STATE OF CALIFORNIA – THE RESOURCES AGENCY

**ARNOLD SCHWARZENEGGER**, *Governor*

**DEPARTMENT OF WATER RESOURCES**
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October 17, 2008

Little Hoover Commission
925 L Street, Suite 805
Sacramento, CA 95814

RE: Bond Oversight Hearing on October 23, 2008

Dear Commissioners:

Thank you for the opportunity to discuss bond oversight and accountability programs at the Department of Water Resources (DWR). This response specifically addresses your questions about implementation of the Governor's Executive Order (S-02-07), the role of audits and other mechanisms to improve bond oversight.

DWR has administered or is currently administering 13 bond measures since 1976: Propositions 3, 28, 55, 25, 44, 70, 81, 82, 204, 13, 50, 84, and 1E. These bonds support a broad range of programs that protect, preserve and improve California's water systems. DWR has also sold commercial paper and revenue bonds for the State Water Project for more than 50 years.

Over the years, our oversight and accountability measures have improved and the transparency of expenditures has greatly increased. This improvement has been driven, in part, by the significant shift from non-competitive programs in which the bond language specified projects, to more recent bonds in which a competitive process is used to award funds. Bond proceeds can be expended directly by DWR, or disbursed to federal, state, local and non-profit entities as grants, contracts and loans.

With this discussion paper and testimony, I hope to answer the concerns of the Commission over the following topics:

- Actions DWR has implemented in response to the Governor's Executive Order.
- The steps DWR has taken to resolve the needed improvements identified in the audits of prior bonds, including Propositions 12, 13, 40 and 50.
- Review lessons DWR has learned from past infrastructure project management to improve oversight of bond expenditures.
- Explain mechanisms DWR has implemented to improve the oversight of the bond expenditures authorized by the voters in 2006.

*Response to the Governor's Executive Order to expand transparency and accountability for the November 2006 bonds*

A number of significant changes to increase transparency and accountability in recent years have been through DWR's response to Executive Order S-02-07 which was signed on January 24, 2007 by Governor Schwarzenegger. The Executive Order was issued to ensure bond funds were spent "efficiently, effectively and in the best interests of Californians." This three-part accountability plan includes front-end accountability, in-process accountability and follow-up accountability. In so doing, the Order emphasized a system of visible check point standards at every step of program funding. This approach provides greater accountability at all stages of the project.

1. Front-End Accountability

The Governor directed each department to establish criteria or processes that govern the expenditure of bond funds to achieve intended outcomes.

In all projects, performance standards and expected outcomes are adopted to ensure the project can be verified as being financially accountable and compliant with project intent. To ensure compliance with the Executive Order and to ensure the public can obtain complete information about projects being funded by the bonds, DWR has also posted all activities on its Bond Accountability Website to include project contact information.

DWR has implemented each program with a focus on the desired outcome and the proper measures to ensure that end product. Programs like the Flood Control Project Subventions Program were established based upon meeting federal regulations because of the important partnership between state and federal requirements on flood protection projects. For local agencies to be eligible for Proposition 1E funding, therefore, they must also meet federal requirements. The Integrated Regional Water Management Stormwater/Flood Management Program uses existing Proposition 50 guidelines that were developed and vetted through a public process in accordance with the bond statute and implementing legislation. Many other programs used similar methods to establish their guidelines. Other programs, like the Floodway Corridor Program and the Levee Repairs Program are based upon regulations developed by DWR that define the basis for allocating bond proceeds

2. In-Progress Accountability

The Executive Order requires ongoing activities to be reviewed, documented and reported to the Department of Finance (DOF). This ensures that funded activities are within the scope and consistent with the orginal intent of the authorizing bond. Multiple methods are being used at DWR to ensure that semi-annual reports to DOF are accurate and detailed and reflect our efforts to ensure accountability remains a priority.

In-Process Accountability activities include:

- Applicable projects are developed consistent with federal principles and guidelines and receive approval from the U.S. Army Corps of Engineers.
- On-site visits and inspections are conducted two or more times annually, for applicable programs.
- Each expense within a funded contract must be supported with documentation, with reimbursements approved only for eligible expenses pursuant to program guidelines and contained within the approved project budget.
- DWR may withhold up to 10 percent of each payment that is only released upon project completion and once all work has been verified.
- Many programs have additional statutorily-required quarterly progress reports.

3. Follow-Up Accountability

After the project is completed, the Executive Order requires an audit to confirm that expenditures were made according to the established plan, were done within governing law and achieved the desired outcome. To achieve this outcome, DWR has contacted DOF to ensure proper audits are anticipated for expenditures of the infrastructure bond proceeds. In addition to the standard audit, DWR has also put in place the following additional steps:

- Upon project completion, all project consultants verify the project complies with all applicable current laws and regulations and submit documents summarizing total project costs and additional funding sources.
- The final project report submitted upon completion of the project must include photographs of the before-project condition, planning and restoration activities and, if applicable, techniques used to achieve restoration, and post-project completion condition.
- All projects doing repair work on levees will receive a close-out visit conducted by the U.S. Army Corps of Engineers and DWR to assure that the project is completed consistent with federal principles and guidelines.
- Any flood control projects governed under Section 12832 of the California Water Code have a final audit of expenditure claims by the State Controller's Office.
- All projects funded via the Integrated Regional Water Management Grant program receive a close-out visit conducted at the time the project is complete and prior to releasing final grant funds.
- All grantees are required to conduct post construction/implementation monitoring and to assess project performance.

DWR is working closely with Department of Finance to ensure accountability and projects financed under Proposition 84 and 1E have been posted to the Bond Accountability Website so the public is provided readily accessible information on how proceeds of state general obligation bonds are being utilized.

*Lessons learned by past audits*

The March 2007 Department of Finance Audit Report reviewed Proposition 12, 13, 40 and 50 funds as of June 30, 2006. The report focused on determining the status of projects associated with each of these bonds and audited the expenditures of the funds. The audit objectives were to provide information on the status of the bond projects, including projects approved, expenditure incurred and the remaining appropriation balances and to review internal controls. The bond program expenditures and disbursements were also reviewed for accuracy and fiscal compliance with statutory or contractual requirements.

Following the audit, DWR hired an outside consultant to ensure that the findings were resolved and proper procedures were put in place to eliminate any future concerns. The following processes were implemented as a result of the audit:

- Previously, bond funding was approved at a program manager level. Additional, multiple-level reviews are now performed within DWR prior to grants being awarded.

- DWR is evaluating a requirement for all staff involved in the grant evaluation and award process to complete a Statement of Economic Interests (Form 700) to avoid any possible conflict of interest with the project or its proponents.

- Guidelines for competitive grant programs are established with public input for grant selection criteria and approval processes.

- Site visits of funded projects are now required to ensure that submitted progress reports are accurate and grant funds are being spent for the intended purpose.

- A centralized, more comprehensive system was developed to record financial and reporting data.

- Additional accountability controls were created, including requiring reports from agencies and vendors performing work and site visits.

These additional oversight measures require more time and input at every level of project management. However, we believe that this involvement creates an atmosphere of greater accountability and responsibility, as well as an increase in project understanding and direction. Management review ensures that projects are selected based on the scoring criteria and review process established by the guidelines.

As the project moves from implementation to completion, there is a greater understanding of what is being done, how it is being done and whether the project is meeting expectations.

*Lessons learned from past infrastructure project management*

With extensive experience in administering general obligation bond programs, DWR has developed a set of best practices that was in place prior to the enactment of the 2006 bonds. These include:

- Clear guidelines, regulations and project solicitation materials to ensure accuracy and understanding for project proponents seeking competitive grants;
- Publicly vetted guidelines to allow stakeholders an opportunity to provide input on program implementation;
- Public briefings and workshops to review guidelines;
- Review legislative direction for clarifying use of funds;
- Review and approval of submitted project applications by management, including approval by the Director; prior to awarding a grant;
- For applicable projects, grantees are required to sign the Operation and Maintenance Agreements that define the grantees' obligations, responsibilities and duties to operate, maintain, repair, replace and rehabilitate their projects upon completion;
- Grantees working on Flood Management programs are required to update the Emergency Response Plan annually for their projects to ensure consistency with these requirements, where applicable;
- Verification of compliance with required environmental review laws before authorizing project work;
- Quarterly progress reports ensure funds are utilized according to the approved project scope and budget;
- Verification that all required permits are in place before authorizing work to begin;
- Regular project inspections conducted by DWR staff to track progress;
- Implement use of appropriate and universal program management tools;
- Require supporting documents with task orders and contracts to ensure appropriate payment;

- Withhold up to 10 percent (retention) of payments pending project completion or final audit of project; and

- Mandatory monthly tracking and monitoring of funds expended on projects.

*Mechanisms in place to improve the oversight of bond expenditures*

To improve oversight and accountability, DWR is taking the following steps to improve transparency:

- DWR has used consulting services to assist in the development and implementation of the Grant and Bond Management System. The system supports a common expenditure mechanism, enables tracking of project costs and benefits, creates standardization within bond financing, allows for data centralization and aids in accuracy and ease of use, sustainability, flexibility and versatility.

- DWR's business enterprise system, SAP, uses a systems, applications and products data processing program to manage bond associated coding that captures costs in internal order and funded program numbers, budget planning, budget tracking and reports.

- Compliance with the Bond Accountability Website created by the Executive Order. This public website includes program and project information such as appropriations, expenditures, project description, award date, award amount, type of project, description of fund contribution to the project including who the funding is from and how much, estimated completion date, project status, mapped location and DWR contact person.

- Bi-weekly meetings are held with Resources Agency to ensure Executive Order compliance.

- Annual audits for Proposition 1E and 84 will be performed by the Department of Finance starting 2009 and continuing through 2017.

- Bond expenditures for projects along the Sacramento and San Joaquin Rivers and their tributaries require approval from Central Valley Flood Protection Board, a seven-member board whose members include governor's appointees and representatives from the Legislature.

- The Central Valley Flood Management Plan, currently under development with input from stakeholders and the public, will help guide the expenditure of the remaining $5 billion in funds for flood management improvements along the 1,600 miles of state-federal levees, flood bypasses, overflow structures, channels, and pumping plants within the Central Valley and will help lay the foundation for future strategic investments in flood infrastructure on a statewide basis.

- An internal department business process guidebook has been developed to ensure consistent procedures and address program, project scope and budget changes from the investment strategy.

- Provide a forum for and encourage extensive public participation and input as draft funding recommendations are developed.

- Implementation of Primavera, a project, portfolio and resource management software for effective tracking and monitoring of all projects.

- DWR uses standardized program management tools such as MS Project, Excel and Access tracking sheets.

- Automated reports have been developed by the DWR business enterprise system where data is extracted from a single departmental system of record (SAP) to reduce the use of specialized, section specific spreadsheets.

- Controls have been implemented which require supervisor approval prior to granting system access.

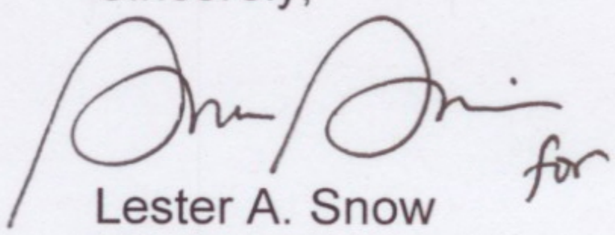
- Several new controls on the payment process have been implemented. The vendor master, program staff and program managers who are responsible to review and approve invoices do not have access to process vendor invoices for payment. Checks are signed by two authorized signatories. Signatories do not have access to vendor master and are not involved in invoice processing.

- Segregation of duties has been implemented for many key bond fund transactions.

Over the years, bond measures have provided the necessary funding to invest in California's water systems, improve flood protection, conserve and manage water supplies, maintain and improve our infrastructure, and provide communities with tools to improve regional self-sufficiency. These are critically important challenges, and DWR takes seriously its responsibility and obligation to effectively administer these programs and provide solid fiscal management, accountability and transparency in our process.

I appreciate the opportunity to provide any additional information on DWR's bond fund oversight activities.

Sincerely,



Lester A. Snow
Director