

Los Angeles Department of Water and Power:

*Its Transfers of Funds to the City Comply
With the City Charter; However, It Needs
to Improve Its Controls Over Contracts,
Expenditures, and Personnel Records*



January 2005
2004-130

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January 26, 2005

2004-130

The Governor of California
President pro Tempore of the Senate
Speaker of the Assembly
State Capitol
Sacramento, California 95814

Dear Governor and Legislative Leaders:

As requested by the Joint Legislative Audit Committee, the Bureau of State Audits presents its audit report concerning certain aspects of the operations of the Los Angeles Department of Water and Power (department).

This report concludes that the department followed the requirements of the City Charter of the city of Los Angeles (city) and the terms and conditions of its bond debt when it transferred more than \$82 million from its Water Revenue Fund and almost \$575 million from its Power Revenue Fund to the city's reserve fund since fiscal year 2001-02. However, the department needs some improvement in its oversight of its expenditures, contracts, and personnel activities. For example, we found the department did not award all the contracts we reviewed in compliance with city and department competitive bidding requirements, ensure that only authorized staff signed contracts, and did not always seek required approvals from the Board of Water and Power Commissioners. Further, the department did not ensure that only authorized employees approved invoices for payment. Moreover, the department did not use available information to consistently assess compliance with, or ensure uniform enforcement of, the policies regarding the city's purchasing card program. Additionally, the department's lack of central control over personnel files has reduced its ability to ensure that those files contain the records necessary to support and explain hiring and promotion decisions. Finally, the individuals who occupy seven of the exempt positions we reviewed carry job titles and perform duties that are different from those approved by the mayor and city council.

Respectfully submitted,

ELAINE M. HOWLE
State Auditor

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SUMMARY

Audit Highlights . . .

Our review of certain aspects of the operations of the Los Angeles Department of Water and Power (department) revealed the following:

- The department followed the requirements of the City Charter of the city of Los Angeles (city) and the terms and conditions of its bond debt when it transferred more than \$82 million from its water fund and almost \$575 million from its power fund to the city's reserve fund since fiscal year 2001–02.*
- The department did not always award contracts in compliance with city and department competitive bidding requirements, ensure that staff signed contracts only when authorized, and did not always seek required approvals from the Board of Water and Power Commissioners.*
- In a November 2004 report, the department's internal auditor reported that the department's administration of a series of contracts and purchase orders for the implementation of an automated supply chain management project, valued at more than \$9.7 million, was materially flawed.*

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RESULTS IN BRIEF

The Los Angeles Department of Water and Power (department) was established by the city of Los Angeles (city) in 1925. The department has sole responsibility for meeting the electric and water needs of its service area—an area almost entirely within the city's boundaries. The Los Angeles City Charter (city charter) grants to the department's governing board, the Board of Water and Power Commissioners (board), the city's rights and property associated with providing water and power to the city's inhabitants and customers. It establishes separate funds for the water and power systems to accumulate and account for the revenues and expenditures of the water and power operations, respectively. The city charter grants the board the authority to appropriate and spend those funds.

The city charter further authorizes the department to transfer surplus money from the Water Revenue Fund (water fund) and the Power Revenue Fund (power fund) to the city's reserve fund. Although board resolutions currently identify the targeted annual transfers as 5 percent of the gross revenue from the water fund and 7 percent of the gross revenue from the power fund, these transfers are potentially limited by provisions in the department's bonds. Under the bonds' provisions, transfers may not exceed the prior year's net income and remaining equity must meet specified equity-to-debt ratios. Our review found that the department followed the requirements of the city charter and the terms and conditions of its bond debt when it transferred a total of \$82.4 million from the water fund and \$574.7 million from the power fund to the city's reserve fund since fiscal year 2001–02.

The department is not unique in transferring money from its water fund and power fund to the city each year. According to a June 2003 presentation of financial information for 38 electric power utilities compiled by Fitch Ratings, a financial research and debt rating company, 32 (84 percent) of the utilities studied transfer an average of 5.82 percent of their annual revenues to city general funds. The department's annual transfers are close to this average.

- ☑ *The department did not ensure that only authorized employees approved invoices for payment.*
 - ☑ *The department did not use available information to consistently assess compliance with, or ensure uniform enforcement of, policies regarding the city's purchasing card program—a program that uses credit cards issued by a commercial bank to provide a cost-efficient procurement process.*
 - ☑ *The lack of central control over the department's personnel files has reduced its ability to ensure that it adequately maintains personnel files that contain the records necessary to support and explain hiring and promotion decisions.*
 - ☑ *The individuals who occupy seven of the exempt positions we reviewed carry job titles and perform duties that are different from those approved by the mayor and city council.*
-

As part of this audit, we were asked to review the department's policies and procedures for expenditures, contracts, and personnel. We found the department needs some improvement in its oversight of its business units' activities in these areas. The department's Corporate Purchasing Services (CPS) is responsible for processing contracts and purchase orders in compliance with city and department rules. CPS did not award contracts in compliance with city and department competitive bidding requirements for two of the 12 contracts we reviewed. According to an assistant city attorney, for one of these contracts, the department has broadly construed the city's administrative code to exempt from competitive bidding all personal services contracts valued at less than \$2 million. Moreover, for the larger of the two contracts, valued at \$149,500, the CPS employee who signed the contract obligating the department was only authorized to sign contracts with a value of \$50,000 or less. In addition, for this contract and five others valued at \$150,000 each, CPS violated board policy because these contracts extended the value of the original contracts beyond the threshold set by board resolution without receiving approval from the board. By not following the department and city policies for competitively bidding contracts and seeking board approval for contracts when required, CPS cannot ensure that it procures high-quality goods and services at the best available prices and adheres to the board's control over the department's contracts. Additionally, although we did not find any significant issues in the department's administration of the 12 contracts we reviewed, a November 2004 report prepared by the department's internal auditor contained a finding that the department's administration of a series of contracts and purchase orders for the implementation of an automated supply chain management project, valued at more than \$9.7 million, was materially flawed.

The department's accounts payable unit (accounts payable) is responsible for overseeing payments to suppliers. However, for 16 of the 45 payments we reviewed (36 percent), although proper, we found that accounts payable's audit clerks did not ensure that only authorized employees approved invoices for payment. Rather, accounts payable relied on business unit managers to enforce the department's policies with respect to expenditures. As a result, accounts payable cannot ensure that it paid only valid claims for authorized goods and services.

CPS is also responsible for administering the department's participation in the city's purchasing card (P-card) program. The city initiated the P-card program—a program that uses

credit cards issued by a commercial bank—to provide a cost-efficient procurement process for city employees. However, CPS has not implemented procedures to use available information on violations of P-card program policies, such as the results of CPS audits of cardholders' purchases and business unit staff reports of P-card policy violations. Use of such procedures would enable CPS to consistently assess compliance with, or ensure uniform enforcement of, P-card program policies. These policies restrict the uses for the P-cards, including prohibiting the purchase of certain types of items. They also set daily and monthly dollar limits on purchases and require business unit staff to review purchases to ensure they are authorized and approved. In addition, CPS has not provided clear guidance to the department's business unit managers for determining the appropriate corrective action business units should take against P-cards in response to P-card policy violations and clear criteria for determining when it would be appropriate to restrict, suspend, cancel, or deactivate P-cards.

Further, the department's lack of central control over personnel files has reduced its ability to ensure that it adequately maintains personnel files that contain the records required by department policy. For example, department policy requires that documents that support and explain civil service hiring and promotion decisions be kept in these files. These documents are an important element of resolving discrimination complaints that may arise against the department over its hiring or promotion practices. Each business unit, which may be located away from the department's headquarters, maintains personnel files for its employees. However, the business units do not always ensure that these files are complete. As a result, the department could not produce the documents necessary to support and explain its hiring and promotion decisions for four of the 12 civil service appointments we reviewed. In addition, the department's personnel files did not contain evidence that the employees who occupied nine of the department's exempt positions possess the qualifications the department used to gain approval for the exemption of the positions from the civil service rules by the mayor and the city council. Further, according to research conducted by the department's human resources director for seven of the exempt positions we reviewed, the individuals who occupy them carry job titles and perform duties that are different from the job titles and duties approved by the mayor and the city council for these positions. By not using these positions as approved, the department reduces the city's control over the department's exempt positions and reduces the transparency to the public of its hiring decisions for exempt employees.

RECOMMENDATIONS

To ensure that the department receives high-quality services and materials at the best available prices, CPS should comply with department and city competitive bidding policies when awarding contracts for goods or services. In addition, CPS should recognize when the contracts it awards are extensions of existing contracts and seek board approval when the amended amount exceeds the threshold contained in the department's policy for obtaining such approval.

Further, to improve its controls over the contracts awarded for goods and services, CPS should promptly implement the recommendations presented in the department's internal auditor's November 2004 report on a series of contracts and purchase orders for the department's implementation of a supply chain management system. CPS also should ensure that its staff members sign contracts that obligate the department only when they are authorized to do so.

In order to ensure that the department processes payments correctly and to ensure that payments are made only for authorized purposes, accounts payable should strengthen its internal control procedures to include a process for verifying that contract administrators at the business unit level review and authorize invoices before approving them for payment.

To strengthen the oversight over the P-card program and to obtain the information needed to evaluate the costs and benefits of the program and minimize abuses, CPS should:

- Collect and use the information that results from CPS audits of cardholders' purchases and business unit staff reports of P-card policy violations to track violations on an ongoing basis, including repeat violations of P-card policy.
- Track and follow up business unit managers' responses to reports of suspected P-card policy violations that result from CPS audits of cardholders' purchases to ensure that the corrective actions business unit managers take against P-cards are effective and that policies are enforced consistently.
- Provide clear guidance for determining the appropriate corrective action business units should take against P-cards in response to violations and clear criteria for determining when it would be appropriate to restrict, suspend, cancel,

or deactivate a P-card. Further, CPS should ensure the uniform enforcement of such policies through its improved monitoring efforts.

To ensure that it adheres to its policies for a single comprehensive record for employees' work history and uniform filing and file retention of employee personnel records, the department should consider changing the decentralized nature of its personnel record keeping and establish a centralized system, administered and maintained under the supervision of the department's director of human resources. In addition, the department should seek approval from the mayor and city council when it uses its exempt positions for duties other than those previously approved by the city.

AGENCY COMMENTS

The department generally agrees with our recommendations, except for those related to our findings on its contracting procedures and its administration of the city's P-card program. Our comments follow its response. ■

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INTRODUCTION

BACKGROUND

The Los Angeles Department of Water and Power (department) is the largest municipal utility in the United States. The department had its beginning in 1902 when the city of Los Angeles (city) established the first Board of Power Commissioners. In 1911 the city organized the Los Angeles Department of Public Service to provide water as well as electricity. The Department of Public Service was superseded in 1925 when the city adopted a new charter that, among other things, created the current department. The department controls its own funds and has full responsibility for meeting the electrical and water needs of its service area. It provides electrical and water service almost entirely within the city's boundaries, to an area that encompasses 464 square miles and a population of approximately 3.8 million.

A five-member Board of Water and Power Commissioners (board) governs the department. Board members are appointed by the mayor, subject to the approval of the city council, and serve a term of five years. They may be removed by the mayor without city council approval. Under the city charter, the board is granted the possession, management, and control of the city's rights, lands, and facilities connected to providing water and power to the city's inhabitants and customers. In addition, the board has the authority, subject to approval by city ordinance, to set rates for water and power customers from time to time as necessary to ensure that the rates are uniform for the nature and quantity of service supplied, and are fair and reasonable. The city charter also establishes a separate fund for the water system and one for the power system to accumulate and account for the revenues and expenditures of the water and power operations, respectively, and grants the board control over the separate funds, including the authority to appropriate and spend those funds.

The board has the authority to appoint a general manager for the department, with the approval of the mayor and city council, and may remove the general manager with the approval of the mayor. The general manager administers the department's affairs. The department is organized into two functions—the water system and the power system—each with its separate fund and directed by its own chief operating officer. The department's chief

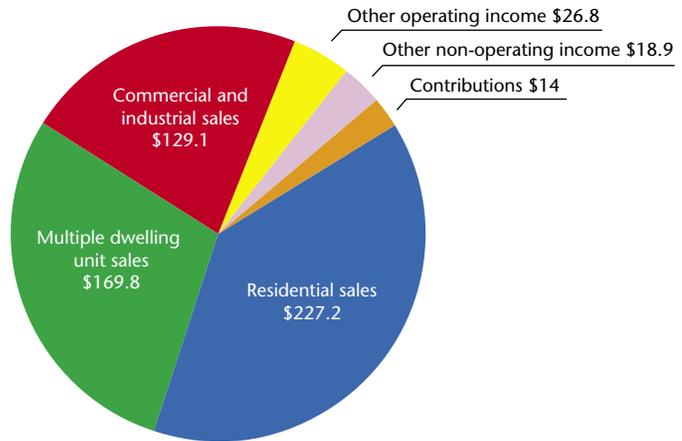
administrative officer manages a number of the department's activities relating to the water and power systems, and the chief financial officer manages the department's financial affairs. The water and power systems are further broken down into major organizations commonly referred to as business units. According to the financial analysis manager of the budget office, each business unit is led by a director, manager, or assistant general manager and may consist of various sections of varying size. For example, under the general manager there are five business units, under the corporate services division there are 10 business units, and under employee relations there are two business units. The department has 34 business units, each with its own administrative sections to handle functions such as personnel or budget coordination.

The department's water system annually supplies an average of 215 billion gallons of water to its 3.8 million consumers through aqueducts that carry water from the eastern slope of the Sierra Nevada, the Sacramento and San Joaquin rivers, the Colorado River through purchases from the Metropolitan Water District of Southern California, and groundwater wells through its groundwater pumping rights. The water is delivered to customers through a pipeline distribution system that extends 7,100 miles. Based on the department's most recent audited financial statements, for the fiscal year ending June 30, 2003, the department's water system generated approximately \$572 million in sales revenue and other income and had roughly \$554 million in operating and other expenses. After adding resources contributed by others and grants for capital projects and other activities and deducting transfers to the city, the department retained almost \$4.5 million in net income from its water system operations. Figures 1 and 2 show the water system's total revenue and expenses for the fiscal year ending June 30, 2003.

The department's power system provides electricity through a system of coal, natural gas, and large hydroelectric, nuclear, and renewable energy sources. It receives its power from generating plants in the Los Angeles basin and from facilities in Nevada, Utah, and the Pacific Northwest. The power system has a total generating capacity of 7,000 megawatts to serve a peak Los Angeles demand of about 5,600 megawatts (one megawatt equals one million watts) and maintains more than 6,000 miles of overhead transmission lines and 4,200 miles of underground distribution lines. Based on the department's most recent financial statements, for the fiscal year ending June 30, 2003,

FIGURE 1

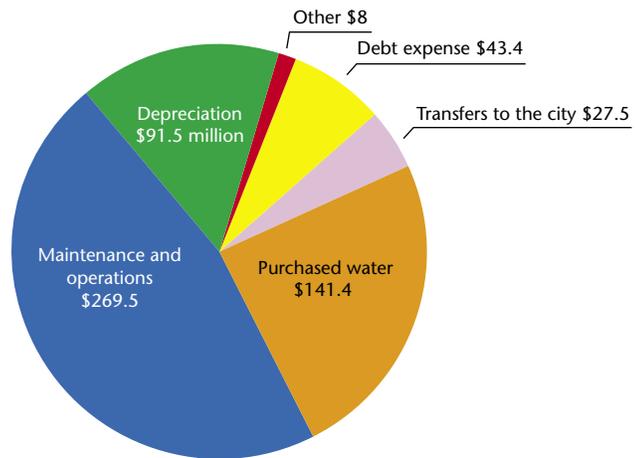
**Water System Revenues for Fiscal Year 2002–03
(in Millions)**



Source: Audited financial statements for the Water Revenue Fund for the fiscal year ending June 30, 2003.

FIGURE 2

**Water System Expenses for Fiscal Year 2002–03
(in Millions)**



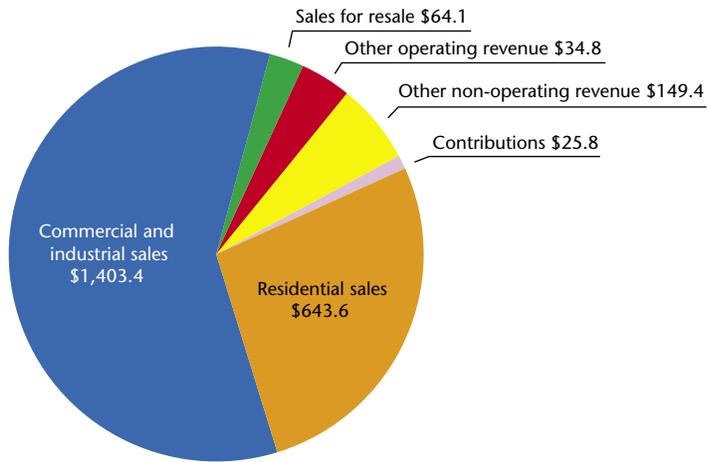
Source: Audited financial statements for the Water Revenue Fund for the fiscal year ending June 30, 2003.

the department's power system generated approximately \$2.3 billion in sales revenue and other income and reported almost \$2.07 billion in operating and other expenses. After adding resources contributed by others and grants for capital projects and other activities and deducting transfers to the city,

the department retained almost \$68 million in net income from power system operations. Figures 3 and 4 show the power system's total revenue and expenses, respectively, for the fiscal year ending June 30, 2003.

FIGURE 3

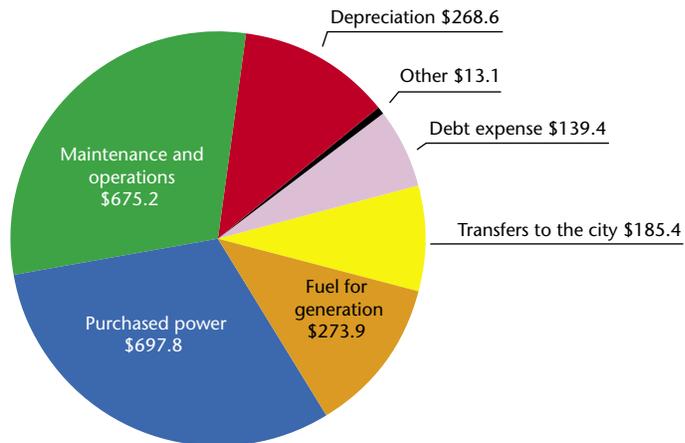
**Power System Revenues for Fiscal Year 2002–03
(in Millions)**



Source: Audited financial statements for the Power Revenue Fund for the fiscal year ending June 30, 2003.

FIGURE 4

**Power System Expenses for Fiscal Year 2002–03
(in Millions)**



Source: Audited financial statements for the Power Revenue Fund for the fiscal year ending June 30, 2003.

THE DEPARTMENT ANNUALLY TRANSFERS FUNDS TO THE CITY

The Los Angeles City Charter (city charter) authorizes the department to transfer surplus money at the end of each fiscal year from the Water Revenue Fund (water fund) and the Power Revenue Fund (power fund) to the city's reserve fund. These transfers must be authorized by city council ordinance and must have the consent of the board. A 2001 department press release quoted the mayor as saying that the transferred funds help the city continue to provide vital services such as police and fire protection, libraries, and recreational facilities.

Traditionally, the board has consented to a yearly transfer of approximately 5 percent of the prior year's audited gross operating revenues for both the water and power systems. However, beginning in fiscal year 2002–03, the board increased the transfer to the city to 7 percent of the power system's prior year gross operating revenues each year. According to the board, it did so to help the city through a fiscally difficult period. For fiscal year 2003–04, the department transferred to the city more than \$27.6 million from the water fund and \$150.2 million from the power fund. In fiscal year 2004–05, the power fund made an additional transfer of \$60 million.

The board may elect to transfer funds in addition to the 5 percent of the water system's gross operating revenue and 7 percent of the power system's gross operating revenue that it transfers to the city each year, as long as the transfers do not exceed the restrictions in the department's bond indebtedness for the two funds or cause unfair or unreasonable rates to be imposed on the department's water and power customers. Under the covenants for both funds' bond debt, annual transfers of surplus money to the city may not exceed the net income from the prior year; nor may they reduce either fund's surplus to less than one-third of its respective total indebtedness.

The city charter establishes two separate funds related to water and power revenues. All revenues related to the department's water assets must be deposited into the water fund, and all revenues related to the department's power assets must be deposited into the power fund. Thus, the rates paid by water and power customers are deposited into two separate, segregated funds. The city charter expressly prohibits the transfer of money from one fund to another or the use of the money in one fund to pay the demands on another fund; however, the city charter specifically provides that the city council may, by ordinance and

with the consent of the board in charge of the fund, direct surplus money in the water fund or power fund to the city's reserve fund at the end of the year. The city charter also allows the transfer of this money from the city's reserve fund to its general fund after the adoption of the city's annual budget. Consequently, surplus revenues in the water fund or the power fund may be transferred to the city's general fund to meet the city's needs as defined in the annual budget adopted by the city council.

Although the city charter permits the department to transfer surplus funds from its water fund and power fund to the city's reserve fund, the department and the city have faced challenges in court over the legalities of those transfers. For example, in June 1999 two nonprofit groups and three individuals filed a class action suit against the city and the department alleging that they were overcharged for water services and that the overcharges resulted in surplus funds that could be transferred to the city. In addition, the suit charged that the surpluses transferred represented an illegal tax because the payments for water services that created the surpluses were essentially property-related user fees or special taxes and, as such, required voter approval. The courts dismissed the suit because the plaintiffs did not show the rates were unreasonable, that the rates constituted taxes, or that the transfers were unauthorized.

Currently, the city and the department are facing another class action suit challenging their method for determining the presence of surplus money in the water fund and power fund and the making of subsequent transfers to the city. The plaintiffs contend that the department's water fund and power fund cannot have surpluses as long as they have outstanding debt to pay. The plaintiffs are seeking to block future transfers, to require the city to return to the water fund and power fund the transfers made since 2000, and to roll back the 11 percent increase in water rates approved by the department and the city in June 2004. According to the department's audited financial statements, as of June 30, 2003, the water fund was obligated to repay approximately \$1.4 billion in bonds and the power fund was obligated to repay bonds totaling approximately \$3.5 billion.

THE DEPARTMENT'S EMPLOYMENT PRACTICES ARE SUBJECT TO THE CITY'S CIVIL SERVICE SYSTEM

As part of this audit, we were asked to review the department's personnel policies and procedures to determine whether they comprehensively address hiring, promotions, and firing.

The city charter requires that the department administer its personnel system under civil service rules developed by the city's Board of Civil Service Commissioners. The city charter allows for few positions that are exempt from the civil service system. These exempt positions include the members of the department's board, its general manager, two positions in the class of assistant general manager, the chief financial officer, and a limited number (up to 15) of other positions that require approval by the mayor and city council and for which the educational, experience, and other professional requirements for the positions justify exemptions from civil service appointment.

In brief, the city's civil service rules require that new employees be hired and promotional appointments be made from a certified list of eligible applicants who have passed open or promotional examinations and are eligible for appointment because they have been ranked among the highest scores on the list. A panel of employees from within and outside the business unit that is hiring or promoting interviews applicants to determine those who are most qualified. Under the city charter, the department may not discharge or suspend a civil service employee without cause. The cause for discharge or suspension must be written and presented to the affected employee and the Board of Civil Service Commissioners. Employees who are exempt from the civil service rules work at the pleasure of the general manager. According to the department's director of human resources, as of June 30, 2004, the department had 8,109 civil service employees and 19 employees who were exempt from the civil service rules.

SCOPE AND METHODOLOGY

The Joint Legislative Audit Committee (audit committee) requested that the Bureau of State Audits (bureau) review certain aspects of the department's operations. Specifically, the audit committee requested that the bureau review how and when the department transfers money from its water fund and power fund to the city as well as the department's policies and procedures regarding expenditures, contracting, and personnel practices.

To gain an understanding of the policy and legal provisions regarding the activities covered in the audit request, we reviewed the relevant articles of the city charter and its administrative code, department manuals, relevant laws, board resolutions, and city council ordinances. To determine whether the department complied with the city charter when transferring funds to the

city, we reviewed the transfers and supporting financial records and resolutions to identify the amount transferred to the city since fiscal year 2001–02, to determine whether the board and the city council followed the city charter in authorizing the transfers, and to identify the rationale for permitting or requiring transfers from the department to the city. In addition, we reviewed the board resolutions and city council ordinances and other documents supporting the transfers to determine whether the transferred funds had been earmarked for any special use by the city. We also reviewed the department's transfers to determine whether they complied with specific restrictions in the covenants of the department's outstanding bond debt.

To determine whether the department's expenditures are for authorized purposes, we first reviewed and evaluated the provisions from the city charter and city administrative code, as well as the department's purchasing manuals, to ascertain whether the policies and procedures contained in them provide adequate controls over the department's expenditures. We next selected a sample of 45 expenditures from fiscal year 2003–04 to determine whether the department adhered to the controls we had identified. To select our sample, we obtained a report of direct charges to the department's water fund and power fund. We then divided those direct charges into categories according to the relative risk that the recorded expenditures might have been for unauthorized purposes. Examples of lower-risk expenditures include labor costs and lease payments, and examples of higher-risk expenditures include those for consultants or professional services. We selected our sample of expenditures from only those categories we considered to be higher risk. In addition, we selected a sample of 24 department purchases made through the city's purchasing card program. We traced the expenditures in the sample to invoices, purchase documents, authorizing signatures, and other supporting documents, such as the city charter and purchasing manuals, to determine whether the expenditures were for authorized purposes.

Similar to our tests of expenditures, for our tests of the department's contracting practices we reviewed the relevant articles from the city charter, sections from the city's administrative code, and department manuals. In selecting our sample, we obtained a list of contracts the department entered into during fiscal year 2003–04 and divided the contracts according to the risk that the department might not have followed its procedures or that the language in the contracts

might not adequately define the scope of work to be performed or the deliverables to be provided under the contract. Examples of contracts that we considered to be lower risk include those for lodging and memberships, while examples of higher-risk contracts include those for professional services. We reviewed the files for 12 contracts that we classified as higher risk to determine whether the department had followed city and department requirements for awarding and administering the contracts. Although we have included in our report findings regarding the department's practices for awarding contracts, we did not identify any significant issues in its administration of the 12 contracts we selected for review. However, a report prepared by the department's internal auditor contained a finding that the department's administration of a series of contracts and purchase orders with one vendor was materially flawed. We present the internal auditor's findings in Chapter 2.

Finally, we reviewed the city's policies and procedures for hiring, promoting, and firing employees. Using a report of personnel actions for fiscal year 2003–04 prepared by the department's personnel unit, we selected a sample of those actions for civil service employees. We also obtained a list of all the department's positions that are exempt from civil service. We then performed tests to determine whether the department followed the requirements of the city's civil service rules, city ordinances, and the city charter when hiring, promoting, or firing civil service employees, and reviewed the department's documents regarding the selection of exempt employees. ■

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CHAPTER 1

The Department's Transfers of Money to the City for General Use Are Allowable and Comply With the City Charter

CHAPTER SUMMARY

The Los Angeles Department of Water and Power (department) followed the requirements of the Los Angeles City Charter (city charter) when it transferred money from its Water Revenue Fund (water fund) and Power Revenue Fund (power fund) to the city of Los Angeles' (city) reserve fund for transfers made since fiscal year 2001–02. During that period, the department transferred a total of \$82.4 million from the water fund and \$574.7 million from the power fund. In addition to complying with the provisions of the city charter, the department must comply with the terms and conditions of its bond debt when transferring surplus funds from the water fund and power fund to the city. Our review of these transfers of surpluses from the water fund and power fund found that the department also complied with the restrictions of its bond debt regarding transfers made to the city.

The department is not unique in its practice of transferring money from its water fund and power fund to the city each year. Fitch Ratings, a financial research and debt rating company, in a study of 38 electrical power utility systems in 12 states and the Virgin Islands, found that 32 (84 percent) of the utility systems transfer money to city general funds. The amount of the transfers averaged almost 6 percent of the utilities' annual operating revenue. This is similar to the annual amounts transferred to the city from the department's water and power systems.

TRANSFERS FROM THE WATER FUND AND POWER FUND COMPLY WITH THE CITY CHARTER

The department followed the requirements of the city charter when it transferred money from its water fund and power fund to the city's reserve fund for the transfers we tested.

Since fiscal year 2001–02, the department transferred a total of \$82.4 million from the water fund and \$574.7 million from the power fund. Table 1 shows the annual transfers from each fund.

TABLE 1
Transfers of Surplus Money From the Water Fund and Power Fund Since Fiscal Year 2001–02
(Dollars in Millions)

Fiscal Year Surplus	Fiscal Year Transferred	Transferred Amount—Water Fund	Transferred Amount—Power Fund	Percentage of Revenues
2000–01	2001–02	\$27,247		5%
2000–01	2001–02		\$154,153	5
2000–01	2001–02		25,000	Additional transfer
2001–02	2002–03	27,523		5
2001–02	2002–03		156,358	7
2001–02	2002–03		29,000	Additional transfer
2002–03	2003–04	27,649		5
2002–03	2003–04		150,214	7
2002–03	2004–05		60,000	Additional transfer
Totals		\$82,419	\$574,725	

Sources: Audited financial statements for the water fund and power fund, Board of Water and Power Commissioners resolutions, and Los Angeles City Council ordinances.

Note: Transfers from the water fund and power fund are made in the fiscal year after the surplus funds are earned.

As we discuss in more detail in the Introduction, the city charter allows the department to transfer surplus money from the water fund and power fund to the city’s reserve fund. The city ordinances and Board of Water and Power Commissioners (board) resolutions that authorize the transfers assign no specific use to the transferred funds.

Currently, the board passes a resolution after the end of each fiscal year consenting to a transfer to the city’s reserve fund of 5 percent of the water system’s gross operating revenue for the fiscal year just ended and 7 percent of the power system’s gross operating revenue. Beyond the traditional annual transfers, the board has consented to additional transfers of funds from the power fund. As shown in Table 1, the department made three additional transfers from the power fund, ranging from \$25 million to \$60 million, during the period we reviewed. According to the

board, the additional transfers were made to assist the city through difficult financial times. In fact, for the \$60 million additional transfer made in fiscal year 2004–05 from the fiscal year 2002–03 power fund surplus, correspondence between the city and the department shows that the city had requested the additional funds to help it close its projected budget deficit for fiscal year 2004–05.

However, in July 2004 the board informed the mayor and the city council that in future years the city should not rely on financial assistance from the department beyond the annual 7 percent transfer from the power fund and 5 percent transfer from the water fund. The board cited the department’s fiduciary responsibility to continue meeting its core mission of providing the city’s residents and businesses with cost-effective, reliable, and high-quality water and power, and to meet its own financial obligations. Specifically, the board cited obligations such as the rising costs of health care and pension benefits and the operating costs of generating electricity, combined with the modest revenue growth and frozen customer electric rates, as having placed pressure on the power fund’s net income.

As we discuss in the Introduction, although the department complied with the city charter when it transferred these funds to the city, it has faced challenges in the courts over the legality of those transfers. The courts have dismissed one of these class action lawsuits and a second is pending.

TRANSFERS FROM THE WATER FUND AND POWER FUND COMPLIED WITH THE TERMS OF THE DEPARTMENT’S BOND PROVISIONS

Restrictions in the Department’s Bond Provisions on Transfers From the Water Fund and Power Fund to the City

Transfers may not exceed the respective fund’s net income from the prior fiscal year.

Transfers may not leave surpluses in the water fund or power fund that are less than one-third of the respective fund’s total indebtedness, including current liabilities.

In addition to complying with the provisions of the city charter, the department also must comply with the terms and conditions of its bonds when transferring surplus funds from the water fund and power fund to the city. The department’s transfers since fiscal year 2001–02 complied with the restrictions of the bond debt regarding its transfers to the city.

The board’s master bond resolution, which applies to all the department’s bond issues, and the official statements associated with individual bond issues constitute the contract between the department and the owners of the department’s bond debt.

Because in these documents the department pledges the assets of the water fund and power fund to repay bond debt, the terms and conditions of the debt contain two restrictions on the amount of money that can be transferred to the city each year. These restrictions are described in the text box on the previous page. When calculating the equity-to-debt ratios to measure compliance with the second restriction shown in the text box, upon the advice of its bond counsel, the department uses only its long-term debt (due in more than one year) related to borrowings, such as bonds, notes, and other evidence of indebtedness as shown on its audited financial statements, which also includes the current portions of those debts (due in the forthcoming fiscal year). The comparisons of transfers from the water fund and power fund to the prior year's net income and the remaining surpluses after the transfer to the two funds' total indebtedness show that the department complied with the restrictions of its bond debt. For example, Tables 2 and 3 show that the water fund's and power fund's prior year's net income exceeded the amounts transferred for each of the three fiscal years shown. Also, while the bonds' restrictions require only that the surplus remaining after the transfers must equal at least one-third of the outstanding debt, Table 2 shows that the remaining surplus for the water fund exceeded the total indebtedness for all fiscal years presented, and Table 3 shows that the remaining surplus for the power fund nearly equaled total indebtedness for one fiscal year and exceeded total debt for the other two fiscal years.

TABLE 2
Restrictions and Water Fund Transfers to the City
(in Millions)

	Fiscal Year 2001–02 Transfer	Fiscal Year 2002–03 Transfer	Fiscal Year 2003–04 Transfer
Amount transferred	\$ 27,247	\$ 27,523	\$ 27,649
Prior year's net income	101,037	84,159	32,021
Fund's remaining surplus	1,703,450	1,760,086	1,764,458
Total indebtedness	\$1,053,918	\$1,045,551	\$1,344,822

Source: Audited financial statements for the water fund for fiscal years 2000–01 through 2002–03.

Note: The approximately \$300 million increase in total indebtedness shown for fiscal year 2003–04 relates to fixed rate bonds issued by the department to pay for capital improvements to the water system.

TABLE 3**Restrictions and Power Fund Transfers to the City
(in Millions)**

	Fiscal Year 2001–02 Transfer	Fiscal Year 2002–03 Transfer	Fiscal Year 2003–04 Transfer
Amount transferred	\$ 179,153	\$ 185,358	\$ 210,214
Prior year's net income	440,161	436,068	253,077
Fund's remaining surplus	3,194,813	3,445,523	3,482,848
Total indebtedness	\$3,446,582	\$3,413,588	\$3,395,268

Source: Audited financial statements for the power fund for fiscal years 2000–01 through 2002–03.

At the close of each fiscal year, the department's general manager and chief financial officer determine whether the department can transfer the targeted percentages—5 percent of the water system's prior year gross revenues and 7 percent of the power system's prior year gross revenues, not to exceed the funds' respective net earnings—based on a review of the operations of the water and power systems, and they then make a recommendation to the board. According to the assistant chief financial officer, the department monitors its compliance with the bonds' restriction on transfers based on equity-to-debt ratios through its preparation of long-range financial plans. Each year the department presents long-range financial plans to the board for the water and power systems that contain a calculation of the equity-to-debt ratio for the prior fiscal year and projections of this ratio for five future fiscal years.

Transfers of funds from the water and power systems have another implication for the department's bonds. The practice of transferring funds to the city can affect the department's credit rating, thereby affecting its cost of borrowing funds for needed capital projects. Maintaining a desirable credit rating allows the department to sell bonds at the lowest available interest rate. For bonds the department issued during 2001 and 2004, Fitch Ratings, Moody's Investors Service (Moody's), and Standard & Poor's ratings services rated the department as a very low credit risk, with a strong capacity to meet its financial commitments. Therefore, the department's transfers of surpluses from the water fund and power fund do not appear to affect the funds' credit ratings negatively.

TRANSFERS OF UTILITY FUNDS TO CITY FUNDS ARE COMMON

The department is not unique in its practice of transferring surplus money from its water fund and power fund to the city each year. In its *June 2003 Public Power Financial Peer Study*, Fitch Ratings, a financial research and debt rating company, presented financial information for 38 electrical power utility systems in 12 states and the Virgin Islands. Included in the financial data is information on transfers of funds from the utility systems to city general funds. Thirty-two of the 38 utility systems in the study (84 percent) transfer money to city general funds. Those transfers ranged from 14 percent to 0.2 percent of the utilities' annual revenues, with an average transfer amounting to almost 6 percent of revenue. Therefore, the percentages transferred by the department are fairly close to the annual average transferred by other utilities.

The percentages transferred by the department are fairly close to the annual average transferred by other utilities.

The department provided a historical perspective on its transfers to the city. According to the department, it originally transferred money to the city to repay general obligation bonds and general fund revenues the city used to finance the construction of waterworks facilities in the early 1900s. The earliest readily available audited financial statements, for the year ending December 31, 1917, show a liability to the city of slightly more than \$16 million. This liability changed through the years because of the issuance of additional debt, payment of bond principal and interest from city funds, and payments to the city by the department. From 1935 through 1946, the department made annual transfers to the city to reduce the debt. Those transfers ranged from 3 percent to 15 percent of gross revenues, with most transfers in the range of 5 percent to 7 percent. Beginning in 1947, the following formula was used to determine the annual payment: 2 percent of the earned surplus balance at the close of the second preceding fiscal year, but not more than 5 percent of gross operating revenue. In all instances, the 5 percent limit applied, and this was the beginning of the department's practice of making the 5 percent transfers. The reference to the 2 percent of earned surplus was dropped in 1951. The department repaid its liability to the city by June 30, 1960, but the 5 percent annual transfers continued. The formula was changed in 1961 to the current formula of 5 percent of total gross operating revenue for the prior fiscal year. As we discussed previously, the board voted in May 2002 to raise the percentage transferred from the power fund to 7 percent of gross revenues, and the transfers from both the water fund and power fund are subject to the availability of net income and targeted debt-to-equity ratios.

In an August 12, 2004, letter to the Joint Legislative Audit Committee, the department's acting general manager cited a research report by Moody's as further rationale for the transfers. In this report, a June 2003 Special Comment paper titled *Moody's Perspective on Municipal Electric Utility General Fund Transfers*, Moody's presented its opinion on the proper role of utility transfers to a municipality's general fund. In answer to the question of whether general fund transfers are merely hidden taxes, a way to take advantage of available cash, or whether transfers have a legitimate role in municipal finance, Moody's was of the opinion that a reasonable return on a municipality's investment in its utility enterprise remains an established basis for transfers of surplus revenues to a municipality's general fund. However, Moody's cautioned that there are numerous examples of abuses regarding transfers, and that the establishment of a fair and equitable return to the municipality for its investment is sometimes left to the political imagination, which may result in a drain on enterprise revenues and a pressure on operations.

With the exception of three supplemental transfers that it has told the city it no longer can depend on, the department practices the type of transfer methodology that Moody's has concluded is sound policy.

Moody's concluded that a sound general fund transfer policy that is stable and well-defined and that determines annual transfer levels is superior to an open-ended annual budget issue, driven every year by the revenue needs of the general fund. Moody's further stated that a municipal policy decided by the local governing body with full input from the utility enterprise's management that sets transfer levels based on utility profitability or is linked to operating and financial performance standards is clearly the soundest type of policy. Moody's cited as an example a policy that establishes the transfer as a reasonable percentage of gross revenues or net revenues, characterizing such a policy as giving predictability for both annual budget and capital improvement planning for the utility and for city government. With the exception of three supplemental transfers that it has told the city it no longer can depend on, the department practices the type of transfer methodology that Moody's has concluded is sound policy. ■

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CHAPTER 2

The Department Needs to Improve Its Controls Over Contracts, Expenditures, and Personnel Records

CHAPTER SUMMARY

The Los Angeles Department of Water and Power (department) needs some improvement in its oversight of its business units' contracts, expenditures, and personnel records. In our review of 12 contracts, we found that the department's Corporate Purchasing Services (CPS) did not always process its contracts in accord with the city of Los Angeles (city) and department competitive bidding requirements and did not always obtain appropriate approval from the Board of Water and Power Commissioners (board). CPS is responsible for processing contracts and purchase orders in compliance with city and department rules. By not following the department and city policies for competitively bidding contracts and not seeking board approval for contracts when required, CPS cannot ensure that it procures high-quality goods and services at the best available prices and does not thwart the board's control over the department's contracts. Further, an internal audit report released in November 2004 highlighted several issues, some serious and material, with the department's administration of a series of contracts and purchase orders issued to one vendor valued at more than \$9.7 million.

In addition, the department's accounts payable unit did not ensure that only authorized employees approved invoices for payment. As a result, accounts payable cannot be sure that it paid only valid claims for authorized goods and services.

CPS is also responsible for administering the department's participation in the city's purchasing card (P-card) program, which uses credit cards issued by a commercial bank to provide a cost-efficient procurement process for city employees. The program's policies restrict the use of P-cards, including prohibiting the purchase of certain types of items and setting daily and monthly dollar limits for purchases, and require that the department's business unit staff review all purchases for appropriateness and ensure that all purchases are approved

properly. However, CPS has not implemented procedures to effectively assess compliance with, or ensure the uniform enforcement of, these policies.

Further, the department's lack of central control over personnel files has reduced its ability to ensure that it adequately maintains personnel files containing the records required by department policy. Each business unit, which may be located away from the department's headquarters, maintains personnel files for its employees. Department policy requires that documents supporting and explaining decisions regarding hiring and promotions be kept in these files. However, the business units do not always ensure that these files are complete. As a result, the department could not produce the documents necessary to support and explain its hiring and promotion decisions for four of the 12 civil service appointments we reviewed.

In addition, the department's personnel files did not contain evidence that the employees who occupy nine of the department's 19 positions that are exempt from civil service requirements (exempt positions) possess the qualifications the department used to exempt the positions from civil service rules. Further, according to research conducted by the department's director of human resources, the individuals who occupy seven of the exempt positions we reviewed carry job titles and perform duties that are different from the job titles and duties approved by the mayor and the city council in exempting these positions.

CORPORATE PURCHASING SERVICES DID NOT ALWAYS FOLLOW ITS OWN AND THE CITY'S POLICIES FOR COMPETITIVELY BIDDING CONTRACTS FOR GOODS AND SERVICES

CPS is responsible for processing contracts and purchase orders in compliance with city and department rules. However, CPS did not comply with the department's and the city's competitive bidding policies for two of the 12 contracts we reviewed. One contract was the third of three consecutive one-year contracts awarded to the same vendor for graphic art and design services, valued at \$149,500 each. CPS sought competitive bids for the first of the three contracts but issued the other two contracts to the vendor without seeking competition. The combined total of these three contracts is \$448,500.

According to the department's manual for personal and professional services contracts, various expert services usually can be performed by more than one vendor and should be awarded via competitive bid.

According to the department's manual for personal and professional services contracts, various expert services usually can be performed by more than one vendor and should be awarded via competitive bid. The manual lists examples of the types of services that should be bid, including photographic, printing, and publication services. In addition, the city's administrative code requires the department to seek competitive bids when practicable. It states that in all cases in which bids are not required by the city charter, competitive proposals or bids shall be obtained as far as is reasonably practicable and compatible with the city's interests. However, the city's administrative code also exempts certain personal services contracts that are less than \$2 million from that requirement. The department has construed this provision to exempt most personal services contracts from competitive bidding. Nonetheless, the department's policy still urges competitive bidding. Because CPS did not adequately explain why obtaining competitive bids for the contract was not in the city's interests, we believe CPS should have followed its policy and sought bids for this contract, as well as the preceding contract. By applying the exemption from competitive bidding requirements so broadly, CPS cannot ensure that it procures high-quality goods and services at the lowest cost.

According to CPS's administrative services manager, the contract we reviewed was for an ongoing need, and CPS decided that it was not practical to prepare a request for proposals (RFP) each year. Instead, it issues an RFP once every three years for a one-year contract. For the second and third years of the three-year cycle, CPS awards without competition two one-year contracts to the same vendor with the same terms as the first contract. However, when we asked the administrative services manager why it was not practical to prepare an RFP for these contracts, she was not consistent in her answer and did not fully address our question. For example, the manager stated that few expenditures were charged against these contracts (annual expenditures ranged from more than \$6,200 to almost \$23,000), so it was more efficient and effective and in the best interest of the department and the city to issue two subsequent one-year contracts to the same vendor with the same terms and conditions as the one that originally was put out to bid. However, when we asked why CPS awarded contracts valued at \$149,500 that traditionally have so little charged against them, the manager replied that it is difficult to anticipate projects requiring the services provided by this contract. Therefore, CPS executes contracts in large enough amounts to cover any

unexpected requirements that may occur. However, it is not clear from the manager's statements how the expenditures from these contracts can be both low and difficult to anticipate.

Further, according to the manager, CPS follows this practice for certain services for which there is an ongoing need.

When we asked the manager to point us to the section of the administrative code that allows CPS to award these two subsequent contracts without seeking competitive bids, she stated that these requirements have become an issue of legal interpretation and referred us to the city attorney's office.

When we contacted the assistant city attorney assigned to the department, he directed us to Section 10.37.8 (Article 11) of the city's administrative code, which allows "service contracts" less than \$2 million to be awarded without competitive bids.

Article 11 requires the city's service contractors to provide a living wage to their employees, in order to maximize the quality and quantity of services rendered by those employees. It specifically focuses on service contractors who represent the public face of the city, such as those whose employees work at the terminals at Los Angeles International Airport, the San Pedro Port, and golf courses and recreational centers operated by the city's Department of Parks and Recreation. Therefore, Article 11 defines a service contract as one that is primarily for services furnished to or for the city to which any of the following applies:

- At least some of the services rendered are provided by employees whose work site is on property owned by the city.
- The services could feasibly be performed by city employees if the awarding authority had the requisite financial and staffing resources.
- The designated administrative agency has determined in writing that paying service contract employees a living wage would further the city's proprietary interests.

Article 11 also gives examples of the types of employees it is intended to cover, such as hotel employees, restaurant and food service employees, janitorial employees, security guards, and clerical employees. The contract we reviewed is for the preparation of finished artwork and other related graphic services—work that does not resemble the services performed by the employees listed in Article 11 of the administrative code.

According to the assistant city attorney assigned to the department, the department has broadly construed Article 11 to exempt most personal services contracts for less than \$2 million from competitive bidding. However, this interpretation has the effect of exempting the vast majority of personal services contracts from the competitive bidding requirements that apply to other kinds of contracts.

Our counsel believes Article 11 could have been read to apply only to those types of services listed in the article and not specialized professional service contracts such as graphic art services. Another provision of Chapter 1 of the Administrative Code, Section 10.15 of Article 2, suggests that professional, scientific, expert, technical, or other special services—which seem to include graphic design services—are generally subject to competitive bidding unless the department makes certain findings. However, according to the assistant city attorney assigned to the department, the department has broadly construed Article 11 to exempt most personal services contracts for less than \$2 million from competitive bidding, citing a provision of Article 11 that requires “service contract” to be interpreted liberally to further the policy of the article. According to another assistant city attorney not affiliated with the department, the Los Angeles city attorney’s office has similarly construed Article 11 to exempt from competitive bidding all personal services contracts valued at less than \$2 million entered into by the city. Because the exemption threshold is so high, the interpretation of Article 11 by the department and the city has the effect of exempting the vast majority of personal services contracts from the competitive bidding requirements that apply to other kinds of contracts. In practice, according to the assistant city attorney, most city departments have policies or practices more restrictive than Section 10.37.8 that result in the majority of such contracts being procured through a competitive selection process. For example, despite this broad reading of the exemption from competitive bidding requirements of the administrative code, the department’s actual policy is to encourage use of competitive bidding for personal services contracts, which it did when it awarded the first in a series of contracts to this vendor. However, the subsequent awards to this vendor were not bid competitively.

Moreover, the CPS staff member who executed the contract was not authorized to do so. As stated previously, the contract we reviewed was valued at \$149,500. However, the CPS staff member who signed the contract had authority at that time to sign contracts only up to \$50,000 in value. CPS’s administrative services manager agreed that the staff member was not authorized to sign this contract and stated management would investigate why this occurred. This same CPS manager later asserted that this staff member received verbal authorization to sign this contract from the former assistant purchasing director. However, the department’s purchasing policies do not provide

for such verbal authorizations. In addition, the second and third contracts were awarded to this vendor for the same products and services and with the same terms as the original contract, making these two successive contracts extensions of the first contract. As such, these two successive contracts were also subject to board approval. In the next section, we discuss the requirement that the department seek board approval and, in certain circumstances, city council approval for its contracts.

CPS also processed another contract we reviewed, valued at \$20,000, without obtaining any informal bids, despite department policy requiring its business units to solicit such bids for contracts valued at less than \$25,000. Unless it processes all its contracts in compliance with city and department competitive bidding requirements, CPS risks paying more for its contracts because of decreased competition.

CORPORATE PURCHASING SERVICES AWARDED CONTRACTS FOR GOODS AND SERVICES WITHOUT OBTAINING REQUIRED APPROVALS

CPS does not always obtain required approval for the contracts it awards. The city's administrative code requires that the board approve contracts valued at more than \$150,000 or lasting more than one year. In addition, a 1989 board resolution prohibits the department from granting through amendments, extensions of existing contracts that increase the value of the original contract to more than \$100,000. According to CPS's administrative services manager, the city attorney's office advised CPS that change orders, which amend existing contracts, are a form of contract, and as such an April 2000 board resolution that increased the general manager's authority to execute contracts up to a value of \$150,000 also increased the general manager's authority to change contracts up to a total amended value of \$150,000. Further, the city's administrative code states that contracts or contract amendments that are not bid competitively and obligate the department for a period of more than three years must be approved by the city council.

For two of the 12 contracts we reviewed, CPS appeared to split contracts, which had the effect of avoiding the required board approvals.

For two of the 12 contracts we reviewed, CPS appeared to split contracts, which had the effect of avoiding the required board approvals. One was the last of six contracts awarded to the same vendor in less than five years for video equipment rental and video assistance. CPS awarded this vendor one contract in October 1999 valued at \$100,000 and, between September 2000 and December 2003, competitively awarded five subsequent

contracts, each valued at \$150,000, thereby falling under the threshold for formal approval by the board.¹ According to CPS's administrative services manager, none of these six contracts required board approval.

As Table 4 shows, the department spent at least 90 percent of the funds for three of the first five contracts at least three months before the contract expired. For example, the department had paid invoices totaling 99 percent of the value of contract 3 almost four months before the contract term ended. Further, after the first contract, four of the five subsequent contracts had terms that began before the end of the previous contract's term. For example, contract 4 started on March 1, 2002, four months before the term of contract 3 ended on July 1, 2002. Because CPS awarded these contracts so frequently, the subsequent five contracts are essentially extensions of the original contract, thereby increasing the original contract's value beyond the threshold prohibited by board resolution. By not obtaining required board approval, CPS thwarts the board's control over the department's contracts intended by board resolution.

TABLE 4

Department Video Equipment Rental Contracts With the Same Vendor

Contract Number	Contract Start Date	Contract Value	Total Expended	Percent of Total Expended	Final Payment Date	Contract End Date
1	10/11/99	\$100,000	\$ 96,035	96%	6/7/00	10/10/00
2	9/12/00	150,000	147,190	98	7/17/01	9/11/01
3	7/2/01	150,000	147,754	99	3/5/02	7/1/02
4	3/1/02	150,000	145,930	97	2/26/03	2/28/03
5	4/15/03	150,000	135,586	90	12/10/03	4/14/04
6	12/22/03	150,000	110,386	74	8/26/04	12/21/04

Source: Department contract and expenditure files.

¹ According to CPS's administrative services manager, board approval formerly was necessary for contracts valued at more than \$100,000. In April 2000, the administrative code was changed to allow departments to execute contracts valued up to \$150,000 without board approval.

When we asked why it was exempt from obtaining board approval for any of these contracts, CPS's administrative services manager responded that all the contracts are price and time contracts for specified materials and services with a contractual period of more than six months and that these contracts expire when either the time or the dollar limit is reached. She further stated that the new contracts went through a competitive bidding process and were awarded under the general manager's authority of up to \$150,000. However, because CPS failed to explain adequately how this practice of awarding a series of contracts that fall just below the threshold for board approval is allowed by board resolution, we conclude that CPS should have submitted all the subsequent contracts to the board for its approval.

In the previous section, we discussed a contract with similar extensions for which CPS should have sought board approval. In that case CPS twice extended the original contract with a value of \$149,500 and one-year duration, increasing the contract's value to \$448,500 and extending its term for a total duration of three years without seeking board approval.

In March 2003, the Los Angeles City Controller (city controller) released an audit report that identified a similar finding. That report found instances of the department entering into two or more contracts with a single contractor for the same or consecutive terms and similar services. According to the report, CPS staff reported that they avoid the lengthy process of obtaining board approval on many contracts by issuing new identical contracts for a new term. In response to the city controller's findings, the report states, CPS established a unit to analyze purchasing trends and to identify more efficient ways to contract, as well as to identify contract splitting and other means of avoiding contract requirements. However, according to its administrative services manager, CPS suspended the unit's efforts and redirected the resources of this unit to respond to the high volume of purchasing requisitions from business units. She stated that CPS continues to request additional personnel to implement various reforms and recommendations from the board, the city controller, and the mayor's office regarding the department's contract management.

According to the city controller's report, CPS staff reported that they avoid the lengthy process of obtaining board approval on many contracts by issuing new identical contracts for a new term.

THE DEPARTMENT'S INTERNAL AUDITOR IDENTIFIED SEVERAL ISSUES RELATED TO ITS ADMINISTRATION OF A SERIES OF CONTRACTS

In November 2004, the department's internal auditor issued an audit report that identified multiple findings related to a series of contracts and purchase orders the department awarded to a vendor beginning in 1999. Originally, the department issued a purchase order valued at \$80,000 to begin implementing an automated supply chain management project, including electronic requisition and bid processes. Subsequently, the department amended the original purchase order and awarded the same vendor five contracts plus four amendments and one additional purchase order. In total, the series of contracts and purchase orders awarded to the vendor were valued at more than \$9.7 million.

Despite having received more than \$9.6 million in payments from the department, the vendor gave one day's notice before abandoning the automated supply chain management system contracted for. According to the internal auditor's report, in June 2004 the request for a \$2.78 million increase in one of the contracts to provide additional services and system enhancements was pulled from the board's agenda. In July 2004 the vendor terminated its services to the department and turned off the system. As a result of the project's failure, the internal auditor reviewed the performance of the department and the vendor during the project and determined that the department had not fully adhered to its guidelines and procedures and had made some inappropriate payments to the vendor.

The department had not sought competitive bids for any of the purchase orders or contracts it awarded, instead basing its decision on its prior experience with the vendor. However, the internal auditor determined that the department's prior experience did not justify claiming this vendor as the sole-source provider for the initial purchase order.

For example, the department had not sought competitive bids for any of the purchase orders or contracts it awarded to the vendor, but instead claimed that the vendor was the sole source for the services the department sought, based on its prior experience with the vendor. However, the internal auditor determined that the department's prior experience with this vendor did not justify it as a sole-source provider for the initial purchase order. In addition, the internal auditor found other problems with the contracts awarded to this vendor and the department's administration of the project, including the following:

- The department's payments on one of the contracts and an amendment exceed their combined value by almost \$150,000.

- The department overpaid invoices where the vendor had overcharged for labor and direct expenses totaling about \$22,600.
- The department has yet to recover the unused portion of the \$275,000 it prepaid for maintenance fees. The vendor has not earned all these prepaid fees because of its early termination of services.
- The department has yet to recover two servers from the vendor's premises, costing more than \$13,000, which it purchased to support the system.
- The department failed to include in one contract a refund or reimbursement clause that would have facilitated a prompt refund of the amounts the department has paid that the vendor did not earn. The department also failed to include a "right to audit" clause in this same contract and one other.
- The department could not locate a complete administrative file for the purchase orders and contracts, which may make it more difficult for the department to resolve contract issues and disputed payments.

As a result of its findings, the internal auditor made recommendations to the department, including the following:

- CPS should provide sufficient justification for sole-source contracts.
- Contract administrators should monitor payments to vendors to ensure that they do not exceed the contract's limits.
- CPS should refer the vendor's early termination of one contract to the city attorney's office.
- CPS should seek to recover overpayments, unearned prepaid fees, and property from the vendor.
- CPS should ensure that contracts include the clauses necessary to protect the department's interests.

On December 22, 2004, the department responded to the internal audit—agreeing to implement all the report's recommendations except those to recover overpayments, unearned prepaid fees, and property from the vendor. For those

recommendations, the department stated that since litigation was pending, it would defer to the city attorney's office to affect the appropriate resolution.

THE ACCOUNTS PAYABLE UNIT DOES NOT ENSURE THAT EXPENDITURES ARE AUTHORIZED PROPERLY

The department's accounts payable unit does not have a system to verify that department staff at the business unit level who are assigned to oversee contractors' work (contract administrators) approve invoices for payment. According to the department's contract administrative manual, the contract administrator's role is to ensure that the vendor and the department fulfill their respective commitments contained in the contract, including approving deliverables and reviewing and certifying proper invoices for payment. The department's *Financial Services Administrative Manual*, the manual that provides guidance to the accounts payable unit, states that before an invoice can be paid, an accounts payable audit clerk must check it against the purchase authority (a purchase order, a sub-purchase order, a contract or legal agreement, or a board resolution), verify that the goods or services invoiced have been received, and verify that the invoice or request for payment has been approved by the contract administrator. If followed, these controls provide assurance that payments are made only for authorized purposes. However, our review of the department's practices and expenditure transactions found that accounts payable relies on the business units to ensure that only authorized employees approve payments to vendors.

When we asked accounts payable how it verified that each invoice was approved by the contract administrator, the assistant manager stated that accounts payable is not overly concerned with who is approving an invoice.

In our review of 45 payments made to vendors in fiscal year 2003–04, we found that the accounts payable audit clerks check invoices and vouchers only for a signature, initials, or a stamp of approval from the respective business unit before processing payments to vendors. They did not check to verify that the individual who initialed the invoice or voucher was, in fact, the contract administrator. When we asked accounts payable how it verified that each invoice was approved by the contract administrator, the assistant manager stated that accounts payable is not overly concerned with who is approving an invoice. According to the assistant manager, accounts payable's concern is that the contract has been approved and that the invoice is billed according to the terms of the contract—it is the contract administrator's responsibility to review and approve the invoice. Because it has not ensured that the appropriate contract administrator has reviewed and approved the invoice, accounts payable cannot be

certain that payments are authorized properly. Therefore, the department is at a higher risk of making payments for services that have not been received or for services outside the scope or limits of the purchase authority.

Accounts payable audit clerks have no way of knowing whether appropriate staff at the business unit approve an invoice because they do not have a system to check whether the person who initialed or stamped an invoice is the one authorized to do so.

We found that many payments approved by the business units were approved by people other than the contract administrator, such as an engineer or a project manager. Specifically, although made for appropriate purposes, for 16 of the 45 payments we tested (36 percent), someone other than the contract administrator approved the invoice for payment. Although we believe it might be reasonable that these individuals review the respective invoices because they may be the ones with the most direct knowledge of the service that was provided, in failing to verify that the contract administrator approved the invoices, accounts payable is disregarding a procedure required by the *Financial Services Administrative Manual* that was intended to prevent unauthorized payments. As a result, accounts payable audit clerks have no way of knowing whether appropriate staff at the business unit approve an invoice because they do not have a system to check whether the person who initialed or stamped an invoice is the one authorized to do so.

CORPORATE PURCHASING SERVICES DOES NOT OVERSEE THE PURCHASING CARD PROGRAM ADEQUATELY

The department's board adopted the city's P-card program in 1996—a program that uses credit cards issued by a commercial bank—for the purpose of establishing a more efficient, cost-effective method of paying for transactions involving small dollar amounts. CPS manages the P-card program. The *Purchasing Card Program Cardholder Manual* (P-card manual) states that CPS use both internal management controls and the P-card system's reporting features to ensure that P-card policies and procedures are followed. However, our review of the department's practices found that CPS does not monitor adequately nor uniformly enforce P-card policies and therefore cannot ensure that it minimizes abuses of the program, such as unallowable or inappropriate purchases. Further, despite similar findings by the department's internal auditor in 2001, CPS has not taken adequate steps to improve its procedures and strengthen its internal controls.

CPS says its limited personnel resources are a barrier to implementing the prior audit recommendations. CPS's administrative services manager stated that CPS has implemented procedural changes, such as changing the way business units are notified of P-card violations and expanding the allowable uses of the P-card, to fulfill the program's goal of being a more effective and efficient way for the department to purchase thousands of items. However, because CPS does not monitor P-card violations effectively or consistently exercise its authority to suspend and/or deactivate P-cards when appropriate, it cannot evaluate the costs and benefits of the program and determine whether it is minimizing abuses.

Corporate Purchasing Services Does Not Monitor P-Card Activities Adequately

Every month CPS audits 20 percent of the cardholders with activity on their cards for compliance with P-card policies. Yet, CPS has not taken steps to use this information to monitor the compliance level of the program better.

Prohibited P-Card Purchases and Actions

- Items available in-house or through existing contracts.
- Computer hardware or software without approval from the department's information technology unit.
- Communications devices and services.
- Car washes, diesel fuel, or gasoline.
- Travel expenses.
- Office supplies.
- Other personal expenses.
- Splitting purchases to circumvent individual purchase limits.

Source: *Purchasing Card Program Cardholder Manual*.

The P-card manual prohibits some actions and the use of P-cards to purchase certain items, including those listed in the text box. However, based on the reports of potential violations found by CPS in its monthly audits, cardholders do not always comply with the manual. We asked CPS to provide copies of its violation reports, which it compiles quarterly based on monthly audits, on the violations found for fiscal year 2003–04. CPS was able to provide the reports only for July 2003 through December 2003 and the month of March 2004. According to CPS, the report for the period April 2004 through June 2004 has not yet been approved, and the potential violations found in January and February 2004 were omitted inadvertently from the reports distributed to business units for the quarter January through March 2004.

In our review of the potential violation reports covering the period from July 2003 through December 2003 and for March 2004, we noted 358 potential violations found by CPS. As shown

in Table 5 on the following page, other than administrative violations, such as submitting documents late and missing approval signatures, the most common P-card violation

Other than administrative violations, such as submitting documents late and missing approval signatures, the most common P-card violation during the seven-month period was the splitting of purchases to circumvent maximum charge limits.

during the seven-month period was the splitting of purchases to circumvent maximum charge limits. Other common violations—those occurring more than 50 times—were the purchase of prohibited items and the purchase of items available through an existing contract.

Similarly, in our testing of 23 P-card purchases made in fiscal year 2003–04 and one made in fiscal year 2002–03, we found one purchase made for a prohibited item, one case in which the cost of a purchase was split to circumvent the daily purchase limit, and one purchase in which the amount charged to the P-card was \$168.87 more than the amount on the vendor’s invoice the employee submitted to support his purchase on behalf of the department. In addition, we found that for nine of the 24 purchases, the receipts did not contain the cardholder’s name or signature, and therefore we could not verify that the authorized cardholder purchased the items. Moreover, there were three other purchases for which someone other than the authorized cardholder signed the receipts, in violation of the policy spelled out in the P-card manual. According to CPS, card sharing has decreased significantly since 2001. However, CPS was unable to provide documentation to support this claim.

TABLE 5

Potential Violations Found in Corporate Purchasing Service’s Monthly P-Card Audits

Type of Violation	July Through September 2003	October Through December 2003	March 2004*	Totals
Item purchased was available through an existing contract	13	15	24	52
Item purchased was prohibited	33	6	15	54
Cost of item purchased was split to circumvent maximum charge limits	83	9	12	104
Item purchased without memo of approval for computer hardware or software	3	3	0	6
Item purchased was an unallowable communications device	1	0	2	3
No receipt was submitted	12	11	5	28
Cardholder did not submit required documents	28	0	7	35
Cardholder exceeded daily transaction limit	0	0	1	1
Cardholder exceeded monthly transaction limit	0	0	1	1
Administrative policies were not followed	56	14	4	74
Totals	229	58	71	358

Source: Purchasing card violations reports.

* CPS was unable to provide violations data for January and February 2004. According to CPS’s administrative services manager, the potential violations found in these months were omitted inadvertently from the quarterly violation report. In addition, the P-card administrator indicated that the audit results for April 2004 through June 2004 were still pending approval.

Although CPS is aware of the types of violations we encountered in our testing, it has not taken steps to ensure that the violations are not repeated, nor has it attempted to use the information it receives to set performance goals or determine what an acceptable violation rate might be. According to CPS, the actual number of violations from monthly audits may be lower because business units may provide an acceptable justification for a potential violation. However, as we discuss later, CPS does not use responses from the business units concerning potential violations to compute the true violation rate.

Although monthly reports submitted by business units may contain valuable information, such as instances of inappropriate use of the cards or a lack of receipts, CPS does not retain, monitor, or track the information contained in these documents and does not follow up except to determine whether all business unit staff have submitted their cardholders' monthly statements.

In addition to potential violations found in the monthly audits performed by CPS, business unit staff also brings potential violations to the attention of CPS. Every month, staff in each business unit reconcile the P-card payment records with the bank statements for each cardholder in their unit and summarize policy violations and discrepancies on a report provided to CPS. Although these documents may contain valuable information, such as instances of inappropriate use of the cards or a lack of receipts, CPS does not retain, monitor, or track the information contained in these documents and does not follow up except to determine whether all business unit staff have submitted their cardholders' monthly statements. In fact, CPS could locate the business unit summary reports for only nine of the 24 transactions we tested. According to CPS, it plans to review the current process to assess the appropriateness of tracking these documents in the future.

Lastly, although CPS requires business unit managers to document justifications for questioned transactions or the corrective actions taken in response to potential violations found among P-card users in their respective business units, CPS does not follow up on these responses to ensure that violations are enforced uniformly. After receiving a report of potential violations from CPS's monthly audit findings, the business unit manager is required to justify why the transactions reported are not violations or document the corrective actions taken and send this response back to the P-card administrator. However, CPS does not monitor these responses beyond checking to see that the business unit manager asserts that action was taken. Specifically, CPS does not attempt to track this information to ensure that the actions taken by the business units are preventing repeat violations or to examine trends in the information to identify those cardholders who repeatedly violate P-card policies. Further, as we discuss in the next

section, business units are not provided with any guidance or criteria regarding how to enforce P-card policies uniformly or when employees' P-cards should be deactivated due to policy violations.

By not sufficiently monitoring the results of its monthly audits or the violations noted by business unit staff in their monthly reports, CPS is foregoing opportunities to assess the program's compliance level.

By not sufficiently monitoring the results of its monthly audits or the violations noted by business unit staff in their monthly reports, CPS is forgoing opportunities to assess the program's compliance level. Therefore, it cannot determine whether violations are being repeated by the same cardholders or whether violations in general or of a specific type are on the rise or declining. In addition, by not actively monitoring the business unit managers' responses to suspected violations through tracking and appropriate follow-up, CPS cannot ensure that the actions taken are effective or that P-card policies are being enforced uniformly. Better monitoring and analysis of these sources of information could be a valuable tool in assessing the cost-effectiveness of the P-card program. According to its administrative services manager, CPS plans to implement a system of monitoring that includes the following to improve its review process of the P-card program:

- Retain for three to six months the records of cardholders with program violations to track whether such violations persist.
- Compile and maintain a database to identify repeat abusers that will serve as a basis for suspending or revoking P-cards.
- After a thorough review of activities, implement necessary actions (suspension or cancellation of P-cards) for persistent violators, with proper notification to the cardholders' supervisors.

Corporate Purchasing Services Does Not Ensure That P-Card Policies Are Enforced Consistently

CPS fails to enforce P-card policies consistently. According to CPS, it has the authority only to restrict, suspend, or cancel P-cards; the responsibility for enforcing P-card policies by other means resides with the business units. However, CPS has provided no guidance to the business unit managers on when it would be appropriate to take action against the use of P-cards.

As we discussed in the previous section, when CPS finds suspected violations in its monthly audits, it documents them and sends a quarterly report to the business unit managers, who are required to provide a written response justifying why

questioned transactions are not violations or indicating the corrective actions taken. However, CPS has not provided any guidance to the business units, beyond the information in the P-card manual, on what constitutes appropriate corrective action against a P-card for the various types of violations or for repeated violations. Therefore, CPS cannot ensure that the business units are taking appropriate and consistent corrective action for similar violations or that they are preventing repeat violations. In fact, when we contacted two business unit managers and two directors, we found that the corrective actions taken in different units for the same type of violation may not be consistent and that there are no clear guidelines for responding to P-card violations. Each individual we contacted indicated that corrective action generally is determined on a case-by-case basis.

CPS has not developed clear criteria for determining when it is appropriate to restrict, suspend, cancel, or deactivate a P-card.

CPS has not developed clear criteria for determining when it is appropriate to restrict, suspend, cancel, or deactivate a P-card. For instance, the P-card manual indicates that persistent cardholder violations may result in the suspension or cancellation of a P-card, but neither CPS nor the business units have implemented a system for monitoring repeat violations. Further, CPS does not follow up when the action taken by a business unit in response to a violation is unclear. For example, when a cardholder exceeded the established daily transaction limit, the business unit manager reported to CPS that the violation was reviewed and the appropriate action was taken. Without follow-up to determine the exact nature of the corrective action, CPS cannot ensure that the business unit appropriately enforced the policy.

Because it has not developed clear criteria for deactivating or suspending a P-card, CPS cannot ensure that business units or CPS itself consistently responds to violations. According to CPS, there were two instances in fiscal year 2003–04 in which CPS suspended a P-card for persistent and gross violations of program policy. In one case, the card was canceled because it exceeded the monthly \$20,000 limit. However, CPS appears to have been inconsistent in how it responds to this type of violation. During our testing, we asked CPS whether any cardholders selected in our sample had been included in its monthly audits, and we were advised that one cardholder in our sample had been audited and was found to have exceeded the \$20,000 monthly credit limit. When we asked why this violation, which occurred in March 2004, did not appear on the March 2004 violation list, the administrative services manager for CPS told us that it was omitted inadvertently from the violation list because the

cardholder had transferred to another business unit and had been issued a new card. We then asked CPS to explain why one card was canceled for exceeding the monthly credit limit and this one was not, and the manager reiterated the reason she had given previously for not including the violation in the March 2004 violation list. She did not explain why the cardholder's new card was not canceled.

CPS has not developed criteria or a process for deactivating long inactive P-cards to reduce the risk of inappropriate use and to ensure that access to P-cards is secure.

In addition, CPS has not developed criteria or a process for deactivating long inactive P-cards to reduce the risk of inappropriate use and to ensure that access to P-cards is secure. According to the administrative services manager for CPS, the business units are responsible for notifying CPS if a card no longer is needed for their operations and requesting the card's cancellation. Apparently, however, this rarely occurs. CPS has access to reports of P-card activity that list the number of cards that have shown no purchase activity for one or more months. The June 2004 report lists 41 cards that have been inactive for 24 months or more. Of these cards, 14 have a monthly charge limit of \$20,000 each. According to CPS, it has contacted some business unit managers about the inactive cards assigned to their units, and they asked to keep the cards for possible future use. CPS states that it will develop a policy for deactivating P-cards that show no activity for a period that will be determined with input from the business units, because some cards are held for the purpose of responding to emergencies based on the nature of the business units' operations.

The Department Has Not Responded Adequately to Past Audit Findings Relating to Its Purchasing Card Program

A prior audit conducted by the department's internal auditor reported findings similar to ours concerning the types of noncompliance, the lack of monitoring, and the need to enforce P-card policies better. However, the department has been unable to provide evidence that it has taken any substantive action to correct or control the program's deficiencies. The internal audit report, released in March 2001, found that some purchases lacked original receipts, were split to circumvent maximum purchase limits, were made for items available through an existing contract or found in current inventory, were made by someone other than the cardholder, or contained clerical errors on purchasing activity reporting forms. In addition, it found that disciplinary actions were not enforced effectively and unissued cards were not secured. As we discussed previously, our

testing as well as CPS's monthly audits continue to find many of the same kinds of violations as those noted in the March 2001 internal audit report.

CPS responded to the department's 2001 internal audit report by attempting to create a policy implementing a progressive system of warnings to cardholders concerning policy violations and, after the first three P-card policy violation letters had been sent, suspending the cardholder's P-card for a fourth violation. However, the department's labor relations office advised CPS that the way the proposed policy was written was confusing and conflicted with current disciplinary policies. Therefore, CPS revised its guidelines and instead implemented a process for notifying business units of potential P-card violations found in monthly audits and requiring the business unit manager to respond to CPS with the justification for questioned transactions or the corrective actions taken. Before the department's internal audit report, violation notices were sent directly to the cardholder.

In addition, CPS indicated that it now emphasizes the unacceptable uses of P-cards, such as the splitting of purchases and card sharing, in its cardholder training sessions. However, it was unable to demonstrate whether this increased emphasis has had an impact on the violation rate. In CPS's formal response to the 2001 internal audit report, it set performance goals of decreasing the rate of violations involving the splitting of purchases from 5 percent to 2 percent, decreasing the rate of unallowable purchases from 6 percent to 2 percent, and eliminating card sharing altogether. However, it has not effectively tracked these types of activities or implemented other procedures to achieve these goals. According to its administrative services manager, CPS is unable to measure its progress in achieving such goals because the number of cardholders has increased over the years and the number of transactions audited has decreased from 100 percent to 20 percent. Additionally, she indicated that some purchases that previously were not allowed, such as dues and memberships, are now allowable with general manager approval and, therefore, it would be difficult to compare past and current violations. We do not believe that any of the reasons stated prevent CPS from using the information it already has to assess its progress in these areas.

DECENTRALIZED RESPONSIBILITY FOR MAINTAINING PERSONNEL FILES REDUCES COMPREHENSIVE PERSONNEL RECORD KEEPING AND OVERSIGHT OF POSITIONS

For four of the 12 civil service personnel actions we reviewed, the department's business units could not provide the documents necessary to support and explain their hiring and promotion decisions for these positions.

The department's policy of decentralizing its personnel record-keeping functions has reduced its ability to ensure that it adequately maintains personnel files that contain the records required by department policy. According to the director of human resources, the department maintains a personnel office in each of its 34 business units. These personnel offices are responsible for administrative and clerical functions, such as ensuring that all personnel transactions are consistent with the city's civil service rules and policies and with the city charter, scheduling training, and maintaining personnel files for business unit employees. However, for the 12 civil service personnel actions we reviewed, the department's business units could not locate in the prescribed personnel files documents supporting the civil service appointments for two of four new employees and for two of four promoted employees. As a result, the business units could not provide the documents necessary to support and explain their hiring and promotion decisions for these positions.

Further, we reviewed the department's 15 positions that the mayor and the city council approved as exempt from the city's civil service system (exempt positions). We found that for nine of these exempt positions the department could not locate evidence demonstrating that the employees who occupy them possess the educational, professional, or work experience qualifications the department used to justify exempting these positions from civil service regulations. However, nothing came to our attention to suggest that these candidates were not qualified for their appointments. According to the department's director of human resources, during the course of our audit the acting general manager took action to correct this condition by instructing her to ensure that each of the personnel files for the department's exempt employees contain résumés describing their qualifications and to ensure that the personnel files for these exempt employees are maintained by the assistant general manager for employee relations.

Except for specific positions exempted by the city charter or by approval from the mayor and the city council, the department is subject to the city's civil service system and is required to follow the city's civil service rules and city charter when executing personnel actions, such as hiring, promoting, or

Although nothing came to our attention to suggest that nine of the department's civil service exempt employees were not qualified for their appointments, the department's business units could not locate evidence demonstrating that these exempt employees possess the educational, professional, or work experience qualifications the department used to justify exempting these positions from civil service regulations.

firing. Under the city's civil service rules, an appointment to a position, through either hiring or promotion, is determined through a competitive process and can be made only from a list of eligible applicants. This list must be certified by the city's personnel department to contain the persons ranked with the highest three examination scores or at least five more applicants than the number of vacancies to be filled. Although the city's personnel department is responsible for providing a certified list of eligible candidates for the department's vacant positions, the department is responsible for ensuring that its business units follow the city's rules for selecting their appointees from the certified list.

In addition to its civil service positions, the department maintains 19 positions that are exempt from the city's civil service system. These positions are primarily the general manager, assistant general managers, executive assistants to the general manager, and the chief financial officer. Four of these positions are expressly exempted from the civil service system by the city charter, and the mayor and city council must approve the remaining 15 exempt positions. To gain approval for these 15 exempt positions, the department must provide to the mayor and city council a request that includes the educational, professional, or work experience requirements for the positions that justify their exemption from the civil service rules.

Under its current policy, the department is to maintain a single personnel file for each employee to document his or her work history at the department. The personnel office of each business unit is to maintain these personnel files for its current employees. When employees transfer between business units within the department, the business units are to ensure that the employees' personnel files are forwarded to the business unit to which they are transferred. The department's administrative manual details the types of documents that should and should not be maintained in these personnel files. Included in the list of documents to be maintained are those that support and explain the department's selection process for new and promoted civil service employees. The department's policy further requires that business units review and maintain these documents for a minimum of two years and then forward them to records retention. The department's stated priorities for its policy regarding the maintenance of personnel files include:

- Ensuring that an employee's complete department work history is maintained in only one file.

- Ensuring that supporting documentation is available for the verification of critical data entered into the automated personnel and payroll systems.
- Providing for uniform filing and records retention of employee personnel records.

Further, the department's administrative process for resolving employment discrimination complaints includes a review of the documents necessary to investigate the complaint. Documents that are needed to support or explain the department's selection of new or promoted employees would be necessary to investigate such complaints.

However, based on the results of our review, in which the department's business units could not provide supporting documentation for one-third of the civil service personnel actions and three-fifths of the exempt personnel actions we selected, the department's current policy of decentralizing the maintenance of employees' personnel files does not further its priorities regarding the documents to be retained in personnel files.

Moreover, according to research conducted by the department's director of human resources, for seven of the department's exempt positions, the individuals who occupy them carry job titles and perform duties that are different from the job titles and duties the department provided to the mayor's office and the city council to gain exemption from the city's civil service system. In fact, the director's research shows that the titles and duties of these seven positions do not match any positions that the mayor and city council approved. Table 6 contains the job titles assigned to the seven employees that occupy the exempted positions approved by the mayor and city council.

We asked the acting general manager why the department has used these exempt positions for duties other than what they were approved for, but he did not respond. When the department uses its exempt positions for job duties other than those approved by the mayor and city council, it reduces the control that the city charter intended the city to have over these positions. Moreover, because the city council's approval is granted through public hearing and city ordinance, the department's current practice regarding these exempt positions reduces the transparency to the public of the department's use of exempt positions.

When the department uses its exempt positions for job duties other than those approved by the mayor and city council, it reduces the control that the city charter intended the city to have over these positions.

TABLE 6

**Exempt Employees Whose Assigned Duties Do Not Match
the Approved Exempt Positions They Occupy**

Assigned Title	Approved Exempt Position Occupied
Assistant general manager, customer service organization	Assistant general manager, power distribution
Assistant general manager, business process improvement program	Director of customer services
Executive assistant to the chief administrative officer	Director of government, regulatory, and legislative affairs
Medical director	Director of policy development
Executive assistant to the assistant general manager for power generation	Budget director
Director of power supply operations	Assistant director of distribution
Manager of equal employment opportunities	Manager of water resources

Source: The department's director of human resources.

RECOMMENDATIONS

To ensure that the department receives high-quality services and materials at the best available prices and does not thwart the board's control over the department's contracts, CPS should:

- Comply with department and city competitive bidding policies when awarding contracts for goods or services.
- Recognize when the contracts it awards are extensions of existing contracts and seek board approval when the amended amount exceeds the threshold contained in the department's policy for obtaining such approval.
- Promptly implement the recommendations presented in the department's internal auditor's November 2004 report on a series of contracts and purchase orders for the department's implementation of a supply chain management system.

Further, to improve its controls over the contracts awarded for goods and services, CPS should ensure that its staff members sign contracts that obligate the department only when they are properly authorized to do so.

In order to ensure that the department processes payments correctly and to ensure that payments are made only for authorized purposes, accounts payable should strengthen its internal control procedures to include a process for verifying

that the contract administrator at the business unit level reviewed and authorized the invoice before approving that invoice for payment.

To strengthen the oversight over the P-card program and obtain the information needed to evaluate the costs and benefits of the program and minimize abuses, CPS should:

- Collect and use the information that results from CPS audits of cardholders' purchases and business unit reports of P-card policy violations to track violations on an ongoing basis, including repeat violations, of P-card policy.
- Track and follow up business unit managers' responses to reports of suspected P-card policy violations that result from CPS audits of cardholders' purchases to ensure that the corrective actions business unit managers take against P-cards are effective and that policies are enforced consistently.
- Provide clear guidance for determining the appropriate corrective action business units should take against a P-card in response to violations and clear criteria for determining when it would be appropriate to restrict, suspend, cancel, or deactivate a P-card. Further, CPS should ensure the uniform enforcement of such policies through its improved monitoring efforts.
- Develop criteria or a process to deactivate long inactive P-cards to reduce the risk of inappropriate use and to ensure that access to P-cards is secure.
- Use the information and data available, such as transaction data, compliance data, and activity data, to establish goals for minimizing the rates of policy violations for the P-card program on an ongoing basis.

To ensure that it achieves its policy for a single comprehensive record for employees' work history and uniform filing and records retention of employee personnel records, the department should consider changing its policy of decentralized personnel record keeping and establish a centralized system, administered and maintained under the supervision of the department's director of human resources. In addition, the department should seek approval from the mayor and city council when it uses its exempt positions for duties other than those previously approved by the city.

We conducted this review under the authority vested in the California State Auditor by Section 8543 et seq. of the California Government Code and according to generally accepted government auditing standards. We limited our review to those areas specified in the audit scope section of this report.

Respectfully submitted,

A handwritten signature in black ink that reads "Elaine M. Howle". The signature is written in a cursive, flowing style.

ELAINE M. HOWLE
State Auditor

Date: January 26, 2005

Staff: Doug Cordiner, Audit Principal
Norm Calloway, CPA
Matt Espenshade
Alysha Loumakis-Calderon

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Agency's comments provided as text only.

Department of Water and Power
111 North Hope Street
Los Angeles, CA 90012-2607

January 7, 2005

Ms. Elaine M. Howle, State Auditor*
Bureau of State Audits
555 Capitol Mall, Suite 300
Sacramento, California 95814

Dear Ms. Howle:

Re: Audit of Los Angeles Department of Water and Power

Thank you for the opportunity to review the Bureau of State Audits' draft report on the audit requested by the Joint Legislative Audit Committee. Your staff is to be congratulated on their thorough, detailed and objective analysis of the Department of Water and Power's transfers of funds, contracting policies, and personnel procedures.

Those who are charged with the responsibility of ensuring that all monetary transfers to Los Angeles' Reserve Fund fully comply with our municipal charter are gratified by the audit's finding that "the Department's transfers of money to the City for general use are allowable and complied with the City Charter." This conclusion is further supported by your demonstration that transfers from the Water and Power Revenue Funds complied with the terms of the Department's bond provisions. Moreover, you have demonstrated that such transfers of municipal utility funds to a city's general fund is a common practice among California cities. I fully endorse the audit's findings on the propriety of this Department's intra-city transfer of funds.

The draft audit's findings that the Department needs to improve its controls over contracts, expenditures and personnel records will be studied in depth. Recommended improvements in these areas not already implemented will be given great weight in this Department's ongoing review of contracting and personnel policies. Your report will assist in our efforts to improve service to our customers and the citizens of Los Angeles. Department of Water and Power staff have prepared detailed comments to each of the sections of the draft audit. They are enclosed herewith for your

* California State Auditor's comments begin on page 61.

Ms. Elaine M. Howle
Page 2
January 7, 2005

reference. It is requested that this written response and all attachments be considered in the process of final editorial review and included in the final report when issued.

Sincerely,

(Signed by: Ronald F. Deaton)

Ronald F. Deaton
General Manager

Enclosures

**Los Angeles Department of Water and Power
Response to California State Auditor Report Entitled:
“Los Angeles Department of Water and Power: Its Transfers of Funds to the City
Comply With the City Charter; However, It Needs to Improve Its Controls Over Contracts,
Expenditures, and Personnel Records”**

SUMMARY

Transfers of Funds to the City

The Department concurs with the audit’s factual findings and conclusion that the transfer complies with the City Charter.

Contracts and Purchase Orders

Corporate Services Response:

Corporate Purchasing Services (CPS) operates within the governance of the City Charter, the L. A. Administrative Code, and City programs in addition to the principles and practices advocated by the Institute of Supply Management and the California Association of Public Purchasing Officers.

There are several factors to consider in the analysis and determination of the procurement method most appropriate for the Department’s needs or requirements. Input from the requesting operating business units and the assigned procurement professional, and advice from the City Attorney’s Office are considered in determining the procurement method to be used by the Department.

The audit consistently refers to procurement of goods and services at the “best available prices”; however, City Charter Section 371 states:

Contracts shall be let to the lowest responsive and responsible bidder furnishing satisfactory security for performance. This determination may be made on the basis of the lowest ultimate cost of the items in place and use. Where the items are to constitute a part of a larger project or undertaking, consideration may be given to the effect on the aggregate ultimate cost of the project or undertaking.

There are a number of exceptions to the competitive bid process as indicated in City Charter Section 371(e). Competitive bidding is solicited whenever practicable. There are instances where bidding is not in the best interest of the Department and does not provide the lowest ultimate cost. The Charter also recognizes there are operating requirements where the standard for award is not the lowest cost but the lowest ultimate value provided by a responsive and responsible vendor for products or services complying with specifications.

We concur with the auditor's findings that there were no significant issues in the administration of the twelve contracts reviewed.

The auditors were also informed that signature authority of the Senior Utility Buyer who signed the contract referred to in the Summary had authority to review up to \$100,000. However, Senior Utility Buyers were given verbal authority to sign contracts up to \$150,000, in the absence of the manager who had signature authority up to \$150,000. The Assistant Purchasing Director at that time (now retired) had given that authority to the Senior Utility Buyers.

Payments to Suppliers

Financial Services – Information factually presented

Purchasing Card Program

Corporate Services Response:

The broad statement in paragraph 6 that CPS has not implemented procedures regarding the P-card program violations is inaccurate. CPS has developed policies, guidelines, and a training manual concerning the use of P-cards. In addition, training has been provided to cardholders on the use of the P-cards. CPS has been consistently assessing compliance with program policy within the staffing and resources available in the business unit. Changes have been implemented as recognized by the auditors in their discussion in Chapter 2.

The auditor acknowledges that the Department revised its guidelines and implemented a process for notifying business units of potential P-card violations found in monthly audits and requiring the business unit manager to respond to CPS with the justification for questioned transactions or the corrective actions taken. Prior to the department's internal audit report, violation notices were sent directly to the cardholder.

Any corrective actions taken in response to employee violations of P-card program policies are the responsibility of the individual's supervisor or manager. The Department is reviewing its policies and procedures to ensure uniform enforcement of its P-card program.

Personnel Records

Employee Relations – Information factually presented.

INTRODUCTION

BACKGROUND

Information factually presented

THE DEPARTMENT ANNUALLY TRANSFERS FUNDS TO THE CITY

Information factually presented

THE DEPARTMENT'S EMPLOYMENT PRACTICES ARE SUBJECT TO THE CITY'S CIVIL SERVICE SYSTEM

Employee Relations - Information factually presented.

SCOPE AND METHODOLOGY

Financial Services – Information factually presented.

Employee Relations - Information factually presented.

Corporate Services – We concur with the Auditor's findings that there were no significant issues in the administration of the 12 contracts reviewed.

CHAPTER 1

The Department's Transfers of Funds to the City for General Use Are Allowable and Complied With the City Charter

CHAPTER SUMMARY

Information factually presented.

TRANSFERS OF WATER AND POWER FUNDS COMPLY WITH THE CITY CHARTER

The Department concurs with the audit's factual findings and conclusion that the transfer complies with the City Charter.

TRANSFERS FROM THE WATER FUND AND POWER FUND COMPLIED WITH THE TERMS OF THE DEPARTMENT'S BOND PROVISIONS

The Department concurs with the audit's factual findings and conclusion that the transfer complies with the terms of the Department's bond provisions.

TRANSFERS OF UTILITY FUNDS TO CITY FUNDS ARE COMMON

Information factually presented.

CHAPTER 2

The Department Needs to Improve Its Controls Over Contracts, Expenditures, and Personnel Records

CHAPTER SUMMARY

Financial Services Response:

While the contract administrator may delegate the approval function, Accounts Payable staff performs a second line review consisting of a three-way match to ensure that it pays a valid claim. Accounts Payable requires an approval signature/stamp in the approval block of voucher control forms. However, as the Audit Report points out, Accounts Payable does not validate the signature against a centralized signature authority list. We are implementing process changes to address this issue.

Employee Relations - Information factually presented.

Corporate Services Response:

- The Department does not concur with the finding that CPS failed to follow department and city policies.
- In paragraph 2, CPS does not provide oversight to Accounts Payable Unit. The Accounts Payable unit is a part of the Financial Services Organization.
- CPS has been continually assessing compliance with the P-Card program policy within the staffing and resources available in the business unit. Changes have been implemented as recognized by the auditors in their discussion in Chapter 2.

CORPORATE PURCHASING SERVICES DOES NOT ALWAYS FOLLOW ITS OWN AND THE CITY'S POLICIES FOR COMPETITIVE BIDDING CONTRACTS FOR GOODS AND SERVICES

Corporate Services Response:

The auditors were informed that signature authority of the Senior Utility Buyer who signed the contract referred to in the Summary had authority to review up to \$100,000. However, Senior Utility Buyers were given verbal authority to sign contracts up to \$150,000, in the absence of the manager who had signature authority up to \$150,000. The Assistant Purchasing Director at that time (now retired) had given that authority to the Senior Utility Buyers. The Department will ensure that appropriate written delegation is given to its Utility Buyers.

CORPORATE PURCHASING SERVICES AWARDED CONTRACTS FOR GOODS AND SERVICES WITHOUT OBTAINING REQUIRED APPROVALS

Corporate Services Response:

The first contracts discussed in this section were competitively bid according to City Charter Section 372. However, because the same vendor was successful in each competitive process, it may have been prudent to have the contract ratified by the Board. The auditors' findings regarding the second contract discussed in paragraph 5 are attributed to the difference in legal opinions.

THE DEPARTMENT'S INTERNAL AUDITOR IDENTIFIED SEVERAL ISSUES RELATED TO ITS ADMINISTRATION OF A SERIES OF CONTRACTS

Corporate Services Response:

The Department is in the process of implementing many of the Internal Auditor's recommendations concerning these contracts. However, since there is the potential for litigation concerning these contracts, the Department is working with the City Attorney's Office as to the appropriate manner in which to implement the Internal Auditor's recommendations.

At this time, further comments on this section by the Department are not appropriate.

THE ACCOUNTS PAYABLE UNIT DOES NOT ENSURE THAT EXPENDITURES ARE PROPERLY AUTHORIZED

Financial Services Response:

Accounts Payable is taking action to get an updated list of contract administrators and their designees, for signature authority. This listing will be maintained and updated by Accounts Payable.

CORPORATE PURCHASING SERVICES DOES NOT ADEQUATELY OVERSEE THE PURCHASING CARD PROGRAM

Corporate Services Response:

● The broad statement in paragraph 1 that CPS has not taken adequate steps to improve its procedures and strengthen its internal controls is inaccurate.

CPS has been continually assessing compliance with the P-card program policy within the staffing and resources available in the business unit. Changes have been implemented as recognized by the auditors in their discussion in Chapter 2.

● Any corrective actions taken in response to employee violations of P-card program policies are the responsibility of the individual's supervisor or manager. The Department is reviewing its policies and procedures to ensure uniform enforcement of its P-card program.

DECENTRALIZED RESPONSIBILITY FOR MAINTAINING PERSONNEL FILES REDUCES COMPREHENSIVE PERSONNEL RECORD KEEPING AND OVERSIGHT OF POSITIONS

Employee Relations Response:

● The information contained within this section is factual. The title Director of Human Relations is interchanged with Director of Human Resources; however this does not change the substance of the document.

RECOMMENDATIONS

Contracts and Purchase Orders

Corporate Services Organization concurs with the recommendations contained herein except as noted above.

Payments to Suppliers

Financial Services Organization concurs with the recommendation contained herein.

Accounts Payable is taking action to get an updated list of contract administrators and their designees, for signature authority. This listing will be maintained and updated by Accounts Payable.

Purchasing Card Program

Corporate Services Organization concurs with the recommendations contained herein except as noted above.

Personnel Records

Employee Relations Organization concurs with the recommendations contained herein.

Personnel Folders for all exempt employees have been established and contain resumes as well as other documents supporting appointments to the positions. The Assistant General Manager of Employee Relations now has possession of and maintains folders for Charter Section 1001 exempt employees. Additionally, centralization of all remaining Department employee folders within the Human Resources Business Unit will begin in April 2005.

Charter Section 1001 exempt positions are being reviewed and when appropriate, the Department will forward recommendations to the Mayor and City Council for approval.

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COMMENTS

California State Auditor's Comments on the Response From the Los Angeles Department of Water and Power

To provide clarity and prospective, we are commenting on the response by the Los Angeles Department of Water and Power (department) to our report. The numbers below correspond to the numbers placed in the margins of the department's response.

- Although the department asserts that there are instances where bidding is not in the best interest of the department and does not provide the lowest ultimate cost, it did not provide any evidence that the two contracts we discuss on pages 27 and 30 represent such instances.
- We point out on page 29 the assertion made by Corporate Purchasing Services (CPS) that this senior utility buyer received verbal authorization to sign the contract from a former assistant purchasing director. However, we also state on pages 29 and 30 that the department's purchasing policies do not provide for such verbal authorization.
- The statement we made is accurate, however, the department has mischaracterized what we said. On page 3 we state that CPS has not implemented procedures to use available information on violations of purchasing card (P-card) program policies, such as the results of CPS audits of cardholders' purchases and business unit staff reports of P-card policy violations. The use of such procedures would enable CPS to consistently assess compliance with, or ensure uniform enforcement of, P-card program policies. Further, beginning on page 36 and continuing through page 43, we discuss several shortcomings in CPS's oversight of the P-card program. These included inadequate monitoring of P-card activities, failing to ensure that P-card policies are enforced consistently, and the inadequate response by CPS to past audit findings relating to the P-card program.
- We understand that disciplinary action in response to a P-card violation is the responsibility of the cardholder's supervisor or manager. However, we believe that since CPS is responsible for

oversight of the P-card program, it should provide guidance to business units on when it would be appropriate to recommend a P-card be restricted, suspended, or canceled.

- The department states that it does not concur with our finding, but does not state why. As a result, we are unable to address its concerns.
- In the sentence cited, we were transitioning from one paragraph to the next and did not intend to represent that CPS is responsible for the accounts payable unit. To avoid any confusion, we revised the sentence.
- On page 3 we state that CPS has not implemented procedures to use available information on violations of P-card program policies, such as the results of CPS audits of cardholders' purchases and business unit staff reports of P-card policy violations. The use of such procedures would enable CPS to consistently assess compliance with, or ensure uniform enforcement of, P-card program policies. Further, beginning on page 36 and continuing through page 43, we discuss several shortcomings in CPS's oversight of the P-card program. These include inadequate monitoring of P-card activities, failing to ensure that P-card policies are enforced consistently, and the inadequate response by CPS to past audit findings relating to the P-card program.
- The response by CPS that "it may have been prudent to have these contracts ratified by the board" implies it had discretion in these instances. However, as stated on pages 30 through 32 of our report, we believe that board approval of these contracts was required under the board's resolution.
- We revised the report to consistently use the title "director of human resources."

cc: Members of the Legislature
Office of the Lieutenant Governor
Milton Marks Commission on California State
Government Organization and Economy
Department of Finance
Attorney General
State Controller
State Treasurer
Legislative Analyst
Senate Office of Research
California Research Bureau
Capitol Press