2011–12	2012–13		
Imported water	\$80,242	\$90,403	\$89,154	\$99,183	\$102,234	57.1%	27%
Debt service	22,834	24,216	23,485	24,814	27,448	15.3	20
Recycling operations	20,439	22,597	24,448	28,090	31,240	17.5	53
Public information/ conservation	6,789	6,325	5,467	5,335	6,187	3.5	(9)
Designated funds	4,425	5,243	6,937	7,388	9,480	5.3	114
Resource planning/ water policy	1,224	1,142	1,060	1,032	1,401	0.8	14
Desalter operations	611	703	773	838	956	0.5	56
<b>Totals</b>	<b>\$136,564</b>	<b>\$150,629</b>	<b>\$151,324</b>	<b>\$166,680</b>	<b>\$178,946</b>	<b>100%</b>	<b>31%</b>

Sources: West Basin Municipal Water District's (West Basin District) operating budgets for fiscal years 2008–09 through 2012–13.

Notes: The amounts in the table are based on the West Basin District's budgeted expenses for the fiscal years shown. We did not audit these amounts. The table focuses on budgeted expenses, as opposed to actual expenses, since the West Basin District establishes its water rates concurrently with its budgeted (or projected) costs. Some key terms shown in the table are defined below:

*Imported water:* These amounts include the amounts the West Basin District budgeted for water purchases and the Metropolitan Water District of Southern California's (MWD) capacity charge and readiness-to-serve (RTS) charge. According to MWD, the RTS charge reflects the cost of MWD providing standby service, such as emergency storage.

*Designated funds:* Designated funds are the balance between total revenues and total expenses.

*Desalter operations:* The desalter operations budget includes oversight, operation, and maintenance of the desalter, along with other costs of treating brackish water to meet drinking water standards.

### ***Different Cost Factors and a Desire to Promote Conservation Contributed to Retailers' Rate Increases***

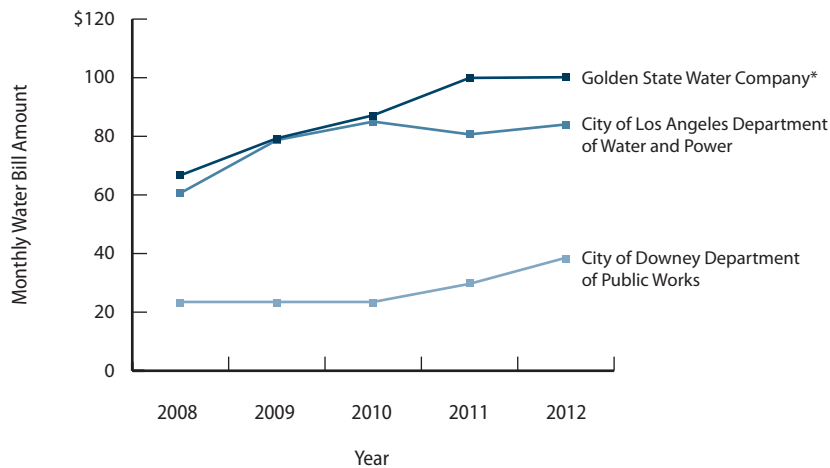
The water rates charged by the three water retailers we reviewed increased from 2008 through 2012. As indicated in Figure 7, the monthly cost of 20 units of water purchased from LADWP rose from \$60.64 in July 2008 to \$84.05 in July 2012, an increase of \$23.41 (39 percent). Over the same time period and for the same amount of water, Golden State Water's monthly costs increased by \$33.45 (50 percent), from \$66.71 to \$100.16. For water purchased from Downey, the monthly cost for 20 units of water increased by \$15.09 (64 percent), from \$23.48 to \$38.57.



Because retailers set their rates based on the amount of budgeted expenses they expect to incur for the upcoming year, we examined each retailer's budgeted expenses and changes to those budgeted amounts over time.

Water bills increased for LADWP's consumers for a variety of reasons, such as increasing capital-related costs and the higher costs of purchasing water from MWD. According to its staff, LADWP's budget for interest and depreciation expense increased by \$64.1 million and \$38.2 million, respectively, from fiscal years 2008–09 through 2012–13. This represented an increase of 69 percent in interest expense and 44 percent in depreciation expense. According to its audited financial statements, LADWP issued roughly \$500 million in revenue bonds in fiscal year 2009–10. The net proceeds from the issuance of these bonds were deposited into the Construction Fund to be used for capital improvements. According to LADWP's water executive managing engineer, the increase in interest expense was a result of the issuance of these bonds, and the increase in depreciation expense was a result of the funds from these bonds being used for new capital improvement projects.

**Figure 7**  
**Monthly Bill for 20 Units of Water Purchased From Three Water Retailers**  
**2008 Through 2012**



Sources: Historical and proposed water rate data provided by each retailer.

Notes: The amounts shown in the figure represent the total monthly water bill for a hypothetical residential customer with a family of four. The figure assumes this family would consume 20 units of water; one unit equals 100 cubic feet (HCF), or approximately 748 gallons. The dollar amounts shown include both the retailer's fixed and variable charges.

Our analysis focused on 20 units of water as a benchmark for residential use based on data provided in the California Department of Water Resources' *20x2020 Water Conservation Plan* (conservation plan), published February 2010. The conservation plan provides baseline consumption data indicating that residential customers in the Los Angeles area used 126 gallons per capita per day in 2005. After multiplying this amount by four people and 365 days a year, and converting the result into monthly units of water, we arrived at 20 units—or 20 HCF—as a monthly benchmark.

\* Almost \$8 of the \$100.16 monthly water bill is because the California Public Utilities Commission authorized the Golden State Water Company to recover revenue shortfalls from prior years in its current rate.

LADWP's budget documents show that the cost of purchased water increased by \$47.7 million (26 percent), from \$185.3 million in fiscal year 2008–09 to \$233 million in fiscal year 2012–13. According to LADWP's water executive managing engineer, this increase was because of increases in MWD's water rates. In addition, LADWP modified its tiered rate structure to encourage conservation. In March 2009 LADWP's board of commissioners declared that the water supply available was insufficient to meet the city's normal water demand. Its solution was to reduce the amount of water a consumer can purchase at the lower Tier 1 rate from 18 units to 15 as of June 1, 2009. Concurrently, it increased the Tier 2 rate by 55 percent. Before the modification, a consumer paid \$60.64 for 20 units of water. After the modification, the consumer pays \$78.73, a 30 percent increase.

Water costs increased for customers of Golden State Water in part because it implemented a new rate structure whereby those customers who do not conserve water will incur higher rates. According to financial reports it filed with the U.S. Securities and Exchange Commission, Golden State Water implemented a tiered structure in November 2008 to promote conservation among its consumers. After the new structure took effect, consumers using more than 20 units of water in a billing cycle paid about 19 percent more. Before the modification, a consumer would pay \$66.71 for 20 units of water; after the modification, the consumer would pay \$79.32.

Golden State Water's water rate also increased to allow it to earn a certain rate of return, or profit, based on its growing assets. According to the CPUC, which regulates Golden State Water, the value of property and assets on which an investor-owned water utility is permitted to earn a specified rate of return is called a *rate base*. Golden State Water's rate base increased each year since 2008. Golden State Water is required to get approval from the CPUC for any change in its rate of return, rate base, and any acquisition of new assets. Acquisition of new assets by any investor-owned utility must be approved by the CPUC before they are implemented, and once in service the assets are included in the rate base. According to its vice president of regulatory affairs, Golden State Water's rate base increased as a result of its investing in new assets to help maintain and replace aging infrastructure.

***Two primary factors contributed to Downey's water rate increases: increases in the cost of pumping groundwater and the cost of eliminating a deficit.***

Two primary factors contributed to Downey's water rate increases: increases in the cost of pumping groundwater and the cost of eliminating a deficit. According to its budget documents, Downey's budget for water supply costs increased by roughly 30 percent from fiscal years 2008–09 to 2012–13. During that same period, water supply costs accounted for nearly 52 percent of Downey's overall water budget. According to Downey's finance director, the increase in water supply expenses was most significantly the result of

increases in the assessment fee being charged by the replenishment district for pumping groundwater.<sup>12</sup> The replenishment district's assessment increased from \$153 per acre-foot in fiscal year 2008–09 to \$244 per acre-foot in fiscal year 2012–13, or nearly 60 percent. Regarding the deficit, Downey's budget documents show that the city's Water Fund operated at a loss from fiscal years 2008–09 to 2010–11. In each year, Downey's budgeted Water Fund expenses exceeded revenues—by \$290,000 in 2008, \$1.3 million in 2009, and \$1.9 million in 2010. Downey's finance manager explained that during those years, the city tapped into its reserves to cover its losses. To help resolve the deficit situation, Downey officials hired an outside consultant to develop a water supply master plan that included a rate structure that would help ensure that Downey had a self-supported Water Fund. Downey's new rate structure included four tiers of rates and annual rate increases of varying percentages from July 2011 through July 2015.

***Portions of Downey's Water Fees May Not Be Allowable Under the California Constitution***

Downey's water rates may generate funds that exceed the amount required to provide its water services, which would violate the California Constitution. Under Article XIII D of the California Constitution, which was added by Proposition 218 in 1996, a property-related fee or charge shall not be extended, imposed, or increased by an agency unless it meets certain requirements. These requirements include provisions that revenues derived from the fee or charge shall not exceed the funds required to provide the property-related service and that these revenues shall not be used for any purposes other than that for which the fee or charge was imposed. In addition, fees or charges based on potential or future use of a service are not permitted. Article XIII D also specifies that the local agency imposing a fee bears the burden of proving that the fee complies with the article. In 2006 the California Supreme Court determined that a local public water agency's charges for ongoing water delivery are property-related fees under Article XIII D. In other words, water fees paid by customers of these agencies are subject to the requirements of Article XIII D.

Downey transferred revenues generated from water fees for uses that it was unable to sufficiently substantiate were related to water service. During fiscal years 2007–08 through 2010–11, Downey transferred

***Downey's water rates may generate funds that exceed the amount required to provide its water services, which would violate the California Constitution.***

<sup>12</sup> We examined the replenishment district's largest one-year rate increase. Our review showed that most of the replenishment district's \$39 per acre-foot increase from \$205 in July 2010 to \$244 in July 2011 was caused by price increases for water purchased from the Central Basin District and West Basin District, an increase in debt service payments for capital improvements, and an increase in litigation costs.

***Downey staff was unable to provide sufficiently detailed evidence to convince us that certain transfers were for water-related purposes.***

to other governmental funds almost \$1 million from its Water Fund, which is used to account for the provision of water services to residential, commercial, and industrial customers. Downey's financial statements indicate that these transfers were made to provide funding for capital expenditures. When we asked Downey for specific details on the amounts transferred to its Sewer and Storm Drain Fund, which is used to account for charges collected for the upkeep of sanitary sewers and federally required drainage upkeep programs, Downey's finance manager explained that the Water Fund paid for the costs incurred by its stormwater engineering division, which helps to ensure that runoff water entering the storm drain system is clean so that rivers and oceans are not polluted. Our legal counsel advised us that court decisions interpreting Article XIII D have not prohibited local governments from charging its customers water fees that would recoup the costs of the government's water department on other government departments, as long as these fees reasonably represent such costs. However, Downey staff was unable to provide sufficiently detailed evidence to convince us that the transfers from its Water Fund to the Sewer and Storm Drain Fund were for water-related purposes. Because Downey was unable to provide support for which costs the transferred amounts were supposed to recoup, we question the legality of these transfers.

In addition, in fiscal year 2010–11 Downey transferred \$3.3 million from its Water Fund to its Transit Fund, which is used to account for Downey's city-operated bus service for senior citizens and disabled individuals and the fixed-route DowneyLINK bus system. Downey staff provided us with documents showing that the transfer was made to acquire property, in part to accommodate a possible future water treatment plant, and Downey's utilities manager stated that the transfer was made to acquire property necessary to implement water treatment facilities in the future. Downey initially could not provide us with sufficient evidence supporting its recent efforts to construct such a treatment facility. For instance, although Downey's capital improvement plan mentioned the treatment facility, the facility was not listed as a priority. Rather, Downey included it as the fourth of four priorities on its list of potential projects that could be added should funding allow. We questioned whether the funds used to acquire the property for the treatment facility could be considered fees based on potential or future use of a service, which are prohibited by Article XIII D. However, our legal counsel did not identify any case law that directly addressed this issue. Moreover, other case law suggests that water fees could be used to pay for long-term capital expenditures. Regardless, in December 2012, the Downey city council enacted a resolution authorizing the city manager to apply for and submit all required documents to obtain funding for the treatment facility. This resolution mitigated our concern that the fees used to purchase the land were based on a potential or future use of water services.

### **Mechanisms Exist for the Public to Provide Input Into Rate Increases, but They Could Be More Effective**

Given the disparity in water rates charged by retailers and the overall trend of increasing water rates in southeastern Los Angeles County, we examined the processes water suppliers use to set their rates and the protections and safeguards in place to help ensure that consumers are protected from unreasonable rate increases. With water, because a consumer's physical location determines the one retailer that will provide water, the consumer cannot choose among retailers to obtain the lowest rate. Given this lack of direct competition, there is increased risk that water suppliers might charge unjustifiably high rates unless mechanisms exist to effectively challenge proposed rate increases.

MWD has several mechanisms that help ensure that its rates are set appropriately. MWD's 37-member governing board consists of representatives from the 26-member agencies to which MWD sells imported water. Although MWD is a government entity and is governed by a board of directors, its directors are not elected to their positions by voters. Instead, the 26-member agencies each appoint at least one representative to MWD's board, with additional members representing agencies that have at least 5 percent of the district's property value. Therefore, when proposals to increase water rates are presented to the board, the representatives are, in effect, voting to increase the rates the agencies they represent will pay. Also, MWD held public board meetings for the rate increase we selected to review. The public was allowed to attend and participate in these meetings, including voicing objections to the proposed rate increases. Finally, ratepayers can resort to the courts to resolve concerns about rates or the rate-setting process. For example, in June 2010 and June 2012 the San Diego County Water Authority filed lawsuits against MWD contending that some of MWD's rates applied unfairly to the authority.

For local wholesalers, two mechanisms help ensure appropriate water rates: transparency and the election process. The two local wholesalers considered the proposed rates that we reviewed at public hearings or meetings held by their governing boards. The public was allowed to attend and participate in these hearings or meetings, and could voice objections to proposed rate increases. Further, publicly elected governing board members represent consumers in the two local wholesalers' service areas. Consumers can contact their representative on these boards to voice concerns about water rate increases. Consumers are also free to use the election process to replace their representatives on the wholesaler's board if they are not satisfied with the board's actions.

*In June 2010 and June 2012 the San Diego County Water Authority filed lawsuits against MWD contending that some of MWD's rates applied unfairly to the authority.*

The mechanisms that exist to protect ratepayers from unjustified rate increases by retail water suppliers depend on whether the retailer is government operated or investor owned. For government-operated retailers, these mechanisms include transparency and consumer advocacy. Government-operated retailers often hold public meetings at which they discuss rate proposals and accept public comment. In addition, they adopt their rates at public meetings, such as city council meetings. Investor-owned retailers support their proposed rate increases with documentary evidence and testimony when they file a general rate case with the CPUC. Members of the public and consumer groups can participate in general rate cases either informally through written or verbal public comments or formally as an intervenor in the case. Moreover, the CPUC's Division of Ratepayer Advocates represents consumer interests in proceedings with the CPUC.

Proposition 218, passed by voters in 1996, amended the California Constitution to enact procedures to be followed when a local government adopts, extends, or increases taxes, property-related assessments, or property-related fees and charges for, among other things, water service. It requires local government-operated retail water suppliers to provide property owners with written notice of any proposed rate increase at least 45 days in advance of a public hearing, and to explain the purpose for any increase. Proposition 218 prohibits local government-operated retail water suppliers from increasing rates if a majority of property owners present written protests.

In general, our review of selected rate increases found that the local government-operated retail water agencies we reviewed adhered to the notice, hearing, and protest requirements of Proposition 218 when increasing fees and charges for water service. For example, in August 2007, LADWP proposed water rate increases needed in part to maintain and upgrade its water system infrastructure. LADWP informed its customers of the proposed increase 45 days in advance of the public hearing, identified the date and location of the hearing, and provided an address to which ratepayers could submit written comments. LADWP also held several rate proposal workshops and public meetings with neighborhood associations and the public to discuss the proposed increase. The Los Angeles city council held a public hearing in October 2007 at which it heard protests against the rate increase. We asked LADWP how many written protests it had received, and LADWP pointed us to documents indicating that less than a majority of the more than 600,000 water customers in LADWP's service area had submitted written protests. The city council also listened to eight verbal protests against the proposed increase at the hearing. The Los Angeles city council subsequently approved the increase.

*LADWP pointed us to documents indicating that less than a majority of the more than 600,000 water customers in LADWP's service area had submitted written protests.*



Similarly, in April 2011, Downey proposed water rate increases to achieve several purposes, including eliminating a projected \$2 million deficit in its Water Fund and funding capital improvement projects. Downey informed its customers of the proposed increase at least 45 days in advance of the public hearing, identified the date and location of the hearing, and provided an address to which ratepayers could submit written protests. The Downey city council held the public hearing in June 2011, at which the city disclosed that it had received 22 written protests against the rate increase, which, the city attorney advised, did not meet the threshold of 50 percent plus one to defeat the proposed rates. The city council also listened to three verbal protests against the proposed increase at the hearing. The Downey city council subsequently approved the increase by a vote of 5 to 0.

LADWP has an additional mechanism—a consumer advocate—to help provide independent analysis of department actions as they relate to water and electricity rates. In 2011 Los Angeles voters passed a charter amendment to create the Office of Public Accountability (accountability office) to provide greater transparency of LADWP's operations and finances and to analyze proposed increases in water and power rates on a timely and continuous basis. The charter amendment also required that the accountability office include a ratepayer advocate. In February 2012 Los Angeles appointed its first ratepayer advocate within the accountability office. The ratepayer advocate's responsibilities include reviewing the rates, the city's budget and needs, and other relevant issues, including complaints brought by consumers. This individual also is responsible for reviewing proposed rate changes before they are presented to LADWP's board. The accountability office is funded by the city at not less than 0.025 percent of the LADWP's annual revenues. According to the city of Los Angeles' voter information packet, the accountability office is anticipated to cost at least \$1 million per year. While the ratepayer advocate has issued reports on power rate increases, as of early November 2012, he has not yet issued a report on a proposed water rate increase.

Although the mechanisms discussed here are in place to help ensure that water rates and rate increases are justifiable, they may contain flaws that reduce their effectiveness. For instance, although the constitutional provisions put in place by Proposition 218 promote transparency for increased water rates paid by the public and the purposes to be achieved by those increases, the likelihood that a majority of individual property owners in a given service area would submit a sufficient number of written protests seems remote, based on the examples we reviewed. LADWP has more than 600,000 water customers and would need to receive hundreds of thousands of written protests from its customers' property owners to avoid implementing a proposed rate increase. Given the

*The likelihood that a majority of individual property owners in a given service area would submit a sufficient number of written protests seems remote, based on the examples we reviewed.*

***State law prohibits public utilities such as private (investor-owned) water retailers from imposing new rates until the CPUC finds that the new rate is justified.***

limited number of protests received in 2012, it seems unlikely that LADWP would ever receive sufficient protests to force it to reject a rate increase.

Unlike government-operated retailers, investor-owned retailers follow a different rate-setting process, one that is overseen by the CPUC. State law prohibits public utilities such as private (investor-owned) water retailers from imposing a new rate until the CPUC finds that the new rate is justified. The CPUC approves rates for large investor-owned water retailers such as Golden State Water through what it calls a “general rate case” process. This process is similar to a court hearing in that it occurs in front of an administrative law judge. One party—the investor-owned retailer—provides evidence such as documentation and testimony to support the need for a rate increase in a rate case application, while another party—the CPUC’s Division of Ratepayer Advocates—analyzes the application and makes a recommendation about the proposed rate increase that represents consumer interests.

The CPUC process sets water rates for a three-year cycle. According to the supervisor of the CPUC’s Division of Water and Audits Program, the first year of the cycle is called the test year. The retailer presents detailed evidence for that year. The other two years are called *escalation* years. The CPUC allows for rate adjustments in the escalation years by applying something similar to a consumer price index adjustment to the test year. Shortly after the water supplier files a general rate case, the CPUC assigns it to one of its five governor-appointed commissioners and to an administrative law judge. The CPUC’s goal is to complete general rate case proceedings within 18 months.

If the parties in the general rate case filing reach a settlement, they can file a motion to adopt the settlement with the commissioners. The CPUC will then litigate any remaining issues the parties have not settled before the assigned administrative law judge. At the conclusion of the hearing, the administrative law judge issues a proposed decision. The proposed decision includes the judge’s recommended ruling on the litigated issues, as well as the judge’s ruling regarding any proposed settlement the parties have filed.

According to a program and project supervisor in the CPUC’s Division of Water and Audits Program, once the judge issues the proposed decision, a comment period allows the parties to comment on it. After the comment period, the proposed decision is placed on the CPUC’s public agenda at its open meeting for a vote by the five CPUC commissioners. As a final step in the process, any commissioner can issue his or her own alternate proposed



decision for consideration. The commissioners consider the proposed decision, as modified in response to comments, at their open meetings.

Although interested parties such as cities or individual consumers may participate in general rate cases filed with the CPUC, they do not always take advantage of the opportunity. In its general rate case before the CPUC to increase water rates beginning in 2010, Golden State Water applied to increase its rates to generate an additional \$20 million in revenue for 2010. During the general rate case, aside from the CPUC's Division of Ratepayer Advocates, no representatives from Golden State Water's Region 2 (which covers much of southeastern Los Angeles County) were parties to the proceeding.

### Water Agencies' Spending on Legal Services Has Little Effect on the Cost of Water

When faced with increasing water rates, some customers may question whether the water suppliers may be making poor spending decisions—for instance, on litigation involving other water suppliers, administrative overhead, or other factors—that are to blame. Our audit revealed that legal and administrative expenses constituted relatively modest proportions of the overall costs for the seven water suppliers we examined. Finally, we found that reserve levels for the seven suppliers were not excessive and in some instances suppliers used those reserves to decrease costs to customers.

As reflected in the text box, the delivery of water in Los Angeles takes place in a litigious environment. In all, the water suppliers we audited participated in several lawsuits involving other water suppliers since 2008. When we examined the amounts that the suppliers spent on legal services, we found that the costs contributed very little to each water supplier's annual costs and ultimately to the cost of water. Table 4 on the following page shows that from fiscal years 2007–08 through 2011–12, legal costs generally accounted for 1 percent to 2 percent of water suppliers' total operating costs, though individual annual amounts varied from less than 1 percent to about 8 percent.

#### Water Delivery in Los Angeles Takes Place in a Litigious Environment

The entities we audited provided us with information regarding litigation taking place from fiscal years 2007–08 through 2011–12. These seven entities identified more than 30 different lawsuits. Some high-profile litigation currently pending includes:

##### *San Diego County Water Authority vs. Metropolitan Water District of Southern California (filed June 2010)*

San Diego alleges that the Metropolitan Water District of Southern California has imposed unlawful water rates that overstate the costs of transporting water to San Diego.

##### *City of Cerritos, et al. vs. Water Replenishment District (filed August 2010)*

Various cities challenged the Water Replenishment District of Southern California's replenishment assessment, stating that it violated Article XIII D of the State Constitution.

**Sources:** Officials from the seven entities included in our audit as noted in the *Scope and Methodology* section of our report.

**Table 4**  
**Legal Costs as a Percentage of Total Operating Expenses**  
**Fiscal Years 2007–08 Through 2011–12**  
**(Dollars in Thousands)**

SUPPLIER	FISCAL YEAR				
	2007–08	2008–09	2009–10	2010–11	2011–12
<b>Metropolitan Water District of Southern California</b>					
Legal costs	\$8,978	\$9,889	\$7,168	\$8,223	\$5,164
Percentage of total operating expenses	1%	1%	1%	1%	<1%
<b>Central Basin Municipal Water District</b>					
Legal costs	\$993	\$1,235	\$1,425	\$1,672	\$5,206
Percentage of total operating expenses	2%	3%	3%	3%	*
<b>West Basin Municipal Water District</b>					
Legal costs	\$255	\$410	\$292	\$299	\$259
Percentage of total operating expenses	<1%	<1%	<1%	<1%	<1%
<b>City of Downey Department of Public Works</b>					
Legal costs	\$6	\$87	\$801	\$818	\$494
Percentage of total operating expenses	<1%	1%	8%	8%	*
<b>City of Los Angeles Department of Water and Power (LADWP)</b>					
Legal costs	\$593	\$593	\$593	\$593	\$593
Percentage of total operating expenses	<1%	<1%	<1%	<1%	<1%
<b>Water Replenishment District of Southern California (replenishment district)</b>					
Legal costs	\$583	\$583	\$583	\$583	\$583
Percentage of total operating expenses	2%	2%	1%	1%	*
SUPPLIER	FISCAL YEAR				
	2007	2008	2009	2010	2011
<b>Golden State Water Company (Golden State Water)</b>					
Legal costs	\$120	\$146	\$132	\$162	\$207
Percentage of total operating expenses	<1%	<1%	<1%	<1%	<1%

Sources: Assertions from the seven suppliers and applicable Comprehensive Annual Financial reports (CAFRs) or other financial reports for the years noted.

Notes: The amounts shown in the table reflect each entity's assertion about the amount of legal-related expenditures incurred for the years shown. We did not audit these amounts.

The amounts shown generally represent attorney fees paid to outside legal counsel to assist in litigation or other legal matters but may also include other expenses such as paid claims resulting from disputes. LADWP and the replenishment district provided their cost information over a five-year period, which we present as an average across each year shown in the table. Finally, Golden State Water's fiscal year coincides with the calendar year.

\* Not available. These entities did not provide CAFRs for fiscal year 2011–12 in time for us to include this information in our report.

The lawsuits we examined covered a wide variety of issues. The San Diego County Water Authority sued MWD in June 2010 and June 2012 over the rates MWD charged. The San Diego County Water Authority believes that some of MWD's rates unfairly result in higher costs for the authority. These lawsuits were still ongoing in early December 2012. In another case,

three cities filed suit against the replenishment district in August 2010, stating that the process the district used to approve replenishment assessment amounts did not comply with the constitutional provisions enacted by Proposition 218. This lawsuit was still ongoing in early December 2012. Finally, the Central Basin District filed suit against the replenishment district in September 2011 for the rights to three Web sites that the Central Basin District claimed it should own. The Central Basin District eventually dropped this lawsuit in February 2012 after it spent almost \$143,500 pursuing the case and the replenishment district spent almost \$190,100 defending itself.

We also examined the amount of administrative expenses water suppliers incurred and found that spending in these areas was generally a modest portion of an entity's operating costs. Table 5 on the following page shows that from fiscal years 2007–08 through 2011–12, administrative expenses accounted for between 2 percent and 38 percent of suppliers' operating costs. Although Downey's administrative costs constituted between 34 percent and 38 percent of the city's total operating expenses from its Water Fund, Downey's administrative costs of roughly \$3.7 million per year was consistent with amounts spent by the Central Basin District and the West Basin District. Further, the percentages for these two districts—as shown in Table 5—are relatively lower when compared to Downey because both local wholesalers face substantially higher total operating costs resulting from the purchase of imported water. As a result, despite the higher percentage of general and administrative costs, Downey's spending seems consistent with many of the suppliers we included in Table 5.

In addition to litigation and administrative expenses, we also examined how funds retained by water suppliers in the form of unrestricted reserves (reserves) changed from fiscal years 2007–08 through 2011–12. As Table 6 on page 37 demonstrates, the overall trend is that water suppliers' reserves—when taken as a percentage of their operating expenses—have generally been declining. For example, Downey has seen its reserves for its Water Fund decrease from \$9.6 million in fiscal year 2007–08, which represented 96 percent of its annual operating expenses, to nearly \$600,000 in fiscal year 2010–11, representing 6 percent of its annual operating expenses. Other water suppliers, as shown in the table, have also seen more modest decreases in their reserve amounts. The one exception to this trend is LADWP, whose reserves have been steadily increasing.

Unrestricted reserves are funds that water suppliers can spend for any purpose they deem necessary and result from revenues that exceed their associated costs and capital contributions. Sometimes water suppliers target certain reserve amounts when preparing their annual budgets to ensure they have enough money available to cover unexpected expenditures, future capital outlay projects, or to help maintain strong credit ratings.

*Although Downey's administrative costs constituted between 34 percent and 38 percent of the city's total operating expenses from its Water Fund, Downey's administrative costs were consistent with amounts spent by the Central Basin District and the West Basin District.*

**Table 5**  
**Administrative Costs as a Percentage of Total Operating Expenses**  
**Fiscal Years 2007–08 Through 2011–12**  
**(Dollars in Millions)**

SUPPLIER	FISCAL YEAR				
	2007–08	2008–09	2009–10	2010–11	2011–12
<b>Metropolitan Water District of Southern California</b>					
Administrative costs	\$89.7	\$91.7	\$78	\$89.5	\$110.8
Percentage of total operating expenses	9%	9%	7%	9%	10%
<b>Central Basin Municipal Water District</b>					
Administrative costs	\$3.7	\$1.8	\$3.5	\$3.8	*
Percentage of total operating expenses	9%	5%	7%	7%	*
<b>West Basin Municipal Water District</b>					
Administrative costs	\$3.6	\$2.8	\$3.1	\$2.9	\$2.8
Percentage of total operating expenses	3%	2%	2%	2%	2%
<b>City of Downey Department of Public Works</b>					
Administrative costs	\$3.6	\$3.3	\$3.8	\$3.7	*
Percentage of total operating expenses	36%	34%	36%	38%	*
<b>City of Los Angeles Department of Water and Power</b>					
Administrative costs	\$90.7	\$89.8	\$107.0	\$94.6	\$94.7
Percentage of total operating expenses	15%	14%	16%	15%	15%
<b>Water Replenishment District of Southern California</b>					
Administrative costs	\$5.3	\$5.5	\$5.6	\$7.4	*
Percentage of total operating expenses	20%	18%	11%	13%	*
SUPPLIER	FISCAL YEAR				
	2007	2008	2009	2010	2011
<b>Golden State Water Company (Golden State Water)</b>					
Administrative costs	\$16.1	\$18.5	\$19.8	\$20.5	\$22.2
Percentage of total operating expenses	21%	23%	22%	21%	22%

Sources: Comprehensive Annual Financial reports (CAFRs) or other entity-provided financial reports for the years noted.

Notes: The amounts shown in the table generally reflect each entity's general and administrative expenses as a proportion of total operating expenses. We did not audit these amounts. Also, the data for Golden State Water pertains only to its Region 2 service area that includes Southern Los Angeles County. The amounts shown for Golden State Water are based on its statement of earnings reports. However, according to its vice president of regulatory affairs, the format of this report overstates the true administrative costs for Golden State Water's Region 2 because the report includes the total allocated costs of Golden State Water's other offices, such as its general office and regional headquarters. Golden State Water's vice president estimates that the overstatement amounts to roughly \$1.5 million per year.

\* Not available. These entities did not provide CAFRs for fiscal year 2011–12 in time for us to include this information in our report.

Some water agencies have used their reserves to avoid increasing their water fees for consumers. According to budget documents provided by Downey for its Water Fund, its water operations had been operating at a loss during fiscal years 2008–09 through 2010–11. Although Downey did not change its water rates, budget documents indicate that its Water Fund operated at a deficit of \$3.5 million over this three-year period. It was not until Downey increased its rates for fiscal year 2011–12

that the annual deficit was corrected. Similarly, documents from the replenishment district indicated that the agency budgeted to use \$8.3 million in reserves in fiscal year 2010–11 and \$10 million in fiscal year 2011–12 to subsidize the replenishment assessment the agency collects from those who pump groundwater.

**Table 6**  
**Reserves as a Percentage of Total Operating Expenses**  
**Fiscal Years 2007–08 Through 2011–12**  
**(Dollars in Millions)**

SUPPLIER	FISCAL YEAR				
	2007–08	2008–09	2009–10	2010–11	2011–12
<b>Metropolitan Water District of Southern California</b>					
Reserves	\$529.2	\$503.2	\$417.1	\$466.7	\$605.8
Percentage of total operating expenses	54%	47%	39%	45%	55%
<b>Central Basin Municipal Water District</b>					
Reserves	\$26.0	\$23.3	\$23.7	\$28.8	*
Percentage of total operating expenses	63%	59%	46%	55%	*
<b>West Basin Municipal Water District</b>					
Reserves	\$79.5	\$66.9	\$55.5	\$58.1	\$62.6
Percentage of total operating expenses	69%	56%	40%	40%	42%
<b>City of Downey Department of Public Works</b>					
Reserves	\$9.6	\$7.7	\$5.1	\$0.6	*
Percentage of total operating expenses	96%	79%	49%	6%	*
<b>City of Los Angeles Department of Water and Power</b>					
Reserves	\$39.8	\$66.1	\$160.8	\$140.9	\$250.0
Percentage of total operating expenses	7%	10%	24%	22%	39%
<b>Water Replenishment District of Southern California</b>					
Reserves	\$20.8	\$34.7	\$32.8	\$19.0	*
Percentage of total operating expenses	77%	113%	67%	34%	*

Sources: Comprehensive Annual Financial reports (CAFRs) or other entity-provided financial reports for the fiscal years noted.

Notes: The amounts shown in the table reflect each entity's unrestricted reserves, which can be spent however the entity deems is advisable and consistent with law. We did not audit these amounts. We have not included the Golden State Water Company (Golden State Water) in our table since its financial reports do not indicate it maintains reserves. Instead, Golden State Water is a privately operated entity whose capital structure consists of shareholder equity, long-term debt, and other credits.

\* Not available. These entities did not provide CAFRs for fiscal year 2011–12 in time for us to include this information in our report.

LADWP reserve amounts increased by \$210 million, or 528 percent, from fiscal years 2007–08 through 2011–12. LADWP's manager of financial reporting stated that a large portion of this increase was due to loans from the State—\$43.5 million from Water Resources to fund water-quality capital improvements and \$55 million from the Department of Public Health to assist in financing construction of a project that will enable LADWP to meet safe drinking water standards—and that these funds can only be used for projects approved by the State.

### Recommendations

To ensure that it can meet the burden of proof that its water fees comply with Article XIII D of the California Constitution, Downey should be able to provide, upon request, documentation that all transfers out of the Water Fund are for water-related purposes. Such documentation should be sufficiently detailed and understandable to the layperson.

If it believes that the mechanisms available to consumers in southeastern Los Angeles County to protect against unreasonable rates or rate increases are not sufficient, the Legislature should consider enacting additional consumer protection mechanisms. Mechanisms to consider include ratepayer advocacy positions similar to those used by the CPUC and LADWP.

We conducted this audit under the authority vested in the California State Auditor by Section 8543 et seq. of the California Government Code and according to generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives specified in the scope section of the report. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Respectfully submitted,



ELAINE M. HOWLE, CPA  
State Auditor

Date: January 29, 2013

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For questions regarding the contents of this report, please contact Margarita Fernández, Chief of Public Affairs, at 916.445.0255.

(Agency comments provided as text only)

City of Downey  
11111 Brookshire Avenue  
Post Office Box 7016  
Downey, California 90241-7016  
December 20, 2012

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

Re: Audit 2012-104 - Southeast Los Angeles County - Water Cost and Delivery-Draft Report

Dear Ms. Howle:

On December 14, 2012, the City received two (2) draft copies of the Southeast Los Angeles County - Water Cost and Delivery Audit Report ("draft report"). The City of Downey provides its comments and clarifications to the draft report and kindly requests that the City's responses be considered in finalizing the draft report. Of course, the City's staff is available to discuss these comments and provide additional documentation as your office deems necessary.

1. Draft Report Comment - Pages 4 and 5

①

*"When examining water rates, we observed that portions of Downey's rates may not be allowable under the California Constitution. Because Downey could not substantiate that almost \$1 million in revenues that it transferred from its Water Fund to other funds were actually for specific water-related purposes, we question whether these transfers comply with the provisions of Article XIII D of the California Constitution, added by Proposition 218 in 1996. Under these provisions, revenues derived from a fee or charge cannot exceed the funds required to provide the service, revenues cannot be used for purposes other than those for which the fee or charge was imposed, and the local agency imposing the fee bears the burden of proving the fee complies with the article. We found that during fiscal year 2008-2009 through fiscal year 2010-11, Downey transferred almost \$1 million from its Water Fund to other funds. Although Downey staff told us that the transfers to the Sewer and Storm Drain Fund paid for costs incurred by the stormwater engineering division, they were unable to provide sufficient documentation supporting what costs the transferred amount represented. Our legal counsel advised us that court decisions interpreting Article XIII D have not prohibited local governments from charging its customer water fees that would recoup the costs of the government's water department on other departments, as long as these fees reasonably represent such costs. We therefore questioned the legality of these transfers."*

②

③

**City Response:**

Your office states in the draft report that the City was unable to substantiate with sufficient documentation that the "almost \$1 million" in revenues that the City transferred from its Water Fund to other funds was for water-related activities. This statement is in fact, inaccurate.

② ④

\* California State Auditor's comments begin on page 47.



(2) (4)

Over the course of the 6-month audit process, the City provided the following documents directly relevant to the revenues (which is closer to approximately \$600,000 and not \$1 million) that the City transferred from its Water Fund to other funds for water-related purposes:

1. Sewer and Storm Water Fund Capital and Engineering budget documents for Fiscal Years 07/08 and end-of-year expenditure reports;
2. Comprehensive Annual Financial Reports (CAFR) detailing the nature of the transfers.

(2) (4)

These documents show that the transfer of the \$600,000 of revenues from the Water Fund to other funds were for water-related purposes

Second, the City submitted to your office annual budget documents for Fiscal Years 07/08 and 11/12, where the City Council reviewed and approved the allocation of Water Fund fees to the Sewer and Storm Drain Fund for water-related activities, specifically illustrating that:

1. The Water Fund received direct benefits from Storm Water Engineering efforts in the form of capturing and storage of runoff through development requirements and City projects to raise water levels for the City's groundwater wells, as well as for runoff compliance costs caused by the City's water system since all dry weather flows emanate from the City's source water; and
2. The Water Fund received direct benefits from the Sewer and Storm capital improvements by preventing contamination of the City's groundwater from leaking sewer pipes/facilities.

(5)

Lastly, this paragraph makes a blanket statement questioning generally City Water Fund transfers, when in fact, your office did not question all Water Fund transfers, but only certain transactions occurring in Fiscal Years 2009-2011 as we discussed on our last telephonic conference call on December 19, 2012.

(6)

Based on the aforementioned documentation coupled with the numerous conference calls with your office to explain the nexus between the transfer of Water Fund revenues to other funds, the City has more than met its burden of proof that the amounts of the water revenue transfers to other funds were adequately supported and justified under California Constitution Article XIII D. If your office determines to leave the above-referenced paragraph in the audit report, we request that the language acknowledge the fact that the City had provided a substantial number of documents (as listed above) to justify the Water Fund transfers and specify that only certain Water Fund transfers were questioned by your office.

## 2. Draft Report Comment - Page 6, 2<sup>nd</sup> Paragraph

### *"Recommendations*

*To ensure that it can meet the burden of proof that its water fees comply with Article XIII D of the California Constitution, Downey should be able to provide, upon request, documentation that all transfers out of the Water Fund are for water-related purposes. Such documentation should be detailed and understandable to the layperson."*<sup>1</sup>

(7)

<sup>1</sup> After the draft report was received by the City, your office notified city staff on December 19, 2012 (the day before this response was due to your office) that the original language under this heading would be changed. Accordingly, the City's comments contained herein respond to this modified language and not to the language appearing in the draft report.

City Response:

As discussed in more detail in Paragraph 1, the City of Downey has met its burden of proof that the amounts of the water revenue transfers to other funds were adequately supported and justified under California Constitution Article XIII D.

3. Draft Audit Report- Pages 8, 3<sup>rd</sup> Paragraph

*"Figure 3 shows that the proportion paid to the replenishment district varies among the retailers we examined, and the proportion of the retailers' rates that goes to local wholesalers is relatively small. For example, 56 cents, or 52 percent, of Downey's \$1.08 rate of per unit,<sup>3</sup> would go to the replenishment district. In comparison, [REDACTED] of [REDACTED]'s rate would go to [REDACTED]"*

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City Response:

The Replenishment Assessment (RA) levied by the Water Replenishment District of Southern California (WRD) for every acre-foot of groundwater pumped by water providers such as the City of Downey is adopted on an annual basis by WRD's Board of Directors and is outside of the water providers' control. Depending on the operations of the water provider, the annual cost for WRD's RA can vary drastically depending upon whether groundwater makes up a small or large amount of the water providers' water supply portfolio. Up until FY 00/01, the City of Downey used small amounts of treated imported water (purchased from MWD-member agency Central Basin Municipal Water District (CBMWD)) to augment its annual potable water supplies. However, due to the ever-rising cost of this water coupled with the potential unreliability of this source due to environmental and other issues, the City prudently moved away from the use of imported drinking water and began using groundwater to meet 100% of its potable water demands beginning in FY 00/01 to help minimize costs for its customers and to ensure a reliable source of drinking water into the future.

Unfortunately for the City of Downey, from 2000 to 2012, WRD subsequently increased its RA from \$112 per acre-foot (AF) of groundwater pumped to \$244/AF, an increase of **118%**. As seen from the analysis provided in the draft report, the cost that the City of Downey pays WRD for its RA constitutes **52%** of Downey's per unit rate, which represents **over half** of the rate that Downey's customers have to pay which is outside of the City of Downey's control. This fact can hardly be characterized as "relatively small," particularly when uncontrolled increases in the RA by WRD have to be borne by Downey's customers. Obviously for those water providers which do not pump much groundwater, the portion of the rate going to WRD for payment of the RA would be much less. However, this impact to the City and its customers is quite **significant** and we respectfully request that this fact be stated in the report.

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The City of Downey understands that this audit report focuses on the most recent five year period; however since the City had not increased its rates for 16 years until recently, in 2011, the continued increase in WRD RA costs year-after-year from when Downey transitioned to 100% groundwater in 2000 through 2012 is relevant and the most significant factor in Downey needing to raise its water rates.

4. Draft Audit Report- Page 10, 2<sup>nd</sup> Paragraph

*"Groundwater can be less expensive than imported water. For instance, retailers purchasing treated imported water in 2012 from local wholesalers paid \$ [REDACTED] ([REDACTED]) or \$ [REDACTED] ([REDACTED]) per acre-foot<sup>4</sup>. In contrast, a water supplier that pumped groundwater out of the Central or West Coast basin paid the replenishment district an assessment of \$244 per acre-foot. If well operation and maintenance costs were \$200 per acre-foot, the total cost of groundwater would be \$444 per acre-foot, or \$ [REDACTED] less than imported water purchased from [REDACTED] and \$ [REDACTED] less than imported water purchased from [REDACTED]."*

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City Response:

The City of Downey agrees that groundwater is generally less expensive than imported water as previously demonstrated by the City's move away from the use of imported water for potable water needs to 100% groundwater in FY 00/01.

- ⑩ Although generally less expensive than imported water, groundwater pumpers in the area have still witnessed a detrimental increase in the WRD RA costs in recent years, rising **118%** from \$112 per acre-foot (AF) of groundwater pumped in 2000 to \$244/AF in 2012; increases that have not been adopted in compliance with California Constitution Article XIII D (Proposition 218) and are illegal.<sup>2</sup> These cost increases in WRD's RA are subsequently paid for by groundwater pumpers' customers such as those in the City of Downey. Further, well operations and maintenance costs can vary widely from one groundwater pumper to the next depending upon water supply system operational factors. As the scope of this audit is to determine the various reasons that affect the rates water suppliers charge, the City of Downey feels that these two issues should be expanded to include this information to provide clarity on the trends and factors that affect water customers' rates in the region.

5. Draft Audit Report- Page 11

"Scope and Methodology

*The Joint Legislative Audit Committee (audit committee) directed the California State Auditor to perform an audit to evaluate the cost of water delivery in southeastern Los Angeles County. Specifically, the audit committee directed the California State Auditor to focus on the significant factors that contribute to a water customer's bill to identify the reasons for the rising cost of water, as well as methods to improve the cost-effectiveness of water delivery. The audit analysis the audit committee approved contained six separate objectives. We list the objectives and the methods we used to address them in Table 1."*

(and)

Page 17, Item No. 6

*"Review and assess any other issues that are significant to the cost and delivery of water to Los Angeles County residents and business."*

*"No other issues came to our attention."*

City Response:

As more fully discussed above, the **118% increase in WRD RA costs** from \$112 per acre-foot (AF) of groundwater pumped in 2000 to \$244/AF in 2012, and the fact that this RA constitutes **52%** of Downey's per unit rate provided in the report is **significant**. Neither Item No. 2 or Item 6 in Table 1 appear to clearly define

⑩ <sup>2</sup> As we have previously advised your office, the Los Angeles Superior Court entered an order on April 25, 2011, in City of Cerritos, et al. v. WRD, Case No. BS 128136 ("Cities Litigation"), declaring WRD's RA over the last four years (2006-10) to be illegal pursuant to Article XIII D of the California Constitution. The Court further ruled WRD must comply with Article XIII D before adopting any new RA. WRD has not done so. WRD adopted the 2011-2012 RA and the 2012-2013 RA without complying with Article XIII D, in complete disregard of the April 25, 2011 Order.

Again, on December 11, 2012, Judge Dau of the Los Angeles Superior Court ruled in the Cities Litigation that the Cities have a right to a refund of illegal excessive RAs collected by WRD for the period 2006-10 in violation of the California Constitution Article XIII D.

WRD's RA as a significant factor. The City of Downey assumes it was not the intent of Table 1 to gloss over this factor, particularly considering how far-reaching WRD's RA costs are to the millions of residents in the region, and recommends that Item No. 2 or Item No. 6 be amended to include WRD's RA as such a factor.

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6. Draft Audit Report-Page 12, 2<sup>nd</sup> Paragraph

*"Specifically, we identified increases in the rates each entity charged and determined why significant increases occurred from one year to the next. Although we identified several reasons for these rate increases, the most prevalent one was that the suppliers' own costs increased. Because suppliers base the rates they charge on the amount of annual revenue they believe necessary to cover their annual costs, when costs increase, so do rates. For example, [REDACTED]. Other reasons for rate increases included improving water conservation by implementing a tiered rate structure in which those consumers who use more water pay higher rates, and eliminating deficits when annual revenues are not sufficient to cover the costs of providing water."*

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City Response:

Although the City of Downey generally agrees with the intent of this paragraph, the use of the phrase "suppliers own costs" misleads the reader into the belief that all of these costs are generated solely by the water supplier when in fact many water suppliers' costs are outside of its control. Typically, these outside costs are passed through from the water supplier to the water customer via water rates. For example, the dramatic increases of the RA by WRD is solely controlled by the WRD Board; electricity, recycled water, inflation, and fuel costs are all outside of a water suppliers' control and are controlled by market forces. In the case of the City of Downey, the RA, electricity, recycled water, inflation, and fuel costs make up the majority of its costs in operating its water supply and distribution system. Downey recommends the wording in this paragraph be amended and expanded to provide clarification on these costs.

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7. Draft Audit Report-Page 13, Bottom Paragraph

***"Different Cost Factors and a Desire to Promote Conservation Contributed to Retailers' Rate Increases***

*The water rates charged by the three water retailers we reviewed increased from 2008 through 2012. As indicated in Figure 7, the monthly cost of 20 units of water purchased from [REDACTED] from \$60.64 in July 2008 to \$84.05 in July 2012, an increase of \$23.41 (39 percent). Over the same time period and for the same amount of water, [REDACTED]'s monthly costs increased by \$33.45 (50 percent), from \$66.71 to \$100.16. For water purchased from Downey, the monthly cost for 20 units of water increased by \$15.09 (64 percent), from \$23.48 to \$38.57."*

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City Response:

The City of Downey understands the need for a basis of water rate comparisons. However the focus, as presented, appears to be on the amount of the increase and corresponding percent with ***no mention of the fact that Downey's water rates are one of the lowest in the region and the State.*** Although the percentage rate increase appears high, it is due to the fact that the ***City of Downey had held its rates at the same level for 16 years.*** For this 16-year period, the increase in costs for water services had been subsidized by the City's general fund. Given the significance of these two factors on the City's water rates, the City feels these points should be included in the final report.

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8. Draft Audit Report-Pages 15 (bottom) to 17

***“Portions of Downey’s Water Fees May Not Be Allowable under the California Constitution***

*Downey’s water rates may generate funds that exceed the amount required to provide its water services, which would violate the California Constitution. Under Article XIII D of the California Constitution, which was added by Proposition 218 in 1996, a property-related fee or charge shall not be extended, imposed, or increased by an agency unless it meets certain requirements. These requirements include provisions that revenues derived from the fee or charge shall not exceed the funds required to provide the property-related service and that these revenues shall not be used for any purposes other than that for which the fees or charge was imposed. In addition, fees or charges based on potential or future use of a service are not permitted. Article XIII D also specifies that the local agency imposing a fee bears the burden of proving the fee complies with the article. In 2006 the California Supreme Court determined that a public water agency’s charges for on-going water delivery are property-related fees under Article XIII D. In other words, water fees paid by customers are subject to the requirements of Article XIII D.”*

*Downey transferred revenues generated from water fees for uses that it was unable to sufficiently substantiate were related to water service. During fiscal year 2008-09 through fiscal year 2010-11, Downey transferred almost \$1 million from its Water Fund, which is used to account for the provision of water services to residential, commercial, and industrial customers, to other government funds. Downey’s financial statements indicate that these transfers were made to provide funding for capital expenditures. When we asked Downey for specific details on the amounts transferred to its Sewer and Storm Drain Fund, which is used to account for charges collected for the upkeep of sanitary sewers and federally required drainage upkeep programs, Downey’s finance manager explained that the Water Fund paid for the costs incurred by its stormwater engineering division, which helps to ensure that runoff water entering the storm drain system is clean so that rivers and oceans are not polluted. Our legal counsel advised us that court decisions interpreting Article XIII D have not prohibited local governments from charging its customers water fees that would recoup the costs of the government’s water department on other government departments, as long as these fees reasonably represent such costs. However, Downey staff was unable to provide sufficient documentation supporting what costs the transferred amounts represented. Because Downey was unable to provide support for what costs the transferred amounts were supposed to recoup, we question the legality of these transfers.*

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**City Response:**

We incorporate by reference the response we provided in Paragraph 1 above as the City’s response to this paragraph.

9. Draft Audit Report-Pages 17 (2<sup>nd</sup> Paragraph) to 18

*“In addition, in fiscal year 2010-11 Downey transferred \$3.3 million from its Water Funds to its Transit Fund, which is used to account for Downey’s city-operated bus service for senior citizens and disabled individuals and the fixed-route DowneyLINK bus system. Downey staff provided us with documents showing that the transfer was made to acquire property, in part to accommodate a possible future water treatment plant. Downey’s utilities manager stated that the transfer was made to acquire property necessary to implement water treatment facilities in the future. Downey initially couldn’t provide us with sufficient evidence supporting its recent efforts to construct such a treatment facility. For instance, although Downey’s capital improvement plan mentioned the treatment facility, the facility was not listed as a priority. Rather, Downey included it as the fourth of four priorities on its list of potential projects that could be added should funding allow. We questioned whether the funds used to acquire the property for the treatment facility could be considered fees based on potential or future use of the service, which are prohibited by Article XIII D. However, our legal counsel did not identify any case law that directly addressed this issue. Moreover, other case law suggests that water fees could be used to pay for long-term capital expenditures. Regardless, in December 2012, the Downey city council enacted a resolution authorizing the city manager to apply*

*for and submit all required documents to obtain funding for the treatment facility. This resolution mitigated our concern that the fees used to purchase the land were based on a potential or future use of water services."*

**City Response:**

The City of Downey finds the presentation of the above issue in its current form confusing and misleading. At the onset, there is mention of a transfer to the Transit Fund and inclusion of a long definition of what the Transit Fund is with no explanation as to the reasoning for such a transfer and the relationship of the Transit Fund to this property acquisition as provided by the City. Further, the second and third sentences are repetitive. The chief reason for transferring among funds for such a project is for ease of transaction where one fund operates in essence, like a clearinghouse. Additionally, the treatment plant as currently proposed, would occupy the existing Utilities Yard property requiring the existing offices, parking, vehicle/equipment/material storage, and other displaced by the treatment facilities to be rebuilt elsewhere. Space occupied by the displaced facilities would take up approx. 90% of the properties acquired by this transaction which is greater than the percentage of the property acquisition funds paid by the water fund (approx. 80/20). However, since the displaced facilities would need to be rebuilt, the intent was to consolidate operations on the newly acquired property to allow space for transit vehicle parking. Given the relationship of the two funds to this project, the first part of this paragraph as described above, is misrepresented and should be amended to provide clarification.

In the same paragraph, your office states that Downey initially could not provide the Auditor with sufficient documents supporting its recent efforts to construct such a treatment facility. This statement is inaccurate. Over the course of the 6-month audit process, the City provided the following documents directly relevant to the efforts made by the City in 2008, 2009, 2010, 2011 and 2012 to move the water treatment plant project forward:

1. April 9, 2008 letter from Representative Lucille Roybal-Allard that the U.S. House Committee on Transportation and Infrastructure would consider the "Water Resources Development Act bill;
2. A copy of House of Representative Bill (H.R.) bill 1738 entitled "Downey Regional Water Reclamation and Ground water Augmentation Project" which would be the funding vehicle for Downey's waste treatment plant'
3. Downey Delegation Schedule dated April 20-12, 2009 to lobby in favor of H.R. 1738;
4. November 9, 2010 Downey City Council staff report approving the acquisition of the properties at 9300 Stewart & Gray Road and a portion of 11921-12007 Woodruff Avenue, Downey for the water treatment plant;
5. Resolution No. 12-7386 dated December 11, 2012 reaffirming the Downey City Council's support for the water treatment plant project and directing the City Manager to secure funding for the project.

These documents provide evidence that:

- the City made a request in 2008 pursuant to the Water Resources Development Act funding for the project;
- the City made requests for appropriations with our federal legislators in 2009 to help fund the project;
- the City staff worked on legislation (HR 1738) to the House Committee on Natural Resources in 2010 that would have provided funding for the project;
- the City completed the purchase of the land for the project in 2011; and
- the City Council reaffirmed its support and commitment for the project at the Council Meeting in December 2012, including authorization for the City Manager to secure funding for the project.

- ⑩ The last part of the paragraph explains that there is **lack** of any case law addressing your office's concerns regarding the use of Water fees to partially acquire property for the water treatment plant. Your office also recognizes that there is support in case law which allows water fees to be used to pay for long-term capital expenses. Given the nature of the law and the documentation and clarification provided to your office, the City questions the reasoning for inserting as the heading to this paragraph: "Portions of Downey's Water Fees May Not Be Allowable under the California Constitution". The City's position is that this heading is misleading in light of your office's acknowledgement that there is no case law that would lead your office to conclude that the City's use of Water fees for the partial acquisition cost for the property was in violation of California Constitution Article XIII D.

10. Draft Audit Report-Page 24

#### ***"Recommendations***

*To ensure that it can meet the burden of proof that its water fees comply with Article XIII D of the California Constitution, Downey should be able to provide, upon request, documentation that all transfers out of the Water Fund are for water-related purposes. Such documentation should be detailed and understandable to the layperson."*

#### **City Response:**

- ④ ⑥ The City of Downey has already met the burden of proof that the amounts of the water revenue transfers to other funds were adequately supported. This burden of proof was thoroughly provided in the form of tables, budget documents, expenditure reports, and statements to the Auditor supporting these transfers. This burden of proof is also provided each year during the annual budget process where the Council approved policies were to fund costs of the Sewer and Storm Drain Fund since the Water Fund a) was receiving direct benefits from Storm Water Engineering efforts in the form of capturing and storage of runoff during dry and wet weather conditions through development requirements and City projects to raise the local water levels which benefit the City's groundwater wells, as well as the runoff compliance costs caused by the City's water system since all dry weather flows emanate from the City's source water; and b) was receiving direct benefits from the Sewer and Storm capital improvements in the form of preventing contamination of the City's groundwater from leaking sewer pipes/facilities. The City has been very cooperative in thoroughly answering questions related to these transfers and such information should be reflected in the audit report should this item continue to be included.
- ⑦ Lastly, we note that your office submitted a material change to its recommendations in the draft report a day before this formal response was due to your office. Our position is that the material change did not give the City sufficient time to respond to the draft report and that the City should have been given additional time to prepare this response.

If you have any questions regarding the City's response to the draft report, you may contact me at (562) 904-7282 or at [joskoui@downeyca.org](mailto:joskoui@downeyca.org).

Sincerely,

*(Signed by: John Oskoui)*

John Oskoui  
Assistant City Manager/  
Director of Public Works



## Comments

### CALIFORNIA STATE AUDITOR'S COMMENTS ON THE RESPONSE FROM THE CITY OF DOWNEY

To provide clarity and perspective, we are commenting on the City of Downey's (Downey) response to our audit. The numbers below correspond to the numbers we have placed in the margins of Downey's response.

When preparing our audit report for publication, page numbers shifted. Therefore, the page numbers that Downey cites throughout its response do not correspond to the page numbers in our final report.

Downey's response quotes our draft report stating that the city had transferred almost \$1 million from its Water Fund to other funds during fiscal years 2008–09 through 2010–11. However, the draft report was revised to state that our audit work regarding these transfers, including our discussions with Downey, related to fiscal years 2007–08 through 2010–11. Pages 2 and 27 of our final report reflect this change.

To clarify our point regarding Downey not providing sufficient evidence regarding certain transfers from its Water Fund, we revised a portion of the text on pages 2 and 28 of our report. These revisions did not affect our conclusions concerning this issue.

Our statement is accurate and we stand by our text. Downey takes issue with our conclusion that, in our auditor opinion, the city could not substantiate that its transfer of nearly \$1 million from its Water Fund was for water-related purposes. As we indicate on page 27 of our report, the California Constitution places the burden of proof on Downey to demonstrate that its fees bear a reasonable relationship to the cost of providing water-related services. Although only a court of law can decide upon the legality of Downey's fees, the point of our critique and resulting recommendation is that Downey needs to maintain clearer documentation specifying the methodology and rationale supporting the amounts transferred so it can more readily defend its actions to water ratepayers. Beginning in early November 2012, we had asked Downey to provide us with the methodology and/or calculations it had used to determine the amounts transferred. Although Downey provided us with budget documents and audited financial statements, these documents did not explain why the nearly \$1 million in transfers reflected costs specifically attributable to its water system. During the audit, Downey provided only high-level verbal explanations, such as those in its response to the audit, which in our opinion does not provide us with sufficient and

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appropriate evidence to conclude on whether Downey's transfers consistently reflected water-related costs as opposed to other city expenses.

- ⑤ Downey states that our report makes a blanket statement questioning generally its transfers from its Water Fund. Our report makes no such statement. In fact, as we mention on page 28 of our report, our legal counsel advised us that court decisions interpreting Article XIII D of the California Constitution have not prohibited local governments from charging its customers water fees that would recoup the costs of the government's water department on other government departments, as long as these fees reasonably represent such costs.

Downey also states that we did not question all water fund transfers. During numerous telephone calls involving Downey and staff of the California State Auditor's office, we discussed examples of the types of transactions we remained unconvinced were for water-related purposes. We did not state nor imply that these were the only transactions we were questioning.

- ⑥ Downey believes that it has more than met its burden of proof that the amounts transferred to other funds were adequately supported. Despite the city's belief, we stand by our statements on pages 27 and 28 of our report that, in our auditor opinion, Downey transferred revenues generated from water fees for uses that it was unable to sufficiently substantiate were related to water service.

- ⑦ Downey's statement on page 46 of our report that the amendment to our recommendation did not give the city time to respond to the draft report is perplexing. This statement is inconsistent with the statement on page 40 of our report that its comments respond to the amended recommendation and not the language appearing in the original draft report.

- ⑧ Downey's response includes quotes from our draft report that contained redactions. We redacted portions of the draft report sent to Downey to maintain the confidentiality of certain information provided by other entities included in our audit.

- ⑨ Downey misunderstands this sentence of our report. We did not characterize the Water Replenishment District of Southern California's (replenishment district) share of Downey's rate as relatively small. As we state on page 8 of our report, the proportion of the retailers' rates that goes to *local wholesalers* is relatively small. As Figure 3 on page 9 of our report shows, no part of Downey's rate goes to local wholesalers.

Downey's response cites an ongoing court case and concludes with a statement that the replenishment district's assessment (i.e. the fee it imposes for pumping groundwater) is illegal. According to the replenishment district's general manager, while a trial court has determined that the replenishment district's imposition of replenishment assessments violated the California Constitution, the court has not yet assessed damages. Furthermore, according to documents pertaining to the replenishment district, it intends to appeal the trial court's determination. Also, because of this ongoing litigation and in accordance with generally accepted government auditing standards that cautions against interfering with such ongoing legal proceedings, we performed no audit work related to the legality of the replenishment district's assessment.

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Downey's response takes issue with the Scope and Methodology section of our report, claiming that the replenishment district's rising assessment should be considered a significant factor. We believe our Scope and Methodology table accurately describes our audit approach. Further, the scope of the audit as approved by the Joint Legislative Audit Committee did not include a review of how the replenishment district sets its rates. Nevertheless, on page 27 of the audit report we provide the reader with some context for one of the replenishment district's more recent rate increases and its cause.

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Contrary to Downey's assertion, our report is not misleading. Our report clearly states on page 8 that the rates consumers pay to retailers help cover the costs of the various water agencies along the water supply chain. For example, Figure 3 on page 9 shows our estimate that more than half of Downey's water rate is attributable to costs imposed by the replenishment district. The paragraph that Downey takes issue with in its response is a summary paragraph from our draft report. We stand by the full text as written in our audit report.

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Downey's criticism of our report is unwarranted. Our report recognizes Downey's lower water rates, as illustrated in Figure 3 and Figure 7 on pages 9 and 25, respectively. In Figure 3 we estimated that Downey's costs were \$1.08 per hundred cubic feet, or roughly three times less than the amounts charged by the other two retailers we reviewed. Similarly, Figure 7 shows that for a given amount of water, Downey's monthly water bill is significantly less than the two other retailers included in the audit. Finally, on pages 26 and 27 of the report, we discuss Downey's rationale for recently increasing its water rates. As such, we stand by our report's text.

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- ⑭ Contrary to Downey's claim, our text is clear and does not misrepresent the facts associated with Downey's transfer of \$3.3 million from its Water Fund. The relevant facts are, as we state on page 28 of our report, that Downey transferred \$3.3 million from its Water Fund to its Transit Fund and that the transfer was made to acquire property, in part to accommodate a possible future water treatment plant. Downey's discussion of other detailed information in this paragraph of its response—for example, the relationship between its Water Fund and Transit Fund—is irrelevant.
- ⑮ We stand by the statement in our report that Downey could not initially provide sufficient documents supporting its efforts to build a water treatment facility on the acquired property. On page 28 of our report, we stated that although Downey's capital improvement plan mentioned the treatment facility, the facility was not listed as a priority, and that Downey included it as the fourth of four priorities on its list of potential projects that could be added should funding allow. Other documents related to the treatment facility provided during the audit were dated from April 2008 through April 2011. Further, a November 2012 e-mail to us from Downey's utility manager stated that the city took advantage of an opportunity to acquire the land to, among other things, implement water treatment facilities *should they be needed in the future*. Based on this information, we reasonably questioned Downey's inability to provide sufficient evidence of its recent efforts to construct the facility. Our concern that the water fees used to purchase the land were based on a potential or future use of water services, and therefore may be inappropriate under the California Constitution, was not mitigated until the Downey city council enacted a resolution in December 2012 authorizing the city manager to apply for and submit all required documents to obtain funding for the treatment facility. We clearly make this point on page 28 of our report.
- ⑯ Downey incorrectly claims that the heading on page 27 of our report is misleading. We stand by our heading as written, which concludes that portions of Downey's water fees may not be allowable. Based on our description of the transfers from Downey's Water Fund to its Sewer and Storm Drain Fund on pages 27 and 28 of our report, we believe we have a basis to question the appropriateness of these transfers. Further, if challenged, a court of law would determine the legality of Downey's use of water fees in these transfers.

cc: Members of the Legislature  
Office of the Lieutenant Governor  
Little Hoover Commission  
Department of Finance  
Attorney General  
State Controller  
State Treasurer  
Legislative Analyst  
Senate Office of Research  
California Research Bureau  
Capitol Press