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ORANGE COUNTY WATER DISTRICT
ORANGE COUNTY'S GROUNDWATER AUTHORITY

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July 20, 2012

Thomas J. Borris, Presiding Judge
Orange County Superior Court
700 Civic Center Drive West
Santa Ana, CA 92701

SUBJECT: APRIL 20, 2012 GRAND JURY REPORT "LET THERE BE LIGHT"

Dear Judge Borris:

As required by the April 20, 2012 Grand Jury letter, the Orange County Water District (District) has reviewed the report, "Let There Be Light: Dragging Special Districts from the Shadows". The District was required to respond to Findings 1, 2, 5-8, 10, 14, and 15 and to Recommendations 1, 4-9. The Board of Directors of the District has authorized this response. The original Findings and Recommendations are provided below along with the District's response.

F1. Most Orange County special districts, with or without the assistance of the Local Agency Formation Commission (LAFCO), have been incapable or unwilling to consolidate, absorb, or eliminate these outmoded and/or redundant agencies. LAFCO typically addresses larger issues such as merging of cities and elimination of "islands" within the county. The special districts themselves have not worked seriously toward their consolidation or demise. In this regard, the enterprise special districts and the non-enterprise special districts require independent evaluation and handling.

The District wholly disagrees. The District was formed in 1933 by an act of the California State Legislature. The District has the unique responsibility to protect Orange County's water rights to the Santa Ana River and to protect and manage the groundwater basin that underlies north and central Orange County. No other agency in the County has similar responsibilities. The District has actively explored consolidation with another local water agency multiple times in the past, including very recently. As of this date, there is insufficient support to consolidate the agencies. Additionally, the District is willing to consider any logical consolidation with another agency if doing so is consistent with the District Act and in the best interest of the groundwater producers and water users in the District's service area.

F2. Special districts have made very little progress in complying with the recommendations made by various governmental agencies. To ensure recommendations are followed, more coordination and cooperation is needed from the city and county agencies.

The District wholly disagrees. This is a broad and general finding. The District would need more information regarding which recommendations were made and not followed to properly respond. The District is willing to work with LAFCO and any other government agencies in considering consolidations that may improve management of the groundwater basin and local water supplies.

F5. The sixteen enterprise districts typically started as local agricultural irrigation providers and sanitation providers for local communities. These special districts have transitioned into providers of potable water and sewerage disposal for the cities that blossomed around them after 1950. These districts grew until their boundaries met a neighboring special district that was also growing. Some of these local smaller providers have already been absorbed by larger districts under one management.

The District agrees.

F6. The sixteen enterprise special districts of Orange County founded between 1919 and 1964 have grown with the urbanization of the county. Thirteen of these special districts rely upon taxes collected by the county while three rely on fees and other sources for their revenue. This suggests that all of these enterprise special districts could wean themselves from tax subsidies and rely on fees for their revenue. Severance from the tax subsidies would enable financial transparency and let the customers see the true cost of the services provided.

The District wholly disagrees. The District anticipates receiving approximately \$19.4 million in property tax revenues in fiscal year 2012-13. This funding has been pledged and used by the District to repay debt service from previous bond issuances which were used to fund the construction of local water supply projects. Elimination of the property tax revenue the District annually receives would necessitate increasing the District's replenishment assessment rate by approximately 24%. If the Grand Jury's recommendation were to occur, the District would recommend a reduction in the ratepayer's property taxes to offset the increase in the District's replenishment assessment.

F7. The unrestricted reserves of the special districts are available to the governing boards to spend as they please. Local citizens are not openly informed of this wealth when agencies ask for fee increases, special assessments, or bond measures. Most of the special districts do not appear to have specific criteria for amassing these reserves nor do they have published long-range plans for their constructive use.

The District wholly disagrees. The District has adopted policies at public meetings for the need and amounts of unrestricted reserves that are maintained. The District has also discussed these policies with representatives of the 19 retail water agencies the District serves. Restricted and unrestricted reserves are accumulated for specific uses to assist the District in managing the groundwater basin.

The District has long-established and strict policies for the reserves it maintains. Reserves are accumulated to ensure the successful operation of the groundwater basin.

Among other necessary reserve funds, the District maintains the following:

Toxic Cleanup Reserve Fund - established for toxic spill emergencies and cleanup. The current target level is \$ 4 million and is to be replenished annually after the adoption of the annual OCWD budget.

Contingency Reserve Fund - established by the District Act to provide for expenditures that have not been anticipated or provided for in the District's annual budget. The money for this fund is to be allocated from the Operating Fund and the Water Reserve Fund at the beginning of each fiscal year. The level of this fund as established by the District Act is not to exceed \$ 3 million.

Basin Equity Assessment Fund - established by the District Act for funds received from the levy of the District's Basin Equity Assessment. These funds are to be used only for the purchase of water for the purpose of groundwater replenishment and/or to reimburse producers assigned pumping limitations per the District Act.

Water Reserve Fund - established by the District Act to accumulate any excess general assessment, or unexpended funds, other than funds allocated to the operating reserve or operating contingencies by the Board of Directors. These funds can be used for the purchase of supplemental water for groundwater replenishment, acquiring, constructing or developing any groundwater intrusion prevention projects, pipelines, wells or other works necessary for the purposes of the district. Going forward, under the new Reserve Policy, this fund shall be designated only for purchases of supplemental water in order to have funds set aside and available. This will provide accountability and transparency to the Board and Groundwater Producers on funds collected and spent on water

purchases. The maximum upper limit is set at enough funds to purchase 50% of water needed to have an accumulated basin overdraft of 125,000 acre-feet.

***Repair and Replacement Fund** - established for replacement or refurbishment of District facilities, to be equal to thirty years of projected Replacement and Refurbishment (R&R) costs as defined in the District's R&R model.*

From 2008 to 2011 the District accumulated \$59 million in reserves which provided for the purchase of 93,000 acre-feet of discounted replenishment water from the Metropolitan Water District in 2011. These purchases will save the groundwater producers and water users within our service territory approximately \$28.3 million in water supply cost.

The District also maintains unrestricted reserves at the current levels to preserve its AAA/AAA/Aa1 credit ratings, which allows the District to access very low interest rate debt to fund local water supply projects, thereby saving the District (and its groundwater producers and water users) millions of dollars.

Moreover, in keeping with the District's policies of financial transparency, the District's reserves are provided in monthly reports to the Board which are agendized at public meetings and available to the public on the District's website, www.ocwd.com, and/or upon written request.

F8. The twenty-seven special districts in Orange County have amassed unrestricted reserves of over \$866,000,000. That is enough money to fund all of these special districts for more than a year without taxes, fees, interest, or other sources of revenue. The boards of directors have the sole discretion to spend these unrestricted reserves.

The District partially disagrees. The District has not independently surveyed all of the special districts' unrestricted reserves amounts, nor their operating budgets, and therefore cannot provide an informed response to this finding. The District agrees with the Grand Jury finding that it is the duty of the boards of directors of the special districts to oversee how reserves are accumulated and spent.

F10. The enterprise special districts could save millions of dollars in administration costs by consolidation into regional special districts. Five or six such enterprise special districts within Orange County could save at least \$500,000 per year for each special district absorbed.

The District partially disagrees. The District concurs that there are special districts that could be studied, reviewed and considered for consolidation. The District is not aware of what criteria was used to determine that “five or six” special districts was the optimum number, nor the minimum \$500,000 estimated savings.

F14. The true cost of water and sanitary sewers in the enterprise special districts is hidden when both taxes and fees fund these districts. Only when the monthly service bills to the customers include all the costs for these services without the tax subsidy will the public understand the true cost of these services and achieve financial transparency.

The District wholly disagrees. The District believes that it is important for water and sanitary sewer districts to be financially transparent, including provision of full revenue source disclosures, so the public is aware of the costs of service. The District’s financial information is available on line and is discussed publicly at agendized meetings. The District will continue to improve upon its financial transparency.

F15. Only one of the special districts, The South Coast Water District, has had recent performance audits. The lack of performance audits for the remaining special districts leaves the potential for inefficiencies, poor practices, outmoded operations, etc. hidden from the governing boards and the communities they serve. The lack of published performance audits has contributed to the public's ignorance of these districts.

The District partially disagrees. Performance audits are one way to maintain an efficient and effective organization. If special districts are not routinely considering ways to improve the operation of their organizations then the potential for waste exists.

District staff spoke with senior management at the South Coast Water District, who indicated the performance audit being cited was of limited value to the organization.

The publication of performance audits could help educate the public on the role and function of special districts. However, there are more appropriate methods to educate the public regarding the roles of special districts and there are other audits the District does and has participated in that validate the District’s responsible fiscal management. Audits include regular financial audits and project audits conducted independently by state and federal agencies.

RECOMMENDATIONS

In accordance with *California Penal Code* §933 and §933.05, the 2011-2012 Orange County Grand Jury requires responses from each agency affected by the Recommendations presented in this section.

Based on its investigation of special districts in Orange County, the 2011-2012 Orange County Grand Juries made ten recommendations of which OCWD is commenting on six items below:

R1. All special districts (except the Vector Control District and the County Cemetery District) should be eliminated from the county tax rolls and should rely solely on fees or the services of surrounding governments. (See F2, F3, F4, F5, & F6.)

The recommendation will not be implemented because it is not reasonable. Each of the special districts receiving property tax revenues should be independently reviewed to determine the optimum method of financing its operations. Raising fees may not be easily accomplished for some special districts and should not be an assumed alternative.

The District anticipates receiving approximately \$19.4 million in property tax revenues in fiscal year 2012-13. These funds have been pledged to repay annual debt service for projects the District has constructed to increase the amount of local water supply available to our service territory. Revenues help repay debt service for infrastructure projects such as the Groundwater Replenishment System which is an historical, international award-winning project that creates 70 million gallons of new purified water every day; enough water for nearly 600,000 residents of the 2.4 million we serve. If this money was not received the District would need to raise our rates about 24% to recover the lost revenue. If the District were to lose these revenues the District would recommend lowering the property tax rates for the citizens within the service area.

R4. Water and sewer districts should be consolidated into no more than six regional districts. Consideration should be given to including the city water agencies in the consolidation. LAFCO should meet with the water and sewer districts before October 31, 2012 to develop plans and schedules for consolidation.

The recommendation will not be implemented because it is not warranted and is unreasonable. The District has the unique responsibility to protect Orange County's water rights to the Santa Ana River and to protect and manage the groundwater basin that underlies north and central Orange County. No other agency in the County has similar responsibilities. Given the District's unique duties and role in

the region, it would be impractical, unreasonable and likely detrimental to the public to consolidate it with retail water agencies due to some misperception regarding cost savings or efficiencies gained through consolidation.

R5. Water and sewer districts should be removed from the tax rolls and operate solely on fees and other revenues for their services. Consideration should be given to forming non-profit agencies with ownership shared by the constituents. These districts should meet with county officials before October 31, 2012 to prepare plans and schedules to remove themselves from the county tax rolls. (See F2, F5, & F6.)

The recommendation will not be implemented because it is not warranted and is unreasonable. The District's receipt of property taxes was provided for with the passage of our District Act by the California legislature in 1933. Thus the California Legislature must amend the Act for the District to be removed from the tax rolls. As previously mentioned the loss of this revenue would create the need to raise our rates by approximately 24%. The District provides a unique service. We doubt that any other form of government would be more efficient; however District staff is willing to meet with agencies and/or officials engaged in discussion of this issue.

R6. Special districts should adopt "board of director's practices" for all their reserves, restricted and unrestricted. All reserves should be classified in their 2013-2014 budgets according to GASB Standard No. 54. LAFCO should work with the special districts to prepare standard criteria for accumulating reserves according to the new classifications by December 15, 2012. These standards should be used in preparing the 2013-2014 budgets. (See F7 & F9.)

The recommendation will not be implemented because it is not warranted. The District has the unique job of managing the groundwater basin under north and central Orange County. The basin yields 65% to 75% of the region's local water supply. The District has long-established and strict policies for the reserves we maintain. Reserves are accumulated to ensure the successful operation of the groundwater basin. For example from 2008 to 2011 the District accumulated \$59 million in reserves which provided for the purchase of 93,000 acre-feet of discounted replenishment water from the Metropolitan Water District in 2011. These purchases will save our service territory approximately \$28.3 million in water supply cost.

Additionally, the District has approximately \$60 million in reserves to help with the maintenance, refurbishment and replacement of over \$800 million in infrastructure and assets.

The District also maintains unrestricted reserves at their current level to preserve our AAA/AAA/Aa1 credit ratings, which allows the District to access very low interest rate debt to fund local water supply projects saving the District millions of dollars.

The District works very closely with the 19 retail water agencies that pump groundwater from the basin. We prepare and review our annual budget with these agencies each spring. Our budget format has evolved and been developed with these agencies to provide a consistent format and transparency that is easy to understand and read.

GASB 54 only applies to governmental funds, not proprietary funds. The District uses proprietary fund accounting and currently reports reserves as restricted and unrestricted.

R7. Excessive unrestricted reserves should be used to reduce existing debts. Future revenues should be reduced to avoid the accumulation of unallocated revenue that does not meet the adopted new standards. (See F7 & F8.)

The recommendation will not be implemented because it is not warranted. The District does not have any unrestricted reserves that could be used to reduce existing debts. There are long established policies for minimum reserve and operating fund levels to ensure that the District can continue to carry out its mission to effectively manage, protect the groundwater basin, and maintain our high credit ratings.

R8. Each special district should have an independent performance audit at least every three years. The executive summary of the performance audit should be distributed to all the taxpayers of each special district. Each of the special districts that has not had a performance audit within the last five years should contract with an independent outside consultant to conduct such an audit during 2012. These audits should be repeated at least every three years. (See FI5.)

The recommendation will not be implemented because it is not warranted. The District continuously reviews operations and considers ways to reduce costs. Examples of these efforts include:

- Several staff positions have been eliminated with attrition;***
- The District has hired a consultant to assist in improving organizational issues;***

- ***Entered into a electricity demand response program to reduce annual power cost;***
- ***Retiree health insurance benefits for all new employees have been reduced;***
- ***Security services have been reviewed and reduced;***
- ***The number of hard copy agendas and staff reports prepared for Board meetings has been reduced and binding methods changed to reduce copying costs.***
- ***A program to improve the Districts ability to recharge Santa Ana River water into the groundwater basin was determined to be ineffective and was eliminated.***

LAFCO conducts an independent municipal service review (MSR) on the District every five years. The MSR is required to address seven specific determinations including growth and population projections, location and characteristics of any disadvantaged communities, present and planned capacity of facilities and services, financial ability of agencies to provide services, accountability for community service needs including governmental structure and operational efficiencies and any other matter related to effective or efficient service delivery. No significant issues for the District were noted in preparation of our most recent MSR.

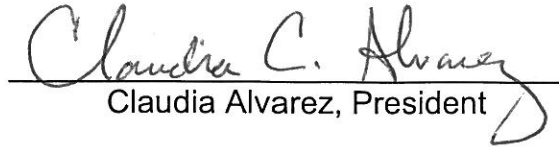
R9. Each special district should contribute 1% of its unrestricted reserve fund to LAFCO to help finance preparing and directing the consolidation, absorption, or elimination, and the setting of standards for reserves for the special districts. These funds should be included in LAFCO's future programs and budgets until the consolidation, absorption or elimination of each special district is achieved. With these additional funds, LAFCO should begin meeting with each special district before the 2014 fiscal year is budgeted for consolidation, absorption and/or elimination of these districts. (See F1, F2, F3, F4, F5, & F6.)

The recommendation will not be implemented because it is not warranted and is unreasonable. The District's unrestricted reserves are collected and maintained for specific purposes for our rate payers. Additionally it is unclear if the District Act provides the legally authority to allow us to contribute 1% of our unrestricted reserves to LAFCO. The 1% figure seems to be an arbitrary amount and should be based upon a specific work plan and should take into account existing LAFCO funding.

If LAFCO needs additional funding to consider, facilitate and process future consolidations, the District recommends that this increased amount of funding be included in future LAFCO budgets.

Thomas J. Borris, Presiding Judge
July 20, 2012
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Please feel free to contact the OCWD General Manager Michael Markus should you have any questions regarding this response to the Grand Jury's "Let There Be Light" report.


Claudia Alvarez, President