# Costa Mesa Sanitary District

...an Independent Special District



July 29, 2016

The Honorable Shawn Dewane
and the Board of Directors
Mesa Water District
1965 Placentia Avenue
Costa Mesa, CA 92627

Dear President Dewane and Board Members:

Last night, the Costa Mesa Sanitary District (CMSD) Board of Directors discussed the so-called "Optimal Governance Structure Study" prepared for your District by Arcadis U.S., Inc. The Board received an analysis of the study from CMSD Treasurer, Marc Davis. Attached for your review is his written analysis.

Mr. Davis has more than thirty years of experience in governmental auditing, accounting and finance management. He a Certified Public Accountant (CPA) and has previously served as Acting Finance Director at both the City of Costa Mesa and the City of Buena Park. Mr. Davis has successfully prepared auditing services of many local, state and federal agencies, including the Department of Justice.

We believe Mr. Davis' experience, skills and knowledge in government accounting and financing makes him extremely well-qualified to perform an analysis and peer review of Arcadis' study and determine its accuracy. As you will see in the attached report, Mr. Davis found numerous flaws and incorrect information in the document that was provided to your agency. We strongly believe that the proposed advisory measure for the November 2016 ballot is extremely premature, as well as ill-informed, hastily prepared and largely inaccurate. In the best interests of the citizens of our community, we urge you to reconsider placing such a measure on the ballot.

We remain open to working with you and other stakeholders on ways in which our two agencies can work together to save money for the betterment of our organizations and the community.

Sincerely,

Michael Scheafer
CMSD Board President

C: CMSD Board of Directors
Scott Carroll, CMSD General Manager
Paul Shoenberger, Mesa Water General Manager

# Memorandum

**To:** Scott Carroll, General Manager

**From:** Marc Davis, Treasurer

**Date:** July 28, 2016

**Subject:** Analysis of Optimal Governance Structure Study

At your request, I have reviewed the Optimal Governance Structure Study (Study) dated July 20, 2016, prepared by Arcadis U.S., Inc. for Mesa Water District (Mesa Water). The purpose of the Study was to perform a high-level evaluation of the combination of Mesa Water with the Costa Mesa Sanitary District (CMSD), and determine what efficiencies and economies of scale could be realized by a combined agency. The following items represent issues or flaws with the report that should be addressed in order to provide an accurate portrayal to the CMSD Board of Directors.

***General Comments***

(1) There is uncertainty as to objectivity in the report. Mesa Water has previously awarded at least one contract to Arcadis in the past, and Arcadis has proposed on a number of other opportunities with Mesa Water for which it was not the successful proposer. When undertaking a study that considers the consolidation of two agencies, it would make better sense to engage a qualified consultant that has no previous ties to either of the agencies. This would ensure that an unbiased, objective report would be prepared. While I am sure Arcadis is a reputable firm, there is a perception of bias that should be eliminated in such an undertaking.

(2) Section 1.2, *Sources*, refers to the sources of information used in preparing the Study. The sources are delineated in the References section at the end of the Study. The sources used for determining financial information of the CMSD includes prior audited financial statements for fiscal years 2011-12 through 2014-15. As such, the most recent financial information used was more than one year old and does not accurately reflect the current financial condition of the CMSD. It makes no sense to use outdated financial information in the development of cost savings for a combined agency.

The Study also utilized the 2012-13 budget, 2013-2015 biennial budget and 2015-2017 biennial budget. The 2015-2017 biennial budget was adopted in June 2015, more than a year ago. While it reflects the original spending plan of the CMSD for the biennial period, plans change. The Study did not take into account the various budget adjustments which have been approved by the Board since the biennial budget's adoption. Without these various changes to the CMSD's spending plan taken into account, any projections of potential costs or cost savings are flawed.

(3) Section 1.2.2, *Mesa Water District*, indicates that Mesa Water is an AAA-rated independent special district. This statement is a little misleading. The AAA rating is a bond rating assigned to both of Mesa Water's certificates of participation. Bond ratings are assigned to the debt to give an indication as to the creditworthiness of the issuer associated with the specific issuance.

(4) Section 1.3, *Approach*, identifies the assumptions used in the preparation of the Study. At the end of this Section, Arcadis states "...Actual savings to be realized depends on a number of actions and conditions that cannot be predicted at this time and could be less than or greater than the estimate in the Study. No assurance is given that the results forecasted herein will be achieved." As such, it would be unwise to make major decisions based upon the results of the Study when the preparer cannot provide any assurance as to the results.

(5) Section 2.1.5, CMSD's *Asset Replacement Plan/CIP*, indicates that Arcadis is unclear whether CMSD has a long-term (100-year) asset replacement plan. The CMSD does have a Replacement Planning Model (RPM) that was developed by an outside consultant an implemented in 2011. The RPM was developed based upon a 35-year rolling look-ahead period in determining annual amounts to set aside for replacement. Upon implementation of the RPM, the CMSD has utilized these annual amounts in prioritizing funding for its various capital improvement projects.

(6) Section 2.3.1, *Customers/Service Area*, states that an assumption is that the new combined service area would remain unchanged. This does not make sense. By having the combined service area remain unchanged, a special district would exist that would not provide all services to its constituents. For example, there are areas where Mesa Water provides water services, but wastewater and solid waste are provided by an agency other than CMSD. Likewise, there are areas where CMSD provides wastewater and solid waste services, but water is provided by an agency other than Mesa Water. The optimal structure would have the service area be the same for the combined agency. This would involve bringing the City of Newport Beach, the County of Orange and Irvine Ranch Water District to the table to discuss service areas. This would be a more difficult process, but it would be the right thing to do.

## ***Specific Comments Regarding Estimated Savings***

### Organization Optimization

Section 2.3.2, *Combined Organizational Structure*, indicates that savings will be realized by combining agencies. I agree with this. However, the positions identified as those that may be eliminated and those that may be retained were determined with a flawed methodology. Duplicative services were determined based upon a review of budgets, job descriptions, organizational charts and other information. There is no way to accurately determine duties performed by reading job descriptions. Many of the job descriptions are broad to allow for a variety of duties that an individual employee may perform. The only way to accurately assess what people are actually doing is through interviews and observations. The Study is silent as to whether these methods were used. We know they were not used at CMSD. It has been my experience in reviewing organizational structures that often times what people are actually doing is different than what the job description says.

A more appropriate methodology to determine an optimal organizational structure would have been to interview all employees, determine duties actually performed, determine positions and responsibilities required under the combined agency, determine appropriate compensation and benefits under the combined agency, then calculate any cost savings.

The Study indicates that the cost of combining the organizations would be approximately $600,000 for legal and financial consultants. I agree that there will be a one-time implementation cost to combine agencies. The only fallacy in the Study is how these costs are allocated between the wastewater, solid waste and water. The Study allocates these costs equally to each Fund. This results in an unequitable allocation of costs as the effort required for each Fund will be different. A more appropriate basis of allocation could be number of personnel, or total expenditures. This would allocate the costs in a more fair and equitable manner and not cause any one rate paying group to pay more than its fair share for the implementation costs.

The Study identifies annual savings of $1,100,000 in personnel costs. However, the underlying calculation of how the $1,100,000 in savings was determined is missing. Furthermore, the savings was allocated equally to wastewater, solid waste and water. I could not find in the Study how the compensation levels were determined, how the benefits were determined, and whether the employees would be at will or under labor agreements.

### Real Estate

Section 3, *Real Estate/Maintenance*, discusses the facilities owned by each agency and where savings could be realized. The information included in Section 3.1, *CMSD Facilities*, is outdated. This Section states that CMSD owns and maintains 3 properties: the 19th Street building, the Paularino building (in the process of purchasing) and the CMSD Yard. At the time the report was prepared, CMSD had already closed escrow on both the 19th Street building and the Paularino building. As such, CMSD only owns 2 buildings (Paularino and

CMSD Yard). CMSD paid $3,750,000 for the Paularino building (excluding any tenant improvements paid to date or yet to be paid), and received $1,302,000 from the sale of the 19th Street building.

Section 3.2, *Mesa Water Facilities*, states that Mesa Water has a combined headquarters and maintenance yard. On May 26, 2016, Mesa Water's Board held a closed session to discuss real property negotiations related to the acquisition of 1975-1985 Placentia Avenue, the properties next door. The Study is silent as to this negotiation. If the property acquisition is still in negotiations, the Study should have addressed this.

Section 3.3, *Proposed Properties for Combined Agency*, discusses the possibility of eliminating CMSD's headquarters and District Yard. The basis is that there is adequate capacity within Mesa Water's building to absorb additional personnel. An unanswered question is if there is already excess capacity at Mesa Water's facility, then why is/was Mesa Water's Board exploring adding additional property?

The Study assumes that CMSD would revert to contracting out for sewer cleaning and would not need the vehicles and equipment, thus making the Yard unnecessary. There is no discussion about the rationale why the CMSD brought the sewer cleaning in-house and the economies of scale generated by doing so. The Study determines the one-time savings of eliminating these two buildings to be $2,600,000, and that these savings would be equally shared between the Wastewater and Solid Waste Funds. While there would be revenue received as a result of the proceeds of the sale of the building(s), it would not result in a savings of $2,600,000 for the following reasons. The buildings were originally purchased/constructed using restricted funds first, to the extent allowable, before using Wastewater and Solid Waste Funds. As an example, 79% of the cost of the CMSD Yard was paid for with restricted funds. If the CMSD Yard were to be sold, 79% of the proceeds of the sale would be restricted once again. The Study assumes approximately $1,500,000 of the $2,600,000 total savings would be generated by the District Yard. Since 79% of the proceeds would be restricted, only $350,000 would be identified as one-time savings. As such, the total one-time savings for real estate is misleading.

<u>Financial Management</u>

Section 4, *Financial Management and Reserves*, discusses the financial strength of the individual organizations. It states that Mesa Water has received AAA ratings from Standard and Poor's (S&P) and Fitch, and that CMSD is currently unrated. Just to clarify, Mesa Water's AAA rating is on the creditworthiness of its debt. CMSD has no debt and thus has nothing to rate.

Section 4.1, *Overview of CMSD's Existing Financial Position*, uses the audited financial statements for the year ended June 30, 2015 as a basis for the analysis. As previously discussed, utilizing data that is more than a year old is problematic and may lead to incorrect conclusions. More importantly, all amounts that are included in the Study as the Wastewater Fund are not correct. For financial reporting purposes, the Wastewater Fund consists of the

Wastewater Fund, Facilities Revolving Fund and Asset Management Fund. The Wastewater Fund accounts for the operation and maintenance of the sewer system, and sewer capital outlay. The Facilities Revolving Fund is restricted and can only be used for specific purposes. The Asset Management Fund is used to accumulate funds in accordance with the RPM for large capital projects that are constructed by the Wastewater Fund. Therefore, it is not appropriate to simply use the Wastewater Fund column in the audited financial statements for purposes of determining savings from a combined agency analysis.

Section 4.3.2.1, *One-Time Savings*, discusses the methodology used to determine the on-time savings of combining agencies. This methodology is all based upon having cash equal to 600 days of operations in each fund. This concept of cash equal to 600 days of operations is a goal that was set by the Mesa Water Board. While that is an admirable goal of Mesa Water, it is an agency-specific goal and should not be used in determining the savings to be generated from a combined agency. For purposes of my analysis, I continued to use the goal since it was disclosed in the Study. The operating expenses of each fund were determined, then divided by 365 days to arrive at one day's cash. Total cash in each fund was divided by the value of one day's cash to arrive at the current days cash. From the current days cash, the benchmark of 600 was deducted to arrive at excess days cash. There are two major flaws in this analysis. The first is that the Study utilized total cash of three separate and distinct funds and collectively referred to them as the Wastewater Fund. The second is that cash as of June 30, 2015, data more than a year old, was used for the calculation.

When determining if there is excess cash as a result of a combined agency, it would have been much more appropriate to utilize current information. Additionally, looking at cash in the audited financial statements does not include reserved or designated cash, as they cannot be presented on the face of the financial statements in accordance with accounting principles. A better source would have been to use the most recent Investment Report of the CMSD as that identifies cash reserves, designations and available cash in each fund. For example, cash for the Wastewater Fund in the Study was reported as $15,279,498. Cash on the Investment Report as of June 30, 2016 for the Wastewater Fund totaled $6,528,865, including reserves and designations.

The Study determined excess cash in the Wastewater Fund of $9,730,000, which exceeds the actual cash balance in the Fund and thus is misleading. If the same methodology were to be used and applied to the correct cash balance, the one-time savings would be calculated to be approximately $1,840,000. But even this is not an accurate portrayal as it overlays Mesa Water's target of 600 days cash onto CMSD, and does not take into account those financial practices that are important to CMSD.

Section 4.3.2.2, *Annual Savings*, indicates that the Wastewater Fund can save an additional $1,040,000 per year on a go forward basis. In order to determine the annual savings, the Study assumes that the CMSD will issue debt in the future to fund capital improvements. There is absolutely no basis in fact on how this assumption was determined. The CMSD has never issued debt to fund capital improvements in its 72 years of existence. The CMSD

Board has prided itself on its ability to maintain its operations, construct capital improvements and be proactive in its prevention efforts without having to issue debt. Thus, the annual savings are hypothetical only.

## ***Conclusion***

As can be seen from this analysis of the Study, the basis upon which the one-time savings and annual savings were determined is flawed. Thus, the results as presented cannot be relied upon for purposes of making an informed decision as to consolidation of agencies. Furthermore, I understand that these flawed savings numbers reported in the Study are being used as a basis for an advisory measure to place on the November ballot. It would be inappropriate to deceive the citizenry with such an incorrect portrayal of a combined agency, and then ask them to advise as to a combination when they were given flawed facts.