



2005-2006 SANTA CLARA COUNTY CIVIL GRAND JURY REPORT

THE SANTA CLARA VALLEY WATER DISTRICT – WHAT’S BENEATH THE SURFACE?

Summary

The 2005-2006 Santa Clara County Civil Grand Jury (Grand Jury) conducted a review of the Santa Clara Valley Water District (SCVWD or District). The Grand Jury examined District documents, conducted interviews, and engaged professional accounting services for this inquiry.

The Grand Jury makes the following findings and recommendations:

1. The District generally does a commendable job of providing water, protecting watersheds, and implementing flood control in Santa Clara County (County).
2. Voters fail to participate actively in SCVWD director elections. Many directors run unopposed and many serve multiple consecutive terms. The elected directors may not represent a broad cross-section of the population. Independent voter advocacy organizations and news media should encourage, educate, and energize the public about the importance of participating in the electoral process. This may also provide a forum for explaining and vetting SCVWD programs for a broader set of stakeholders.
3. There is an effort under way (AB 2435) to terminate the provision for annual Board of Supervisors (BOS) review of the SCVWD budget. The Grand Jury firmly believes that the current oversight arrangement should not be terminated. The effective management of a service as vital to the County as water cannot be improved by reducing oversight. The reality of limited voter involvement argues all the more for retaining the relationship between the SCVWD and BOS. Furthermore, the Grand Jury believes this relationship should be a model for oversight of other independent special districts in the County.
4. Since the SCVWD Board has powers for taxation, eminent domain, rate setting, and debt issuance, no Board members should be appointed. The two currently appointed Board positions should be converted to be filled by elected BOS members. Participation of BOS members would serve to strengthen the link between the SCVWD and the BOS to perform the budget oversight function as well.
5. There are strongly held diverse opinions concerning the proper role of the District and its spending. Projects and expenditures are not always supported

by the public or by retail distributors. The District needs to better communicate and vet its activities with the various stakeholders and the public. Program goals should be selected through procedures that are more responsive to these views.

6. Water rates have increased significantly over time because of higher costs and Board decisions. Poorly understood rate differentials between North and South County have to be better justified and explained. The District should carefully prioritize its capital projects and other costs to fully justify rate increases.
7. Outside auditors question some District financial practices, including management of CalPERS benefits accounts, year-end cash balance, and cash flow. The District should consult outside financial advisors to be sure it is using best practice.
8. There have been substantial criticisms that reserves are excessive and inadequately justified. Even though the District has reduced its reserves significantly in recent years, it should clearly document its reserve management policy and justify its reserve levels. It should also reconsider and justify the balance between pay-as-you-go and debt funding of capital projects.
9. The District is implementing performance measurement and improvement programs that impose extra workload on the staff. The District needs to refine and coordinate its performance measurement efforts to refocus on those programs that can offer the most useful and tangible results.

Background

In 1968 the Santa Clara County Water Conservation District and the Santa Clara County Flood Control & Water Conservation District were consolidated and became known as the Santa Clara County Flood Control and Water District. It was later renamed the Santa Clara Valley Water District. The SCVWD was created by the Legislature under the Santa Clara Valley Water District Act, California Water Code Appendix, Chapter 60 (District Act), as a special water district with an independent Board of Directors. To address concerns of some County Supervisors, the County retained oversight of the District's budget and the power to appoint two at-large Board members.

The SCVWD has responsibility as the County's principal water resource agency for supplying wholesale water, water treatment, flood protection and watershed stewardship. The District's jurisdiction encompasses the county's 1,300 square miles. It serves the 15 cities and 1.8 million residents in the County. The District resells water to 13 retailers, five private companies and eight public agencies. Long-term County water requirements are continually analyzed and reviewed by the District. Santa Clara Valley's current annual water needs are just below 400,000 Acre Feet (AF). This is equivalent to about 130 billion gallons per year. Consumption is expected to grow approximately 18% by 2020, in spite of continuing efforts to conserve and recycle water.

In years of normal rainfall, approximately half of the County's water comes from groundwater, local surface water stored in reservoirs, and recycled water. The remainder is imported from the Sierra snow pack through the Sacramento/San Joaquin River systems and is purchased by the District from both the State Water Project and the Central Valley Project. The Hetch Hetchy water system is the third water source. It is operated by the San Francisco Public Utilities Commission, which contracts to supply water directly to several North County communities. The District operates and maintains ten reservoirs, three sub-basins or aquifers (Santa Clara County, Coyote, and Llagas sub-basins), three water treatment plants, three pumping stations, a hydroelectric plant, 18 groundwater recharge facilities, and an extensive water distribution system. As a hedge against drought, the District has contracts for banking water outside the county.

As of Fiscal Year (FY) 2006, the District has 813 authorized full-time-equivalent employees working in four divisions:

1. Water Utility Enterprise – municipal, industrial, and agriculture water supply
2. Watershed Operations – flood control and environmental stewardship
3. Capital Program Services – planning and construction management for capital projects
4. Administration – management, finance, and support

The four division officers report to the Chief Executive Officer (CEO), who in turn reports to the District's Board.

The Clean, Safe Creeks and Natural Flood Protection Special Parcel Tax (Measure B) was passed by over two-thirds of the voters in November 2000. The District Act was consequently amended to include environmental stewardship. The SCVWD assumed responsibility for ensuring clean and safe water in creeks, creating healthy creek and Bay ecosystems, and establishing trails and parks along the waterways. The District often enters into agreements with County municipalities and federal and state governmental agencies to partner on capital-intensive projects. The District must comply with increasingly rigorous water quality and environmental standards and operate in conformance with all government regulations.

The District and its operations can be characterized as follows:

- It is unique in that it has two primary responsibilities, providing water and performing flood control
- It is a capital-intensive business
- It is dependent on matching funds from government agencies for many of its projects

- It is required to interact with a complex, multi-agency system with diverse regulatory and jurisdictional powers
- It is involved with local communities whose interests must be respected and considered in the development of projects
- It works in a setting that often requires large, long-term projects

The complexity and long-term nature of SCVWD activities often cause a public perception that the District is slow to act and bureaucratic.

Since creation of the District, the BOS has essentially rubber-stamped the District's annual budget, except on two occasions when more substantive reviews took place. Several years ago, some discussion of the budget ensued when the Audubon Society raised concerns during the County's budget review. The Society felt the District's budget did not include sufficient environmental programs. In 2005, the BOS initiated an auditor's budget review of the District by the County Management Audit Division (discussed in more detail below).

Over the past six years the District has been the subject of several audits. In 2000, the District contracted with Malcolm Pirnie, Inc. for a performance audit of the water utility element of District operations. In 2006, the Red Oak Consulting Division of Malcolm Pirnie is doing a performance audit. In addition, the District has an annual independent financial audit. This audit is the basis for preparing the District Comprehensive Annual Financial Report (CAFR).

Discussion

In July of 2005, the Grand Jury initiated a review of the District by collecting and studying background information and detailed District management and operations information. The Grand Jury interviewed over 45 individuals, including current, former, and retired District employees, managers, and directors; concerned citizens; water retailers; County Supervisors; legislators; a city council member; and representatives of audit agencies. To assist with this review, the Grand Jury engaged the services of a forensic Certified Public Accountant (under Penal Code § 925-926).

This report covers the following topics:

- Mission
- Oversight and governance
- Personnel
- Finance
- Projects

MISSION

The District has taken the initiative to cooperate with all levels of government agencies, resulting in a multi-year permitting process for accomplishing flood control projects effectively. The District has designed and developed explicit policies, processes and practices for accomplishing its mission. Some examples are:

- Capital project planning and tracking
- Water resources planning
- Annual budgeting
- Water rate setting
- Management process improvement

The District appears to do a commendable job of delivering water, providing flood control, and serving as environmental steward for clean safe creeks.

A major source of contention about how the District operates appears to derive from differing views of its role. Many critics believe that the District should limit itself to the core functions of providing safe water and flood control. Thus, they might argue that a stream channel should be converted into a concrete conduit rather than an environmentally rich, restored creek.

The District takes a broader view, which includes environmental responsibility and public education. This stems from the increasing impact of environmental regulations and is supported by the majority of the voting public. To meet these new missions, the District has increased its range of activities, its staff, and its budget. The District proposed Measure B and achieved community support of that initiative by slightly over the required two-thirds majority. The District views this as a public mandate for its expanded environmental role. This role also leads to increased interactions with government agencies and local communities concerned with water and environmental issues.

The District chooses to operate as a pioneering organization and one which is perceived by peers and public as a premier operation. Along with this expanded role, the District conducts more extensive public relations and educational efforts. Since the District is prohibited from electioneering, it could not spend public funds to promote the Measure B initiative. It does spend funds to educate the public and create a positive image which helps to achieve passage of District-sponsored initiatives. The distinction between advocacy and education is subtle and subject to interpretation.

OVERSIGHT AND GOVERNANCE

Ostensibly, there are many sources of oversight and accountability for the District. Independent sources of oversight include: (1) voter election of five of the seven

District Board members, (2) District Water Commission review of water operations and rate setting, (3) annual BOS review of the District budget, (4) a required annual independent audit of District financial statements, and (5) oversight by the Clean, Safe Creeks Independent Monitoring Committee.

The District receives feedback about performance from other sources, including various advisory committees, special interest groups, concerned citizens, employee satisfaction surveys, and State and Federal agencies. The District has also chosen to undertake process and performance improvement programs.

Oversight by Voters

To assess the role of voters in overseeing the District, the Grand Jury obtained the voting records for all District elections since 1990 from the County Registrar of Voters. Analysis of these data shows that there were 22 races for District seats in 10 elections over the 14 years from 1990 to 2004. An average of only 43% of the eligible voters cast ballots in those general elections. Even fewer (28%) eligible voters cast ballots for District candidates. In 14 of these 22 races (64%) candidates were unopposed; in five elections (23%) two candidates ran, in one election (5%) three candidates ran, and in two elections (9%) four candidates ran (see Figure 1).

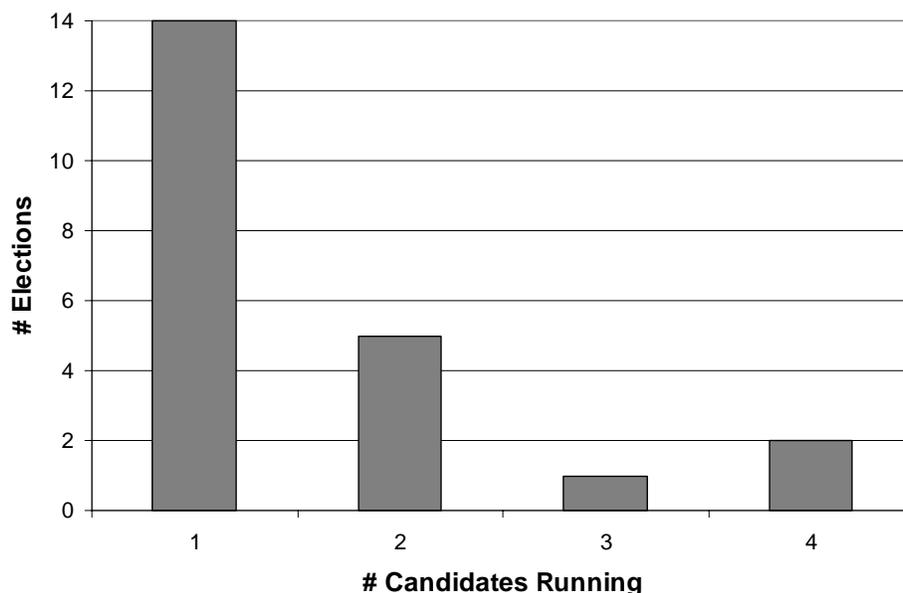


Figure 1: Competition in the past 22 elections for the SCVWD Board, 1990-2004

The five current elected directors have served 19, 12, 11, 9, and 5 years. Two of the seven directors are appointed by the BOS and have served 25 and 9 years. The average tenure of all seven current Board members is about 13 years.

Once on the Board, re-election or reappointment is almost assured. It was suggested during Grand Jury interviews that the only way a new member gets on the District Board is if an existing member retires. It might also be possible for an

unopposed retiring director to withdraw just before the election filing deadline and essentially guarantee the chances of a coincidentally available successor.

The SCVWD claims that it requires no oversight by the BOS because it is an independent district with its own elected Board accountable to the voters through the electoral process. This claim does not appear to be borne out by historical election data. It appears that voters are generally uninformed, uninterested, and do not provide effective oversight of the District.

Since the District has the power to tax, set rates, issue bonds, and impose eminent domain, some assert that all members should be directly accountable to the voters. Appointments are viewed as subject to political influence.

Water Commission and Other Advisory Committees

The purpose of the Water Commission is to assist the SCVWD directors with issues pertaining to water supply and quality as well as policy matters that are of interest to the municipalities and the County. Concerns include water rates, quality, reliability, and monitoring the Clean Safe Creeks and Natural Flood Protection Program. The Water Commission is composed of two representatives selected by each of the 15 municipalities and two County Supervisors.

There are seven other District advisory committees: Environmental Committee; Agricultural Committee; Landscape Committee and four flood control and watershed committees. The members of these committees are appointed by the District Board.

BOS Budget Oversight

The Board of Supervisors has had the responsibility to review and approve the District's annual budget under § 20 of the District Act. In response to the Management Audit Division's budget review of the District, ordered by the BOS in 2005, the directors wrote a letter to the BOS which objected to the scope of the auditor's review. It further suggested that the Management Audit Division was being overly intrusive and unreasonably demanding in the nature and substance of its inquiries. The District characterized the review as an "unauthorized management audit." The audit was completed and the District budget approved by the BOS without change.

The BOS now appears to be shrinking from its budget review responsibility by claiming (1) it does not have the resources to properly understand the District's budget or the impact of changes they might make and (2) it might incur legal liability if BOS actions resulted in some negative consequences. In spite of the stated concern in (1), two BOS members currently serve on the Valley Transportation Authority Board and on the Water Commission. The BOS is responsible for many aspects of County management that are at least as complex.

Removing the District from County BOS Oversight

This almost unprecedented 2005 auditor's budget review of the District, ordered by the BOS, caught the District by surprise during its annual budget cycle. This led to a recommendation, approved by the District Board and BOS, that the Santa Clara Valley Water District Act be modified to remove BOS oversight of the SCVWD budget. A substantial number of people interviewed, as well as the Grand Jury, believe that the District requires more, not less, accountability through vigilant oversight. The Grand Jury believes the District should welcome such oversight to solidify its approach to performing its crucial role for County residents. Opposing arguments on this issue include:

Arguments for severance:

- The SCVWD is an independent district and does not need a second board to provide budget oversight. No other independent special district in California is subject to review by two elected boards
- Oversight occurs through the voters
- The BOS does not have, nor does it desire to have, sufficient expertise and resources to understand and evaluate the District's operations and budget. The BOS traditionally approves the District's budget with minimal review
- The enabling legislation establishing BOS authority for budget oversight is based on concerns that are no longer relevant
- The SCVWD periodically contracts for performance and annual financial audits
- There is added cost and overhead for both the BOS and the District to perform a review of the SCVWD budget

Arguments against severance:

- Voters do not participate in District elections sufficiently to ensure oversight of what arguably is one of the most important assets and services for the County. It is not clear how District oversight will be improved by severing BOS authority over the District budget
- Outside overview appears to be useful. Some of the County auditor's assessments were considered by the District to be of merit and appear to be affecting District actions. A combination of public pressure, stakeholder pressure, State financial pressures, and County audit observations and recommendations has forced the District to reconsider and revise issues such as water rates, staffing levels, overhead, and reserve levels

- While the relationship between the District and the County may be unique, it has been beneficial and should serve as a model for improving oversight of other independent special districts in the County, some of which currently are run less professionally
- The SCVWD Act provides for the District to use County services that might save money overall by sharing common services and infrastructure. These provisions may be lost under current proposed amendments to the Water District Act (AB 2435)
- Any concerns that the County and/or the BOS could incur a liability as a result of a budget decision made while exercising oversight of the SCVWD appear to the Grand Jury to be ill-founded. Similar decisions are made regularly by the BOS in its other areas of responsibility without problem

The Grand Jury finds the arguments against severance to be compelling. Ongoing high-quality oversight of this crucial, large, and complex District from diverse points of view is essential. If the BOS retains oversight responsibility for the District budget, the County must identify the appropriate resources to understand and constructively critique the District's budget and operations.

Whether or not the District separates itself from the BOS, the two appointed director positions should be converted to elected positions as the terms of the incumbents end.

Oversight by the Board of Directors

The role of the District Board is to define the District's mission and be accountable for its achievement. The mission is stated to include, "... a healthy, safe, and enhanced quality of living in Santa Clara County through watershed stewardship and comprehensive management of water resources in a practical, cost-effective, and environmentally sensitive manner." In practice, this requires the Board to establish District policies, monitor their implementation and determine whether these activities are accomplished in a cost-effective manner. The Board also lobbies for the District before the public and government agencies. It serves as a channel for communication for the District and the public.

To help perform these governance functions, the Board has adopted a number of procedures to quantify and structure management processes (e.g., the Carver Policy Governance Model; the California Awards for Performance Excellence Program, which is a California adaptation of the Malcolm-Baldrige-based performance program; and the International Standards Organization (ISO) 9001 and 14001 quality and environmental management standards). The Grand Jury applauds SCVWD efforts to emphasize management and quality standards.

The SCVWD Office of Performance Excellence, which leads these activities, had a 2005 budget of over \$1.2 million. District staff reported that providing the information required by management process formalisms sometimes becomes a project in itself, diverting significant time and resources. A preliminary draft of the ongoing Red Oak audit has found issues with the translation of management objectives into practice.

The quest for effective measurement places a burden on the operation of the entire agency. The District needs to refine and coordinate its performance measurement efforts to refocus on those programs that can offer the most useful and tangible results.

PERSONNEL

Staff Size

Critics believe that the District staff is excessive. As shown in Figure 2, the authorized staff has grown from 567 in FY 1994 to 903 in FY 2005, while the filled positions went from 541 to 789. A major increase in staff size came about with the passage of Measure B. The District recently eliminated 90 open budgeted positions partly as a result of losing \$51 million over two fiscal years to the Educational Revenue Augmentation Fund (ERAF), a levy on districts and local governments to fund State budget shortfalls. It currently has 813 employees authorized in FY 2006, and no changes in staffing levels are projected. About 30% of the staff (245 persons) is currently eligible for retirement. This may represent a loss of key expertise from the District in coming years.

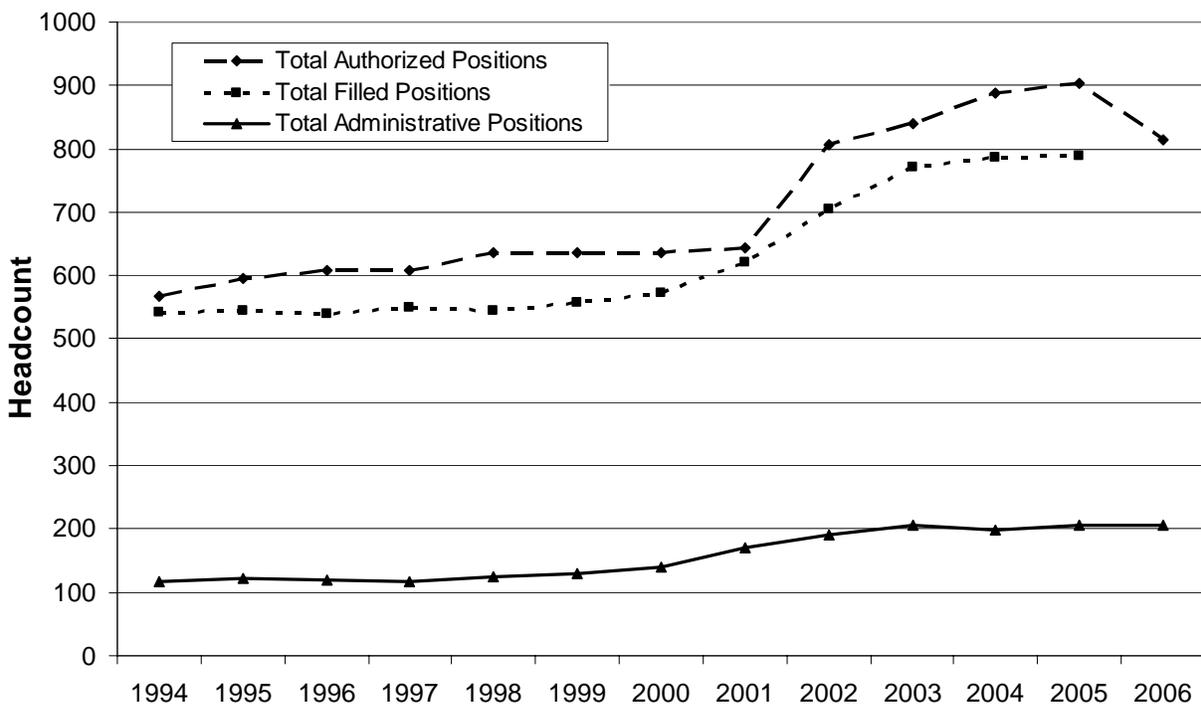


Figure 2: District headcount by Fiscal Year

One major criticism is the size of the administrative staff, estimated to be 214 persons (FY 2006). This represents 26% of the total authorized headcount (813 persons). The major categories of administrative staff are:

- Financial Services: 25 personnel (Accounting, Payroll, Claims, and Reimbursements)
- Human Resources: 38 personnel (Recruitment and Examination, Benefits Administration, Equal Opportunity, and Program Administration)
- Administrative Services: 37 personnel (Mail Center, Library, Reproductions, and Word Processing)
- Risk and Insurance: 2 personnel (Claims, Workers' Compensation, and Self-Insurance Funds)
- Equipment: 11 personnel (Purchase and Vehicle Maintenance, and Field Equipment)
- Other Administrative Positions: 101 personnel

There are also 33 unclassified, senior, high-salary employees (average \$152,000 base salary as of January 2006) who serve at the pleasure of the CEO.

Salaries

The District's Human Resources Department acknowledged that the minimum and maximum salary ranges for similar positions which exist in the County tend to be higher in the District as they attempt to attract highly qualified candidates. The District's budgets for salaries and benefits doubled from \$49 million in FY 2000 to \$99 million in FY 2006. This is due to increases both in staff size and in associated salaries and benefits.

Salaries are set by Board policy at the 60th percentile of corresponding job classifications for what the District views as comparable agencies. The District claims that in the late 1990s, it was difficult to recruit qualified candidates because of competition with "dot com" companies. As a result, higher salaries and benefits had to be paid. The Grand Jury has some difficulty understanding why water-related jobs were more difficult to fill as a result of industry demand for other technology specialties.

Other government agencies and service companies interviewed indicated that capable staff were lost to the SCVWD because of salary differentials. Accordingly, employee salaries in other agencies had to be increased to compete. The excellent salaries and benefits appear to have attracted more senior people to the District. The Grand Jury believes there should be a "level playing field" between County and local government agencies in recruiting and retaining qualified staff.

The District's compensation system compares data from similar labor markets as well as collective bargaining agreements with its three unions. The comparisons include four water districts, five local cities, and the County, and takes into account base salary, employer-paid benefits, and retirement contributions.

- For Employees Association jobs in 2005, the average salary was over 4% higher than comparable markets. This represented a decrease from 2004, when the average was 6% higher. Specific salaries ranged from about 1% above market comparisons for Industrial Electrician II positions to 10% above market for Associate Real Estate Agent positions
- For Engineers Society jobs, the average salary was over 3% higher than comparable markets. This represented a decrease from 2004 when the average was somewhat less than 6% higher. Specific salaries ranged from about 2% above market comparisons for Assistant Engineer I (Civil) positions to 4% above market for Associate Civil Engineer (Regular) positions
- For Mid-Management Association jobs, the average salary was almost 7% higher than comparable markets. This represented a decrease from 2004 when the average was almost 8% higher. Specific salaries ranged from about 0.4% below market for Facilities Management positions to 17% above market for Laboratory Services positions
- For the 33 unclassified positions, the average salary was lower than comparable markets by about 1% in both 2004 and 2005

The 2005 BOS auditor's budget review stated that District salaries and benefits were on average about 26% higher than those of County employees. Salary differentials, not including benefits, found by the Grand Jury were only 2 to 10 % higher when compared to directly corresponding County jobs. The 26% figure may be a result of the fact that there are proportionately many more personnel in lower paid jobs in the County.

Benefits

SCVWD employees have generous retirement benefits. After 10 years employment, they are eligible for full lifetime health insurance. After 15 years, health insurance coverage includes the employee and one dependent. As with many retirement health-benefit programs, associated benefit obligations are not fully funded. The District is aware of this and has developed a catch-up plan.

In January 2003, the District increased its CalPERS contributions from 2% to 2.5% at age 55. A 2.5% benefits rate appears not to be uncommon among County municipalities. This means that a 30-year employee, who would have received 2% of their salary for each year served, will now receive 2.5%. The 2.5% rate will increase the District's benefits costs by about 25%. It applies not only to the employee's future wages but also to those earned in the past.

The District recognizes the problems with continuing to offer benefits at this level and has been in discussion with its three unions regarding wages and benefits, including health care.

District wage and benefits increases over the past five to ten years appear to have locked the District into high personnel costs. In retrospect, shorter term bonus or offset payments might have solved the competition issues with local industry and resulted in lower projected costs.

FINANCE

Board Spending

In FY 2005, the budget for director fees and expenses totaled almost \$312,000. Expenditures for the Board advisory committees were over \$411,000. For Fiscal Years 2003 through 2005, District staff and directors attended 344 out-of-area meetings or conferences. Director travel accounted for 48% of the trips. One Director stood out in this regard and accounted for about 52% of Board travel. From a business practices point of view, it might be expected that travel would most frequently be justified to send staff, rather than directors, to professional, educational, or inter-agency meetings.

In 2003, the total reimbursements for the Director who traveled the most (Director A) were almost \$70,000, about 140% above the average reimbursement level for other directors (see Figure 3). This was the subject of a highly critical article in a local newspaper. In FY 2003 and FY 2004, this Board member made 85 out-of-area trips, compared to 24 trips for the next most-traveled member. This was more than the total of 75 trips for all other Board members combined. Travel expenses for Director A increased by about 65% between FY 2000 and 2003. Activities for this Director also involved memberships and significant positions on other water-related agencies, e.g., serving as Vice Chair of the Bay Area Water Forum and the Association of Bay Area Governments' CALFED Task Force. This Director is affiliated with about 12 agencies involved with water and environment.

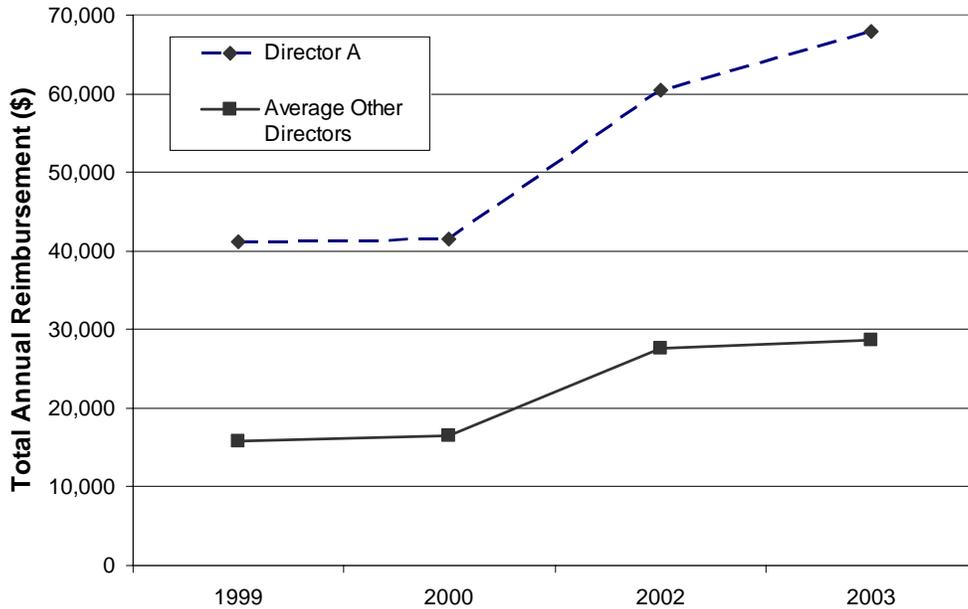


Figure 3: Comparison of total annual reimbursement for Director A with Board average

The District asserts that the services provided by this Director are extremely valuable in keeping the District informed and in promoting its legislative agenda. In addition, they facilitate the District having an impact on State and Federal water policies, as well as obtaining matching project funds from government agencies.

The Grand Jury, after interviewing this Director and reviewing travel and expenses, believes this Director's contribution may be substantial and cost-effective, although it appears anomalous and has created a negative impression with some public critics. It is not clear to the Grand Jury how this Director's lobbying activities are coordinated with the interests of the District and the rest of the Board, except through retrospective trip reports. The question arises as to how the District ensures that individual Board members represent Board and District strategy and goals when traveling, as opposed to their own personal agendas. The District is currently reviewing travel and meeting policies.

Water Rates

One of the primary sources of District revenues is the District's Water Enterprise group which provides wholesale water to retailers. The District's wholesale water comes from two main sources – imported water and groundwater. Imported water for the North County is stored and treated before it is sold. Water from ground sources is used for both North and South County (the dividing line is defined to be roughly Metcalf Road). Such water is used by well owners and is pumped, without treatment, by some retailers. The District imposes a *groundwater charge*, or what users refer to as a *pump tax*. Imported water is considerably more expensive than groundwater. Aquifers in the

southern part of the County are recharged by seasonal rainfall, supplemented as necessary by local and imported water.

Specific water-rate concerns voiced to the Grand Jury include perceptions that may or may not “hold water:”

- Over time, larger retailer bills to customers are driven by increasing pass-through costs from the District
- The SCVWD sets excessively high rates to fund the District’s ostentatious life style
- “Pump taxes” to pay for recharging aquifers with imported water, are excessive, since rainfall accomplishes much of this naturally

These perceptions represent a problem in communicating the complex facts, judgments, and justifications the District uses in their rate setting policies and practices.

What is perceived as an ongoing rate increase is disturbing to those viewing the District. They see no end to higher water rates, even though the demand over the next ten years is forecast to be relatively flat. Several key factors, over which the District has little control, drive the rates:

- Costs of water from Federal and State sources are up 100% and 24% respectively over that last four years
- Costs of chemicals and electrical power have increased 86% and 71% respectively over the last four years
- \$51 million was paid over the last two fiscal years to the State’s ERAF, representing a major and unanticipated loss of property tax funds
- Costs of complying with complex government regulations have increased substantially

Each year the District analyzes and sets the water rates to be charged to its customers. The rates set by the District are passed on by water retailers. The District’s rate-setting process is complex and extensive, and includes price differentials for residents in different parts of the County. Based on policies set by the SCVWD Board, North County users currently pay about twice the amount paid by South County users (see Figure 4).

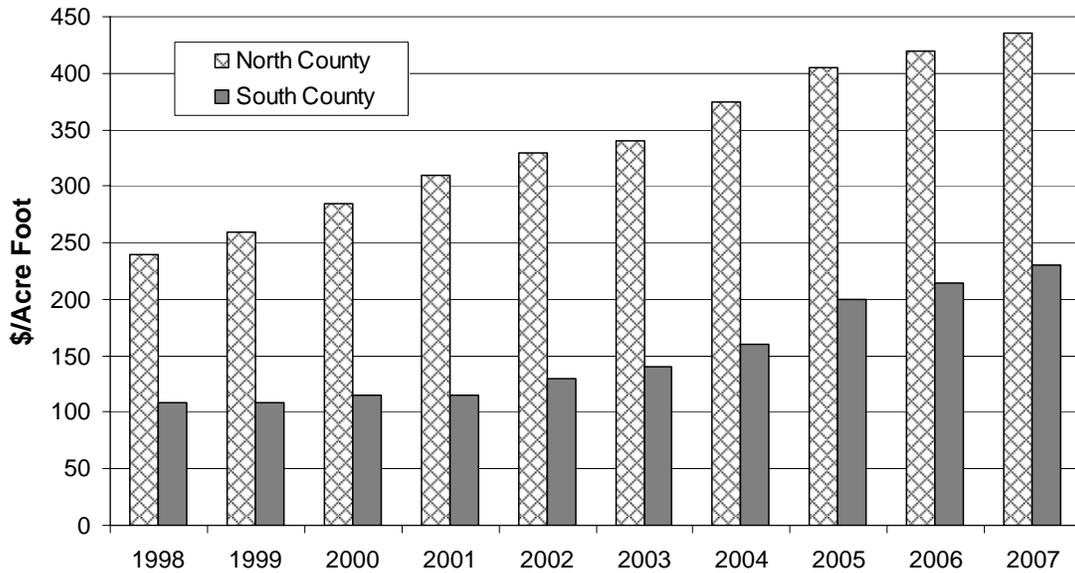


Figure 4: Historical comparison of North and South County water rates

This reflects, in part, a Board decision to subsidize South County agricultural users in order to encourage open space preservation. Over and above the basic cost of components, such as chemicals, electrical power, and imported water, the directors must exercise judgment as to what rate structure will be acceptable to the public (see Figure 5).

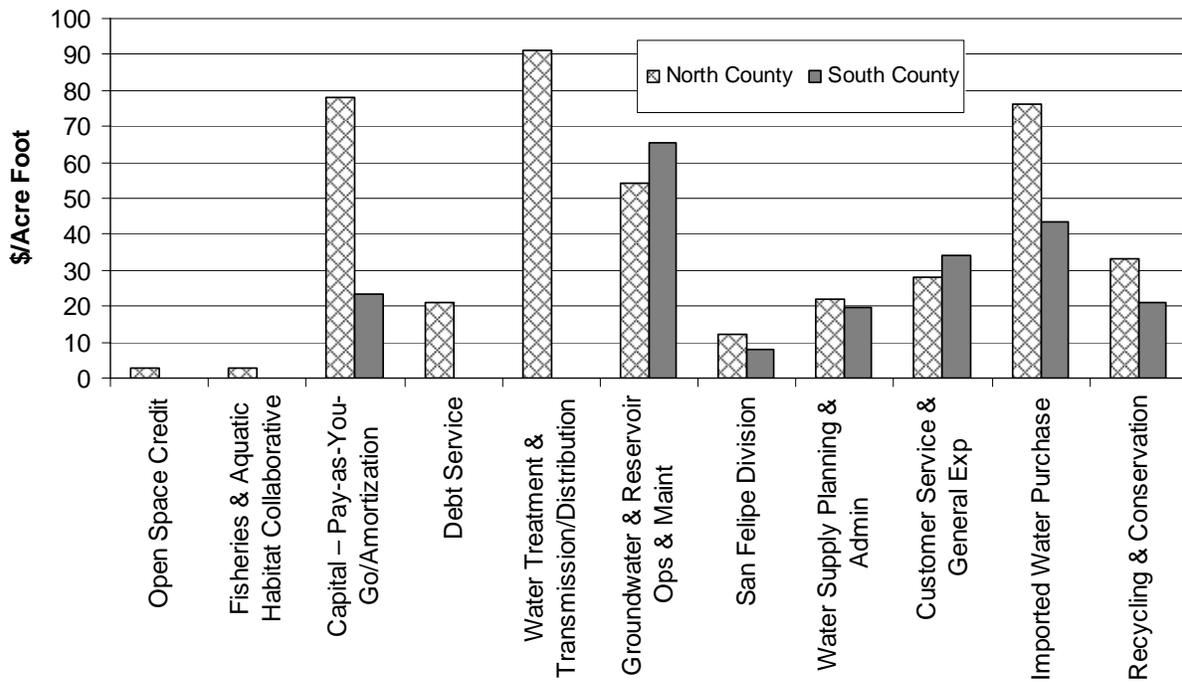


Figure 5: Components of North and South County water rates for 2006

These rates are reviewed by the Water Commission. In the past nine years the rates in both North and South County have increased. It appears contradictory that the ratio between North County and South County rates has gone down (from 3:1 in 2001 to 2:1 in 2006) even though the North County primarily uses increasingly expensive imported, treated water. This has caused some retailers and citizens interviewed by the Grand Jury to question how the District can possibly justify such continuing and seemingly arbitrary increases.

Over and above the unavoidable increases in water purchase and processing costs, the Board makes policy decisions as to which future development and capital projects to fund. The District staff prepares a range of rate projections based on alternative project priorities. The costs for these have to be paid from rate increases. The aggressiveness of future plans determines the magnitude of such rate increases. This could increase rate projections by up to 25% for North County users and 21% for South County over the next five years.

In response to increased rate concerns, the District evaluated options such as eliminating staff positions, reducing administrative budgets, postponing capital projects, reducing reserves, and working more closely with the community and water retailers to control costs.

Although water rates have continually increased over time, the North County prices the District charges retailers for water are in the mid-range of those charged by other water wholesalers (see Figure 6). A similar comparison holds true for retail rates.

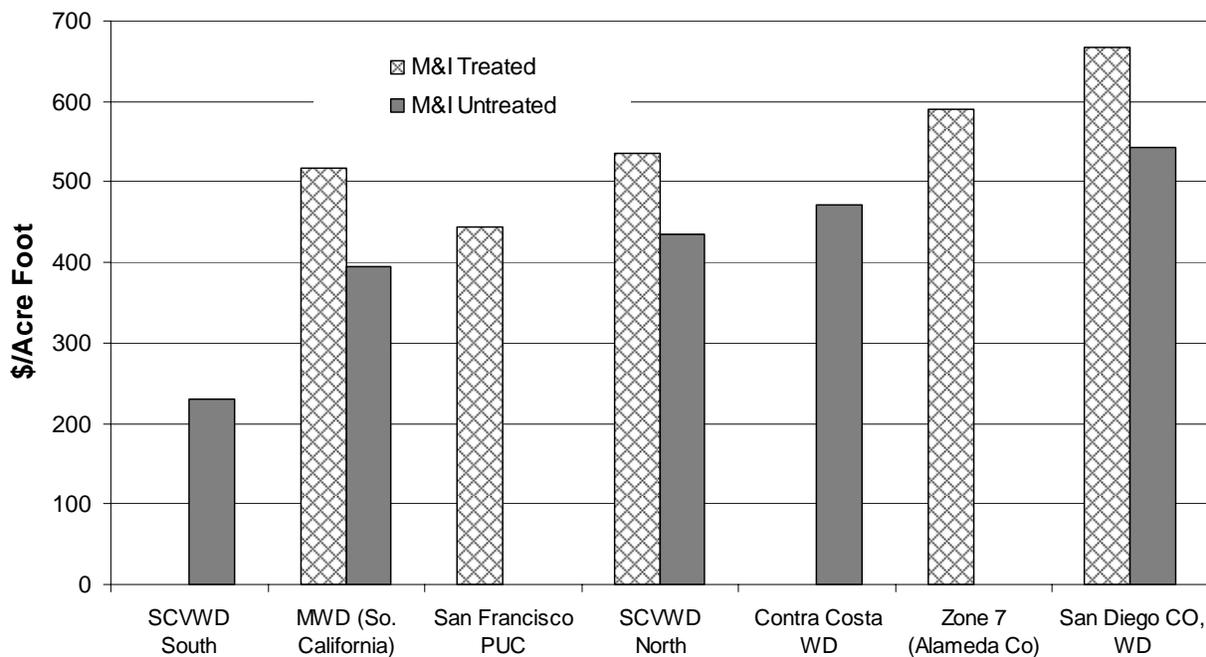


Figure 6: Municipal and industrial water rates for comparable California wholesalers

Financial Reserves

Several of the individuals interviewed expressed concern about the magnitude of the District's reserves. The issue of reserves is one not limited to this District. Many special districts have substantial reserves and have been criticized in a number of reports, specifically the Little Hoover Commission report (2000), a California State audit report (2000), the Malcolm Pirnie audit report (2000), and the report of the BOS-mandated auditor's budget review (2005). The Little Hoover Commission found that water districts hold as much as 900% of their income in reserves. One of the two major findings of the State audit was that water district reserves are too high.

Total reserves from FY 2002 to FY 2006 are shown in Figure 7. In FY 2002 the District had \$580 million in reserves, both restricted (\$77 million) and unrestricted (\$504 million). At the time of the Grand Jury investigation for FY 2006, the District had reduced its reserves to an estimated \$320 million. The reduction in reserves resulted to some extent from ERAF assessments, but mostly from the completion of projects.

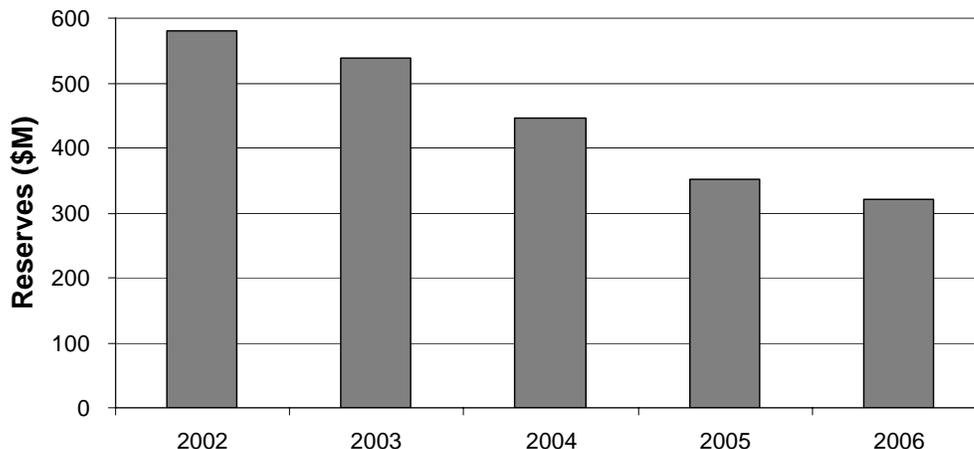


Figure 7: Total District financial reserves by Fiscal Year

The uses of restricted reserves are constrained by external obligations, creditors, grantors, contributors, or laws/regulations of other governments. Unrestricted reserves have two parts, designated and undesignated. Unrestricted designated reserves are funds not constrained by externally imposed restrictions and are used at the discretion of the Board. Unrestricted undesignated reserves are funds for which no uses have been specified.

Funding of reserves from current revenues (pay-as-you-go) has the effect of increasing the current water rates to pay for future capital projects. This increases the cost to the current consumers to ensure that the District has sufficient funding for its future projects.

Bonds are another way of financing District projects. It has been suggested that funding capital projects with bonds is more equitable in that the costs are passed to the

actual (future) users rather than current ones. On the other hand, debt financing increases some costs because of entailed interest charges, as well as issuance and insurance costs. Such debt also encumbers the ability of the District to take on further debt financing.

Besides the financial tradeoffs, the balance between reserve financing and debt financing is a public and Board policy issue. There should be a prudent and explicit balance between the two approaches. The SCVWD appears to have opted more for reserve-based funding than for debt-based funding of future projects. The BOS auditor examined the use of bonds by seven other large state water districts (assets over \$1 billion each). The average percentage of bond funding by these districts was 48%, while that of the SCVWD was approximately 22%.

Short-Term Loans, Overdrafts, and Investment Practices

The professional auditor's review of the District budget and financial information that was part of this inquiry raised questions about a number of financial practices. The practice of using short-term debt appears to be unnecessary in light of the \$322 million in reserves on hand in cash and cash equivalents. The stated purpose of such borrowing is to "finance capital expenditures while taking advantage of short-term rates."

Despite an abundance of liquidity, the District has been overdrawn in its general checking account at the close of four of the past six fiscal years, according to the Investments Table in the 2005 Comprehensive Annual Financial Report. The apparent difficulty in the District's ability to manage its cash position, and the resultant need for borrowing, appears to be a direct result of the District's strategy of extending the duration of its investment portfolio in the interest of achieving higher yields on its fixed-income investments. While the District's approach towards maximizing yields on its investment portfolio is sound, the District should consider segmenting its portfolio into two elements. The first would be a short-term portfolio that is intended to provide sufficient liquidity over the short-term planning horizon (six months to one-year). The second would be a long-term portfolio that is intended to capture higher yields traditionally associated with fixed-income securities of a longer term-to-maturity.

The District has selected the performance of the State of California Local Agency Investment Fund (LAIF) as the benchmark indicator by which it measures the performance of its investment portfolio. LAIF appears to be unsuitable as a benchmark. LAIF's investment objectives are suited to liquid assets. The composition of its investment portfolio differs from that of the District. The District can plan for disbursements in an orderly manner and has the ability to extend the duration of its portfolio to attain higher yields associated with longer-term securities of a similar credit quality.

The District uses *effective yield*, rather than *total return*, to report the performance of its investment portfolio. Consequently, the District excludes any unrealized gains or losses on the securities held within its portfolio in its rate of return

calculations. In order to provide a more complete perspective on the investment portfolio performance, the District should consider reporting results on both an effective yield and total return basis.

It has also been suggested that the District might reduce investment costs and increase its yield by combining its investment operations with those of the County, which manages a significantly larger portfolio.

CalPERS Liability

According to the District's June 30, 2005 audited financial statements, the unfunded pension liability was approximately \$42 million, as of the most recent actuarial valuation (June 30, 2004). Its annual pension cost was approximately \$9 million in FY 2005.

In determining the annual pension funding requirements, CalPERS makes long-range assumptions regarding the annual rate of return on the investments it holds on behalf of participating agencies. CalPERS charges or credits the accounts of participating agencies for the cost of funds held that are either in excess or deficit of the agency's pension liability at the time of measurement. The result of this arrangement is that agencies (such as the SCVWD) in effect borrow funds from CalPERS to finance their pension liabilities at the rate of 7.75% per annum.

Based upon an analysis of pension obligation bond trade data, as of April 27, 2006, it would be reasonable to expect that the District could refinance its pension liability at the rate of approximately 5.75% per annum, thereby generating a 2% savings over the 20-year amortization period. Savings from this approach would amount to approximately \$800,000 annually.

As an alternative to issuing pension obligation bonds, the District could consider using its existing reserves to pay off all or part of its \$42 million unfunded liability. During the past 12 months, the District's investments have yielded about 3.75% per annum. Hence, pension benefit cost savings could amount to approximately 4%, or \$1.6 million, per year. Such savings would vary from year to year depending upon the District's actual investment performance.

The District should engage the services of an outside financial advisor to evaluate the benefits of appropriate strategies to refinance its \$42 million unfunded pension liability.

Perceived SCVWD Opulence

One of the most visible aspects of the District is its headquarters facility. The building was referred to as the "Taj Mahal" during many Grand Jury interviews. From the outside, the building is imposing. The entryway and interior atrium, boardroom, senior offices, and marble floors reinforce the impression of opulence. The total building

cost, including land, design, construction, and furnishings, was about \$26 million. The building has about 91,000 square feet.

The Grand Jury conducted a detailed review of the rationale and trade offs made in the course of designing and acquiring the new facility in 1999-2000. A rationale for the upscale appearance of the building exterior and interior main lobby is said to be that the District wanted the building to reflect the high standards it maintains in its core business.

The Site Analysis Report, which preceded the construction of the building, appears to be comprehensive. It evaluates the factors usually considered prior to starting construction, including an own-versus-lease decision. Total construction costs per square foot were reported to be about \$285, including land purchase, construction, and furnishing. This appears to be reasonable for the time, considering labor rates, building size and infrastructure (e.g., on-site generators, power plant, and laboratories).

After touring other portions of this building and other District administrative office facilities, the Grand Jury found, with the exception of the public facilities mentioned earlier, the space is typical of engineering and administrative spaces found throughout Silicon Valley.

Existing building occupancy is high. Other District office space (e.g., the old administration building at this site and facilities about seven miles distant, on Great Oaks Boulevard) is needed to accommodate staff. District management states that, in retrospect, a larger facility should have been constructed.

CAPITAL PROJECTS

The Grand Jury investigated the way in which the District manages capital projects. Projects are perceived as too costly, lengthy, and sometimes poorly managed. The Grand Jury found that the process used to identify, prioritize, fund, develop, and construct these projects is systematic and thorough. It is also lengthy and complex. In part this is due to the involvement of multiple jurisdictions and regulatory requirements, as well as the need to obtain funding from government agencies.

The Capital Project Process

The District's process involves the definition of proposed projects, initial management review, and development of a top-level proposal identifying scope, schedule, resources, and costs. The next step is an iterative process of setting priorities, funding, and staffing, followed by Board review, public outreach, and final approval. There is yet another iteration leading to a detailed design, requiring Board approval, before any request for proposal is prepared and issued. Change requests during project implementation are subject to further evaluation and approval by the Board. Projects ultimately selected are included in a Board-approved, 5-year Capital Improvement Plan which is updated annually. The staff maintains a less detailed 15-year capital improvement plan for internal use.

Alviso – a Complex Example

The Alviso Project exemplifies the polarization which can arise between individual groups of citizens and the SCVWD. The Alviso area was annexed by San Jose in 1969. The SCVWD has flood control responsibilities, while San Jose has other responsibilities in this area. The SCVWD has built flood control projects for Coyote Creek and Guadalupe River, which flow into the San Francisco Bay on either side of Alviso.

The citizens of Alviso have voiced many complaints about being underserved by government in general, but have specific concerns regarding flood control. They have suffered three major floods since 1969. The area is below sea level and protected by levees.

There appears to be a history of neglect and finger-pointing among the multiple jurisdictions involved. A citizens' group, Alviso Water Task Force (AWTF), is concerned with the adequacy of the Guadalupe flood control measures and the manner in which the projects along the Guadalupe River were managed. Among these concerns are:

- Flood control projects generally begin at the mouth of a river so that any changes do not adversely affect down-stream properties. Members of AWTF state that the downtown San Jose portion of the Guadalupe River Flood Control Project was completed before appropriate flood control measures were taken in Alviso.
- The new bridges for State Highway 237 across the Guadalupe River have to be raised to allow for more water flow, with an estimated cost to the District of \$15 million.
- The six-foot-high levees were built in such a way that views from the landward side were blocked. The levee also blocks the view from the Yacht Club building, which had been moved previously to preserve that view. The SCVWD spent extra money to create a raised pathway along the landward side of the levees to provide a view. No levee access has been provided for the handicapped.
- Excess vegetation remains in the waterways so that flood-level flows cannot be accommodated by the slough.
- There are problems with squatters and waste dumping on property under SCVWD jurisdiction. The SCVWD has no police power over this area.
- There appear to be conflicting views between the SCVWD and the AWTF as to the most effective technical solution for flooding problems, restoration of local salt ponds, and preventing potential damage to the San Jose sewer treatment plant.

The SCVWD has a \$2.7 million plan to complete an environmental upgrade to the slough by 2008, but there is disagreement about what constitutes adequate flood control. A longer term conceptual plan has been developed and presented to the local citizens, which calls for the construction of a levee system running along the south peninsula bay shoreline to prevent tidal flooding. It includes management and rehabilitation of the salt ponds ringing the south bay. Citizens and the District participate in monthly meetings on these issues.

Conclusions

The Santa Clara Valley Water District is a complex agency with a wide-ranging and critical mission for the County. The Grand Jury's inquiry reviewed inputs from many sources and revealed both positive and negative aspects of District operations. On the whole, the District does well in delivering water, providing flood control, and exercising environmental stewardship. There are many areas of District activities that involve judgments about goals, priorities, funding approaches, and allocation of costs that result in real and perceived differences of opinion.

The Grand Jury's findings and recommendations are detailed below:

Finding 1

The District generally does a commendable job of providing water, protecting watersheds, and implementing flood control in Santa Clara County.

Recommendation 1

None

Finding 2

Voters fail to participate actively in SCVWD director elections. Many directors run unopposed and many directors serve for multiple consecutive terms. The elected directors may not represent a broad cross-section of the population.

Recommendation 2

Independent voter advocacy organizations, such as League of Women Voters, public forums such as the Commonwealth Club, chambers of commerce, and news media should encourage, educate, and energize the public about the importance of participating in the electoral process. This may also provide a forum for explaining and vetting SCVWD programs for a broader set of stakeholders.

Finding 3

The current statutory basis of the SCVWD includes a provision for annual Board of Supervisors review of the SCVWD budget. There is an effort under way (AB 2435) to terminate this relationship between the SCVWD and the BOS.

Recommendation 3

The Grand Jury firmly believes that the current oversight arrangement should not be terminated. The effective management of a service as vital to the County as water cannot be improved by reducing oversight. The reality of limited voter involvement argues all the more for retaining the relationship between the SCVWD and BOS. The BOS currently plays an active role with representatives on the Board of the Valley Transportation Authority and the Grand Jury believes the SCVWD demands similar commitment. Furthermore, the Grand Jury believes this relationship should be a model for oversight of other independent special districts in the County.

Finding 4

Currently two SCVWD directors are appointed by the BOS and yet participate in decisions about rate setting, eminent domain, taxation, and debt issuance, without direct mandate from County voters.

Recommendation 4

No District Board members should be appointed. The two Board positions that are currently appointed should be converted to be filled directly by County Supervisors, who are already elected by the people. Currently two BOS members serve on the Water Commission and two on the Valley Transportation Authority Board. Participation of BOS members would serve to strengthen the link between the SCVWD and the BOS to perform the budget oversight function as well.

Finding 5

There are strongly held diverse opinions concerning the proper role of the SCVWD and its spending. Actions by the District Board have led to projects and expenditures that are not always supported by the public or by retail distributors. These have led to heated public debates about the scope and efficiency of SCVWD operations.

Recommendation 5

The District needs to better communicate and vet its activities with the various stakeholders and the public. Program goals should be selected through procedures that are more responsive to these views. The District has recently begun to take steps in this direction.

Finding 6

Water rates have increased significantly over time. Part of this increase is caused by higher costs and part is due to Board policies regarding future projects and allocation of costs. There are rate differentials between North and South County which raise contentious issues that are not well understood.

Recommendation 6

The District should clarify the reasons for rate differentials and trends among users to ensure that stakeholders, including the public, have an understanding of and confidence in the equity of rate setting practices. The District should carefully prioritize its capital projects and other costs to ensure that rate increases are fully justified by needs vetted with the Water Commission and the public.

Finding 7

Outside auditors question some financial practices of the District. Concerns include financing the unfunded balance of the District CalPERS benefits accounts, managing year-end cash balance, and controlling cash flow. Some of these issues could save the District between \$800,000 and \$1.6 million per year. Critics believe the District could safely increase its return on investments.

Recommendation 7

The District should consult outside financial advisors to be sure it is using best practice to prudently, but optimally, manage the large amount of resources it controls.

Finding 8

There have been substantial criticisms that reserves are excessive and inadequately justified. During the last three years, reserves have dropped significantly from \$580 to \$320 million. The District is currently reviewing its reserve management policy.

Recommendation 8

The District should clearly document its reserve management policy and justify its reserve levels to stakeholders and the public. It should also reconsider and justify the balance between pay-as-you-go and debt funding of capital projects to reduce the requirements for large reserve holdings.

Finding 9

The District is implementing a number of performance measurement and improvement programs that impose extra workload on the staff. The Office of Performance Excellence had a 2005 budget of over \$1.2 million.

Recommendation 9

The District needs to refine and coordinate its various performance measurement efforts into a smaller number of focused, cost-effective programs that can offer the most useful and tangible results to influence District operational efficiency and to define objectives.

PASSED and ADOPTED by the Santa Clara County Civil Grand Jury on this 26th day of May, 2006.

Thomas C. Rindfleisch
Foreperson

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