
Performance Audit of Public Utilities Department's Reserves

FORMAL PROCEDURES AND FEWER RESERVES
WILL IMPROVE FINANCIAL ADMINISTRATION

MAY 2014

Audit Report

Office of the City Auditor
City of San Diego



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THE CITY OF SAN DIEGO

May 28, 2014

Honorable Mayor, City Council, and Audit Committee Members

City of San Diego, California

Transmitted herewith is a performance audit report on the City of San Diego's Public Utilities Department's Reserves. This report was conducted in accordance with the City Auditor's Fiscal Year 2014 Audit Work Plan, and the report is presented in accordance with City Charter Section 39.2. The Results in Brief are presented on page 1. Audit Objectives, Scope, and Methodology are presented in Appendix B. Management's responses to our audit recommendations are presented after page 27 of this report.

We would like to thank staff from the Public Utilities Department for their assistance and cooperation during this audit. All of their valuable time and efforts spent on providing us information is greatly appreciated. The audit staff members responsible for this audit report are Andy Horita, Chris Kime, and Kyle Elser.

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Results in Brief

The City's Public Utilities Department (PUD) maintains eleven reserve funds related to the Water and Wastewater systems. The Fiscal Year 2014 budget estimates that over \$145 million will be held in these reserve funds. If our recommendations are implemented, \$7 million will be moved out of reserve accounts. The PUD's reserves, like the other reserves held throughout the City, were established to address unexpected events in a fiscally prudent manner. Best practices and bond credit rating agencies recommend that reserve policies and procedures be documented and regularly updated. The City recently revised the reserve policy for the General Fund and is in the process of revising the policy related to the PUD's reserves. We found that the PUD's financial administration of the reserve accounts could be improved by making changes to the Water and Wastewater fund reserve policy and by following documented procedures.

Specifically, we found:

- The PUD follows the City Reserve Policy but the number of existing PUD reserve funds is greater than necessary, and four of the eleven existing reserves could be eliminated.
- The PUD relies on institutional knowledge and ad hoc procedures rather than documented procedures to calculate reserve adjustments.
- Reserve balances are not reported based on documented procedures which have resulted in some discrepancies in the reserve balances reported.

The current number of PUD reserve funds resulted from the City's efforts to restore its financial standing in the bond community in 2008. However, the number of reserve funds that were created is greater than the number currently needed. Also, the PUD has not developed documented procedures for reserve adjustment calculations and reserve balance reporting.

Reducing the number of reserves that the PUD is required to monitor, adjust, and reconcile will reduce the department's administrative burden, increase financial transparency, and use existing resources more efficiently. In addition, adopting formal reserve calculation procedures will provide improved reporting of reserve amounts.

We made a total of three recommendations to improve the financial administration of the PUD's Reserves, and management agreed with all of the recommendations.

Background

The City's Public Utilities Department (PUD) operates large, complex Water and Wastewater systems as financially self-sufficient enterprises. The Water system consists of over 3,000 miles of pipeline, covers over 404 square miles, and serves a population of 1.3 million. In Fiscal Year 2012, the Water system had \$569 million in revenue and \$438 million in expenditures, including capital expenditures. In Fiscal Year 2014, the Water system budget is \$428 million in revenue and \$528 million in expenditures which includes capital improvements. The excess in expenditures will be funded using available cash and reserve funds.

The Wastewater system consists of over 3,000 miles of pipeline, three wastewater treatment plants, and a biosolids processing facility. The Wastewater system covers over 450 square miles and serves a regional population in excess of 2.5 million. In Fiscal Year 2012, the Wastewater system had \$419 million in revenue and \$413 million in expenditures, including capital expenditures. In Fiscal Year 2014, the Wastewater system budget is \$409 million in revenue and \$461 million in expenditures which includes capital improvements. As is the case with the Water fund, the excess in expenditures will be funded using available cash and reserve funds.

As enterprise funds, the PUD's Water and Wastewater revenues and expenditures are accounted for separately from the City's other enterprise and General Fund activities. The Water fund's revenues may not be used to cover operating or capital expenditures of the Wastewater fund, or vice versa.

The PUD uses strategic financial planning to ensure the financial viability of the Water and Wastewater systems. For instance, the PUD uses annual and long-term budgets to project the operation and maintenance expenses necessary to maintain the Water and Wastewater systems in good working order. Capital expenditures, such as the repair and replacement of existing pipelines, are also included in the PUD's detailed financial plans. In addition to these operating, maintenance, and capital expenditures, the PUD incurs additional costs related to regulatory compliance from state and federal agencies such as the U.S. Environmental Protection Agency, California Department of Public Health (CDPH), and the Air Pollution Control District.

In addition to the annual inflow of revenues from Water and Wastewater ratepayers and outflows of cash to pay operating and capital expenditures, the PUD maintains several reserve funds related to the Water and Wastewater systems. The PUD's reserves, like the other cash reserves held throughout the City, were established to address unexpected future events in a fiscally prudent manner. The current City reserve policy states the following:

Strong reserves position an organization to weather significant economic downturns more effectively, manage the consequences of outside agency actions that may result in revenue reductions, and address unexpected emergencies, such as natural disasters, catastrophic events caused by human activity, or excessive liabilities or legal judgments against the organization.

Not only are reserves a priority for the City, bond credit ratings agencies view reserve amounts as an important factor when assessing the financial health of an organization. The City's original reserve policy, which was established in 2008, was a component of the City's effort to restore its financial standing in the bond community. Maintaining, regularly updating, and adhering to an appropriately constructed reserve policy is a good business practice recognized by the Government Finance Officers Association (GFOA), and is among the factors considered by bond credit rating agencies and the investment community when assessing the credit-worthiness of an organization.

According to the GFOA, "a well-designed and properly maintained system of documenting accounting policies and procedures enhances both accountability and consistency." The City has committed to reviewing its reserve policy every two years. Any proposed changes to the reserve policy will be brought forward for City Council consideration and approval. The City recently revised the reserve policy for the General Fund and is in the process of updating the policy related to the PUD's reserves.

**Public Utility Department
Reserves Established by the
City's Reserve Policy**

The City's reserve policy related to the PUD's reserves was last revised in December of 2011, and lists a total of eleven reserve accounts related to the PUD's Water and Wastewater funds. The Water fund reserves include: Operating reserve, Rate Stabilization reserve, Secondary Purchase reserve, Dedicated Reserve from Efficiency and Savings (DRES), Appropriated reserve, and Capital reserve. The Wastewater policy lists the same reserves, with the exception of the

Secondary Purchase reserve, for a total of eleven designated reserve funds between the Water and Wastewater funds. **Exhibit 1** presents a description of each of these reserves.

Exhibit 1

Water and Wastewater Reserves per Current City Reserve Policy

Reserve Fund	Description
Operating reserve	The Operating reserve level for Water and Wastewater funds is defined as the number of days of operation the reserve could support in the event of a major disruption to revenues. The current target is a 70-day reserve.
Rate Stabilization reserve	The Rate Stabilization reserve exists to maintain the legal Debt Service Coverage Ratios in accordance with Water and Wastewater bond documents.
Secondary Purchase reserve (Water only)	The Secondary Purchase reserve related to the Water fund is established to purchase additional water supply in case of a major drought or unforeseen emergency that diminishes the City's normal supply. The size of the reserve is equal to six percent of the annual water purchase budget.
Dedicated Reserve from Efficiency and Savings (DRES)	The DRES reserve was established in Fiscal Year 2007 to protect and preserve savings from efficiencies, changing priorities, or other actions related to reducing costs of capital improvements or operations and maintenance of the Water and Wastewater systems. The Independent Rates Oversight Committee (IROC) oversees the DRES and its use in accordance with the approved guidelines. The DRES has no annual budgeted target amount.
Appropriated reserve	The Appropriated reserve for Water and Wastewater funds is budgeted annually at \$3.5 million per fund for unanticipated expenditures. It may be used to fund either operating or capital needs. The Appropriated reserves are budgeted annually and are reported in the City's budget document within the department expenditures as line items.
Capital reserve	The Capital reserve for Water and Wastewater funds is intended for unanticipated capital needs. The reserve is budgeted annually at \$5.0 million per fund. The Capital reserves are included in the annual Capital Improvement Program budget as line items.

Source: City reserve policy.

Reserves such as the Operating reserve, Rate Stabilization reserve, Capital reserve, and Secondary Purchase reserve (for Water funds) are common among public utilities. In general, reserves are necessary to support strong bond ratings. According to the current City reserve policy, some of the PUD's reserves are defined by a specific dollar amount or formula used to calculate the reserve's balance. Other

reserves provide no funding targets and the calculation of the fiscal-year ending reserve amount is not based on a formula contained in the City's reserve policy. Note that the Appropriated and Capital reserves are budgetary items and are accounted for differently than the other reserves listed above.

**Public Utilities Department
Reserve Balances Reporting**

Fiscal Year-end Water and Wastewater reserve balances may be found in the City's Comprehensive Annual Financial Report (CAFR), in bond documents, or in the City's annual budget document. While reserve amounts are not included in the audited financial section of the CAFR, some reserves were reported in the unaudited introductory section in Fiscal Years 2011 and 2012. Specifically, the City's annual CAFR presented three Water fund reserves (Operating, Rate Stabilization, and Secondary Purchase) and two Wastewater fund reserves (Operating and Rate Stabilization).

Water and Wastewater bond documents also present reserve balances, but the documents do not always report all of the reserves established by the City's reserve policy. For example, the 2010 Water Bond Refunding Official Statement did not include the balance for the Appropriated reserve. The Appropriated reserve was also omitted from the annual report for Water bonds for Fiscal Year 2012.

Finally, the City's budget document reported the actual fiscal year-end balance for Water and Wastewater reserves for fiscal years beginning with Fiscal Year 2011. Actual reserve amounts are not presented until two years after the end of the fiscal year. For instance, the Fiscal Year 2011 actual reserve balances were presented, for comparison purposes, in the Fiscal Year 2013 budget document. The Appropriated reserves are budgeted annually and are reported in the City's budget document within the department expenditures as line items. Since they are budgeted in the annual operating budget and they are not balance sheet items, no balance is shown in the reserve section of the budget document. Actual and budgeted balances for each reserve, according to the City's budget documents, are presented in **Exhibit 2** below.

*Exhibit 2***Water and Wastewater Fund Reserve Balances at Year-End**

Water Fund Reserve	FY 2011 Actual	FY 2012 Actual	FY 2013 Budget	FY 2014 Budget
Operating reserve	\$ 29,922,568	\$ 29,556,542	\$ 29,496,823	\$ 30,662,165
Rate Stabilization reserve	\$ 20,500,000	\$ 50,300,000	\$ 23,500,000	\$ 20,500,000
Dedicated Reserve from Efficiency and Savings	\$ 13,972,678	\$ 21,392,908	\$ 36,392,908	\$ 0
Appropriated reserve ¹	\$ 3,500,000	\$ 3,500,000	\$ 3,500,000	\$ 3,500,000
Capital reserve	\$ 5,000,000	\$ 5,000,000	\$ 5,000,000	\$ 5,000,000
Secondary Purchase reserve	\$ 11,262,502	\$ 12,503,886	\$ 12,826,971	\$ 12,544,476
Total	\$ 84,157,748	\$122,253,336	\$110,716,702	\$72,206,641

Wastewater Fund Reserve	FY 2011 Actual	FY 2012 Actual	FY 2013 Budget	FY 2014 Budget
Operating reserve	\$ 33,925,808	\$ 39,531,010	\$ 43,730,646	\$ 43,314,185
Rate Stabilization reserve	\$ 21,300,000	\$ 21,300,000	\$ 21,300,000	\$ 21,300,000
Dedicated Reserve from Efficiency and Savings	\$ 36,272,893	\$ 28,681,368	\$ 27,722,827	\$ 0
Appropriated reserve ¹	\$ 3,500,000	\$ 3,500,000	\$ 3,500,000	\$ 3,500,000
Capital reserve	\$ 5,000,000	\$ 5,000,000	\$ 5,000,000	\$ 5,000,000
Total	\$99,998,701	\$98,012,378	\$101,253,473	\$73,114,185

Source: City Budget Documents.

In addition to the cash held in reserves as required by the City's reserve policy, the PUD maintains substantial cash balances that are available to meet the Department's operating or capital needs. For example, in Fiscal Year 2011 the PUD reported a combined available cash balance for Water and Wastewater funds of \$51 million after subtracting the required reserves and other allocations.

¹ The Appropriated Reserve is not presented in the Reserve section of the City's Budget documents. This amount represents the amount dictated by the City's reserve policy.

Management of the Public Utility Department's Reserves

The PUD's reserves are primarily managed by the Department with some involvement from other Mayoral departments and advisory groups. For instance, before reserve amounts are reported in bond documents, the City's Disclosure Practices Working Group reviews the reported amounts for accuracy. The Comptroller's Office is also involved with reviewing reserve transfers for accuracy. The Independent Rates Oversight Committee (IROC), an independent advisory body, oversees the DRES reserve. By the end of Fiscal Year 2014, the DRES reserve is expected to be fully utilized as part of a planned spend-down of the PUD's cash balances.

In some circumstances, such as when Capital Improvement Program (CIP) project funds are needed, the City Council may be required to approve the expenditure of reserve funds. In other circumstances, as **Exhibit 3** below illustrates, Chief Financial Officer (CFO) or Chief Operating Officer (COO) approval may be required in order to access reserve funds. Once the required approval is obtained, the PUD sends a memorandum request to the Comptroller's Office to transfer the funds.

Exhibit 3

Approvals Required for Reserve Expenditures

Reserve	Operating Expenditures	Capital Expenditures	Note
Operating reserve	CFO/COO	Not applicable	
Rate Stabilization reserve	PUD Department Director and CFO	Not applicable	
Dedicated Reserve from Efficiency and Savings	IROC and City Council	IROC and City Council	City reserve policy does not distinguish Operating versus Capital expenditures
Appropriated reserve	PUD Department Director	City Council	
Capital reserve	Not applicable	City Council or CFO/COO	City Council approval not required if an unforeseen emergency exists
Secondary Purchase reserve	City Council	Not applicable	

Source: City reserve policy.

Between Fiscal Year 2011 and 2013, the PUD made annual adjustments to some reserve levels at the beginning of the fiscal year. For Water funds, adjustments to the Operating, Secondary Purchase, and Rate Stabilization reserves were made via an annual memorandum to the Office of the City Comptroller. For Wastewater funds, only adjustments to the Operating reserves were requested via the annual memorandum to the Office of the City Comptroller since no change was needed for the Rate Stabilization Reserve and the Wastewater fund does not have a Secondary Purchase Reserve. Other adjustments are made via communications between the PUD and Comptroller's Office, such as emails, separate memoranda, or communications through the City's financial system, SAP. These adjustments may be made to comply with the existing funding targets defined in the City's reserve policy, or to meet internal targets set by PUD's management.

Audit Results

Finding 1: The PUD Could Use Funds More Efficiently and Reduce the Complexity of Financial Administration by Eliminating Some Reserve Accounts

We found that the Appropriated Reserve and DRES reserve for both Water and Wastewater funds are not necessary and could be eliminated to reduce an administrative burden on PUD. These reserves can be used to provide additional funds for operating or Capital Improvement Program (CIP) expenditures.

In an emergency, the Operating reserve exists to provide funds to meet operating needs. In the event of a need for additional CIP funds, there is flexibility in the annual CIP budget to fund unanticipated projects or make additional funding available through reprioritizing of existing projects. Not only are the Appropriated and DRES reserves for Water and Wastewater funds not necessary, but these reserves also impose administrative burdens on the PUD that could be eliminated.

The PUD's financial staff could be more effective if they were not required to report on reserves that were not necessary or beneficial to the department. According to the Government Finance Officers Association, a city that uses fund accounting should periodically undertake a comprehensive evaluation of its fund structure to ensure that individual funds that have become superfluous are eliminated. Similarly, maintaining unnecessary reserve accounts is not consistent with the PUD's goal of operating a fiscally-sound and effective public utility.

Certain PUD Reserves Should Be Eliminated

We found that four of the eleven Public Utilities Department's (PUD) reserves may not be necessary and could be eliminated. The four reserves that could be eliminated are the Appropriated reserve for Water and Wastewater funds and the Dedicated Reserve from Efficiency and Savings (DRES) for Water and Wastewater funds. The Appropriated and DRES reserves both set aside reserve funds for Capital Improvement Program (CIP) expenditures and impose unnecessary administrative burdens because there are sufficient

existing reserves for CIP projects. According to the PUD's Fiscal Year 2014 budget, a total of \$7 million will be held in the Appropriated reserve for Water and Wastewater funds. The Appropriated reserve amount of \$3.5 million in each fund was established in the current reserve policy, which was last revised in 2011. The DRES reserve is projected to have a zero balance at the end of the 2014 Fiscal Year due to the PUD's plan to use cash to pay for capital projects, rather than incurring additional debt. The balance at the beginning of the fiscal year for the DRES reserve was approximately \$54 million for Water and Wastewater combined.

All four of these reserves provide additional funds that could be used for CIP expenditures. However, there is flexibility built into the annual CIP budget to fund unanticipated projects or make additional funding available through reprioritizing of existing projects. If necessary, the PUD would also be able to draw additional CIP funds from the Water or Wastewater fund cash balances. If the cash balances were not sufficient to support the PUD's unanticipated CIP needs, the department would be able to draw on the Capital reserve for Water and Wastewater funds.

*Dedicated Reserve from
Efficiency and Savings
(DRES)*

The Dedicated Reserve from Efficiency and Savings (DRES) was created by the City in 2007, along with the Independent Rates Oversight Committee (IROC) which is responsible for overseeing the reserve. The stated purpose of the DRES reserve is to protect and preserve savings related to CIP and operations. Although savings related to the PUD's operations may be transferred into the DRES, according to the PUD, it has primarily been funded with unspent CIP dollars. The current City reserve policy states that DRES funds will be used to accelerate CIP schedules, which will "minimize future City rate increases." We found that the DRES reserve does not directly accelerate CIP schedules because the cash held in the reserve is not readily available to be spent on CIP projects. Before the DRES funds can be used for CIP projects, the IROC and City Council must approve the transfer of funds out of the reserve. Similarly, the DRES does not minimize future rate increases if CIP dollars remain unspent as a cash reserve. The DRES reserve was created to minimize future rate increases by taking savings from CIP and operations and applying them to CIP projects so rates would not have to be increased to fund future CIP expenditures. This mechanism could be bypassed and monies spent directly on CIP. Finally, maintaining the DRES creates unnecessary administrative burdens.

The City's reserve policy does not set an annual target amount for the DRES reserve. Rather, the PUD transfers funds to the reserve when eligible unspent dollars are identified. At the end of Fiscal Year 2012, the DRES reserve had a balance of \$29 million in the Wastewater fund and \$21 million in the Water fund, for a combined total of \$50 million. As noted in **Exhibit 2** on page 6, at the end of Fiscal Year 2014 the DRES is expected to have a zero balance for both Water and Wastewater funds. No new contributions to the DRES reserve are planned for Fiscal Year 2015. The full drawdown of the DRES reserve was part of the PUD's plan to finance CIP projects using cash resources rather than incurring additional debt to fund future projects. According to the PUD, cash funding the CIP program indirectly minimized the rate increases needed for fiscal years 2014 and 2015. The Water fund's CIP financing plans using the DRES reserve's cash were reviewed and approved by the IROC and the City Council. While the Wastewater fund's financing plans are not yet final, we reviewed a draft version of the proposed revenues and expenditures and found that they were consistent with the Water fund's plans.

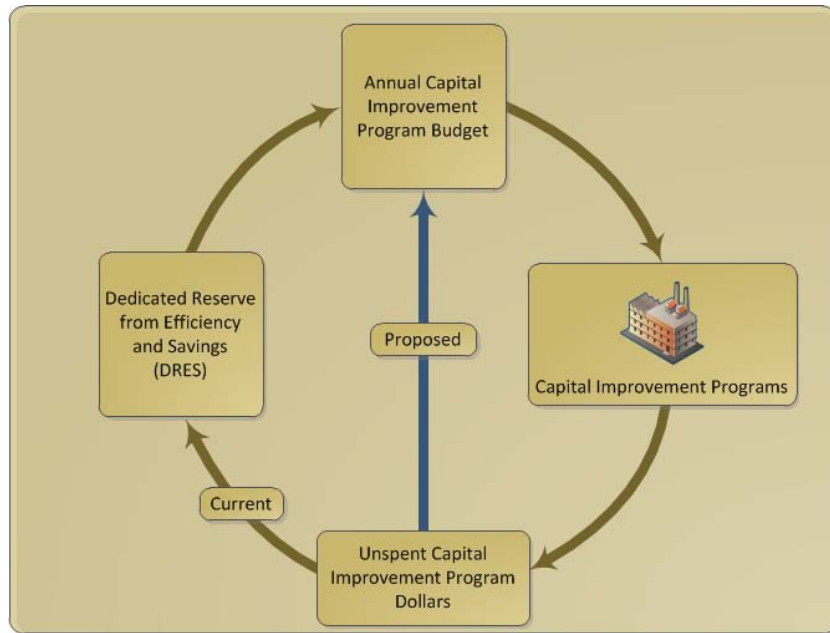
We found that the cash resources from the DRES reserve do not accelerate CIP schedules, per se. Rather, the cash from the DRES reserve provides an alternative to funding CIP projects with bond or loan funds. The \$50 million in combined Water and Wastewater DRES reserves would have been available for CIP projects whether the funds were parked in the DRES reserve prior to being used to fund CIP projects or if they were held in the PUD's cash balances. In fact, holding the DRES reserves outside of the PUD cash balance may create the impression that the reserved funds are not available to be spent on CIP projects, thus reducing the apparent amount of cash available for CIP. Although removing the DRES reserve may create the impression that cash is available to be used for non-CIP expenditures, this is not a likely outcome based on the PUD's substantial need to invest in capital improvements.

If the DRES reserves for Water and Wastewater funds were eliminated, the unspent cash that had been budgeted for CIP projects would still be available to allocate to additional projects and the availability of the cash balance would be more transparent. Moreover, there would be fewer administrative barriers to accessing the funds if they did not flow through the DRES prior to being reallocated for CIP projects. Specifically identifying which funds are eligible to be transferred into the DRES requires PUD staff to

segregate unspent CIP dollars by funding source and make transfers of any eligible cash into the DRES. Under the existing reserve policy, the cash that was transferred into the DRES must be transferred back out of the reserve when a CIP project is designated. **Exhibit 4**, below, illustrates the current process of transferring unspent CIP dollars into the DRES reserve and subsequently transferring the funds out, and a proposed alternative process.

Exhibit 4

Illustration of Transfers Into and Out of the DRES Reserve



Source: OCA generated.

The DRES does not directly minimize future rate increases. In general, the rates charged to Water and Wastewater customers are driven by three factors. The first factor is the PUD's need to maintain sufficient cash flow to pay operating expenses, the cash component of the CIP, and debt expenses. Second, rate increases may be needed in order to maintain minimum target reserve levels. Finally, rates may need to be raised to meet bond covenant requirements that include the legal obligation to maintain a minimum debt coverage ratio. Recently, water rates were increased in order to meet bond-related covenant requirements. According to the Water and Wastewater bond covenants, the PUD is required to generate sufficient operating revenues to satisfy debt payment target amounts. The majority of PUD's operating revenues come from ratepayers, and despite the

PUD's large cash balances, a water rate increase was required. According to the PUD, the cash on hand was used to finance the capital program, thus postponing the need to assume additional debt. The PUD also noted that the rate increase was a result of PUD postponing the calendar year 2011 and 2012 pass-through of wholesale water rate increases from the San Diego County Water Authority. Thus, existing cash—whether it is held in the DRES reserve, or in the PUD's cash balance—does not directly minimize the need for rate increases because rate increases may be driven by the need for increased operating revenues.

Appropriated Reserve The Water and Wastewater Appropriated reserves are each budgeted annually at \$3.5 million for unanticipated operating or capital expenditures. We found that the Appropriated reserve is rarely used and other financial resources are available to fund unanticipated expenditures. As noted previously, there is flexibility built in to the annual capital improvements budget to cover unanticipated capital expenditures, either the Operating reserves or cash balances are available to cover either operating or capital needs. If the cash balances were not sufficient to support the PUD's unanticipated CIP needs, the department would be able to draw on the Capital reserve for Water and Wastewater funds.

Although the Appropriated reserve was originally created to provide the ability for the Council to independently initiate expenditures outside of the normal budget process, recent budget process clarifications by the City Attorney show that the Council does not have this authority. This clarification rendered the Appropriated reserve for the General Fund obsolete. As a result, the Appropriated reserve for the General Fund was eliminated. Based on discussions with PUD management, the existing alternative financial resources available, and the City Attorney's process clarifications, we determined that the Appropriated reserves for Water and Wastewater are not necessary and should be eliminated from the City reserve policy to improve transparency and reduce the administrative burden on PUD financial staff.

Recommendation #1 **The Public Utilities Department should propose a change to the City's Reserve Policy to eliminate the Appropriated and Dedicated Reserve from Efficiency and Savings (DRES) reserves for Water and Wastewater funds. (Priority Level 2)**

Finding 2: Internal Practices for Calculating PUD Reserve Adjustments Are Subject to Error and Should Be Documented to Improve Accuracy, Consistency, and Transparency

The current practice for calculating reserve adjustments is not always consistent with the City's reserve policy, is subject to error, and lacks details that would improve transparency. The requests to increase or decrease the cash balances in the reserves are communicated using a memorandum from the PUD to the Office of the City Comptroller at the beginning of each fiscal year. The reserve adjustments are necessary to ensure that the balance in each reserve fund is consistent with the targets established by the City's reserve policy, is sufficient to meet the Public Utilities Department's (PUD) financial plans for operations and capital projects, and is in compliance with bond covenants.

The PUD relies on institutional knowledge and ad hoc procedures to calculate reserve adjustments. Relying on formal, documented procedures for transfers into or out of reserve funds has not been the PUD's practice. During Fiscal Years 2011 through 2013, discrete increases or decreases to the cash balances in reserve funds were typically over one million dollars and one adjustment involved a \$26.8 million transfer. With such large dollar amounts involved, it is especially important that the procedures used to calculate the reserve adjustments are well-documented, promote accuracy, and lead to consistent results. The procedures used to make the reserve adjustment calculations should not vary depending on who computes the reserve adjustment.

PUD's Current Practice for Calculating Reserve Adjustments is Not Consistent

At the beginning of each fiscal year, the PUD makes adjustments to the reserve balances using a memorandum that is sent to the Comptroller's Office and requests that funds be transferred to or from a reserve account in the City's financial system, SAP. However, between Fiscal Year 2011 and 2013 not all of the PUD's reserves were adjusted this way. For Water funds, adjustments to the Operating, Secondary Purchase, and Rate Stabilization reserves were made via the annual memorandum request. Only adjustments to the Operating reserve were requested via the annual memorandum for Wastewater funds since no change was needed for the Rate Stabilization Reserve and the Wastewater fund does not have a Secondary Purchase Reserve.

Adjustments to the other reserve funds are not included in the annual memorandum to the Office of the City Comptroller, but are made using separate requests as transfers are needed. Some reserves, such as the Dedicated Reserve from Efficiency and Savings (DRES) are adjusted several times a year, but there are no clear policies defining when contributions must be made to the DRES.

The PUD does not have a written policy regarding which reserves to include in the annual memorandum to the Office of the City Comptroller and how the reserves should be calculated. In fact, the format of the reserve adjustment calculations varied depending on who completed the memorandum to the Comptroller's Office. One consequence of the ad hoc calculation procedures is that the formula used to determine the necessary reserve adjustments has not always been consistent with the description contained in the City's reserve policy.

Reserve Calculations Are Not Always Consistent With the City's Reserve Policy

For Water and Wastewater funds, the City's reserve policy provides a formula for calculating the Operating reserve amount. Specifically, the formula for the Water fund Operating reserve is described in the City's reserve policy as the "operating budget for the fiscal year (less the water purchase budget and the Appropriated reserve)." However, when calculating the Water fund Operating reserve, the PUD subtracts budgetary accounts, such as the State Revolving Fund Debt Payment and Bond Debt general ledger accounts, which are not described in the City's reserve policy. Like the Water fund Operating reserve calculation, the Wastewater fund Operating reserve also subtracts budgetary accounts that are not included in the City's reserve policy. According to the PUD's management, these additional accounts are subtracted from the operating budget because they provide a more accurate amount to be held in reserve for operating expenses. While the PUD's rationale seems reasonable and avoids overstating the department's operating requirements, this procedure deviates from the Council Policy formula and is not formally documented.

Current Reserve Calculation Practices Are Subject to Error

Another consequence of the PUD's current practice of calculating reserve adjustments without relying on documented procedures is that the adjustments are subject to error. As noted previously, the procedures used to calculate some of the reserve adjustments included in the memorandum to the Comptroller's Office varied based on who completed the request and did not consistently depict the required adjustment.

For example, the PUD memorandum requesting a transfer for the Water Fund Rate Stabilization reserve in Fiscal Year 2013 contained a \$26.8 million potential error, as described below. The budgeted amount for the reserve for Fiscal Year 2013 was \$23.5 million, and the ending balance for the prior fiscal year was \$50.3 million. In November of 2012, the reserve was reduced to \$23.5 million, per a request from PUD to the Comptroller's Office. Two months later, in January of 2013, the PUD requested an \$11.8 million decrease from the "FY 2012 balance" of \$50.3 million to the "FY 2013 target" of \$38.5 million. The "target" term was a reference to the revised Fiscal Year 2013 budget amount. The PUD's request to reduce the reserve amount did not take into consideration the fact that the reserve had already been reduced from \$50.3 million to \$23.5 million. As a result, the PUD should have requested an increase in the reserve (from \$23.5 million to \$38.5 million), of \$15 million. The difference between the \$11.8 million decrease that was requested and the correct \$15 million increase that should have been requested is \$26.8 million. The details of the reserve adjustments are illustrated in **Exhibit 5** below.

Exhibit 5

Water Fund Rate Stabilization Reserve Transfer Request for Fiscal Year 2013 (in millions of dollars)

Date	Reserve Balance	Note
11/21/12	\$50.3	PUD requests \$26.8 decrease to the reserve from \$50.3 to reach the budget of \$23.5
11/21/12	\$23.5	Comptroller's Office transfers \$26.8 out of the reserve
1/23/13	\$23.5	PUD memo marked "revised" requests \$11.8 decrease from the "FY 2012 balance" of \$50.3 to the "FY 2013 target" of \$38.5, but the reserve balance is \$23.5
1/23/13	\$38.5	Comptrollers transfer \$15 in to reach the desired reserve balance of \$38.5

Source: OCA generated based on SAP data.

Ultimately, the Comptroller's Office and PUD worked together to ensure that the correct journal entries were made and the reserve levels were adjusted appropriately. If the PUD had relied on documented procedures to consistently show the requested adjustment as a reduction from the current balance, rather than a fiscal year target—which was the practice in prior and subsequent fiscal years—the risk of these discrepancies would have been reduced.

Transparency Would Be Improved If Documented Procedures Were Used

In addition to being subject to error, the current method of adjusting reserve levels lacks details that would improve transparency. For example, the PUD adjusts the Water Secondary Purchase reserve balance to ensure that at least six percent of the annual water purchase budget is maintained in case of emergency. The memoranda to the Comptroller's Office did not clearly and consistently show how the annual water purchase budget amount was determined. Specifically, the Fiscal Year 2012 and 2013 adjustments included screen shots of the water purchase budget's general ledger accounts, which allowed for an easy means of verifying the amounts used in the calculations. In contrast, the Fiscal Year 2011 and 2014 adjustments to the Water Secondary Purchase reserve did not provide a screen shot to support the amounts used in the calculation. In general, the level of documentation varied according to the PUD employee who prepared the annual memorandum to the Comptroller's Office. If the memoranda had provided additional details, it would have made it possible for an independent reviewer to understand the rationale behind the calculation, to check it for accuracy, and to determine if the calculation is consistent with City policy.

Documented Procedures Would Improve Policy Compliance, Accuracy, and Transparency

According to the Government Finance Officers Association, "a well-designed and properly maintained system of documenting accounting policies and procedures enhances both accountability and consistency." The accounting procedures should also be updated periodically to ensure that they are consistent with City policy and that they accurately depict the process being used.

In order to improve policy compliance, accuracy, and transparency the PUD should document the accounting procedures used to calculate the reserve amounts and define the format to be used for the annual memorandum to the Comptroller's Office. Specifically, the policy should address the following areas (to the extent that the reserves remain in place after the implementation of the recommendations in Finding 1):

Operating reserves	Operating reserve procedures should document the rationale underlying which budgetary accounts are being subtracted from the Water or Wastewater operating budget. The PUD's procedures should be consistent with the expectations outlined in the City's reserve policy.
Rate Stabilization reserve	Reserve calculation procedures should require consistent presentation of the current balance in the reserve, the targeted balance, and the necessary adjustment, if any, in order to clearly and accurately communicate the amount of any adjustment that is needed.
Secondary Purchase reserve	Calculation procedures should clearly and consistently show how the annual water purchase budget is derived.
Dedicated Reserve Efficiency and Savings (DRES)	The PUD should develop written policies and procedures regarding contributions to the DRES reserve. The Department's procedures should be consistent with the procedures outlined in the City's reserve policy, and the rationale for any requested adjustment, or non-adjustment, should be included in the annual memorandum to the Comptroller's Office.

Recommendation #2 The Public Utilities Department should document the accounting procedures used to calculate all reserve amounts contained in the City's Reserve Policy and define the format to be used for the annual memorandum to the Comptroller's Office.
(Priority Level 2)

Finding 3: External Reporting of the PUD's Reserve Balances Could Be Improved

Public Utilities Department (PUD) reserve balances are not reported based on documented procedures, which resulted in some inconsistent reserve balance reports. Specifically, the reserve balances reported by the PUD in the City's budget reports are not always the same as the reserve amounts presented in bond documents. The City's fiscal year ends on June 30, and its Comprehensive Annual Financial Report is presented as of that date. As such, the reader of the financial data would expect that the balance in the reserve account should be the same no matter where the balance is reported. While most reserves were reported consistently, any inconsistent reporting diminishes financial transparency and the accuracy of the PUD's financial reports. We identified two differences in the reported reserve amounts due to differences in how the reserve was calculated and adjustments made to the balance after the end of the fiscal year.

Operating Reserve Calculations Were Different

In Fiscal Year 2012, we found a significant difference in the reported Wastewater fund's Operating reserve amount. The actual amount that was reported in the City's annual budget document was \$4.3 million greater than the amount shown in the Wastewater-related annual bond report. The Operating reserve level is determined based on a formula for the number of days of operation that could be supported in the event of a major disruption to revenues. The current target is a 70-day reserve.

The actual year-end balance in the Operating reserve is reported by the PUD in the City's annual budget document and in Water and Wastewater-related bond documents. Information contained in bond documents may be important to investors, and the City takes precautions to ensure that the information contained in bond documents is accurate. Every aspect of the bond documents is reviewed by City departments and independent legal counsel to ensure that the information is accurate. We found that the amount reported in the bond document was accurate.

The difference in the PUD-reported Wastewater fund's Operating reserve amount for Fiscal Year 2012 was due to a misunderstanding of the components within the reserve that were to be reported in the City's annual budget document. According to the City's reserve

policy, the Wastewater fund's Operating reserve should not have included revenue from agencies that utilize the City's Wastewater treatment system. As noted previously, the PUD does not have formal, documented procedures that would define how the Operating reserve is to be calculated. The difference in the reported Operating reserve amounts is summarized in **Exhibit 6** below.

Exhibit 6

Reported Fiscal Year 2012 Wastewater Fund Operating Reserve Balances

Source	Amount	Note
Public Utilities Department Budget	\$ 39,531,010	This amount erroneously includes excess revenues from other agencies.
Wastewater Bond Annual Report for Fiscal Year 2012	\$ 35,250,000	The amount in the bond document was rounded to the nearest thousand, but was accurate.
Difference	\$ 4,281,010	

Source: PUD budget and bond annual report.

Dedicated Reserve from Efficiency and Savings (DRES) Reserve Balances Were Inconsistent Due to Timing Differences

In addition to differences in the reported reserve amounts due to how the reserve was calculated, we found that adjustments made to reserve balances after the end of the fiscal year accounted for some differences. Each fiscal year, accounting entries are made after the end of the fiscal year that affect the year-end balance in the reserves. These entries may be made several months after the fiscal year ends on June 30th. These adjustments are tracked using extra accounting periods in the City's financial system, SAP. For example, since there are twelve months in a year there are twelve standard accounting periods. However, it may be necessary to make adjustments after the end of a fiscal year that affect the June 30th balance. These adjustments are tracked in SAP using accounting period 13, or greater.

While adjustments to year-end reserve balances are typical and necessary, there is ample time to ensure that the reported amounts are consistently presented. First, bond documents are reported annually in late March or early April, approximately nine months after the end of the fiscal year. Additionally, the PUD reports year-end balances in the reserve funds as part of the annual budget which does not become final until June. Finally, the City's Comprehensive Annual Financial Report (CAFR) has been finalized, in recent years,

prior to the end of the calendar year. Thus, by the beginning of each calendar year the PUD knows the final audited ending balance in each reserve fund. This should allow the PUD to report the balances consistently. While most reserve balances are reported consistently, we found one exception in our sample timeframe related to a timing difference.

In Fiscal Year 2011, the PUD reported over one million dollars less in the Dedicated Reserve from Efficiency and Savings (DRES) reserve than was reported in the official statement for the Water bond. We found that the amount reported in the bond document was accurate as of period 12 in SAP. Similarly, the amount reported by the PUD for period 13 was also accurate as of the end of that accounting period. The balance according to the two reports is summarized in **Exhibit 7** below.

Exhibit 7

Reported Fiscal Year 2011 Water Fund DRES Reserve Balances

Source	Amount	Note
Public Utilities Department Budget Document	\$ 13,972,678	This is the balance in Water fund for period 13 in SAP
Water Bond Official Statement, Refunding Series 2012A	\$ 15,127,000	The amount in the bond document was rounded to the nearest thousand, but was accurate for period 12 in SAP
Difference	\$ 1,154,322	

Source: PUD budget, bond document, and SAP data.

The Lack of Written Policies and Procedures Causes Inconsistent Reserve Balance Reports

One consequence of inconsistent reports of fiscal-year ending reserve amounts is that the PUD may not be achieving optimal fiscal transparency. In general, the users of the PUD's financial information do not have access to the City's underlying financial data. Because of this, it would not be possible for the average financial information user to evaluate whether the differences in the reported reserve amounts were due to an error, a timing difference, or some other cause. Our audit did not find that the differences in the reported reserve amounts were due to a lack of care or oversight regarding the PUD's financial data. Rather, the differences were due to a lack of a consistent policy regarding how the reserves are to be presented, calculated, and reported.

Recommendation #3 The Public Utilities Department should develop a written procedure to ensure that fiscal year-end balances for all reserves contained in the City's Reserve Policy are presented consistently in the City's budget document and bond-related documents, as required. (Priority Level 2)

Conclusion

According to the existing City reserve policy, the Public Utilities Department (PUD) maintains eleven reserve funds related to the Water and Wastewater systems. The PUD's reserves, like the other reserves held throughout the City, were established to address unexpected events in a fiscally prudent manner. We found that the Appropriated reserve and Dedicated Reserve from Efficiency and Savings (DRES) for Water and Wastewater funds were unnecessary and imposed administrative burdens on the PUD that could be eliminated. We recommended that the PUD eliminate these unnecessary reserves.

Also, we found that the PUD has not developed documented procedures for reserve adjustment calculations and reserve balance reporting. Government Finance Officers Association best practices and bond credit rating agencies recommend that reserve policies and procedures be documented and regularly updated. We determined that the PUD's financial administration, computational accuracy, and reporting consistency could be improved by making changes to the Water and Wastewater fund reserve policy and by following documented procedures.

We made a total of three recommendations to improve the financial administration of the PUD's Reserves, and management agreed with all of the recommendations.

Recommendations

- Recommendation #1** The Public Utilities Department should propose a change to the City's Reserve Policy to eliminate the Appropriated and Dedicated Reserve from Efficiency and Savings (DRES) reserves for Water and Wastewater funds. (Priority Level 2)
- Recommendation #2** The Public Utilities Department should document the accounting procedures used to calculate all reserve amounts contained in the City's Reserve Policy and define the format to be used for the annual memorandum to the Comptroller's Office. (Priority Level 2)
- Recommendation #3** The Public Utilities Department should develop a written procedure to ensure that fiscal year-end balances for all reserves contained in the City's Reserve Policy are presented consistently in the City's budget document and bond-related documents, as required. (Priority Level 2)

Appendix A: Definition of Audit Recommendation Priorities

DEFINITIONS OF PRIORITY 1, 2, AND 3

AUDIT RECOMMENDATIONS

The Office of the City Auditor maintains a classification scheme applicable to audit recommendations and the appropriate corrective actions as follows:

Priority Class ¹	Description ²	Implementation Action ³
1	Fraud or serious violations are being committed, significant fiscal or equivalent non-fiscal losses are occurring.	Immediate
2	A potential for incurring significant or equivalent fiscal and/or non-fiscal losses exist.	Six months
3	Operation or administrative process will be improved.	Six months to one year

¹ The City Auditor is responsible for assigning audit recommendation priority class numbers. A recommendation which clearly fits the description for more than one priority class shall be assigned the higher number.

² For an audit recommendation to be considered related to a significant fiscal loss, it will usually be necessary for an actual loss of \$50,000 or more to be involved or for a potential loss (including unrealized revenue increases) of \$100,000 to be involved. Equivalent non-fiscal losses would include, but not be limited to, omission or commission of acts by or on behalf of the City which would be likely to expose the City to adverse criticism in the eyes of its residents.

³ The implementation time frame indicated for each priority class is intended as a guideline for establishing implementation target dates. While prioritizing recommendations is the responsibility of the City Auditor, determining implementation dates is the responsibility of the City Administration.

Appendix B: Audit Objectives, Scope, and Methodology

Objectives In accordance with the City Auditor's Fiscal Year 2014 Work Plan, we conducted a performance audit of the reserve funds held by the Public Utilities Department (PUD). Specifically, our objectives were to:

- Determine if the City's policy for Public Utilities reserves follow best practices for municipal government agencies;
- Determine the appropriateness of the Public Utilities reserve amount calculation procedures; and
- Assess the effectiveness of Public Utilities reserve amount monitoring and reporting;

Scope and Methodology To determine if the City's policy for Public Utilities reserves follow best practices for municipal government agencies, we:

- Interviewed PUD management and staff, current and former members of the Independent Rates Oversight Committee, the Debt Management department director, and management and staff from the Office of the City Comptroller.
- Reviewed the bond Official Statements for the City, Master Installment Purchase Agreements, City budget documents, and annual bond disclosure documents.
- Reviewed bond disclosure documents for other California municipalities.
- Reviewed Government Finance Officers Association best practices.

To determine the appropriateness of the Public Utilities reserve calculation procedures, we:

- Interviewed PUD management and staff, current and former members of the Independent Rates Oversight Committee, and management and staff from the Office of the City Comptroller.
- Reviewed independent Cost of Service Studies, external audits and agreed-upon procedures, capital improvement program plans, internal City memoranda, and City policy documents.
- Evaluated the current procedures for reserve calculations.

To assess the effectiveness of Public Utilities reserve amount monitoring and reporting, we:

- Determined the extent to which PUD reserves are reported publicly.
- Compared the PUD reserve amounts reported in various public documents from Fiscal Year 2011 through 2013.
- Identified discrepancies between publicly-reported PUD reserve amounts and determined the cause of the differences.

We conducted this performance audit in accordance with 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. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.



THE CITY OF SAN DIEGO

MEMORANDUM

DATE: May 23, 2014
TO: Eduardo Luna, City Auditor
FROM: Halla Razak, Director of Public Utilities
SUBJECT: Public Utilities Department Reserves Audit

The City acknowledges the Office of the City Auditor Performance Audit of the Public Utilities Department's Reserves. The following summarizes the recommendations contained in this report and Management's responses to each recommendation.

RECOMMENDATION #1: The Public Utilities Department should propose a change to the City's Reserve Policy to eliminate the Appropriated and Dedicated Reserve from Efficiency and Savings (DRES) reserves for Water and Wastewater funds. (Priority 2)

MANAGEMENT RESPONSE: Agree

Staff has requested that the current City's Reserve Policy eliminate the Appropriated and DRES reserves for both the Water and Wastewater funds, per Report to City Council No. 14-035. This item was heard at the Budget and Government Efficiency Committee on May 22, 2014 and was passed unanimously by the Committee and will be forwarded to City Council.

RECOMMENDATION #2: The Public Utilities Department should document the accounting procedures used to calculate all reserve amounts contained in the City's Reserve Policy and define the format to be used for the annual memorandum to the Comptroller's Office. (Priority 2)

MANAGEMENT RESPONSE: Agree

The Public Utilities Department will formally document the reserve calculation procedures in a Reserve Calculation and Presentation Department Instruction, which will be in accordance with the revised Reserve Policy and include the prescribed format for the annual memorandum to the Comptroller's Office and any necessary attachments.

Date to be completed: July 2014

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May 23, 2014

Eduardo Luna, City Auditor

RECOMMENDATION #3: The Public Utilities Department should develop a written procedure to ensure that fiscal year-end balances for all reserves contained in the City's Reserve Policy are presented consistently in the City's budget document and bond-related documents, as required. (Priority 2)

MANAGEMENT RESPONSE: Agree

The Public Utilities Department will include a procedure in the Reserve Calculation and Presentation Department Instruction (referenced above) to ensure that fiscal year-end balances for all reserves contained in the City Reserve Policy are presented consistently in the City's budget document and bond-related documents, as required.

Date to be completed: July 2014



Halla Razak, Director of Public Utilities

cc: Scott Chadwick, Chief Operating Officer
Stacey LoMedico, Assistant Chief Operating Officer
Tony Heinrichs, Deputy Chief Operating Officer
Rolando Charvel, City Comptroller
Marie Wright-Travis, Assistant Public Utilities Director
Lee Ann Jones-Santos, Public Utilities Deputy Director