



**Office of the City Auditor
Report to the City Council
City of San Jose**

**AN AUDIT OF SEWER FUND
EXPENDITURES**

**The City Should Improve Budgetary Control And
Establish Fund Reserve Guidelines For The
Wastewater Enterprise Funds**

**Opportunities Exist To Increase Water
Pollution Control Plant In-Lieu Fees To The
General Fund By \$7.2 Million Retroactively
And \$1.3 Million Annually**

**The Annual WPCP And SBWRP Reconciliation
Processes Can Be Done More Efficiently**

**Controls Over Wastewater Expenditures
Should Be Strengthened**

**Resumption Of Wastewater Interest Transfers
Could Increase General Fund Revenues By
\$2.5 Million Per Year While Opportunities
Exist To Reduce Costs And Increase Sewer
Service And Use Charge And Storm Drain
Revenues By \$1.7 Million Per Year**

**The 1959 Sewage Treatment Plant Agreement's
Methodology For Allocating Water Pollution
Control Plant Expenses Costs San Jose About
\$1 Million Per Year**

**Report 99-04
August 1999**



CITY OF SAN JOSÉ, CALIFORNIA

800 N. First Street • San Jose, California 95112 • Tel: (408) 277-4601

GERALD A. SILVA
City Auditor

August 16, 1999

Honorable Mayor and Members
of the City Council
801 North First Street, Room 600
San Jose, CA 95110

Transmitted herewith is a report on *An Audit Of Sewer Fund Expenditures*. This report is in accordance with City Charter Section 805.

An Executive Summary is presented on the blue pages in the front of this report. The City Administration's response is shown on the yellow pages before the Appendices.

I will present this report to the Finance Committee at its August 25, 1999, meeting. If you need additional information in the interim, please let me know. The City Auditor's staff members who participated in the preparation of this report are Sharon Erickson and Cynthia Chin.

Respectfully submitted,

Gerald A. Silva
City Auditor

finaltr
GS:bh

cc: Carl Mosher	Debra Figone	Sherry Langbein
Kay Winer	Joan Gallo	Linda Moya
Larry Lisenbee	John Lopez	John Guthrie
Melody Tovar	Joni Pattillo	Mike Ryder
Peter Jensen	Scott Brown	Darrell Dearborn
Mollie Dent	Patricia Deignan	Mark Burton
Rich Desmond	Najon Chu	





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Executive Summary

In accordance with the City Auditor's 1998-99 Audit Workplan, we have audited the City of San Jose's (City) internal controls over Sewer Service and Use Charge (SSUC) Fund expenditures. This is our second in a series of audits of the SSUC Fund and the sewer services that the Environmental Services Department (ESD) provides. We conducted this audit in accordance with generally accepted government auditing standards and limited our work to those areas specified in the Scope and Methodology section of this report.

Finding I The City Should Improve Budgetary Control And Establish Fund Reserve Guidelines For The Wastewater Enterprise Funds

The City of San Jose (City) has more than \$264 million in the twelve separate accounting funds that comprise the wastewater enterprise system. Our review revealed that in July 1996, City staff drafted fund reserve guidelines for five of these funds. Those guidelines recommended a minimum reserve level of about \$40 million – \$118 million less than the fund balance for these five funds as of June 30, 1998. The City's five-year capital improvement program includes major capital projects that would reduce these fund balances if projected expenditures actually occur. However, because of the complexity of the wastewater enterprise fund accounting system and the lack of an omnibus operating budget perspective, it is and will be difficult to determine what sewer-related monies are available. In addition, current fund transfer policies and procedures reduce the City's budgetary flexibility. In our opinion, the City can improve budgetary control by establishing fund reserve guidelines, ensuring compliance with those guidelines, and proposing interfund transfers that maximize budgetary flexibility. In addition, we recommend that the Administration evaluate the feasibility of preparing an annual comprehensive report that summarizes the City's wastewater activities. By so doing, the Administration and the City Council would have added information regarding sewer revenue sources and uses and enhanced budgetary flexibility.

RECOMMENDATIONS

We recommend that the Administration:

- Recommendation #1** **Update and adopt wastewater fund reserve guidelines that include all wastewater funds. (Priority 3)**
- Recommendation #2** **Retain funds in excess of adopted fund reserve guidelines in the wastewater fund that initially received the revenue. (Priority 3)**
- Recommendation #3** **Implement a policy to draw down excess undesignated fund balances and verify that transferred amounts are directly related to proposed expenditures less excess undesignated fund balances. (Priority 3)**
- Recommendation #4** **Report to the City Council Finance Committee on the feasibility of preparing an annual comprehensive report that summarizes all of the City’s wastewater activities. (Priority 3)**

Finding II Opportunities Exist To Increase Water Pollution Control Plant In-Lieu Fees To The General Fund By \$7.2 Million Retroactively And \$1.3 Million Annually

Like other enterprise funds, the Water Pollution Control Plant (WPCP) pays an annual in-lieu fee to the General Fund. Our review of the in-lieu fee the WPCP has paid the General Fund since 1993-94 revealed that the City underestimated the in-lieu fee by 1) unnecessarily reducing estimated property taxes by 35 percent and 2) not including all WPCP revenues in its franchise fee calculation. As a result, we estimate that since 1993-94 the General Fund has not received about \$7.2 million in the in-lieu fees it should have received. Further, we estimate that the General Fund is not receiving about \$1.3 million annually in the in-lieu fees it should be receiving. In our opinion, the City Attorney and Administration should assess the feasibility of paying \$4.6 million from the Treatment Plant Operating Fund

to the General Fund for in-lieu fees from 1993-94 to 1996-97. Further, the City Attorney and Administration should assess the feasibility of 1) paying an additional \$2.6 million from the Treatment Plant Operating Fund to the General Fund for in-lieu fees for 1997-98 and 1998-99; 2) increasing the annual in-lieu fee payment from the Treatment Plant Operating Fund to the General Fund by \$1.3 million; and 3) charging the other tributary agencies a portion of the in-lieu fees.

RECOMMENDATIONS

We recommend that the City Attorney and Administration:

- Recommendation #5** Assess the feasibility of paying \$4.6 million from the Treatment Plant Operating Fund to the General Fund for in-lieu fees from 1993-94 to 1996-97. (Priority 2)
- Recommendation #6** Assess the feasibility of 1) paying an additional \$2.6 million from the Treatment Plant Operating Fund to the General Fund for in-lieu fees for 1997-98 and 1998-99; 2) increasing the annual in-lieu fee payment from the Treatment Plant Operating Fund to the General Fund by \$1.3 million; and 3) charging the other tributary agencies a portion of the in-lieu fee. (Priority 2)

Finding III The Annual WPCP And SBWRP Reconciliation Processes Can Be Done More Efficiently

Agreements between the City of San Jose (City) and each of the San Jose/Santa Clara Water Pollution Control Program's (WPCP) tributary agencies require that the City annually calculate and allocate capital, operating, and South Bay Water Recycling Program (SBWRP) expenditures. Environmental Services Department (ESD) staff calculates each of these items separately. Prior to the beginning of each fiscal year, ESD staff uses the proposed budget to calculate each agency's contribution for which ESD staff bills them on a quarterly basis. During the third quarter of the next fiscal year, ESD staff reconcile tributary contributions to actual expenditures. Our review revealed that ESD's reconciliation process 1) takes about six to eight weeks of staff time, 2) is not well documented, and 3) produces results that cannot be easily

related to audited financial statements. In our opinion, the ESD should simplify its accounting structure and document its procedures. By so doing, the ESD will reduce the staff time devoted to the reconciliation process by an estimated two weeks, simplify its accounting structure, ensure that future reconciliations will be done efficiently, and provide tributary agencies with added assurance regarding future contribution charges.

RECOMMENDATIONS

We recommend that the ESD:

Recommendation #7 Prepare written policies and procedures for the annual WPCP and SBWRP billing and cost reconciliation process that: (1) document the reason for the calculation and (2) eliminate unnecessary steps from the calculation. (Priority 3)

We recommend that the Administration and the City Attorney's Office:

Recommendation #8 Approach the City of Santa Clara about amending the current agreement to eliminate the Treatment Plant Income Fund (Fund 514) in 1999-2000. (Priority 3)

Finding IV Controls Over Wastewater Expenditures Should Be Strengthened

Our review of sewer fund expenditures revealed several basic internal control weaknesses. Specifically we identified that:

- Directors' names appear on encumbrances and checking accounts;
- Departments are not conducting required semi-annual audits of sewer fund special checking accounts; and
- Departments do not have approved charts of account and their uses for charging expenditures to the twelve wastewater funds.

As a result, the City is exposed to inappropriate uses of sewer funds. Accordingly, the Administration needs to institute policy and procedural changes, enforce compliance with

existing requirements, and develop approved charts of account and their uses for charging expenditures to wastewater funds.

RECOMMENDATIONS

We recommend that the Finance Department:

Recommendation #9 **Revise its policies and procedures regarding the use of directors' names on encumbrances and checking accounts, and ensure that such names are removed. (Priority 2)**

Recommendation #10 **Enforce compliance with its procedures regarding semi-annual audits of departmental special checking accounts. (Priority 3)**

We recommend that the Administration:

Recommendation #11 **Develop approved charts of account and their uses that program managers can use for charging various expenses to the twelve wastewater funds. (Priority 3)**

Finding V Resumption Of Wastewater Interest Transfers Could Increase General Fund Revenues By \$2.5 Million Per Year While Opportunities Exist To Reduce Costs And Increase Sewer Service And Use Charge And Storm Drain Revenues By \$1.7 Million Per Year

Prior to the passage of Proposition 218, the City transferred interest earnings from the wastewater funds to the General Fund in accordance with the City Charter. After the passage of Proposition 218, the City discontinued the transfer of interest from the Sewer Service and Use Charge (SSUC) Fund to the General Fund. In April 1998, the City Auditor proposed separating pre-Proposition 218 from post-Proposition 218 fund balances in order to continue interest transfers on fund balances accumulated prior to the passage of Proposition 218. We estimated that the SSUC Fund would have earned approximately \$2.5 million in interest income during 1997-98

that the City could have transferred or swept directly into the General Fund. However, due to City Attorney Office concerns about Proposition 218, the City Auditor shelved the proposal. The City Auditor also proposed that the City remove SSUC fees from the property tax bill, and consolidate billing for SSUC fees with bi-monthly Recycle Plus bills. Our audit of the Utility Billing System estimated that the City could save and/or earn an additional \$1.5 million by combining SSUC and storm drain fees with bimonthly Recycle Plus billings. We estimate the net benefit of combined billing has increased to \$1.7 million per year. These increased revenue/reduced costs to the SSUC Fund would partially offset the \$2.5 million interest transfers on pre-Proposition 218 balances from the SSUC Fund to the General Fund.

RECOMMENDATIONS

We recommend that the Administration and the City Attorney's Office:

Recommendation #12 Research the feasibility of transferring interest from pre-Proposition 218 SSUC operating and capital fund balances to the General Fund. (Priority 2)

We recommend that the City Council direct the City Attorney to:

Recommendation #13 Research the applicability of Proposition 218 to Sewer Service and Use Charge (SSUC) fees, if the City were to separate the collection of those fees from property tax bills. (Priority 2)

We further recommend that:

Recommendation #14 Depending on the outcome of these discussions, the Administration should accelerate its analysis of consolidated SSUC billing with Recycle Plus bills. (Priority 2)

Finding VI The 1959 Sewage Treatment Plant Agreement’s Methodology For Allocating Water Pollution Control Plant Expenses Costs San Jose About \$1 Million Per Year

In 1959, the Cities of San Jose and Santa Clara formed a partnership and became joint owners of the Water Pollution Control Plant (WPCP). In 1983, San Jose and Santa Clara and the tributary agencies that use the WPCP entered into a Master Agreement that specifies how operating and maintenance costs will be allocated to each entity. Our review of the agreements revealed that 1) the allocation of costs between San Jose and Santa Clara differs from that of the other tributary agencies and 2) that difference works to the detriment of San Jose. As a result, San Jose pays about \$1 million per year more in operating costs than it would if costs were allocated the same between San Jose and Santa Clara as they are between the other tributary agencies. According to the City Attorney’s Office, the agreement will not expire until the year 2031. Nonetheless, we recommend that should the Administration and the City Attorney approach the City of Santa Clara about amending the agreement prior to 2031, that they include calculating WPCP user fees on estimated usage. By doing so, the joint owners of the WPCP will ensure that costs are allocated fairly and equitably.

RECOMMENDATIONS

We recommend that the Administration and City Attorney:

- Recommendation #15 Include in any discussion with the City of Santa Clara about updating and amending the 1959 Sewage Treatment Plant Agreement calculating WPCP user fees on estimated usage. (Priority 2)**

Introduction

In accordance with the City Auditor's 1998-99 Audit Workplan, we have audited the City of San Jose's (City) internal controls over Sewer Service and Use Charge (SSUC) Fund expenditures. This is our second in a series of audits of the SSUC Fund and the sewer services that the Environmental Services Department (ESD) provides. We conducted this audit in accordance with generally accepted government auditing standards and limited our work to those areas specified in the Scope and Methodology section of this report.

The City Auditor's Office thanks the Finance Department, Streets and Traffic Department, Public Works Department, and especially ESD's Administrative Services Division for their time, information, insight, and cooperation during the audit process.

Background

The Wastewater System

The City of San Jose's sanitary sewer system consists of a network of approximately 1,857 miles of gravity sewer, 7.2 miles of force mains, and 22 pumps/lift stations to the San Jose/Santa Clara Water Pollution Control Plant (WPCP). The sanitary sewer system currently serves a population of approximately 850,000 City residents, as well as three other jurisdictions. The City is the exclusive provider of wastewater services within the City limits. The replacement value of the system is estimated at approximately \$1 billion.

The City jointly owns the WPCP with the City of Santa Clara. The WPCP has a design capacity of 167 million gallons per day (mgd) and is the largest advanced wastewater treatment facility in California. Its regional service area covers approximately 300 square miles with a population of approximately 1.16 million that includes the cities of San Jose, Santa Clara, Milpitas, Cupertino, Campbell, Saratoga, Los Gatos, Monte Sereno and the adjacent unincorporated areas.

Located on an approximately 1,700 acre site in the Alviso area of San Jose and approximately six miles from the downtown business district, the WPCP discharges treated effluent to Artesian Slough, which flows into the southern portion of San Francisco Bay. The WPCP operates pursuant to a National Pollutant Discharge Elimination System permit that the State of

California Water Quality Control Board - San Francisco Bay Region issues.

Sewer Service And Use Charges

The primary source of revenue for the City's wastewater system is SSUC fees. SSUC fees have remained at the same level since 1994-95. SSUC fees are designed to charge users of sewer services in proportion to the benefit they receive. There are three broad categories of users including approximately 194,400 residential locations, 9,400 commercial and light industrial locations, and 50 monitored industrial locations. The Adopted 1998-99 Operating Budget includes approximately \$68.8 million in SSUC Fees. This includes \$50.6 million in fees from residential users, \$14.2 million from commercial and light industrial users, and \$4 million from monitored industrial users. Exhibit 1 shows SSUC single family residential rates for the last eleven years.

Exhibit 1 SSUC Single Family Residential Rates

Year	Monthly Rate
1988-89	12.70
1989-90	13.34
1990-91	14.20
1991-92	15.30
1992-93	17.00
1993-94	17.39
1994-95	18.96
1995-96	18.96
1996-97	18.96
1997-98	18.96
1998-99	18.96

The Sewer Service And Use Charge Fund

The SSUC Fund is used to account for SSUC fees, SSUC billing costs, sewer maintenance and rehabilitation, administration, and flow reduction programs. The City transfers monies out of the SSUC Fund to the following City funds: WPCP Operating and Capital, Sanitary Sewer Capital, Clean Water Financing Authority, and the General Fund. Exhibit 2 shows SSUC Fund estimated expenditures for 1998-99.

**Exhibit 2 SSUC Fund Budgeted Expenditures For 1998-99
(In Millions)**

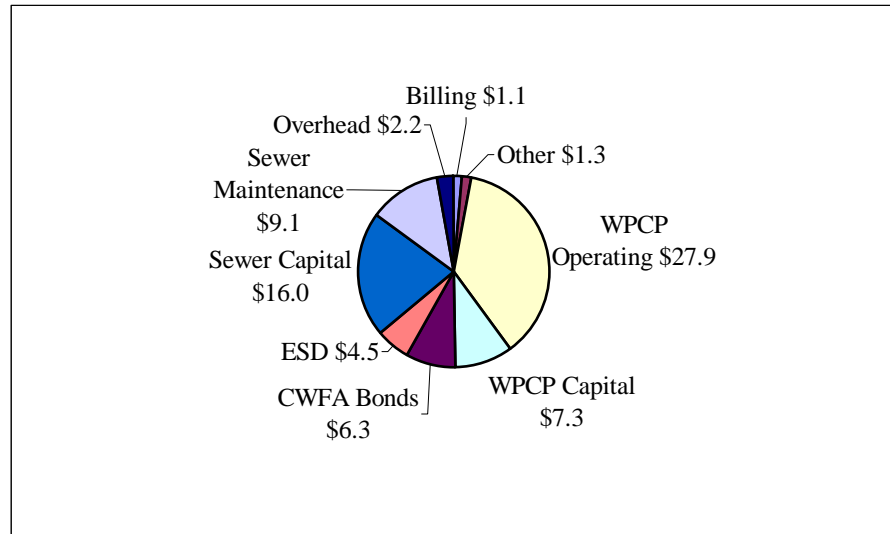


Exhibit 3 summarizes SSUC Fund net income for the past ten years.

**Exhibit 3 Sewer Service And Use Charge Fund Ten-Year Net
Income (In Millions)**

	89-90	90-91	91-92	92-93	93-94	94-95	95-96	96-97	97-98	98-99 Budget
Beginning fund balance	20.5	19.8	19.4	18.7	21.7	25.8	31.8	33.4	36.9	38.8 *
Revenue										
Sewer service and use charges	45.8	48.7	51.7	57.0	62.5	66.8	66.6	67.3	69.6	68.8
Interest	0.6	0.9	0.6	0.5	0.6	1.0	0.9	0.0	1.5	1.3
Other	1.1	0.4	0.3	0.5	1.9	0.4	0.2	0.1	2.1	0.5
Total revenue	47.5	50.0	52.6	58.0	65.0	68.2	67.7	67.4	73.2	70.6
Expenses										
Operating expenses	9.9	10.6	12.5	12.3	13.9	15.5	12.6	14.8	13.5	18.2
Transfer to WPCP funds	20.0	20.0	20.0	20.0	23.7	24.6	25.8	26.7	39.3	35.2
Transfer to sewer capital funds	10.7	12.3	14.0	15.9	16.0	16.0	16.0	16.0	16.9	16.0
Transfer for bond repayment	7.7	7.4	6.8	6.8	6.7	6.6	10.1	6.4	0.0	6.3
Interest transfer to General Fund	0.0	0.0	0.0	0.0	0.5	0.5	1.6	0.0	0.0	0.0
Total expenses	48.3	50.3	53.3	55.0	60.8	63.2	66.1	63.9	69.7	75.7
Net income	(0.8)	(0.3)	(0.7)	3.0	4.2	5.0	1.6	3.5	3.5	(5.1)
Ending fund balance	19.7	19.5	18.7	21.7	25.9	30.8	33.4	36.9	40.4	33.7

SOURCE: City of San Jose Operating Budgets

* Beginning fund balance based on budget, not actual.

*Wastewater
Treatment System
Enterprise Fund
Accounting*

The SSUC fund is one of twelve Wastewater Treatment System Enterprise Funds that the City uses to account for the financing, construction, and operation of the sewer system and the WPCP. According to the City’s Comprehensive Annual Financial Report, the City uses enterprise funds *“to account for operations that are financed and operated in a manner similar to private business enterprise, where the intent is that costs and expenses (including depreciation) of providing services to the general public on a continuing basis be financed or recovered primarily through user charges.”* Exhibit 4 lists the Wastewater Treatment System Enterprise Funds.

Exhibit 4 Wastewater Treatment System Enterprise Funds

Fund
512 – Treatment Plant Capital
513 – Treatment Plant Operating
514 – Treatment Plant Income
530 – South Bay Water Recycling
531 – Treatment Plant Renewal and Replacement Reserve
534 – South Bay Water Recycling Project Grant
537 – CWFA Payment
538 – CWFA Payment 95A-C
539 – Sewage Treatment Plant Connecting Fee
540 – Sanitary Sewer Connecting Fee
541 – SSUC
545 – SSUC Capital

As shown in Exhibit 5, the combining statements for the wastewater enterprise funds show positive net income for the City’s wastewater enterprise system over the last eight years.

**Exhibit 5 Sewer Collections And Treatment Plant Operations
(In Millions)**

	1991	1992	1993	1994	1995	1996	1997	1998
District revenue	7.3	8.3	13.5	9.6	13.0	10.5	10.9	13.3
Sewer service and use charges	49.1	52.1	57.5	63.0	66.8	66.7	67.0	69.6
Sewer and treatment plant connection fees	5.2	3.1	3.6	3.3	4.0	8.2	8.1	8.7
Contributions (equity)	5.2	5.2	8.9	5.7	7.8	3.8	11.5	20.2
Investment income	14.2	12.2	9.9	8.7	11.3	15.6	18.4	10.0
Other	1.3	2.3	4.0	4.2	1.7	6.0	1.6	2.6
Revenue	82.3	83.2	97.4	94.5	104.6	110.8	117.5	124.4
Operations and maintenance	45.0	48.5	50.2	60.1	48.1	61.1	65.8	38.1
General and administrative	10.7	11.9	9.9	11.7	16.1	11.0	14.4	16.5
Depreciation and amortization	12.0	12.2	12.5	12.4	12.8	12.4	12.8	13.7
Materials and supplies	0.0	0.0	0.3	0.3	0.2	0.3	0.3	0.3
Interest expense	6.4	6.0	5.6	5.1	4.7	6.7	8.2	6.5
Loss on disposal of fixed assets	0.1	0.1	0.1	0.0	0.0	0.0	0.0	0.0
Transfers out	0.0	1.2	1.2	1.8	1.6	4.1	4.2	0.1
Expenditure	74.2	79.9	79.8	91.4	83.5	95.6	105.7	75.2
Net Income (loss)	8.1	3.3	17.6	3.1	21.1	15.2	11.8	49.2

Source: Audited Financial Statements as of June 30

Overhead Rates

Overhead charges are assessed to recover the estimated fair share of indirect General Fund support service costs (staff and materials) which benefit other City program and fund activities. The overhead charge supports Human Resources, Finance, Information Technology, City Manager, and City Attorney activities. The Finance Department annually develops the overhead rates that are applied to projected salary costs.

The Master Agreement between San Jose, Santa Clara, and the other WPCP tributary agencies specifically allows the City to charge overhead on its WPCP expenditures. The Agreement originally specified that San Jose charge a 17.313 percent overhead rate on applicable labor expenses to be adjusted on an annual basis.

The City's calculated overhead rates vary by fund. Overhead is allocated to the SSUC Fund at the rate of 33.57 percent of personal expenditures. It should be noted that the Master Agreement between the City and the other WPCP tributary agencies specifically allows the City to charge an overhead rate on applicable labor expenses to be adjusted on an annual basis.

Exhibit 6 shows the total overhead allocation to the wastewater funds for the last three years.

Exhibit 6 Overhead Allocation To Wastewater Funds

Fund	1996-97	1997-98	1998-99 (as of Feb-99)
512 - WPCP Capital	271,436	79,459	30,288
513 - WPCP Operating	2,464,086	3,043,348	2,775,153
530 - South Bay Water	211,857	650,193	161,486
539 - WPCP connection fee fund	11,455	12,709	7,431
540 - Sanitary sewer connect fee	525,913	26,617	95,266
541 - SSUC	2,070,773	2,130,635	2,198,548
545 - SSUC Capital	-	391,541	273,976
Total	5,555,520	6,334,502	5,542,148

SOURCE: FMS

Organizational Responsibility

The Support Services Division of the ESD provides financial management and reporting services for the ESD’s special funds including many, but not all, of the wastewater enterprise funds. The Division also monitors the ESD’s direct expenditures from the SSUC Fund that totaled about \$3.1 million in 1997-98.

The Public Works Department’s Design and Construction and Engineering Services Divisions charge a portion of their expenditures to the SSUC Fund. These expenditures totaled about \$682,000 in 1997-98.

The Sewer Maintenance Program of the Streets and Traffic Department charged about \$7.2 million to the SSUC Fund in 1997-98. The SSUC Fund also funded about \$256,000 in Streets and Traffic administrative costs. The Streets and Traffic Department, in total, was responsible for about 10 percent of total SSUC Fund expenditures during 1997-98.

The SSUC Fund also funds SSUC billing and remittance processing. This includes Santa Clara County charges for placing SSUC fees on the property tax bills and Treasury Division Sewer Billing Unit costs. These costs total about \$1.1 million per year as shown in Exhibit 7.

Exhibit 7 SSUC Billing And Remittance Processing Costs

	1995-96	1996-97	1997-98	1998-99 Budget
Santa Clara County Fee	\$600,796	\$609,080	\$620,046	\$625,000
Treasury Division Costs	<u>\$334,892</u>	<u>\$288,368</u>	<u>\$415,101</u>	<u>\$451,655</u>
TOTAL	\$935,688	\$897,448	\$1,035,147	\$1,076,655

Scope and Methodology

The scope of our audit was to evaluate the efficiency and effectiveness of the City's internal controls over SSUC Fund expenditures, and evaluate the effectiveness of those internal controls that ensure interfund transfers are appropriate and in compliance with the City's Municipal Code.

We compiled SSUC expenditures for 1997-98 by type and program for the departments of ESD, Public Works, and Streets and Traffic. We reviewed the budgetary controls over those expenditures with staff in those departments, and spot-checked expenditures for two months during 1997-98 for appropriateness.

We compiled billing and collection costs for 1995-96 through 1998-99, and overhead and interfund transfers for 1994-95 through 1998-99. We reviewed the appropriateness of these transfers. We verified the controls over outstanding interfund loans from the wastewater funds, and determined that the terms seem reasonable.

To assess the efficiency and effectiveness of the sewer fund accounting system, we compiled a detailed flow-of-funds chart showing sources of revenue, including interfund transfers. We reviewed with departmental staff their responsibilities for monitoring the wastewater enterprise funds, and discussed possible means of simplifying the accounting structure with ESD and Finance Department staff. We reviewed the Finance Department's documentation of the purpose for each of the wastewater funds.

We reviewed the controls over the distribution of pooled investment earnings among the wastewater funds, and verified the distribution for 1997-98. We obtained and reviewed the wastewater fund reserve guidelines that staff prepared in 1996, and compiled monthly net cash flow for the SSUC Fund for the eighteen months ending January 1999.

We reviewed the controls over billing WPCP tributary agencies. We obtained and reviewed the detailed worksheets calculating those amounts for 1996-97, and verified that the calculations were in accordance with the various agreements that govern the amount that San Jose should bill to the other agencies.

In addition, we assessed the effectiveness of controls over the ultra-low flow toilet (ULFT) program expenditures.

Specifically, we reviewed the controls over cash payments for the ULFT program, and reimbursements from the Santa Clara Valley Water District. The SSUC Fund paid for ULFT expenditures until 1997-98, at which time the WPCP Operating Fund began paying those expenditures.

We performed only limited testing to determine the accuracy and reliability of information in the various computer reports used – in particular, reports from the City’s Financial Management System (FMS). We met with ESD, Streets and Traffic, Public Works, and Finance Department staff to review the completeness and reliability of the information we were extracting from FMS. We did not audit the general and specific application controls for the computer system used in compiling the various computer reports we reviewed.

Finding I

The City Should Improve Budgetary Control And Establish Fund Reserve Guidelines For The Wastewater Enterprise Funds

The City of San Jose (City) has more than \$264 million in the twelve separate accounting funds that comprise the wastewater enterprise system. Our review revealed that in July 1996, City staff drafted fund reserve guidelines for five of these funds. Those guidelines recommended a minimum reserve level of about \$40 million – \$118 million less than the fund balance for these five funds as of June 30, 1998. The City’s five-year capital improvement program includes major capital projects that would reduce these fund balances if projected expenditures actually occur. However, because of the complexity of the wastewater enterprise fund accounting system and the lack of an omnibus operating budget perspective, it is and will be difficult to determine what sewer-related monies are available. In addition, current fund transfer policies and procedures reduce the City’s budgetary flexibility. In our opinion, the City can improve budgetary control by establishing fund reserve guidelines, ensuring compliance with those guidelines, and proposing interfund transfers that maximize budgetary flexibility. In addition, we recommend that the Administration evaluate the feasibility of preparing an annual comprehensive report that summarizes the City’s wastewater activities. By so doing, the Administration and the City Council would have added information regarding sewer revenue sources and uses and enhanced budgetary flexibility.

**Wastewater
Enterprise
Accounting**

As of June 30, 1998, there was more than \$264 million in the twelve separate accounting funds that comprise the wastewater enterprise system. Exhibit 8 is a schedule of those wastewater fund balances for the last six years.

**Exhibit 8 Schedule Of Wastewater Fund Balances
(In Millions)**

FUND	DESCRIPTION	6/30/93	6/30/94	6/30/95	6/30/96	6/30/97	6/30/98
512	WPCP Capital	36.0	29.3	39.0	18.2	20.5	48.0
513	WPCP Operating	36.0	41.8	45.8	42.6	33.8	30.4
514	WPCP Income	22.4	15.7	11.2	6.0	2.0	3.1
530	SBWRP (*)	0.0	0.0	0.0	86.1	67.4	9.5
531	WPCP Renewal and Replacement Reserve (*)	16.9	18.0	20.4	22.3	22.0	5.0
534	SBWRP Grant	0.0	0.0	0.6	13.8	15.5	16.5
537	CWFA Payment Fund	0.0	0.0	0.0	3.7	2.5	3.7
538	CWFA Payment Fund	1.9	2.0	2.7	1.7	3.8	2.1
539	WPCP Connecting Fee	38.5	41.1	37.2	38.5	34.7	33.9
540	Sewer Connecting Fee	18.2	24.2	34.1	46.6	56.0	50.8
541	SSUC	21.7	25.8	31.8	33.4	38.3	40.4
545	SSUC Capital	0.0	0.0	0.0	0.0	0.0	20.7
Total		191.6	197.9	222.8	312.9	296.5	264.1

(*) Includes restricted assets.

Source: Audited Financial Statements – fund balances calculated as current assets plus restricted assets less current liabilities.

Draft Fund Reserve Guidelines

In July 1996, the Administration developed wastewater fund reserve guidelines *“to ensure that funds are prudently managed and that rate adjustments are adequately planned for . . . reserves are maintained in those funds for various purposes including:*

- *Meeting bond obligations*
- *Complying with State Revenue Program Guidelines*
- *Providing for future plant expansions*
- *Responding to unforeseen emergency expenditures and repairs not covered by insurance . . .*

‘Excess’ reserves will be used to fund future capital needs and sewer related operating budgets so that reserves are gradually reduced to the policy level.” The draft guidelines identified targeted reserve levels for five of the wastewater funds that the Environmental Services Department (ESD) monitors. According to the Administration’s guidelines, the *“reserve balance in these funds has increased in recent years to levels higher than is necessary to assure an adequate margin of financial safety and to meet bond obligations for long-term capital improvements.”* According to the staff report, this occurred for two principal reasons:

First, the success of the Treatment Plant preventive maintenance program has delayed the need to replace major pieces of equipment and consequently, the equipment replacement reserve has grown and earned considerable interest.

Secondly, in 1982, the Sewage Treatment Plant Connection Fee Fund was increased to pay for San Jose's share of the 24 million gallon-per-day Plant expansion. It was intended that this expansion would provide sufficient capacity for new connections through 1992, at which time the next Plant expansion would be necessary. However, this additional capacity has not yet been needed resulting in accumulation of reserves.

Guideline Reserve Balances Were Exceeded

The 1996 fund reserve guidelines were developed in collaboration with the Finance Department, Office of the City Attorney and the City Manager's Budget Office. However, our review revealed that the guideline reserve balances have been exceeded. Specifically, the guidelines proposed retaining \$39.9 million in five wastewater fund reserves – Funds 512, 513, 531, 539 and 541. As shown in Exhibit 9, at the time the guidelines were prepared there was about a \$122.7 million unrestricted fund balance in Funds 512, 513, 531, 539 and 541, as of June 30, 1996. Our review revealed that as of June 30, 1998, there was \$157.7 million in those five funds – \$118 million more than proposed guidelines for these five funds. In addition, there was \$264.1 million in total unrestricted fund balances in the twelve wastewater funds as of June 30, 1998, as shown in Exhibit 9.

Exhibit 9 Proposed Fund Reserve Targets And Actual Fund Balances (In Millions)

Fund	1996 Proposed Fund Reserve Guidelines	Estimated Fund Reserve as of 6/30/96 in the Targeted Funds	Actual Fund Balance as of 6/30/98 in the Targeted Funds	Actual Fund Balance as of 6/30/98 in All Wastewater Funds
512 - WPCP Capital	1.0	18.0	48.0	48.0
513 - WPCP Operating	7.6	34.0	30.4	30.4
514 - WPCP Income				3.1
530 - South Bay Water				9.5
531 - Replacement Reserve (*)	5.0	20.4	5.0	5.0
534 - SBWRP Grant				16.5
537 - CWFA Payment Fund				3.7
538 - CWFA Payment Fund				2.1
539 - WPCP connection fee fund	18.4	18.4	33.9	33.9
540 - Sanitary sewer connect fee				50.8
541 - SSUC	7.9	31.9	40.4	40.4
545 - SSUC Capital				20.7
Total	39.9	122.7	157.7	264.1

(*) The Administration proposed that the Sewage Treatment Plant Connection Fee Fund target should fluctuate depending on revenue stream and projected expansion activities.

Source: Draft report to the City Manager dated July 10, 1996, and Audited Financial Statements as of June 30, 1998.

The Capital Improvement Program Should Be Considered

The proposed 1999-2003 Capital Improvement Program (CIP) includes nearly \$400 million in wastewater fund capital expenditures. This would significantly reduce wastewater fund balances when those expenditures actually occur. It should be noted that in 1996, the ESD projected that “*excess reserves will be used to fund future capital needs and sewer-related operating budgets so that reserves are gradually reduced.*” However, that projection notwithstanding, between June 30, 1996, and June 30, 1998, the wastewater fund balances in the targeted funds actually grew by \$35 million.

Cash Flow Requirements Should Be Considered

Our review also revealed that absent a change in the method of collecting SSUC revenue twice a year, staff’s estimate of the cash required to maintain a positive balance in the SSUC Fund (541) may be understated. Specifically, staff estimated that a total of \$7.9 million should be maintained in Fund 541 as a reserve to “*maintain a minimum fund balance of 15% of the collection, treatment, and recycling system operating expenditures, and maintain a rate stabilization reserve of*

\$2M.” Because the City collects SSUC revenue on the County’s property tax bills, revenues are usually received one-half in January and one-half in June. As a result, Fund 541 may need as much as \$30 million in cash reserves at the end of the fiscal year to fund expenses in the first half of the following year. Fund 513 (the WPCP Operating Fund) may have similar cash flow requirements.

We recommend that the Administration:

Recommendation #1

Update and adopt wastewater fund reserve guidelines that include all wastewater funds. (Priority 3)

Complexity Of Wastewater Accounting Obscures The Accumulation Of Large Fund Balances

According to the Adopted 1998-99 Operating Budget, “*the Sewer Service and Use Charge (SSUC) Fund was established to account for the financing, construction, and operation of the sanitary sewer system and for the City of San Jose’s share of the financial, construction, and operation of the regional San Jose/Santa Clara Water Pollution Control Plant (WPCP). Services provided through this fund are: Sewer maintenance; Sewer rehabilitation; Sewage treatment at WPCP; Reduction of wastewater flow.*”

However, our review revealed that, in practice, the accounting for the above services takes place in the twelve separate funds that constitute the City’s wastewater treatment system enterprise funds. Financial reporting for those funds is consolidated in only one place – the Comprehensive Annual Financial Report (CAFR). In the 1998 CAFR, information on the twelve wastewater funds appeared on pages 158 through 181.

The City’s budget documents do not provide an omnibus perspective on the entire wastewater system. Budgetary information and approvals are split between the operating and capital budgets. What’s more, operational responsibility is split between various departments. In our opinion, the complexity of the wastewater accounting system has obscured the reporting of financial results of the wastewater enterprise, including the accumulation of large fund balances. For example, if \$264.1 million in unrestricted reserves had accumulated in one fund, it seems likely that both the Administration and the City Council would have paid attention to it.

The complex accounting and budgeting system for the wastewater funds has a variety of causes. First, although the primary source of revenue into the system is SSUC fees, there are also two types of developer fees (the Sewage Treatment Plant Connection Fee and the Sanitary Sewer Connection Fee) that provide revenue into the system. The City accounts for each of these fees in separate funds. Second, the Treatment Plant has an income fund, an operating fund, and a capital fund, and a variety of memo funds. Finally, the Clean Water Financing Authority (CWFA) accounts for its bonds in two funds. As a result, the City uses at least twelve funds to account for its wastewater enterprise.

**Sources Of
Wastewater Budget
Information**

In order to document the flow of funds through the wastewater enterprise, we had to use information from the adopted operating and capital budgets and the CAFR, and conducted several interviews with City staff. Furthermore, as shown in Exhibit 10, the information was widely scattered even within those documents.

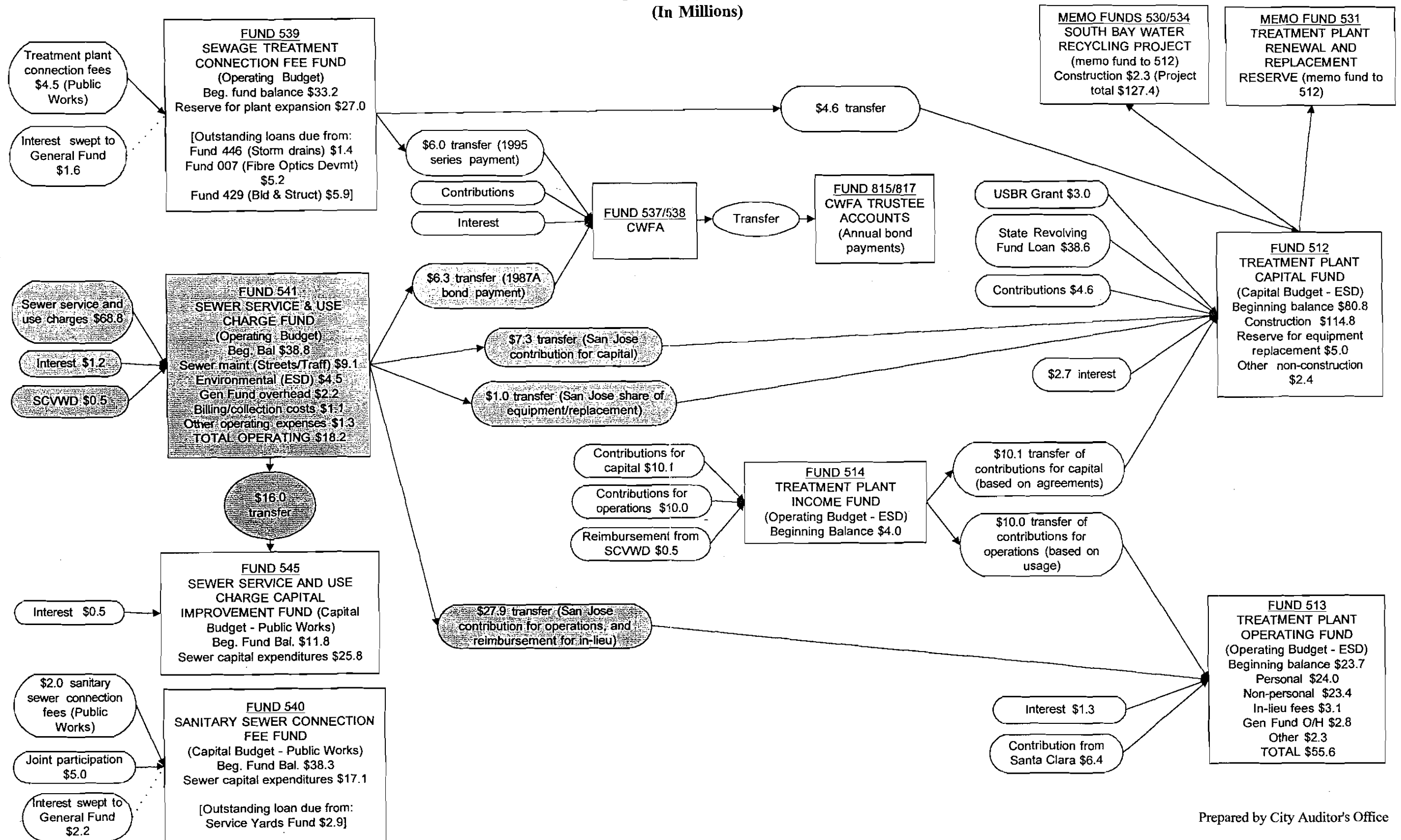
Exhibit 10 Table Showing Sources Of 1998-99 Wastewater Budget Information

Fund	Type of Information	Budget Document
512	WPCP capital expenditures	<ul style="list-style-type: none"> Source and Use of Funds Summary in the Capital Budget (p. 722-724) and project detail (p.725-743)
513	WPCP operating expenditures	<ul style="list-style-type: none"> WPCP division expenditures in Operating Budget (p. 466-470) Source and Use Statement in the Operating Budget (p. 803)
514	WPCP other income	<ul style="list-style-type: none"> Source and Use Statement in the Operating Budget (p. 804)
530	SBWRP	<ul style="list-style-type: none"> Fund 530 does not appear separately in budget; SBWRP expenditures are included in Fund 512 budget. Fund 530 is reported in the CAFR.
537 538	CWFA	<ul style="list-style-type: none"> “Transfers in” appear in Operating Budget Source and Use Statement for Funds 541 (p. 800) and 539 (p. 805) Expenditure/transfer information does not appear in the budget Funds 537 and 538 are reported in the CAFR
539	WPCP connection fees	<ul style="list-style-type: none"> Connection fee revenue and transfers out are shown in the Source and Use Statement in the Operating Budget (p. 805)
540 545	Sanitary sewer capital expenditures	<ul style="list-style-type: none"> Source and Use of Funds Summary in the Capital Budget (p. 467-474) and project detail (p. 475-505)
541	Sewer service and use charge fund	<ul style="list-style-type: none"> Program budgets for sewer services including maintenance, rehabilitation, treatment, and wastewater flow reduction are shown in the Inter-Departmental Program section of the Operating Budget (p. 769-776) ESD division expenditures (some of which are charged to wastewater funds) are shown in the departmental budget section of the Operating Budget (p. 431-470) Sewer service and use charge fund revenues, expenditures, and transfers (including transfers to capital funds) are shown on the Source and Use Statement in the Operating Budget (p. 799-800)

Complex Flow Of Funds

As a result, budgeting and accounting for the above funds is an arduous, labor-intensive endeavor. Exhibit 11 shows the budgeted 1998-99 flow of funds through the wastewater enterprise funds.

Exhibit 11
Wastewater Enterprise Budgeted 1998-99 Flow of Funds
(In Millions)



Prepared by City Auditor's Office

Reduced Budgetary Flexibility

Wastewater system revenues include SSUC fees, regional district operational and capital revenue, service connection, engineering and inspection fees, wastewater discharge permits, and investment income. The City bills the tributary agencies for operating and capital costs, and transfers those revenues to either operating or capital funds on that basis.

Nonetheless, most wastewater system revenue is undesignated – that is, it can be used for a variety of sewer-related purposes. Our review revealed that 72 percent of the total fund balances as of June 30, 1998 was actually undesignated, while 11 percent was reserved for a specific purpose, and 17 percent was related to contributed capital. Thus, the wastewater system allows for considerable discretion when allocating revenue to sewer-related activities.

However, our review revealed that accumulated fund balances may appear to be more restricted in their potential uses than they are. This occurs when the City makes transfers to one fund versus another. For example, the WPCP Capital Fund (Fund 512) has a fund balance of \$48 million. It appears that money can only be used for WPCP capital expenditures. In fact, that money is undesignated and to the extent that it was originally derived from SSUC fees, it could have been used for a number of other sewer-related purposes (such as CWFA debt service or sewer maintenance). In order to avoid this problem, we recommend that the Administration retain funds in excess of adopted fund reserve guidelines in the fund that initially received the revenue.

Fund Designations

According to the Governmental Accounting Standards Board,

Fund balance designations may be established to indicate tentative plans for financial resource utilization in a future period, such as for general contingencies or for equipment replacement. Such designations reflect tentative managerial plans or intent . . . Such plans or intent are subject to change and may never be legally authorized or result in expenditures.

In our opinion, the Administration should establish fund balance designations in the fund that received the revenue instead of accumulating fund balances in specific capital or operating funds. In this way, the Administration can earmark funds for planned projects. In addition, as priorities change, the

City retains maximum flexibility in allocating those funds to the highest priority areas.

We recommend that the Administration:

Recommendation #2

Retain funds in excess of adopted fund reserve guidelines in the wastewater fund that initially received the revenue. (Priority 3)

Interfund Transfers

The City recognizes SSUC and developer fee revenues in three funds: Fund 539 (the Treatment Plant Connection Fee Fund), Fund 540 (the Sanitary Sewer Connection Fee Fund), and Fund 541 (the SSUC Fund). Over the course of the year (timing varies by fund), the City transfers funds to various operating and capital funds. For example, Exhibit 12 shows the transfers out of Fund 541 to other wastewater funds from 1989-90 to 1998-99.

Exhibit 12 Schedule Of Transfers From Fund 541 To Other Wastewater Funds From 1989-90 To 1998-99 (In Millions)

	1989-90	1990-91	1991-92	1992-93	1993-94	1994-95	1995-96	1996-97	1997-98	1998-99 Budget
WPCP Capital (Fund 512)	0.0	0.0	0.0	0.0	1.0	3.0	2.0	3.0	15.6	7.3
WPCP Operating (Fund 513)	21.2	19.0	19.0	19.0	21.6	22.6	22.6	22.6	22.6	27.9
WPCP Income (Fund 514)	0.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	0.0
CWFA (Funds 537/538)	6.5	6.5	6.6	6.6	6.6	6.6	10.1	6.4	0.0	6.3
Sewer Capital (Funds 540/545)	10.7	12.3	14.0	15.9	16.0	16.0	16.0	16.0	16.9	16.0
Transfers out	38.4	38.8	40.6	42.5	46.2	49.2	51.7	49.0	56.1	57.5

The City Manager’s Budget Office is responsible for reviewing and approving all interfund transfers. According to the Budget Office, a consultant study of the sewer system’s maintenance costs formed the basis for the \$16 million annual transfer to Sewer Capital (Funds 540/545) that began in 1993-94.

However, our review revealed that, in general, there is no written justification for the amounts transferred, and no policy in place to reduce unnecessary accumulations of funds. As a result, excess funds may accumulate in those operating and capital funds. We found that annual transfers between the wastewater funds are not necessarily based on current expenditure projections or take into account carryover fund balances. In many cases, the amounts transferred are identical

from year to year. In our opinion, the Budget Office should implement a policy to draw down excess undesignated fund balances and verify that transferred amounts are directly related to proposed expenditures less excess undesignated fund balances. By so doing, undesignated fund balances would accumulate in the fund that initially receives the revenue. As a result, the City would retain maximum flexibility for any future uses of those funds.

*Interfund Transfers
To The WPCP*

In the specific case of interfund transfers from the SSUC Fund to the Treatment Plant Operating and Capital funds, we found that the ESD had calculated the amount due from the City, but did not necessarily use that figure to determine transfer amounts. For example, at the beginning of 1997-98, San Jose had a cash credit of \$27.3 million in excess contributions in the WPCP Operating Fund. San Jose’s projected share of WPCP Operating Fund expenditures totaled \$32.8 million (an ESD staff member calculates the amounts due from all the jurisdictions using the WPCP). Nonetheless, the City transferred \$22.6 million from 541 – the same amount the City had transferred for the previous three fiscal years. In our opinion, the ESD should use San Jose’s estimated share of WPCP operating, capital, and SBWRP expenditures, less any carryover cash credit, as the basis for the proposed transfers to the WPCP Operating and Capital Funds.

We recommend that the Administration:

Recommendation #3

Implement a policy to draw down excess undesignated fund balances and verify that transferred amounts are directly related to proposed expenditures less excess undesignated fund balances. (Priority 3)

**Annual
Comprehensive
Report**

According to the CAFR,

Enterprise Funds are used to account for operations that are financed and operated in a manner similar to private business enterprise, where the intent is that costs and expenses (including depreciation) of providing services to the general public on a continuing basis be financed or recovered primarily through user charges... The Wastewater Treatment System funds were established to account for the financing, construction, and operation of the sewer system and the

regional San Jose/Santa Clara Water Pollution Control Plant.

The City's budget documents should provide users with an understanding of total funds available so that the City Council can make informed decisions about funding capital projects, issuing bonds, or adjusting user fees. In practice the City's budget documents show budgets for the component funds, but not the wastewater system in total. The only place to see the combined activity and fund balances of the wastewater system are in the City's CAFR – in fine print beginning on page 135. As a result, it may be difficult for the average reader to determine what wastewater system funds are available for what purposes. In our opinion, rate-setting and capital budget planning, in particular, should be based on the flow of funds through the entire system. An annual financial report on the wastewater system would facilitate this understanding.

Another enterprise of the City – the Airport – began preparing a CAFR two years ago. In the Airport's CAFR, Airport Administration reports on the Airport's business environment, major initiatives, outlook for the future, project financing, operating revenues and expenses. The report also includes the Airport's audited financial statements, ten-year statistical information related to airport operations, and the bond disclosure report. According to Airport staff, the airlines, City Council, rating agencies, investors (i.e. bond holders), regulatory agencies (i.e. the FAA), and other airports have received the report very well. Airport staff were able to compile much of the report from information available elsewhere. Although report preparation was time-consuming in the first year, staff expects that subsequent updates will be less so.

The wastewater enterprise publicly reports its financial information in a variety of ways – in the City's budget documents and annual CAFRs, CWFA Official Statements and financial statements, and in San Jose/Santa Clara Treatment Plant Advisory Committee memoranda. As a result, the City could compile much of the information in a wastewater system annual report from information that is available elsewhere.

In our opinion, the Administration should evaluate the feasibility of preparing an annual comprehensive report that summarizes all of the City's wastewater activities and report back to the City Council Finance Committee on the results of the evaluation.

We recommend that the Administration:

Recommendation #4

Report to the City Council Finance Committee on the feasibility of preparing an annual comprehensive report that summarizes all of the City’s wastewater activities. (Priority 3)

CONCLUSION

The City accounts for its wastewater enterprise system using twelve separate accounting funds. In July 1996, staff drafted proposed fund reserve guidelines for five of the wastewater funds. Our review revealed a total of \$158 million in fund balance in those five wastewater funds, which is \$118 million more than the proposed fund reserve guidelines of \$40 million. In addition, the City lacks an omnibus budget perspective for the twelve wastewater funds that makes it difficult to know what sewer-related monies are actually available. In our opinion, the City can improve budgetary control by establishing fund reserve guidelines, ensuring compliance with those guidelines, and proposing interfund transfers that maximize budgetary flexibility. Finally, the Administration should evaluate the feasibility of preparing a comprehensive annual report on wastewater activities similar to the annual report the Airport Department prepares.

RECOMMENDATIONS

We recommend that the Administration:

- Recommendation #1** **Update and adopt wastewater fund reserve guidelines that include all wastewater funds. (Priority 3)**

- Recommendation #2** **Retain funds in excess of adopted fund reserve guidelines in the wastewater fund that initially received the revenue. (Priority 3)**

- Recommendation #3** **Implement a policy to draw down excess undesignated fund balances and verify that transferred amounts are directly related to proposed expenditures less excess undesignated fund balances. (Priority 3)**

Recommendation #4 **Report to the City Council Finance Committee on the feasibility of preparing an annual comprehensive report that summarizes all of the City’s wastewater activities. (Priority 3)**

Finding II

Opportunities Exist To Increase Water Pollution Control Plant In-Lieu Fees To The General Fund By \$7.2 Million Retroactively And \$1.3 Million Annually

Like other enterprise funds, the Water Pollution Control Plant (WPCP) pays an annual in-lieu fee to the General Fund. Our review of the in-lieu fee the WPCP has paid the General Fund since 1993-94 revealed that the City underestimated the in-lieu fee by 1) unnecessarily reducing estimated property taxes by 35 percent and 2) not including all WPCP revenues in its franchise fee calculation. As a result, we estimate that since 1993-94 the General Fund has not received about \$7.2 million in the in-lieu fees it should have received. Further, we estimate that the General Fund is not receiving about \$1.3 million annually in the in-lieu fees it should be receiving. In our opinion, the City Attorney and Administration should assess the feasibility of paying \$4.6 million from the Treatment Plant Operating Fund to the General Fund for in-lieu fees from 1993-94 to 1996-97. Further, the City Attorney and Administration should assess the feasibility of 1) paying an additional \$2.6 million from the Treatment Plant Operating Fund to the General Fund for in-lieu fees for 1997-98 and 1998-99; 2) increasing the annual in-lieu fee payment from the Treatment Plant Operating Fund to the General Fund by \$1.3 million; and 3) charging the other tributary agencies a portion of the in-lieu fees.

Annual In-Lieu Fee The City maintains a number of enterprise funds, which, if they were privately held, would pay taxes of various types on their operations. The WPCP is one such enterprise. In 1993-94, the WPCP began paying an annual fee in-lieu of business tax, franchise fees, utility taxes, and property taxes to the General Fund. Since that time, the WPCP has paid the General Fund an in-lieu fee of from \$2.6 to \$3.1 million per year.

The policy of the City's Budget Office has been to adjust the wastewater enterprise in-lieu fee annually using the rate of growth in the secured property tax roll. The Budget Office has not recalculated the WPCP in-lieu fee amount in several years. Exhibit 13 shows the WPCP in-lieu fee payments to the General Fund since 1993.

Exhibit 13 WPCP In-Lieu Fees

Year	In-Lieu Fee
1993-94	\$2,636,000
1994-95	2,636,000
1995-96	2,835,000
1996-97	2,849,000
1997-98	2,924,000
1998-99	3,100,000

**Auditor’s
Recalculation Of
The In-Lieu Fee**

The original WPCP in-lieu calculation included a business tax, franchise fee, utility tax, and property tax component. We recalculated each of these components using current information from the Adopted 1998-99 Operating Budget, the City’s audited financial statements, and the City’s Financial Management System.

We found that the City may have slightly misestimated the amount of business tax and utility tax that would have been paid, but significantly underestimated the amount of franchise fee and property taxes that would have been paid if the enterprise were private. Moreover, we found that the City underestimated the amount of the in-lieu by (1) reducing estimated property taxes by 35 percent, and (2) not including all WPCP revenue in the franchise fee calculation. The individual components of the calculation are:

- Business tax in-lieu – The original calculation of \$18.00 per employee was applied to an estimated total of 303 employees. Currently, the business tax rate is \$154.50 for the first eight employees plus \$18.54 for each employee thereafter; there are 314 FTE assigned to WPCP and the Technical Services and Environmental Enforcement Divisions of ESD.
- Franchise fee in-lieu – The franchise fee rate that some other utilities pay is (and was) 2 percent of gross receipts. The original calculation was based on total SSUC fees of \$57 million, or only one part of wastewater revenues. We believe a better estimate of WPCP activity is wastewater enterprise operating revenue, which was nearly \$105 million in 1997-98.
- Utility tax – The current utility tax rate is (and was) 5 percent of utility charges. Fund 513’s adopted 1998-99 budget for utility and phone expense is \$4,016,808 – down from the \$5.1 million that was estimated in 1993-94.

- Property tax – The original calculation of property tax in-lieu was one percent of the total WPCP asset value. This estimate was substantially reduced after the City Attorney opined that the City would be best served to impose an amount equal to what the City would have received, not what the enterprise fund would have paid in taxes. Since the City only receives 15.5 percent of total property tax, this reduced the property tax component significantly. The City reduced the property tax in-lieu by another 35 percent to reflect the amount of the in-lieu fee that San Jose ratepayers would have paid (approximately 65 percent of WPCP costs). We used the 1993 estimate of \$1,056,427,000 as a base value, plus additions to fixed assets from the annual financial statements (a total of \$162 million), and increased the total by 2 percent per year. We did not retain the 65 percent assumption since the in-lieu fee is the estimated tax that the City of San Jose would receive if the WPCP were privately owned. Using this method, we estimate that WPCP’s asset value has increased to nearly \$1.4 billion.¹ San Jose’s current property tax rate is 0.155 percent of assessed value.

Following this revised methodology, the 1998-99 in-lieu transfer would be \$4,399,021 rather than the \$3,100,000 that is currently budgeted. We estimate the total retroactive difference would be \$7,249,904. Exhibit 14 shows this comparison.

¹ Including portions of the South Bay Water Recycling Project capitalized as of June 30, 1998.

Exhibit 14 Auditor's Recalculation Of Wastewater In-Lieu For 1993-94 Through 1998-99

	1993-94 Original Calculation	1993-94 Recalculation	1994-95 Recalculation	1995-96 Recalculation	1996-97 Recalculation	1997-98 Recalculation	1998-99 Recalculation
BUSINESS TAX							
Number of employees	303	307	321	328	324	317	314
Rate per employee ²	\$18.00	\$18.00	\$18.00	\$18.00	\$18.54	\$18.54	\$18.54
<i>In-lieu amount</i>	\$5,000	\$5,537	\$5,789	\$5,915	\$6,013	\$5,883	\$5,828
FRANCHISE FEE							
WPCP revenue	\$57,108,000	\$87,746,321	\$93,033,723	\$108,033,336	\$102,833,102	\$104,541,014	\$104,541,014
Rate	2%	2%	2%	2%	2%	2%	2%
<i>In-lieu amount</i>	\$1,142,000	\$1,754,926	\$1,860,674	\$2,160,667	\$2,056,662	\$2,090,820	\$2,090,820
UTILITY TAX							
Utility/phone expense	\$5,100,000	\$4,000,000	\$4,000,000	\$3,618,547	\$2,736,831	\$3,325,098	\$4,016,808
Rate	5%	5%	5%	5%	5%	5%	5%
<i>In-lieu amount</i>	\$255,000	\$200,000	\$200,000	\$180,927	\$136,842	\$166,255	\$200,840
PROPERTY TAX							
Asset value	\$1,056,427,000	\$1,080,220,605	\$1,113,342,643	\$1,146,468,080	\$1,200,484,383	\$1,262,047,672	\$1,355,827,320
CSJ rate	0.1798%	0.1550%	0.1550%	0.1550%	0.1550%	0.1550%	0.1550%
San Jose portion	65%						
<i>In-lieu amount</i>	\$1,234,646	\$1,674,342	\$1,725,681	\$1,777,026	\$1,860,751	\$1,956,174	\$2,101,532
<i>Total in-lieu amount</i>	\$2,636,646	\$3,634,805	\$3,792,144	\$4,124,534	\$4,060,268	\$4,219,132	\$4,399,021
Actual payment	\$2,636,000	\$2,636,000	\$2,636,000	\$2,835,000	\$2,849,000	\$2,924,000	\$3,100,000
<i>Difference</i>		\$998,805	\$1,156,144	\$1,289,534	\$1,211,268	\$1,295,132	\$1,299,021
						TOTAL:	\$7,249,904

Comparison Of Alternative Methods To Calculate In-Lieu Fees

We estimate that if the enterprise were privately held it would pay a total of \$17.1 million in business taxes, franchise fees, utility taxes, and property taxes. We estimate that San Jose residents would pay about 65 percent of that amount, or \$11.1 million. However, the City's General Fund would only receive about \$4.4 million of those fees and taxes – the difference being that San Jose only receives about 15.5 percent of property taxes. Exhibit 15 shows this comparison.

² Currently, the business tax rate is \$154.50 for the first eight employees plus \$18.54 per employee thereafter.

Exhibit 15 Comparison Of Alternative Methods To Calculate In-Lieu Fees For 1998-99

	1998-99 in-lieu fees (current methodology)	What WPCP and San Jose residents would pay if the enterprise were private	What the General Fund would receive if the enterprise were private
Business tax in-lieu	\$5,880	\$5,828	\$5,828
Franchise fee in-lieu	\$1,342,992	\$2,090,820	\$2,090,820
Utility tax in-lieu	\$299,880	\$200,840	\$200,840
Property tax in-lieu	\$1,451,944 ³	\$14,805,634 ⁴	\$2,101,532 ⁵
Total	\$3,100,696	\$17,103,122	\$4,399,020
San Jose residents' share ⁶		65%	
San Jose residents' payments		\$11,117,029	

The auditor's recalculated in-lieu fee is based on what the General Fund would receive if the enterprise were private -- \$4.4 million. As shown in Exhibit 15, this is far less than San Jose residents would have paid if the enterprise were private -- \$11.1 million. Accordingly, in our opinion, increasing in-lieu fees would not constitute a subsidy of other jurisdictions' ratepayers.

This issue is important because the City Attorney previously determined that San Jose's sewer service and use charges (SSUC) are property-related fees as defined by Proposition 218. As such, the City made programmatic and budgeting changes effective July 1, 1997 to restrict the use of SSUC fees. Similarly, there may be differences in how the City calculates and collects pre-Proposition 218 versus post-Proposition 218 in-lieu amounts. For the years prior to July 1, 1997, we estimate that the Treatment Plant Operating Fund should pay \$4.6 million in in-lieu fees to the General Fund to correct in-lieu amounts for the years 1993-94 through 1996-97. Exhibit 16 shows our calculation.

³ Based on San Jose residents' share (65%) of the City's portion (17.98%) of estimated property taxes (1% of current estimated asset value).

⁴ Using current tax rate of 1.0920% for WPCP's tax rate area.

⁵ Based on the City's portion (currently 15.5%) of estimated property taxes (1% of current estimated asset value).

⁶ Based on San Jose's share of WPCP operating and capital budgets (65%).

Exhibit 16 Recalculated In-Lieu Amounts For 1993-94 Through 1996-97

	1993-94	1994-95	1995-96	1996-97	Total
Recalculated in-lieu amount from Exhibit 14	\$3,634,805	\$3,792,144	\$4,124,534	\$4,060,268	\$15,611,751
Actual in-lieu payment	\$2,636,000	\$2,636,000	\$2,835,000	\$2,849,000	\$10,956,000
Difference	\$998,805	\$1,156,144	\$1,289,534	\$1,211,268	\$4,655,751

We recommend that the City Attorney and Administration:

Recommendation #5

Assess the feasibility of paying \$4.6 million from the Treatment Plant Operating Fund to the General Fund for in-lieu fees from 1993-94 to 1996-97. (Priority 2)

Furthermore, we estimate that the Treatment Plant Operating Fund should pay \$2.6 million to the General Fund for the years after Proposition 218 became effective (1997-98 and 1998-99), and beginning in 1999-2000 increase the annual in-lieu fee payment by about \$1.3 million per year. Exhibit 17 shows our calculation.

Exhibit 17 Recalculated In-Lieu Amounts For 1997-98 Through 1998-99

	1997-98	1998-99	Total
Recalculated in-lieu amount from Exhibit 14	\$4,219,132	\$4,399,021	\$8,618,153
Actual in-lieu payment	\$2,924,000	\$3,100,000	\$6,024,000
Difference	\$1,295,132	\$1,299,021	\$2,594,153

However, it should be noted that Proposition 218 has had complex effects on local government financing. Although we are unaware of any specific guidance from the courts, various interpretations of Proposition 218 may affect the recalculated in-lieu amounts for 1997-98 through 1998-99 in Exhibit 17, and future in-lieu payment amounts.

Effect On Tributary Agencies

As currently structured, payment of the in-lieu fee does not affect what the other tributary agencies pay. The in-lieu fee is included in the WPCP operating budget that the Treatment

Plant Advisory Committee (TPAC)⁷ reviews. The actual payment is a transfer from the Treatment Plant Operating Fund (Fund 513) to the General Fund. However, the in-lieu fee is not included in the WPCP operating costs the tributary agencies pay. As a result, how much San Jose pays in in-lieu fees from Fund 513 to the General Fund has no impact on what the tributary agencies pay.

The property tax in-lieu fee compensates the General Fund for indirect City services such as police and fire protection. Similarly, the franchise fee in-lieu compensates the General Fund for use of City rights-of-way. As such, in-lieu fees are a cost to the WPCP that may be charged to tributary agencies.

We recommend that the City Attorney and Administration:

Recommendation #6

Assess the feasibility of 1) paying an additional \$2.6 million from the Treatment Plant Operating Fund to the General Fund for in-lieu fees for 1997-98 and 1998-99; 2) increasing the annual in-lieu fee payment from the Treatment Plant Operating Fund to the General Fund by \$1.3 million; and 3) charging the other tributary agencies a portion of the in-lieu fee. (Priority 2)

CONCLUSION

Our review revealed that since 1993-94, the City’s General Fund has not received about \$7.2 million in WPCP in-lieu fees it should have received. In addition, the General Fund is not receiving about \$1.3 million annually in WPCP in-lieu fees.

RECOMMENDATIONS

We recommend that the City Attorney and Administration:

Recommendation #5

Assess the feasibility of paying \$4.6 million from the Treatment Plant Operating Fund to the General Fund for in-lieu fees from 1993-94 to 1996-97. (Priority 2)

⁷ The TPAC includes representatives from the tributary agencies.

Recommendation #6 **Assess the feasibility of 1) paying an additional \$2.6 million from the Treatment Plant Operating Fund to the General Fund for in-lieu fees for 1997-98 and 1998-99; 2) increasing the annual in-lieu fee payment from the Treatment Plant Operating Fund to the General Fund by \$1.3 million; and 3) charging the other tributary agencies a portion of the in-lieu fee. (Priority 2)**

Finding III The Annual WPCP And SBWRP Reconciliation Processes Can Be Done More Efficiently

Agreements between the City of San Jose (City) and each of the San Jose/Santa Clara Water Pollution Control Program's (WPCP) tributary agencies require that the City annually calculate and allocate capital, operating, and South Bay Water Recycling Program (SBWRP) expenditures. Environmental Services Department (ESD) staff calculates each of these items separately. Prior to the beginning of each fiscal year, ESD staff uses the proposed budget to calculate each agency's contribution for which ESD staff bills them on a quarterly basis. During the third quarter of the next fiscal year, ESD staff reconcile tributary contributions to actual expenditures. Our review revealed that ESD's reconciliation process 1) takes about six to eight weeks of staff time, 2) is not well documented, and 3) produces results that cannot be easily related to audited financial statements. In our opinion, the ESD should simplify its accounting structure and document its procedures. By so doing, the ESD will reduce the staff time devoted to the reconciliation process by an estimated two weeks, simplify its accounting structure, ensure that future reconciliations will be done efficiently, and provide tributary agencies with added assurance regarding future contribution charges.

Allocation Of WPCP Costs

Prior to the beginning of each fiscal year, ESD staff uses the proposed budget to calculate each agency's contribution for capital, operating, and SBWRP expenditures. Capital, operating, and SBWRP allocations are each calculated on a separate basis. ESD staff bills the tributary agencies for these expenses in four, evenly divided quarterly payments.

Reconciliation Process

The WPCP budget is routinely higher than actual shared expenditures. As a result, the annual reconciliations show large cash balances or overpayments for the year. These cash balances represent the difference between contributions collected for the year (based on budget) less allocated expenditures (actuals). Interest on these balances must be calculated and allocated to offset the entities' expenses. Exhibit 18 summarizes the ending credit balances in the Treatment Plant Operating Fund for each entity from June 30, 1995 through June 30, 1998.

**Exhibit 18 Ending Credit Balances In The Treatment Plant
Operating Fund For Each Contributing Entity From
June 30, 1995 Through June 30, 1998⁸**

Year Ending	San Jose	Santa Clara	West Valley	Cupertino	Milpitas	District 2-3	Burbank	Sunol	Total
6/30/95	\$38,092,079	\$1,482,761	\$1,141,447	\$540,235	\$545,636	\$201,611	\$39,174	\$21,178	\$42,064,121
6/30/96	\$32,653,339	\$1,908,126	\$1,114,404	\$683,399	\$502,086	\$216,989	\$40,025	\$19,644	\$37,138,012
6/30/97	\$27,331,893	\$904,433	\$898,003	\$209,952	\$191,157	\$195,542	\$26,539	\$17,082	\$29,774,601
6/30/98	\$20,168,827	\$748,789	\$721,654	\$253,211	\$448,959	\$160,365	\$23,736	\$16,097	\$22,541,638

During the third quarter of the next fiscal year, ESD staff reconcile tributary agency contributions to actual expenditures. ESD staff enter information from the City’s Financial Management System reports and the proposed budget into an automated spreadsheet to prepare these reconciliations. The differences are then credited/debited to agency accounts.

The reconciliation is quite cumbersome. Our review revealed that 1) ESD does not have written policies and procedures that document the reasons various items are added to or subtracted from this reconciliation and 2) parts of the process are duplicative. Although the duplicative calculations in the reconciliation process net out (there is no financial effect), they add unnecessary complications and staff effort to the calculation, and produce results that cannot be easily related to the audited financial statements.

Several generations of City staff have used the reconciliation format for several years. Complications arise because San Jose bills the tributary agencies for their share of encumbrances on an accrual basis, but allocates interest earnings to the tributary agencies on a cash basis.

We recommend that the ESD:

⁸ As shown in Exhibit 18, San Jose’s ending cash balance in the Treatment Plant Operating Fund has declined from \$38,092,079 to \$20,168,827 as of June 30, 1998. It should be noted that implementing the recommendations in Finding 1 of this report will further reduce San Jose’s ending cash balance in this fund.

Recommendation #7

Prepare written policies and procedures for the annual WPCP and SBWRP billing and cost reconciliation process that: (1) document the reason for the calculation and (2) eliminate unnecessary steps from the calculation. (Priority 3)

**Multiple Funds
Complicate
Reconciliations**

The 1959 Sewage Treatment Plant Agreement between San Jose and Santa Clara specifies that an income fund, an operating fund, and a capital fund be established to account for WPCP activity. The 1959 Agreement requires the City to maintain a Treatment Plant Income Fund to account for all income derived from outside users for use of the treatment plant, the sale of sewage by-products, and the rental of any treatment plant property. Therefore, all income from tributary agencies is first collected in Fund 514 and then transferred to funds 512 and 513. For unspecified reasons, transfers out do not always equal contributions collected from the tributary agencies. As a result, this fund has cash balances that must be segregated between operating and capital.

In addition to the added work of having to maintain manual records that segregate operating and capital cash balances, having both operating and capital components in one fund complicates the annual reconciliation process. Specifically, we found that Fund 514 includes both WPCP operating and capital contributions and other WPCP revenue. Similarly, Fund 512 includes both WPCP capital costs and SBWRP capital costs. Thus, to accumulate WPCP operating costs, staff must split WPCP operating costs out of Fund 514 costs and add them to Fund 513 WPCP operating costs. Similarly, to accumulate WPCP capital costs, staff must split out Fund 514 WPCP capital expenses and add them to Fund 512 WPCP capital costs.

Furthermore, the use of multiple SBWRP funds complicates the cost distribution process for the SBWRP. Specifically, ESD staff do not account for the SBWRP separately in one fund, but in three funds. Therefore, ESD staff must split out Fund 512 SBWRP costs and add them to Fund 530 and Fund 534 costs to accumulate total SBWRP costs.

As a result, staff expends considerable effort separating costs by type within each fund. In fact, ESD staff estimate that they spend from six to eight weeks a year preparing the tributary agency reconciliations. According to ESD staff, use of Funds

530 and 534 should cease in 1999-2000 when construction of Phase 1 of SBWRP is complete. ESD staff plan to account for SBWRP Phase 2 expenses in Fund 512, as part of the South Bay Action Plan. This will help reduce the number of funds in the wastewater enterprise and the level of complexity in the reconciliations.

Cannot Easily Tie To Audited Financial Statements

Because what the ESD bills the tributary agencies is based on the above cited reconciliation process, these agencies are not able to tie their ultimate billing back to audited financial statements. Such audited financial statements would provide the tributary agencies with added assurance that ESD calculated their contributions correctly.

According to the *Handbook of Public Administration* edited by James L. Perry,

Sound practice calls for the establishment and reporting of the minimum number of funds that satisfies legal requirements and effective financial management. Fund proliferation can be inefficient in its inflexibility and complexity.

In our opinion, Fund 514 (Treatment Plant Income Fund) unnecessarily complicates the allocation of operating and capital expenditures between the tributary agencies. Accounting for this fund alone requires significant unnecessary staff time. ESD staff estimate that eliminating Fund 514 will reduce the staff time spent on reconciliations by two weeks. In addition, eliminating Fund 514, and phasing out funds 530 and 534, will allow the tributary agencies to tie the cost reconciliations back to the City's audited financial statements.

We recommend that the Administration and the City Attorney's Office:

Recommendation #8

Approach the City of Santa Clara about amending the current agreement to eliminate the Treatment Plant Income Fund (Fund 514) in 1999-2000. (Priority 3)

CONCLUSION Annual ESD reconciliations of the WPCP and SBWRP are inefficient. In our opinion, the ESD should document its WPCP and SBWRP billing and cost reconciliation process, and eliminate unnecessary steps. In addition, eliminating Fund 514, and phasing out Funds 530 and 534, will allow the tributary agencies to tie the cost reconciliations back to the City's audited financial statements. In this way, the tributary agencies will have added assurance that ESD calculated contribution amounts correctly.

RECOMMENDATIONS

We recommend that the ESD:

Recommendation #7 Prepare written policies and procedures for the annual WPCP and SBWRP billing and cost reconciliation process that: (1) document the reason for the calculation and (2) eliminate unnecessary steps from the calculation. (Priority 3)

We recommend that the Administration and the City Attorney's Office:

Recommendation #8 Approach the City of Santa Clara about amending the current agreement to eliminate the Treatment Plant Income Fund (Fund 514) in 1999-2000. (Priority 3)

Finding IV Controls Over Wastewater Expenditures Should Be Strengthened

Our review of sewer fund expenditures revealed several basic internal control weaknesses. Specifically we identified that:

- Directors’ names appear on encumbrances and checking accounts;
- Departments are not conducting required semi-annual audits of sewer fund special checking accounts; and
- Departments do not have approved charts of account and their uses for charging expenditures to the twelve wastewater funds.

As a result, the City is exposed to inappropriate uses of sewer funds. Accordingly, the Administration needs to institute policy and procedural changes, enforce compliance with existing requirements, and develop approved charts of account and their uses for charging expenditures to wastewater funds.

Use Of Directors’ Names On Encumbrances And Checking Accounts

At the direction of the Finance Department, the Environmental Services Department (ESD) established a “director’s encumbrance” for the Water Efficiency Program (WEP) to account for payments to three ultra-low flow toilet (ULFT) suppliers. By so doing, the WEP was able to encumber a total amount to be spent on ULFTs without having to specify the estimated distribution of those expenditures among the three suppliers. Accordingly, when we reviewed Fund 541 expenditures in FMS we noted encumbrances up to \$378,000 in the name of the previous director of the ESD. We verified that expenditures from this encumbrance were paid to the three contracted ULFT suppliers. We also verified that the ESD accounted for these expenditures separately from the previous director’s personal reimbursements, such as travel advances.

We also determined that a similar situation existed with the WEP checking account that is used to reimburse WEP customers. Specifically, the checking account was in the name of the current director of ESD. As a result, the ESD was drawing checks up to \$50,000 in the name of the director from the City’s accounts to replenish the WEP account. In our opinion, this use of the director’s name on the encumbrance and checking account is unnecessary, and taken together with the use of the director’s name on the encumbrance creates an additional and unnecessary risk that funds will be used inappropriately.

Importance Of Management Controls

An effective system of internal accounting controls reduces the City's exposure to inappropriate uses of sewer funds. In our opinion, San Jose's system of internal controls over the ULFT program are adequate. However, all City department directors are in a position to potentially circumvent and/or defeat some aspects of any internal control system. For example, a department director could potentially access the City's Financial Management System (FMS), approve FMS Edit Lists, gain access to issued checks or even exert pressure on employees who are important players in any programs' internal controls. Accordingly, in our opinion, having the director's name on encumbrances and checks is unnecessary and creates an additional element of risk that exceeds any benefits such a practice produces.

We recommend that the Finance Department:

Recommendation #9

Revise its policies and procedures regarding the use of directors' names on encumbrances and checking accounts, and ensure that such names are removed. (Priority 2)

Semi-Annual Audits

The Finance Department allows departments, with the approval of the Director of Finance, to establish special checking accounts for those activities requiring a short check preparation time for numerous checks of small amounts. Section 5.7.2 of the Finance Administrative Manual (FAM) provides procedural guidelines for checking accounts at subsidiary banks (that is, accounts that are not part of the City's main checking account).

Departments are responsible for developing and maintaining written procedures for their accounts, but the FAM specifies that departments must obtain written approval of their procedures from the Finance Department prior to beginning operation of their checking accounts. The FAM also specifies that *"departments must perform a semi-annual audit of the checking account by staff other than staff maintaining the account and provide the Department Director with a report of findings."*

During our review of the WEP checking account, we noted that the WEP program had not been conducting Finance Department required semi-annual audits. While WEP program staff have established a good separation of duties, they were unaware of the requirement to conduct these audits. WEP program staff

submitted their procedures to the Finance Department for review and approval, but Finance did not inform them of this requirement.

According to the Finance Department, they conduct semi-annual reviews of all subsidiary checking accounts to ensure that signature cards are up to date and checks do not exceed the maximum allowable amount. In our opinion, Finance staff should verify that departments are conducting FAM-required semi-annual audits at that time.

We recommend that the Finance Department:

Recommendation #10

Enforce compliance with its procedures regarding semi-annual audits of departmental special checking accounts. (Priority 3)

Lack Of Approved Charts Of Account And Their Uses For Charging Expenditures To The Twelve Wastewater Funds

There are twelve funds in the City’s wastewater system. There are several City departments that can charge expenditures against these twelve funds. Some departments, such as Public Works and Streets and Traffic, charge employee time and other expenses to several of the twelve wastewater funds.

Our review revealed that neither the ESD, Streets and Traffic, nor Public Works has documented the approved uses of these wastewater funds. Furthermore, none of these departments have approved charts of account and their uses that program managers can use for charging various expenses to the twelve wastewater funds. This is of special concern where divisions, programs, and individuals are split-funded. Although our review did not identify instances of mischarging, we believe that approved charts of account and their uses would be useful to staff and would provide management with added assurance that future charges will be proper.

We recommend that the Administration:

Recommendation #11

Develop approved charts of account and their uses that program managers can use for charging various expenses to the twelve wastewater funds. (Priority 3)

CONCLUSION Our review of sewer fund expenditures revealed several basic internal control weaknesses. Specifically, we identified that directors' names appear on encumbrances and checking accounts, departments are not conducting required audits of special checking accounts, and departments do not have approved charts of account and their uses for charging expenditures.

RECOMMENDATIONS

We recommend that the Finance Department:

Recommendation #9 **Revise its policies and procedures regarding the use of directors' names on encumbrances and checking accounts, and ensure that such names are removed. (Priority 2)**

Recommendation #10 **Enforce compliance with its procedures regarding semi-annual audits of departmental special checking accounts. (Priority 3)**

We recommend that the Administration:

Recommendation #11 **Develop approved charts of account and their uses that program managers can use for charging various expenses to the twelve wastewater funds. (Priority 3)**

Finding V

Resumption Of Wastewater Interest Transfers Could Increase General Fund Revenues By \$2.5 Million Per Year While Opportunities Exist To Reduce Costs And Increase Sewer Service And Use Charge And Storm Drain Revenues By \$1.7 Million Per Year

Prior to the passage of Proposition 218, the City transferred interest earnings from the wastewater funds to the General Fund in accordance with the City Charter. After the passage of Proposition 218, the City discontinued the transfer of interest from the Sewer Service and Use Charge (SSUC) Fund to the General Fund. In April 1998, the City Auditor proposed separating pre-Proposition 218 from post-Proposition 218 fund balances in order to continue interest transfers on fund balances accumulated prior to the passage of Proposition 218. We estimated that the SSUC Fund would have earned approximately \$2.5 million in interest income during 1997-98 that the City could have transferred or swept directly into the General Fund. However, due to City Attorney Office concerns about Proposition 218, the City Auditor shelved the proposal. The City Auditor also proposed that the City remove SSUC fees from the property tax bill, and consolidate billing for SSUC fees with bi-monthly Recycle Plus bills. Our audit of the Utility Billing System estimated that the City could save and/or earn an additional \$1.5 million by combining SSUC and storm drain fees with bimonthly Recycle Plus billings. We estimate the net benefit of combined billing has increased to \$1.7 million per year. These increased revenue/reduced costs to the SSUC Fund would partially offset the \$2.5 million interest transfers on pre-Proposition 218 balances from the SSUC Fund to the General Fund.

Reduced Interest Transfers To The General Fund

As of June 30, 1998, the City had accumulated \$264 million in cash for the purpose of meeting sewer system cash flow requirements and funding various sewer-related projects. Among the budget balancing actions approved during the early years of this decade were ongoing transfers of interest earnings from the SSUC operating fund into the General Fund. This was in accordance with City Charter Section 1211, which provides that *“all revenues and receipts which are not required by this*

Charter, state law or ordinances to be placed in special funds shall be credited to the General Fund.” After the passage of Proposition 218, the City determined that the transfer of interest from the SSUC operating fund to the General Fund should be discontinued. This change took effect in 1997-98.

Prior to the passage of Proposition 218, the City transferred wastewater fund earned interest from the SSUC operating fund (Fund 541) and the Sanitary Sewer Connecting Fee Fund (Fund 540) to the General Fund. During 1996-97, the City transferred \$4.2 million in interest earnings from the wastewater funds. Included in the \$4.2 million was \$1.4 million from the SSUC Fund and \$2.8 million from the Sanitary Sewer Connecting Fee Fund.⁹ Subsequent to Proposition 218, the City stopped transferring interest from Fund 541 to the General Fund.

Exhibit 19 compares wastewater fund earned interest in 1996-97 and 1997-98 to the interest earnings the City transferred or swept to the General Fund.

⁹ It should be noted that Senate Bill 1760, which was signed into law by the governor in September 1998, amends the Government Code to impose certain requirements on the fees and charges collected on or after January 1, 1999, by a local agency for sewer and water connections. The act specifically requires that “*Any interest income earned from the investment of moneys in the capital facilities fund shall be deposited in that fund.*”

Exhibit 19 Interest Transfers From The Wastewater Enterprise Funds To The General Fund (In Millions)

Description	Fund 539¹⁰	Fund 540¹¹	Fund 541¹²	Fund 545¹³	Total
1996-97					
• Interest earnings	1.8	3.4	1.6	0	6.8
• Interest earnings transferred to the General Fund	0	2.8	1.4	0	4.2
1997-98					
• Estimated interest earnings	1.6	2.6	1.2	0.6	6.0
• Interest earnings transferred to the General Fund	1.6	2.6	0	0	4.2
1998-99					
• Estimated interest earnings	1.6	2.2	1.3	0.6	5.7
• Interest earnings transferred to the General Fund	1.6	2.2	0	0	3.8

Proposed Transfer Of Interest On Pre-218 Fund Balances

In April 1998, the City Auditor's Office proposed an alternative means to comply with the requirements of Proposition 218. Specifically, we proposed that the City establish a new fund to account for post-Proposition 218 sewer fees – that is, sewer fees billed and collected after the effective date of Proposition 218 – July 1, 1997. We further proposed that the City (1) retain in Fund 541 the fund balance accumulated prior to July 1, 1997, and (2) continue to transfer interest earnings from balances accumulated prior to July 1, 1997, from Fund 541 to the General Fund. The City Auditor's Office estimated this would allow the transfer of \$2.5 million to the General Fund in 1997-98, and again in 1998-99.¹⁴

Exhibit 20 shows the method that the City Auditor proposed to account for the separation of pre-Proposition 218 and post-

¹⁰ Fund 539 – Sewage Treatment Connecting Fee Fund. Source of funding is developer fees. Beginning in 1997-98, interest was "swept" directly into the General Fund.

¹¹ Fund 540 – Sanitary Sewer Connecting Fee Fund. Source of funding is developer fees. Beginning in 1997-98, interest was "swept" directly into the General Fund.

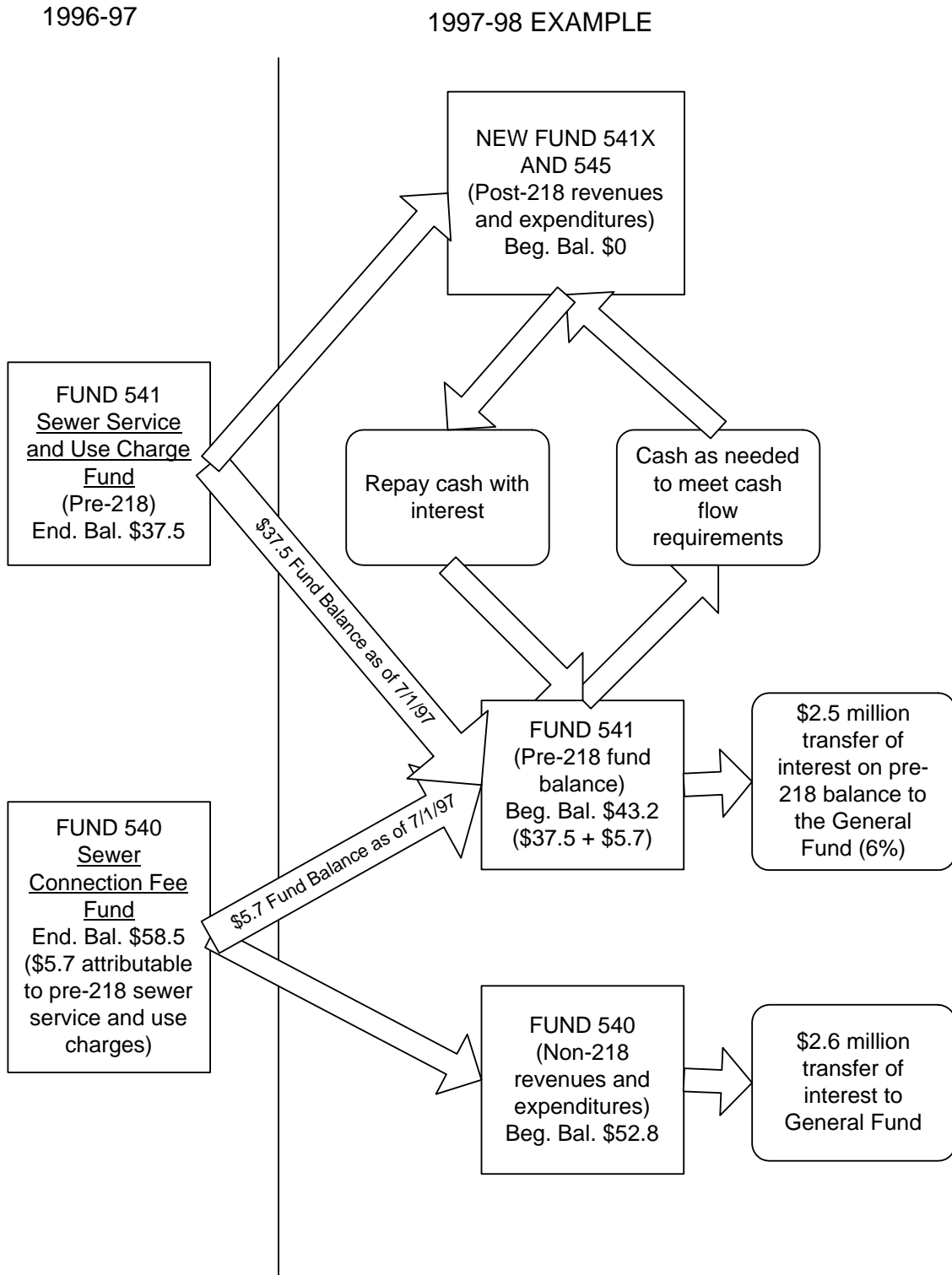
¹² Fund 541 – SSUC Fund. Source of funding is SSUC fees. Interest transfers discontinued subsequent to passage of Proposition 218.

¹³ Fund 545 – SSUC Capital Fund. Fund 545 was created in 1997-98 to separate connection-fee funded capital projects (source of funding is developer fees) from SSUC-funded capital projects (source of funding is SSUC fees).

¹⁴ It should be noted that the SSUC operating and capital funds (Funds 541 and 545) earned approximately \$1.9 million in interest income during 1998-99. If the City simply reverted to the practice in place before the passage of Proposition 218, it could transfer that \$1.9 million into the General Fund annually plus earn an additional \$787,000 by collecting SSUC revenue bi-monthly instead of semi-annually. However, if the City implemented the full process shown in Exhibit 20, we estimate the SSUC Fund would earn (and could transfer to the General Fund) a total of \$2.5 million by (1) earning additional interest on the transfer of \$5.7 million from Fund 540 that is attributable to pre-Proposition 218 SSUC revenues, and (2) earning interest on interfund loans to a new post-Proposition 218 SSUC fund.

Exhibit 20 shows the method that the City Auditor proposed to account for the separation of pre-Proposition 218 and post-Proposition 218 fund balances.

Exhibit 20
City Auditor's April 1998 Proposal To Separate Pre-Proposition 218 And
Post-Proposition 218 Fund Balances (In Millions)



This proposal would have allowed the transfer of interest earnings from the SSUC operating and capital funds to the General Fund of approximately \$2.5 million in 1997-98 and approximately \$2.4 million in 1998-99. However, because of City Attorney Office concerns about Proposition 218, the City Auditor shelved the proposal.

We recommend that the Administration and the City Attorney's Office:

Recommendation #12

Research the feasibility of transferring interest from pre-Proposition 218 SSUC operating and capital fund balances to the General Fund. (Priority 2)

**Effect Of Collecting
SSUC Fees On
Property Tax Bills**

A major reason for the City Attorney's decision that Proposition 218 applies to San Jose's SSUC fees is that we collect these fees on the property tax bill. The following excerpts from the CWFA's official statement for the 1997A Series Bonds explain:

Due to the fact that the San Jose sewer service and use charges for residential and commercial uses are collected on the property tax bill . . . the San Jose City Attorney has determined that these charges are Property Related fees as defined in Proposition 218. As such, the procedural and substantive provisions of Proposition 218 related to Property Related Fees apply to the sewer service and use charge and San Jose has made certain program and budgeting changes effective July 1, 1997 to comply with its mandates. These include the segregation of the sewer service and use charge funds from other sanitary sewer revenues and the cessation of transfers of interest to San Jose's General Fund . . .

In contrast,

Santa Clara bills for sewer service use and the charges for said use are a component of its monthly utility billing statement. The Santa Clara City Attorney has determined that its sewer charges are not Property Related Fees . . . The interpretation and application of Proposition 218 will ultimately be determined by the courts with respect to a number of

the matters discussed above, and it is not possible at this time to predict with certainty the outcome of such determination.

Advantages Of Consolidated Billing

In April 1997, the City Auditor's Office issued an audit of the Utility Billing System. In that report, we estimated that consolidating sewer billing services with Recycle Plus billings could save \$715,000 in County collection fees and increase interest income by \$867,000 per year. As a result of the cost savings and interest earnings that the City could realize (in return for a minimal increase in costs), we determined that combining sewer and storm drain fees with Recycle Plus billings was a reasonable option that the City Council should consider. Appendix B is an excerpt from the Office of the City Auditor's "*An Audit Of The City of San Jose's Utility Billing System,*" April 1997.

In November 1998, the City Council approved an agreement with Creative Computer Solutions to provide Recycle Plus billing computer system operations and maintenance services. Once the new system is operational, the Administration has said staff will conduct further analysis to determine the feasibility of the audit recommendation. The target date for this analysis is September 1999.

In our opinion, the City Council should direct the City Attorney to research the applicability of Proposition 218 to SSUC fees if the City were to separate the collection of those fees from the property tax rolls. Depending on the outcome of these discussions, the Administration should accelerate its analysis of consolidated billing.

It should be noted that the new computer system will become operational in October 1999. According to the ESD, the new system should stabilize for at least a year and a half before bill consolidation is attempted.

Revenue And Cost Implications

Our audit of the Utility Billing System estimated total savings and additional interest income to the SSUC and Storm Sewer Funds of \$1.5 million by combining sewer and storm drain fees with bimonthly Recycle Plus billings. Based on budgeted 1999-2000 sewer and storm drain assessments, we estimate the net benefit of this proposal has increased to \$1.7 million per year. Of that amount, we estimate the SSUC Fund and the Storm Sewer Operating Fund would benefit by \$1.4 million and

\$0.3 million, respectively. Specifically, we estimate the SSUC Fund would save \$648,000 per year in County collection fees and earn an additional \$787,000 in interest. Based on 1999-2000 budgeted storm drain assessments, we estimate that the Storm Sewer Operating Fund would save \$133,000 per year in County collection fees and earn an additional \$162,000 in interest.¹⁵

Thus, the potential cost saving and revenue enhancement implications of the City Auditor's proposed changes in SSUC billing partially offset SSUC fund interest transfers to the General Fund as shown below. This could forestall any future SSUC fee increases to compensate for interest transfers to the General Fund.

SSUC Fund interest transfers on pre-Proposition 218 balances to the General Fund	\$2.5 million
SSUC Fund revenue/cost savings	\$1.4 million
Net cost to SSUC Fund	\$1.1 million

We recommend that the City Council direct the City Attorney to:

Recommendation #13
Research the applicability of Proposition 218 to Sewer Service and Use Charge (SSUC) fees, if the City were to separate the collection of those fees from property tax bills. (Priority 2)

We further recommend that:

Recommendation #14
Depending on the outcome of these discussions, the Administration should accelerate its analysis of consolidated SSUC billing with Recycle Plus bills. (Priority 2)

CONCLUSION Prior to the passage of Proposition 218, in accordance with the City Charter, the City transferred interest earnings from the wastewater funds to the General Fund. After the passage of

¹⁵ Current negotiations with the County over property tax administration costs may reduce the County collection fee portion of that estimate. In addition, we retained our estimate that the City would incur increased printing and handling charges of \$24,000 per year.

Proposition 218, the City discontinued the transfer of interest from the SSUC Fund to the General Fund based upon a City Attorney opinion that Proposition 218 applies to San Jose's SSUC fees. A major reason for the City Attorney's opinion was the fact that the City collects SSUC fees on a San Jose property owner's property tax bill. A City Auditor 1997 audit of the Utility Billing System recommended combining SSUC and storm drain fees with bimonthly Recycle Plus billings. By so doing, we estimated total savings and additional interest income to the SSUC Fund of \$1.5 million per year. For 1999-2000, we estimate the net benefit of combined billing would be \$1.7 million per year. In addition, if the City transferred interest earnings from pre-Proposition 218 accumulated SSUC Fund balances, then annual General Fund revenues would increase by about \$2.5 million.

RECOMMENDATIONS

We recommend that the Administration and the City Attorney's Office:

Recommendation #12 Research the feasibility of transferring interest from pre-Proposition 218 SSUC operating and capital fund balances to the General Fund. (Priority 2)

We recommend that the City Council direct the City Attorney to:

Recommendation #13 Research the applicability of Proposition 218 to Sewer Service and Use Charge (SSUC) fees, if the City were to separate the collection of those fees from property tax bills. (Priority 2)

We further recommend that:

Recommendation #14 Depending on the outcome of these discussions, the Administration should accelerate its analysis of consolidated SSUC billing with Recycle Plus bills. (Priority 2)

Finding VI The 1959 Sewage Treatment Plant Agreement’s Methodology For Allocating Water Pollution Control Plant Expenses Costs San Jose About \$1 Million Per Year

In 1959, the Cities of San Jose and Santa Clara formed a partnership and became joint owners of the Water Pollution Control Plant (WPCP). In 1983, San Jose and Santa Clara and the tributary agencies that use the WPCP entered into a Master Agreement that specifies how operating and maintenance costs will be allocated to each entity. Our review of the agreements revealed that 1) the allocation of costs between San Jose and Santa Clara differs from that of the other tributary agencies and 2) that difference works to the detriment of San Jose. As a result, San Jose pays about \$1 million per year more in operating costs than it would if costs were allocated the same between San Jose and Santa Clara as they are between the other tributary agencies. According to the City Attorney’s Office, the agreement will not expire until the year 2031. Nonetheless, we recommend that should the Administration and the City Attorney approach the City of Santa Clara about amending the agreement prior to 2031, that they include calculating WPCP user fees on estimated usage. By doing so, the joint owners of the WPCP will ensure that costs are allocated fairly and equitably.

Current Cost Allocation Method

The 1959 Sewage Treatment Plant Agreement between San Jose and Santa Clara specifies that costs are allocated to San Jose and Santa Clara on the basis of each City’s assessed valuation. The 1983 Master Agreement between the owners, San Jose and Santa Clara, and the tributary agencies, specifies that operating and maintenance costs be allocated based on flow and loadings, and capital costs be allocated based on plant capacity. Thus, San Jose’s Environmental Services Department (ESD) bills the tributary agencies using the 1983 Master Agreement’s parameters (that is the share of WPCP costs that these agencies pay based on their actual sewage flow). The ESD then re-allocates the total cost related to San Jose and Santa Clara between the two of them based on assessed valuation – not actual sewage flow. As a result, San Jose and Santa Clara pay their share on a different basis than the other jurisdictions.

Exhibit 21 summarizes the basis for allocating WPCP Operating and Capital Costs to participating agencies.

Exhibit 21 Basis For Allocating WPCP Operating And Capital Costs

Agency	Basis of Operating Cost Allocation	Basis of Capital Cost Allocation
San Jose	Assessed valuation*	Assessed valuation*
Santa Clara	Assessed valuation*	Assessed valuation*
West Valley	Estimated flow and loadings	Agency's share of plant capacity
Cupertino	Estimated flow and loadings	Agency's share of plant capacity
Milpitas	Estimated flow and loadings	Agency's share of plant capacity
CSD No. 2-3	Estimated flow and loadings	Agency's share of plant capacity
Burbank	Estimated flow and loadings	Agency's share of plant capacity
Sunol	Estimated flow and loadings	Agency's share of plant capacity

*The total estimated flow and loadings or capacity for Santa Clara and San Jose are added together; this amount is then divided between the two cities based on their assessed valuation.

As shown in Exhibit 22, we estimate that allocating costs on the basis of assessed valuation costs San Jose about \$1 million per year.

Exhibit 22 WPCP Costs Allocated To The City Of San Jose Assessed Valuation Vs. Actual Flow/Capacity Methodology

	1995-96	1996-97	1997-98
OPERATING COST ALLOCATION			
Actual cost allocated to San Jose	27,668,663	26,879,393	27,471,386
Allocated cost based on flow/capacity	26,622,238	25,982,768	26,412,061
Difference	1,046,425	896,625	1,059,325
CAPITAL COST ALLOCATION			
Actual cost allocated to San Jose	5,865,400	6,639,000	11,686,100
Allocated cost based on flow/capacity	5,809,960	6,524,535	11,576,634
Difference	55,440	114,465	109,466
Total	1,101,865	1,011,090	1,168,791

Although the 1959 Agreement that specifies the assessed valuation methodology expires in 2000, the City Attorney has opined that, by entering into supplemental agreements with regards to the South Bay Water Recycling Project, the City has by inference extended the agreement to the year 2031, when those agreements expire.

We recommend that the Administration and the City Attorney:

Recommendation #15

Include in any discussion with the City of Santa Clara about updating and amending the 1959 Sewage Treatment Plant Agreement calculating WPCP user fees on estimated usage. (Priority 2)

CONCLUSION

Our review of the allocation of WPCP operating and capital costs among the tributary agencies revealed that San Jose pays about \$1 million more per year than it should. We recommend that the City of San Jose approach the City of Santa Clara about amending the 1959 Sewage Treatment Plant Agreement calculating WPCP user fees on estimated usage.

RECOMMENDATIONS

We recommend that the Administration and City Attorney:

Recommendation #15 Include in any discussion with the City of Santa Clara about updating and amending the 1959 Sewage Treatment Plant Agreement calculating WPCP user fees on estimated usage. (Priority 2)

CITY OF SAN JOSE - MEMORANDUM

TO: Gerald Silva
City Auditor

FROM: Carl W. Mosher, Director
Environmental Services Department

SUBJECT: SEE BELOW

DATE: August 13, 1999

RECEIVED

APPROVED: *Kay Winer*

DATE: *8/13/99*

AUG 13 1999

CITY AUDITOR

SUBJECT: RESPONSE TO *AN AUDIT OF SEWER FUND EXPENDITURES*

The Administration has reviewed the City Auditor's report entitled "*An Audit of Sewer Fund Expenditures*," and concurs with all of the substantive recommendations.

Background

The following information is provided to assist in understanding the rationale, relationship and complexity of the wastewater system funds. Revenues and expenditures of the wastewater system are accounted for in two broad categories of funds; City of San Jose only funds and Tributary Agencies' or Treatment Plant funds. There are a total of twelve funds that have been established to manage and account for the revenues and expenditures associated with the collection and treatment of sewage. The principal source of revenue for these funds comes from rate payers.

In 1959, the Cities of San Jose and Santa Clara formed a partnership and became joint owners of the San Jose/Santa Clara Water Pollution Control Plant (Plant). In 1983, the Cities of San Jose and Santa Clara entered into Master Agreements with the other six municipalities and sanitary districts (tributary agencies) which utilize the services of the Plant. These agreements impact the accounting system structure for maintaining accountability for revenue and expenditures in relationship to the Plant.

The 1959 Agreement between the cities of San Jose and Santa Clara specify that an income fund, an operating fund, and a capital fund be established to account for Plant activity and to account for the revenue derived from the tributary agencies, rental of Plant lands or the sale of sewage by-products.

Listed below is a brief description of each of the funds associated with the wastewater system. Portions of these funds are distributed among the Departments of Environmental Services, Streets and Traffic, and Public Works.

Fund 512 – San Jose/Santa Clara Treatment Plant Capital Fund

Fund 512 was established to fund Treatment Plant capital improvements, and to identify each tributary agencies interest in the Plant. The source of revenue for this fund is contributions from member agencies. This Fund was created by the March 30, 1959 Sewage Treatment Plant Agreement between San Jose and Santa Clara. It was amended in February 22, 1983 by the Agreement Between Cities of San Jose and Santa Clara and the Tributary Agencies.

Fund 513 - San Jose/Santa Clara Treatment Plant Operating Fund

Fund 513 accounts for the revenues and expenditures associated with the operation and maintenance of the jointly-owned Plant. Three sources of revenue provide moneys for this fund: 1) payments from the City of Santa Clara, 2) payments from the tributary agencies, and 3) transfers from San Jose rate payers via Fund 541 – the Sewer Service and Use Charge Fund, representing San Jose's share of Plant operating costs. Fund 513 was created by the Sewage Treatment Plant Agreement Between San Jose and Santa Clara, March 30, 1959. Amended by the Maser Agreement for Wastewater Treatment Between City of San Jose, City of Santa Clara and the Tributary Agencies, February 22, 1983 and again by the Improvement Agreement Among San Jose-Santa Clara Clean Water Financing Authority, City of San Jose and City of Santa Clara dated November 1, 1995.

Fund 514 – San Jose/Santa Clara Treatment Plant Income Fund

This fund was established by the March 30, 1959 Sewage Treatment Plant Agreement between the Cities of San Jose and Santa Clara to record revenues received from the tributary agencies. Monies collected from the tributary agencies is first collected in Fund 514 and then transferred to Funds 512 and 513.

Fund 530 – South Bay Water Recycling Fund

Fund 530 was established as a memo fund to Fund 512 to account for the transfer of bond proceeds of the Sewer Revenue Bonds, to fund South Bay Water Recycling Program construction.

Fund 531 – Treatment Plant Renewal/Replacement Reserve Fund

This Fund was established to pay for extraordinary repairs, renewals and replacement of facilities of the Plant. The revenue source for this fund is from the contributions from the member agencies. A minimum balance of \$5 million is required per the Clean Water Financing Authority 1982 Revenue Bonds Agreement. This fund was created by the Improvement Agreement Between the

City of San Jose-Santa Clara Clean Water Financing Authority, dated July 1, 1982 and amended October 1, 1984.

Fund 534 – South Bay Water Recycling Project Grant

Fund 534 was established to fund the South Bay Water Recycling Project, to account for payments made by the participating agencies, and to account for grant revenues. The money in this fund can only be used after the bond proceeds in Fund 530 are used.

Fund 537 – San Jose/Santa Clara Clean Water Financing Authority Payment Fund – 1995 A,B,C

This Fund was established in order to make payments to the Clean Water Authority for the Wastewater System 1995 Revenue Bonds. The City was required to keep separate accounting for revenue, interest and payment expenses of the debt service. The revenue source for this fund is from the member agencies contributions.

Fund 538 – San Jose/Santa Clara Clean Water Financing Authority Payment Fund

Fund 538 was established in order to make payments to the Clean Water Authority for the Wastewater System 1997 (refunded) Revenue Bonds. The City was required to keep separate accounting for the revenue, interest and payment expenses of the debt service. The revenue source for this fund is from the participating agencies contributions.

Fund 539 – Sewage Treatment Plant Connection Fee Fund

The Sewage Treatment Plant Connection Fee Fund is a depository of fees from new residential, commercial and industrial connections to the San Jose/Santa Clara Water Pollution Control Plant. This fund pays the costs of expanding the capacity of the Plant to accommodate growth, and is a revenue stream pledged for debt service in bond documents.

Fund 540 – Sanitary Sewer Connection Fee Fund

This Fund is used to pay for construction, reconstruction and land acquisition to improve or extend the sanitary sewer collection system. Revenues for this fund are collected through fees paid by private developers as a condition to develop in the City of San Jose.

Fund 541 – Sewer Service and Use Charge Fund

The Sewer Service and Use Charge Fund serves as the “general fund” for all of the City’s wastewater-related programs. Its major source of revenue is San Jose

residential, commercial and industrial rate payers. The Fund pays for San Jose's share of Treatment Plant operating and maintenance costs, Plant equipment replacement, debt service on revenue bonds for Plant capital improvements, operation and maintenance costs of the sewage collection system and administrative services costs. The revenue stream from this Fund has been pledged for debt service in the various bond documents.

Fund 545 – Sewer Service and Use Charge Capital

This fund is used to pay for costs for construction and administration of rehabilitation projects of the City of San Jose's sanitary sewer system. The revenue source for this Fund comes from a transfer of monies from the Sewer Service and Use Charge Fund (Fund 541).

The Auditor identified a potential source of \$1 million per year revenue (Finding VI, Recommendation No. 15) related to the 1959 Agreement between the Cities of San Jose and Santa Clara based on treatment plant operation and maintenance cost allocation methodologies. The Auditor also recommended (Finding III, Recommendation No. 8) that San Jose approach the City of Santa Clara about amending the current agreement to eliminate the Treatment Plant Income Fund (Fund 514). It should be noted that there are several issues within the 1959 Agreement that benefit both San Jose and Santa Clara that may be impacted by implementing the Auditor's recommendations.

The most concerning issues are: 1) San Jose, based on the terms of the agreement, is the administering agency of the treatment plant; 2) the City of San Jose therefore, manages the Plant through its city administration and City Council. Santa Clara's input into the management of the Plant, is only through the Treatment Plant Advisory Committee; 3) the 1959 Agreement binds both parties to the cost sharing of all projects related to the treatment plant. The more recent Agreements between San Jose and Santa Clara with the Tributary Agencies, do not bind the other agencies to a cost sharing agreement for all treatment plant related projects. These and other issues in which San Jose benefits from the 1959 Agreement will be included in any analysis to determine the feasibility of approaching the City of Santa Clara regarding the possibility of agreement amendments.

Our response to specific recommendations is as follows:

Recommendation No. 1 - The Administration should update and adopt wastewater fund reserve guidelines that include all wastewater funds. (Priority 3)

The Administration concurs with this recommendation. The ESD has drafted the updated fund reserve guidelines for all wastewater funds and submitted the draft to the Budget Office for review and comments.

Recommendation No. 2 - The Administration should retain funds in excess of adopted fund reserve guidelines in the wastewater fund that initially received the revenue. (Priority 3)

The Administration concurs with this recommendation. The ESD will work with the Budget Office to accomplish this recommendation as part of the budget process.

Recommendation No. 3 - The Administration should implement a policy to draw down excess undesignated fund balances and verify that transferred amounts are directly related to proposed expenditures less excess undesignated fund balances. (Priority 3)

The Administration concurs with this recommendation. The ESD will work with the Budget Office to accomplish this recommendation as part of the budget process.

Recommendation No. 4 - The Administration should report to the City Council Finance Committee on the feasibility of preparing an annual comprehensive report that summarizes all of the City's wastewater activities. (Priority 3)

The Administration concurs with this recommendation. The ESD will prepare a report, during the Operating Budget process, for submittal to the Finance Committee that will incorporate a five-year wastewater activity plan including; fund activities, fees and charges, and projected rate analysis.

Recommendation No. 5 - The City Attorney and the Administration assess the feasibility of paying \$4.6 million from the Treatment Plant Operating Fund to the General Fund for in-lieu fees from 1993-94 to 1996-97. (Priority 2)

The City Attorney and the Administration concur with the recommendation to assess the feasibility of paying money from the Treatment Plant Operating Fund to the General Fund for in-lieu fees. Included in the assessment will be a review of the methodology and an analysis of fund impact and amount to be paid.

Recommendation No. 6 - The City Attorney and the Administration assess the feasibility of 1) paying an additional \$2.6 Million from the Treatment Plant Operating Fund to the General Fund for in-lieu fees for 1997-98 and 1998-99, 2) increasing the annual in-lieu fee payment from the Treatment Plant Operating Fund to the General Fund by \$1.3 million; and 3) charging the other tributary agencies a portion of the in-lieu fee. (Priority 2)

The City Attorney and the Administration concur with the recommendation to assess the feasibility of paying additional monies from the Treatment Plant Operating Fund to the General Fund; increasing the annual in-lieu fee payment and charging the Tributary Agencies a portion of the in-lieu fee. Included in the assessment will be a review of the methodology, an analysis of fund impact, applicability of retro charges, effect on rates, impact on the fund reserve, and impact on the tributary agencies.

Recommendation No. 7 - That ESD prepare written policies and procedures for the annual WPCP and SBWRP billing and cost reconciliation process that: 1) document the reason for the calculation; and 2) eliminate unnecessary steps from the calculation. (Priority 3)

The Administration concurs with this recommendation. The Environmental Services Department has completed draft procedures for the annual WPCP and SBWR billing and cost reconciliation process.

Recommendation No. 8 - That the Administration and the City Attorney's Office approach the City of Santa Clara about amending the current agreement to eliminate the Treatment Plant Income Fund (Fund 514) in 1999-2000. (Priority 3)

The Administration concurs with this recommendation. The City Attorney's Office and the Administration will work on a strategy for approaching the City of Santa Clara regarding the elimination of the Treatment Plant Income Fund (Fund 514)

Recommendation No. 9 - We recommend that the Finance Department revise its policies and procedures regarding the use of directors' names on encumbrances and checking accounts, and ensure that such names are removed. (Priority 2)

The Administration concurs with this recommendation. The Finance Department had taken steps to change directors' names on encumbrances to program names. It is the policy of the Finance Department that all checking accounts are in the city's name. Any checking account found to be in a director's name will be changed immediately.

Recommendation No. 10 - We recommend that the Finance Department enforce compliance with its procedures regarding semi-annual audits of departmental checking accounts. (Priority 3)

The Administration concurs with this recommendation. The Finance Administration Manual (FAM) requires semi-annual reviews of departmental checking accounts with a report to directors in section 5.7.2. The Finance Department will redistribute a copy of section 5.7.2 to all

department directors with departmental checking accounts, along with a reminder that the departments review and abide by the requirements.

Recommendation No. 11 - That the Administration develop approved charts of account and their uses that program managers can use for charging various expenses to the twelve wastewater funds. (Priority 3)

The Administration concurs with this recommendation. Departments involved (ESD, Public Works and Streets and Traffic) with the various expenses to the wastewater funds, have made initial contact and will begin developing methodologies and strategies on how to present the information to their respective staffs.

Recommendation No. 12 - That the Administration and the City Attorney's Office research the feasibility of transferring interest from pre-Proposition 218 SSUC operating and capital fund balances to the General Fund. (Priority 2)

The Administration concurs with this recommendation. The City Attorney's Office and the Administration will research the feasibility of transferring interest to the General Fund.

Recommendation No. 13 - That City Council direct the City Attorney to research the applicability of Proposition 218 to Sewer Service and Use Charge (SSUC) fees, if the City were to separate the collection of those fees from property tax bills. (Priority 2)

The Administration concurs with this recommendation. The City Attorney's Office will research the applicability of Proposition 218 to Sewer Service and Use Charge fees as directed by Council.

Recommendation No. 14 - We recommend that: Depending on the outcome of these discussions, the Administration should accelerate its analysis of consolidated SSUC billing with Recycle Plus bills. (Priority 2)

The Administration concurs with this recommendation. The Recycle Plus billing system conversion is targeted for completion in the fall of 1999. The new system should be allowed to perform at its normal level for at least one year. We agree to accelerate an analysis of consolidating the billing functions however, any decisions for the next step will not preclude the one year performance.

It should be noted that any additional costs for the consolidation of the billing parameters would impact any potential for savings.

Gerald A. Silva
August 13, 1999
Sewer Fund Expenditures Audit
Page 8

Recommendation No. 15 - That the Administration and City Attorney include in any discussion with the City of Santa Clara about updating and amending the 1959 Sewage Treatment Plant Agreement calculating WPCP user fees on estimated usage. (Priority 2)

The Administration concurs with this recommendation. The Administration and the City Attorney will include in any discussions with the City of Santa Clara regarding updating or amending the 1959 Agreement, the recalculation of user fees.

As a final comment on the Audit, the Administration would like to thank the City Auditor's office for their cooperative effort and constructive work performance during this audit.

A handwritten signature in black ink, appearing to read 'Carl W. Mosher', with a horizontal line extending to the right.

CARL W. MOSHER
Director
Environmental Services Department

APPENDIX A

DEFINITIONS OF PRIORITY 1, 2, AND 3 AUDIT RECOMMENDATIONS

The City of San Jose's City Administration Manual (CAM) defines the classification scheme applicable to audit recommendations and the appropriate corrective actions as follows:

Priority Class ¹	Description	Implementation Category	Implementation Action ³
1	Fraud or serious violations are being committed, significant fiscal or equivalent non-fiscal losses are occurring. ²	Priority	Immediate
2	A potential for incurring significant fiscal or equivalent fiscal or equivalent non-fiscal losses exists. ²	Priority	Within 60 days
3	Operation or administrative process will be improved.	General	60 days to one year

-
- ¹ The City Auditor is responsible for assigning audit recommendation priority class numbers. A recommendation which clearly fits the description for more than one priority class shall be assigned the higher number. (CAM 196.4)
 - ² For an audit recommendation to be considered related to a significant fiscal loss, it will usually be necessary for an actual loss of \$25,000 or more to be involved or for a potential loss (including unrealized revenue increases) of \$50,000 to be involved. Equivalent non-fiscal losses would include, but not be limited to, omission or commission of acts by or on behalf of the City which would be likely to expose the City to adverse criticism in the eyes of its citizens. (CAM 196.4)
 - ³ The implementation time frame indicated for each priority class is intended as a guideline for establishing implementation target dates. While prioritizing recommendations is the responsibility of the City Auditor, determining implementation dates is the responsibility of the City Administration. (CAM 196.4)

APPENDIX B

Excerpt From The Office Of The City Auditor's "An Audit Of The City Of San Jose's Utility Billing System," April 1997

Opportunities Exist For The City To Combine Other City Billing Functions With The UBS

According to the 1994 Computer Systems Masterplan, the purpose of the UBS system was to "*assume City control of garbage billing to improve control over garbage collection contractors, maximize revenue, and facilitate future incorporation of additional City billing functions.*" (Emphasis added)

As currently configured, the UBS database includes all residential properties in the City, but not commercial properties. The upgraded UBS computer system will have more capacity, and the upgraded software is expected to have the capacity to bill other City services including metered services.

Other Jurisdictions Have Consolidated Billing

Other jurisdictions typically have a consolidated billing operation -- that is, they bill for several services. This reduces the proportionate cost of billing each service. For example,

- Sunnyvale bills for refuse, sewer, and water;
- Phoenix bills refuse and water;
- Seattle bills for refuse and utilities, except water; and
- Tacoma bills for refuse and utilities.

*Consolidating Sewer Billing Services Could Save \$700,000 Per Year
And Increase Interest Income For The City By \$870,000 Per Year*

The Treasury Division of Finance (Treasury) processes annual sewer and storm drain assessments for the City's commercial and residential property owners. Treasury forwards these assessments to the County for inclusion on property tax bills. The County charges the City \$715,000 per year to collect sewer and storm drain assessments and remit them to the City.

We estimate that the City could save or earn more than \$1.5 million per year by expanding its utility billing operation to include sewer and storm drain fees. This would require a change in the way that the City bills and collects sewer and storm drain fees. Currently sewer and storm drain fees are billed as special assessments on owners' property taxes. The sewer service and use charge for a single family residence is \$18.96 per month. The storm drain fee is \$3.95 per month. The County collects these assessments and remits them to the City in January and June of each year. The Sewer Billing Unit in Finance (6 FTE) currently processes about 190,000 residential assessments and 6,400 commercial assessments. We estimate that if these accounts were billed bi-monthly through the UBS system, rather than the County's assessment system, we could save more than \$700,000 in County collection fees and earn an additional \$870,000 in interest. Tables XI and XII summarize our calculation.

TABLE XI

ESTIMATED INTEREST EARNINGS IMPACT OF BI-MONTHLY SEWER/STORM BILLING ASSUMING 5.7 PERCENT RATE OF RETURN

Month	Special Assessments		Bi-Monthly Billing	
	Special Assessment Receipts	Cumulative Balance With Interest	Bi-monthly Billing Receipts	Cumulative Balance With Interest
July	0	0	0	0
August	0	0	\$11,922,824	\$11,922,824
September	0	0	0	11,979,457
October	0	0	11,922,824	23,959,184
November	0	0	0	24,072,990
December	0	0	11,922,824	36,110,161
January	\$35,768,472	\$35,768,472	0	36,281,684
February	0	35,938,372	11,922,824	48,376,846
March	0	36,109,080	0	48,606,636
April	0	36,280,598	11,922,824	60,760,341
May	0	36,452,930	0	61,048,953
June	35,768,472	72,394,554	11,922,824	73,261,760
Total	\$71,536,944	\$72,394,554	\$71,536,944	\$73,261,760
Additional Interest Earnings				\$867,206

TABLE XII

ESTIMATED COST SAVINGS AND REVENUE IMPACT OF BI-MONTHLY SEWER AND STORM DRAIN BILLING

Additional interest earnings (from above)	\$ 867,206
No change in assumed personal and in-house computing costs	0
Savings from County 1% collection fee on sewer assessments	715,370
Estimated additional bi-monthly printing/handling charge (assuming 6,400 commercial sewer accounts)	(24,192)
Total Savings And Additional Interest Income	\$1,558,384

As a result of the dramatic cost savings that the City could realize, combining sewer and storm drain fees with Recycle Plus billings is a reasonable option that the City Council should consider.

#4 We recommend that the City Council consider combining sewer and storm drain fees with Recycle Plus billings. (Priority 2)