City of Austin

AUDIT REPORT

A Report to the Austin City Council

Mayor
Lee Leffingwell

Mayor Pro Tem
Sheryl Cole

Council Members
Chris Riley
Mike Martinez
Kathie Tovo
Laura Morrison
Bill Spelman

Austin Water Utility Capital Improvement Project Funding Audit

December 2011

Office of the City Auditor

City Auditor
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REPORT SUMMARY

Austin Water's capital project funds are used in a timely manner and spent on applicable projects. However, City provisions for funding projects in the Drinking Water Protection Zone are inconsistent with State law; as a result, capital projects in that zone have not been submitted to voters for approval. Furthermore, Austin Water has a long-standing cash deficit, which if funded today would reduce its operating cash by approximately 25 percent.

AUDIT NUMBER: AU11123

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GOVERNMENT AUDITING STANDARDS COMPLIANCE

We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

AUDIT TEAM

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December 2011

Austin Water Utility
Capital Improvement Project Funding Audit

Audit Report Highlights

Why We Did This Audit

This project was included in the FY 2011 Strategic Audit Plan as a result of concerns identified by stakeholders related to capital improvement project funding.

What We Recommend

We recommend that the Austin Water Utility revisit its financial policy related to CIP funding and citizen participation on projects in protected areas and eliminate deficit CIP cash balances identified.

For more information on this or any of our reports, email oca_auditor@austintexas.gov

Mayor and Council,

I am pleased to present this audit on Austin Water Utility capital improvement project funding.

BACKGROUND

The Austin Water Utility (AWU) Capital Improvement Program (CIP) provides funding for capital projects necessary to serve new growth, ensure system reliability, comply with regulatory requirements, and accommodate roadway improvements in the Utility's service area. The AWU Financial Management Division is responsible for managing the Utility's CIP. In FY 2011, AWU's CIP budget was $275.5 million.

OBJECTIVE AND SCOPE

Our objective for this audit was to evaluate CIP funding to ensure that costs have been allocated according to policies and procedures and that amounts have been utilized in a timely manner.

The audit focused on expenditures financed by short and long-term debt, as well as unspent bond proceeds from FY 2007 to FY 2011. We also reviewed the AWU CIP spending plan for FYs 2012 to 2016.

WHAT WE FOUND

Austin Water Utility CIP funds are utilized in a timely manner, and spent on applicable projects. However, we noted that City provisions for funding projects in the Drinking Water Protection Zone are inconsistent with State law; as a result, capital projects in that zone have not been approved by voters. Furthermore, Austin Water has a long-standing cash deficit in CIP funds, which if funded today would reduce its operating cash by approximately 25 percent.

Based on our work, we made two recommendations aimed at addressing the issues identified during the course of the audit.

We appreciate the cooperation and assistance we received from staff in the Austin Water Utility during this audit.

Kenneth J. Mory, City Auditor

BACKGROUND

The Austin Water Utility (AWU) Capital Improvement Program (CIP) provides funding for capital projects necessary to serve new growth, ensure system reliability, comply with regulatory requirements, and accommodate roadway improvements in the Utility's service area. The AWU Financial Management Division is responsible for managing the Utility's CIP. In FY 2011, AWU's CIP budget was $275.5 million.

OBJECTIVES, SCOPE, AND METHODOLOGY

This performance audit of the Austin Water Utility CIP funding was conducted as part of the Office of the City Auditor's FY 2011 Strategic Audit Plan, as presented to the City Council Audit and Finance Committee.

Objectives

Our objective for this audit was to evaluate CIP funding to ensure that costs have been allocated according to policies and procedures and amounts have been utilized in a timely manner.

Scope

The audit focused on expenditures financed by short and long-term debt, as well as unspent bond proceeds from FY 2007 to FY 2011. We also reviewed the AWU CIP spending plan for FYs 2012 to 2016.

Methodology

To accomplish our audit objectives, we performed the following steps:

- conducted interviews of applicable divisions and management staff;
- reviewed applicable laws, policies and procedures;
- reviewed CIP spending plans and identified projects' funding sources; and
- analyzed and tested a judgmental sample of financial transactions to determine compliance with relevant bond covenants.

AUDIT RESULTS

While AWU CIP funding is spent in a timely manner and on applicable projects, we noted that capital projects in the Drinking Water Protection Zone have not been submitted to voters for approval; also, some AWU CIP funds showed a long-standing cash deficit .

Austin Water Utility (AWU) CIP funds are utilized in a timely manner, and spent on applicable projects. However, we noted that City provisions for funding capital improvement projects in the Drinking Water Protection Zone (DWPZ) are inconsistent with State law; as a result, capital projects in that zone have not been submitted to voters for approval. Furthermore, Austin Water has a long-standing cash deficit in CIP funds, which if funded today would reduce its operating cash by approximately 25 percent.

Finding 1: AWU CIP funds are utilized in a timely manner and spent on applicable projects.

Funds acquired to finance capital projects should be expended in a timely manner. Beginning in 1997, AWU began funding the majority of its CIP by issuing commercial paper, which is a short-term investment tool. Based on our review of funding sources for the capital projects included in AWU's spending plan for FYs 2007 to 2011, 74 percent of funding is from commercial paper, 17 percent from cash, and the remaining 9 percent is from other sources, such as grants and fees.

AWU is required by law to reimburse the CIP expenditures with commercial paper proceeds within 18 months. Based on this practice, expenses not funded with operating transfers are first incurred and funded with commercial paper proceeds, which are subsequently refinanced by issuing revenue refunding bonds.

We analyzed AWU bonds authorized since 1976 to identify any unspent bond proceeds. Based on our review, we identified approximately $1 million in unspent bond proceeds out of a total of approximately $1.6 billion originally authorized. The unspent bond proceeds amount to approximately 0.06 percent of the total bonds authorized, and represent unspent proceeds from various bond authorizations from 1976 to 1992. AWU management indicated that they have asked for legal guidance to determine how to handle the unspent proceeds in accordance with bond covenants.

Proceeds from commercial paper are used for interim financing and subsequently refinanced by issuing revenue refunding bonds. Per City ordinance, these proceeds are to finance the cost of the water and wastewater system additions, improvements and extensions and may not be used to finance costs associated with something else (e.g., Public Safety, Parks, Public Works, Transportation, or Electric Utility System).

We reviewed a judgmental sample of 40 payment transactions (totaling approximately $40 million) which were funded by commercial paper and were associated with 30 CIP projects in our scope period. Based on our work, we did not identify any material exceptions.

Finding 2: City provisions for funding capital improvement projects in the Drinking Water Protection Zone (DWPZ) are inconsistent with State law, which supersedes municipal legal requirements; as a result, capital projects in the DWPZ have not been submitted to voters for approval.

Per current AWU financial policies, certain capital projects located within the DWPZ are to be funded through voter-approved revenue bonds. Per policy, this requirement applies to projects which fall into any of the following categories: (1) new water and wastewater plants; (2) capital expansions; and (3) growth-related projects. However, this financial policy conflicts with State law. According to a ruling by a Texas district court in 1984 and a more recent legal opinion by the City Attorney in 2009, the City does not have the statutory authority to hold a binding election with respect to revenue bonds.

The DWPZ is an area that extends to the west of Austin which has been designated by the City as environmentally sensitive. The City's Smart Growth Initiative seeks to direct growth away from this area into less environmentally sensitive areas. In this context, it would appear that the intent of AWU's financial policy is to ensure voters' input when pursuing capital projects in the DWPZ.

However, as a result of the conflicting requirements between City policies and State law, AWU has been funding capital projects, including those projects located in the DWPZ, with commercial paper and/or cash, and without seeking voter approval.

The AWU CIP spending plan for FY 2012 includes a total of 445 capital projects; 27 of those projects (approximately 6 %) are located in the DWPZ. While we did not attempt to determine whether each of these projects would be subject to the financial policy's requirement discussed above, we identified the projects illustrated in Exhibit 1 as examples of either capital expansions or growth related projects located in the DWPZ that were financed by cash and/or commercial paper.

While AWU's management has expressed concerns regarding the conflicting guidance, City management has not formally recommended changes to the financial policies to the City Council, resulting in approval and funding of projects in the DWPZ in a manner which is inconsistent with Council direction per the AWU financial policies.

EXHIBIT 1
Examples of Growth-Related and Capital Expansion Projects in the DWPZ

CIP Project #	Project Name	Project Description	Project Budget	Amount Spent as of 9/30/11	Spending Plan	Funding Source
3353.025	Travis Country West	Travis Country West Reimbursement	$ 1,680,071	$ 1,680,071	FY 08	commercial paper
3353.068	Circle C / CCR 103 Water Line Improvements	Service Extension Reimbursements	$ 1,473,195	$ 3,440	FY 12	commercial paper cash
5071.002	Loop 360 Water Imprv - Allen Road Pump Station	Project to improve the pressure in the south system. Includes the construction of two pump stations and changes to existing distribution system to create a new pressure zone.	$ 5,618,000	$ 5,003,387	FY 12	cash

SOURCE: OCA analysis of selected projects in the City's CIP system (e-CAPRIS), October 2011.

Finding 3: Austin Water has a long-standing cash deficit in CIP funds, which, if funded today, would reduce its operating cash by approximately 25 percent.

AWU financial policies require that capital projects be financed through a combination of cash (referred to as pay-as-you-go financing through cash transfers from current operations), and debt. These policies also establish a ratio of at least 20% equity contribution for all CIP projects.

During this audit we identified CIP funds that have deficit cash balances, for a total of approximately $12 million. These funds have little or no activity, and have carried these deficit cash balances for up to eleven years.

The largest deficit of $9.2 million is related to the 1999 water supply agreement with the Lower Colorado River Authority (LRCA), when AWU purchased $100 million of water rights from LRCA. Per Council authorization, this payment was to be funded as follows:

- $72.7 million with proceeds from debt issuance;
- $12 million from the Utility's 1999 ending fund balance, and
- $15.3 million from Utility's future revenues.

Between 2000 and 2001, AWU financed $72.7 million by issuing commercial paper. Between 2000 and 2002, AWU transferred a total of $18.1 million cash from operations, which resulted in a deficit cash balance of $9.2 million. AWU has not made any additional cash transfers since fiscal year ending 2002. Although the plan was to fund the remaining deficit in 2001 and 2002, AWU elected to fund other capital expenditures rather than addressing the long-standing deficit.

Another deficit of $3.2 million is carried in a fund that was budgeted to be funded by specific fees. However, according to AWU's management these fees are no longer being deposited into this fund.

If deficit cash balances were to be funded immediately, AWU would have approximately $12 million less cash available to pay for other operating requirements. This deficit represents approximately 25% of the Utility's $48 million unaudited operating cash, as of September 30, 2011.

RECOMMENDATIONS

The recommendations listed below are a result of our audit effort and subject to the limitation of our scope of work. We believe that these recommendations provide reasonable approaches to help resolve the issues identified. We also believe that operational management is in a unique position to best understand their operations and may be able to identify more efficient and effective approaches and we encourage them to do so when providing their response to our recommendations. As such, we strongly recommend the following:

1. **The Director of Austin Water and the City's Chief Financial Officer, in coordination with the City Attorney, should develop a proposal for revising the Utility's financial policies, to be submitted to Council for approval, which include:**
    a. **strategies to finance capital projects in a manner which is consistent with State law; and**
    b. **strategies for citizen participation in the decision making process for capital projects in the Drinking Water Protection Zone which are consistent with current Council intent.**

MANAGEMENT RESPONSE: **Concur.** Refer to Appendix A for management response and action plan.

2. **The Director of Austin Water should eliminate deficit CIP cash balances, while maintaining an adequate reserve for operations.**

MANAGEMENT RESPONSE: **Concur.** Refer to Appendix A for management response and action plan.

APPENDIX A
MANAGEMENT RESPONSE

MEMORANDUM

TO: Office of the City Auditor

FROM: Greg Meszaros, Director
Austin Water Utility

DATE: November 29, 2011

SUBJECT: Austin Water Response to CIP Funding Audit

I have reviewed the Office of the City Auditor's Capital Improvement Project Funding Audit and concur with all of the recommendations related to Austin Water.

Austin Water recognizes our need to work with City Financial and Law Department representatives to develop changes in our financial policies to make them consistent with State law. Additionally, this audit identified deficit balances that Austin Water has already initiated transactions to address. This audit has provided valuable recommendations for Austin Water to focus its attention to make improvements.

I have included the attached Action Plan that provides more detail on our strategies for improving CIP funding.

Greg Meszaros, Director
Austin Water Utility

ACTION PLAN

Austin Water Capital Improvement Project Funding Audit

Recommendation	Concurrence and Proposed Strategies for Implementation	Status of Strategies	Proposed Implementation Date
1. The Director of Austin Water and the City's Chief Financial Officer, in coordination with the City Attorney, should develop a proposal for revising the Utility's financial policies, to be submitted to Council for approval, which include: a. strategies to finance capital projects in a manner which is consistent with State law; and b. strategies for citizen participation in the decision making process for capital projects in the Drinking Water Protection Zone which are consistent with current Council intent.	**Concur.** The Austin Water Utility (AWU) will initiate coordination with the City's CFO and Attorney to draft revisions to AWU's current financial policies to comply with the State law regarding bond elections and revenue bonds. In addition, AWU will work with this same group to identify our current decision making processes through Council, Boards and Commission, and citizen participation, and develop any new strategies for citizen participation regarding capital projects in the Drinking Water Protection Zone. During the FY 2013 budget development process, AWU will propose any changes to our financial policies and citizen participation processes.	Planned. The AWU plans to initiate discussions regarding these strategies.	March 2012. AWU will initiate discussions, develop draft revisions to the financial policies, and develop any new strategies for citizen participation. Sept 2012. AWU will work within the 2013 budget development process to obtain approval of the financial policies by the Audit & Finance Committee. Also, any new strategies for citizen participation will be implemented during the budget process.

Recommendation	Concurrence and Proposed Strategies for Implementation	Status of Strategies	Proposed Implementation Date
2. The Director of Austin Water should eliminate deficit CIP cash balances, while maintaining an adequate reserve for operations.	**Concur.** AWU will eliminate the deficit CIP cash balances related to the LCRA payment and fee supported funds through the scheduled transfer of cash from the operating fund to the CIP cash fund during FY 2012.	Underway. AWU has drafted IET transactions that will transfer sufficient operating cash to eliminate the LCRA and fee supported deficit balances. An additional deficit cash balance in the cash funded current water CIP projects will be eliminated over the current and next fiscal years through additional operating cash transfers.	December 2011. March 2013.