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**SERRANO WATER DISTRICT
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June 28, 2012

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

Re: Response of Serrano Water District to Orange
County Grand Jury Report "Let There Be Light"

Dear Judge Borris:

Pursuant to California Penal Code sections 933(c) and 933.05, the Board of Directors of the Serrano Water District ("SWD"), which is the governing board of SWD, has approved this letter responding to the findings and recommendations in the Orange County Grand Jury's April 27, 2012 report entitled "*Let There Be Light, Dragging Special Districts from the Shadows*" (the "Report"). The Report requests that SWD respond to its findings F1, F2, F5, F6, F7, F8, F10, and F11, and recommendations R1, R4, R5, R6, R7, R8 and R9.

SWD responds as follows to the Findings and Recommendations of the Report:

Grand Jury Finding F1: "Most Orange County special districts, with or without the assistance of the Local Agency Formation Commission Organization ("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."

Response to Grand Jury Finding F1: SWD disagrees with Finding F1. The Report does not provide specific information to support Finding F1, including the express assumption that special districts are “outmoded and/or redundant” and the implicit assumption that consolidation or elimination of special districts is necessary or desirable; and SWD has not specifically investigated and is not otherwise aware of facts documenting or supporting Finding F1. SWD notes that, in its May 9, 2012 response to the Report, LAFCO also disagrees with Finding F1. With respect to SWD specifically, SWD has over the years communicated with a number of agencies adjacent to its service area regarding the potential for merger or consolidation, the provision of services, or the shared use of staff resources in order to increase the quality of service to the lands and residents within these other agencies, and to achieve greater economies of scale for SWD.

Grand Jury Finding 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.”

Response to Grand Jury Finding F2: SWD disagrees with Finding F2. The Report does not provide specific information to support Finding F2, and SWD has not specifically investigated and is not otherwise aware of facts documenting or supporting Finding F2. As described in its response to Finding F1, SWD has made a number of efforts to effect mergers, consolidations, or the shared use of services and staff resources.

Grand Jury Finding 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.”

Response to Grand Jury Finding F5: SWD generally agrees with Grand Jury Finding F5. SWD was formed to serve agricultural water to the lands within its boundaries, and has transitioned over the years into an independent governmental agency providing municipal, domestic, and agricultural water service to the lands and residents within its boundaries.

Grand Jury Finding 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 of them 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.”

Response to Grand Jury Finding F6: SWD partially agrees with Grand Jury Finding F6. SWD concurs that enterprise special districts in Orange County have grown with the urbanization of the County, but disagrees with the remainder of Finding F6. SWD receives no share or allocation of the property tax generated from lands within its boundaries, and is not in a

position to evaluate either the propriety of other enterprise special districts receiving tax allocations, or the effect upon those agencies and their customers of the elimination of those property tax allocations.

Grand Jury Finding 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.”

Response to Grand Jury Finding F7: SWD partially agrees with Grand Jury Finding F7. SWD concurs with the conclusion that special district boards of directors have discretion regarding their agencies’ use of reserve funds. The Report does not provide specific information to support the other conclusions in Finding F7, and SWD has not specifically investigated and is not otherwise aware of facts documenting or supporting those other conclusions in Finding F7. SWD’s reserves, both restricted and unrestricted, are reported monthly to its board of directors in agenda materials that are publicly accessible and publicly available. SWD has plans and policies for the size and use of its reserves that are regularly reviewed by its board of directors; these reviews are undertaken at open, public meetings of the SWD board of directors.

Grand Jury Finding F8: “The twenty-seven special districts in Orange County have amassed unrestricted reserves of over \$866,000,000. That is enough 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.”

Response to Grand Jury Finding F8: SWD partially agrees with the Grand Jury Finding F8. SWD concurs with the conclusion that the boards of directors of special districts have discretion regarding the use of their agency’s unrestricted reserves. SWD has not specifically investigated and is not otherwise aware of facts documenting or supporting the other conclusions in Finding F8.

Grand Jury Finding 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.”

Response to Grand Jury Finding F10: SWD disagrees with Finding F10. The Report does not provide specific information to support Finding F10, and SWD has not specifically investigated and is not otherwise aware of facts documenting or supporting Finding F10. SWD has no information regarding what “five or six” enterprise special districts are being referred to in the Report, or the basis for or significance of either “five or six” special districts or the claimed \$500,000 annual savings from the consolidation of enterprise special districts. But, based on facts specific to it, SWD has determined that Finding F10 is inaccurate and incorrect. SWD holds appropriative water rights licenses from the State of California Water Resources Control Board to the surface flows of Santiago Creek and its watershed that are impounded within Santiago Reservoir (Irvine Lake), as well as contractual water rights to Irvine Lake water

pursuant to a 1928 agreement with The Irvine Company. Consolidation of SWD as part of a larger, regional water agency could jeopardize both the State appropriative water rights licenses and the contractual water rights, and thereby significantly adversely impact the supply of water to the lands and residents within SWD's boundaries, as well as the cost of that water. In addition, as a small water agency, SWD provides a high level of personalized service to its customers, which likely would be reduced or lost if SWD were consolidated into a larger, regional agency.

Grand Jury Finding 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."

Response to Finding F15: SWD partially agrees with Finding F15. SWD has not specifically investigated and is not otherwise aware of any facts regarding the conduct of a "performance audit" by the South Coast Water District, or the scope of that "audit." SWD concurs with the Report that the periodic evaluation of agency performance is one way to highlight to the governing board, and to allow the governing board to address, issues relating to efficiency, practices and operations. Such an evaluation is conducted by LAFCO approximately every five years as part of its municipal services review of every special district. SWD believes that "performance audits" are just one of a number of ways to educate the governing board regarding agency efficiency, practices and operations, or to educate the public on special districts generally.

Grand Jury Recommendation 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 for the services of surrounding governments."

Response to Recommendation R1: This recommendation will not be implemented by SWD because it is not warranted, insofar as SWD is concerned. SWD does not receive any allocation or share of property taxes from the lands within its boundaries, and has no authority to effect the elimination of tax revenues from any other special district.

Grand Jury Recommendation R4: "Water and sewer agency 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 agencies before October 31, 2012 to develop plans and schedules for consolidation."

Response to Recommendation R4: The recommendation will not be implemented by SWD because it is not warranted and is not reasonable. SWD has received no information, and has no reason to believe, that its consolidation with one or more other agencies into one of "six regional districts" would in any way increase efficiency, transparency or cost effectiveness, or reduce costs to SWD's customers. As described more fully in its Response to Grand Jury Report Finding F10, the consolidation of SWD into another water agency could result in the loss of SWD's appropriative water rights licenses and contractual water rights, which would have a significant negative impact upon the lands and customers within SWD's boundaries by

reducing the quantity of water supplies available to serve SWD customers and increasing the cost of water service to them. In addition, the consolidation of SWD into a large, regional water agency would likely result in reduced levels and quality of service to SWD customers. Discussions regarding the reorganization of local utility services should be initiated and made by the customers who are directly affected.

While SWD will not implement efforts to consolidate it into a regional water agency, SWD does meet regularly with the staff of LAFCO to discuss issues of inter-agency cooperation, coordination and efficiency. SWD has taken a number of steps to foster inter-agency cooperation, coordination and cost efficiency for the benefit of the water users within SWD and other agencies, including SWD's long-standing agreement to provide wholesale water service to the City of Orange, and SWD's current provision of accounting and other staffing services to the East Orange County Water District.

Grand Jury Recommendation R5: "Water and sewer district 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."

Response to Recommendation R5: This recommendation will not be implemented by SWD because it is not warranted and is not reasonable. SWD does not receive any allocation or share of property taxes from the lands within its boundaries, and has no authority to effect the elimination of tax revenues from any other special district. The assumption of retail water sales within the boundaries of SWD by one or more "non-profit agencies" could result in the loss of SWD's appropriative and contractual water rights, which would significantly reduce the amount of water available for use by SWD customers and increase the cost of the remaining water. Such consolidation would also likely reduce the level and quality of service that SWD provides to its customers.

Grand Jury Recommendation R6: "Special districts should adopt 'board of director's practices' for all their reserves, restricted and non-restricted. All reserves should be classified in their 2013-2014 budgets according to GASB Standard No. 54. LAFCO should work with the special district to prepare standard criteria for accumulating reserves according to the new classifications by December 15, 2012."

Response to Recommendation R6: This recommendation requires further analysis to determine the applicability of GASB Standard No. 54 to SWD's budget, and the propriety of adopting "board of director's practices" and GASB 45 for restricted and non-restricted SWD reserves. Further, because SWD is almost unique among Orange County water agencies in that it receives a significant supply of its water resources from local surface water supplies for which it holds water rights, it is questionable whether any "standard criteria" for reserves would appropriately apply to SWD. Possible implementation of all or a portion of Recommendation R6 will be studied by SWD and considered by the SWD board of directors by October 27, 2012.

Grand Jury Recommendation 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.”

Response to Recommendation R7: This recommendation will not be implemented by SWD because it is not feasible or reasonable. SWD does not have “excessive unrestricted reserves.” SWD’s reserves serve particular purposes, and meet the plans and policies of SWD’s board of directors. It is questionable whether SWD’s unrestricted reserves can legally be used to reduce SWD’s existing outstanding debt. Further, unlike virtually any other water agency in Orange County, SWD’s principal assets include a large water storage reservoir and a water treatment plant; a policy to reduce future revenues in order to avoid the accumulation of unallocated reserves would be irresponsible in light of the need for unrestricted reserves to be available in the event of emergency conditions affecting either SWD’s reservoir or its treatment plant.

Grand Jury Recommendation 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.”

Response to Recommendation R8: This recommendation requires further analysis to determine the scope and extent of a “performance audit,” and its cost and relative benefits to the SWD governing board, its management and customers. As indicated in its response to Finding F15 of the Report, LAFCO conducts an evaluation of each special district’s performance as part of its municipal services reviews of special districts every five years. SWD will study this issue and bring it to the SWD board of directors for consideration by October 27, 2012.

Grand Jury Recommendation 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 years budgeted for consolidation, absorption and/or elimination of these districts.”

Response to Recommendation R9: This recommendation will not be implemented by SWD because it is not feasible or reasonable. Absent the statutory authority or requirement to do so, a “contribution” by SWD of 1% of its unrestricted reserves would likely be an unconstitutional gift to LAFCO, exposing the members of SWD’s board of directors to personal liability for that amount. In addition, there is no indication that LAFCO lacks the resources it needs to conduct the studies and analysis that LAFCO determines appropriate with regard to the provision of water, sewer and other municipal services in Orange County.

Please feel free to contact me should you have any questions regarding the responses of the Serrano Water District to this grand jury report.

Very truly yours,

Serrano Water District

By: Robert F. Rickerl
Robert F. Rickerl,

President of the Board of Directors