



REPORT TO COUNCIL City of Sacramento

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Staff Report
June 24, 2008

Honorable Mayor and
Members of the City Council

Title: Presentation of the internal audit report, *Contracting Process Review: The Department of Utilities*

Location/Council District: City-wide

Recommendation: Receive and file the Contracting Process Review: *The Department of Utilities* internal audit report.

Contact: Martin Kolkin, City Auditor, 916-808-5704

Presenters: Martin Kolkin

Department: City Manager's Office

Division: Internal Audit

Organization No: 0310

Description/Analysis

Issue: The attached internal audit report, *Contracting Processes Review: The Department of Utilities*, highlighted numerous areas where management oversight and internal controls could be increased significantly.

The City Auditor recommends that:

- 1) The Director of Utilities or his representatives take immediate action to significantly increase managerial oversight of contracts and projects; and
- 2) The City Manager or his representatives perform a comprehensive overhaul and update of the City's *Administrative Policy Instructions "APIs"*.

The audit lists two categories of findings with eleven recommendations for improvements. Due to the serious nature of the management control weaknesses identified in this audit, a Departmental quarterly report-back to the Mayor and City Council is recommended. Additionally, a follow-up internal audit is recommended within the next 24 months.

The City Manager's Office and DOU management took numerous steps to address deficiencies noted in the audit. These actions included:

- Increasing the physical security of inventory by the Field Services Division of DOU, including restricting access and the installation of fencing;
- Developing new policies and procedures;
- Conducting a physical inventory of all water meters in the City;
- Investigating and performing corrective action on inaccurate inventory reports;
- Submitting a staff report on 05/27/08 to the Mayor and City Council regarding the payment of outstanding Badger Water Meter invoices;
- Preparing a RFP to standardize the radio read technology. The radio read technology contract will be independent of water meters contract. Additionally, water meters will be competitively bid for each contract;
- Restricting contracted backhoe services to emergency use with Superintendent's approval; and
- Hiring a consultant to assist in the updating of APIs.

Additionally, management anticipates that numerous procedural problems would be resolved with the implementation of the City's new financial/human resources system, which will require specific protocols before allowing a transaction to process.

Policy Considerations: The City Auditor's presentation of the *Contracting Processes Review: The Department of Utilities* internal audit is consistent with the City's core values of fiscal responsibility and accountability.

Environmental Considerations:

California Environmental Quality Act (CEQA):

Under the California Environmental Quality Act (CEQA) guidelines, this audit report does not constitute a project and is therefore exempt from review.

Sustainability Considerations: Provide catalyst for improvements of municipal operations.

Other: Not Applicable

Commission/Committee Action: Receive and file.

Rationale for Recommendation: The *Contracting Processes Review: The Department of Utilities* audit report, issued by the City Auditor, highlights significant areas for improving management oversight of contracts and projects. The report was discussed in detail with the Department of Utilities, the Department of Finance, and the City Manager's Office. The City Auditor recommends that as the final step

of the process, on quarterly basis, the Department of Utilities report back to the Mayor/City Council regarding the status of implementing the audit recommendations.

Financial Considerations: No additional financial considerations

Emerging Small Business Development (ESBD): No goods or services are being purchased as a result of this agreement.

Respectfully Submitted by:



Martin Kolkin, City Auditor

Recommendation Approved:



Ray Kerridge
City Manager

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Attachment 1

Background: In accordance with the approved Audit Workplan for calendar year 2007, the City Auditor completed a limited scope examination of the Department of Utilities.

Two audit reports are issued due to the complexity and nature of findings discovered during the completion of audit fieldwork. This report addresses the Department of Utilities' contracting processes. A separate audit report addresses the Department of Utilities' inventory and debit card usage. The contracting processes examined are the responsibility of the Department of Utilities' management. The City Auditor's responsibility is to express an opinion on management oversight and controls.

This report provides the Mayor, City Council, and the City Manager with an objective evaluation of the Department of Utilities' managerial oversight of contracts and projects.

CITY OF SACRAMENTO INTERNAL AUDIT

Contracting Processes Review: The Department of Utilities

Report Number 2007-02





OFFICE OF THE
CITY MANAGER

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May 16, 2008

Honorable Mayor, City Council Members, and City Manager:

The Sacramento City Auditor has completed a limited scope audit of the Department of Utilities. Due to the complexity and nature of findings discovered during the completion of audit fieldwork, two separate audit reports were issued. This report will address the Department of Utilities' contracting processes. A separate audit report addresses the examination of the Department of Utilities' inventory and debit card usage. The contracting processes examined are the responsibility of the Department of Utilities' management. The City Auditor's responsibility is to express an opinion on management oversight and controls.

This examination was conducted in accordance with the City Council's core values and guiding principles of fiscal responsibility and accountability, as well as applicable standards contained in Government Auditing Standards, issue by the Comptroller General of the United States, with the exception of a peer review.

This report provides the Mayor, City Council, and the City Manager with an objective evaluation of the Department of Utilities' contracting processes.

In my opinion, the Director of Utilities or his representatives need to take immediate action to significantly increase managerial oversight of contracts and projects.

Audit conclusions were discussed in detail with the City Manager's Office, the Interim Director of the Department of Utilities, and the Director of Finance. The written responses to this report are included in the Appendix. I appreciate the courtesy and professionalism of the numerous municipal departments and their staff that cooperated and made this complex audit possible.

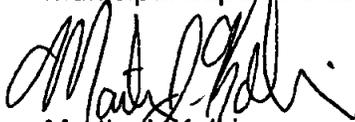

Martin C. Kolkin
City Auditor

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The Department of Utilities
Report Number 2007-02

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Executive Summary of Findings
Contracting Processes Review:
The Department of Utilities
Report Number 2007-02

At the request of the Mayor and City Council and the direction of the City Manager, a limited scope examination of the Department of Utilities ("DOU") was performed.

Due to the complexity and nature of findings discovered during the completion of audit fieldwork, two separate audit reports were issued. This report addresses the Department of Utilities' contracting processes. A separate audit report addresses the examination of the DOU's inventory and debit card usage.

Based upon the work performed, the City Auditor noted the following findings:

1. DOU CONTRACTS/PROJECTS REVIEW

1A. Badger Meter, Inc.

**1A1. Resolutions and Staff Reports to the Mayor and City Council
Resolutions 98-174 & 2001-547 Suspended Competitive Bidding,
5/12/1998 & 8/9/2001, respectively**

Resolutions 98-174 and 2001-547 required that competitive bidding ensue once technology developed for radio frequency reading water meters (refer to pg.2).

The DOU's 08/09/01 staff report to the City Council made an inaccurate statement that no other meter or radio read technology was compatible with the Badger system. In fact, the radio read technology was purchased from a third party vendor, American Meter Company ("AMC"). The AMC radio read technology was designed to be mounted on any utility's meter and was available as early as 1997.

Resolution 2004-833, Suspended Competitive Bidding, 10/26/2004

The DOU' staff report recommended suspending competitive bidding and awarding the contract to Badger Meter, Inc. to standardize the purchase of radio frequency reading water meters (refer to pg.3).

However, the staff report failed to disclose that the radio reading technology for the purchase of new Badger water meters would not be standardized with the existing Badger radio frequency reading water meters. Rather, two separate and non-compatible systems would now be required to extract the radio reading data.

1A2. Authorized & Actual Spending for Badger Meter, Inc.

DOU spent \$1,117,876 and \$12,813 in excess of the Mayor and City Council approved contracts for water meters (refer to pg.3).

Also, twenty-one days prior to the 08/21/01 award of contract by the City Council, DOU improperly obtained two purchase orders, totaling \$88,475.

Authorized & Actual Spending for Badger Meters, Inc.

Contact Years	Authorized Spending	Actual Spending	<Overspent>/ Underspent
05/1998 to 05/2001	\$1,050,000	\$2,167,876	\$<1,117,876>
08/2001 to 06/2004	4,050,000	4,062,813	<12,813>
10/2004 to 10/2007	9,000,000	4,267,437	4,732,563
Total	\$14,100,000	\$10,498,126	\$ 3,601,874

1A3. Failure to notify the City Manager and City Council of Significant Departures from Planned Spending

Although not required by City Code, DOU did not follow prudent business practices and notify the City Manager's Office, the Finance Department, or the Mayor and City Council of significant departures from planned spending, expending \$4,732,563 less than anticipated on water meter during contract years 10/2004 to 10/2007 (refer to pg.4).

1A4. Water Meters Purchased Outside of Sole Source Contract

On 06/02/05, DOU improperly purchased 16 Badger water meters, costing \$9,676, from a vendor outside of the City's sole source contract (refer to pg.4).

1A5. \$764,693 of Unpaid Badger Meter, Inc. Invoices

\$764,693 of water meter invoices were unpaid as of 04/30/08. Also, \$39,134 of meters were purchased past the 10/26/07 contract expiration. On 01/28/08, \$558,019 of the \$764,693 invoiced meters were returned to the vendor for rework (refer to pg. 5).

1B. North Natomas Pump Station, Architectural/Aesthetic Design

The project fund balance of \$46,707 was used for five other projects (refer to pg. 6).

1C. Basin 26 Detention: City Council Authorization Not Obtained for a \$103,407 project

City Council authorization was not obtained for a \$103,407 project (refer to pg. 7).

1D. Backhoe Services of \$99,900 Not Competitively Bid

The DOU files contain no documentation of competitive bidding for backhoe services for fiscal year 2006 (refer to pg. 7).

1E. Sump 28, 70, and 111 Outfall Stabilization

River levels prevented the project work from being completed for nearly a year. The low bidder of \$77,800 withdrew. The project was neither awarded to the next lowest bidder nor re-bid. Instead, the contract was split into three parts and all three parts were awarded to a non-bidding contractor for an aggregate total of \$81,450 (refer to pg. 7).

The Project Manager stated the project was not competitively bid due to time constraints. The Department Director's authorization was not obtained as required by the City's exceptions to competitive bidding, API 48.

1F. Pocket Road Emergency Contracts

DOU signed emergency work contracts with two contractors for \$75,000 and \$95,000. Both contracts were signed after all emergency work was performed and prior to obtaining the certificate of liability insurance, and the performance bond.

This practice provided little, if any, managerial control, transference of risk, or financial protection for the City (refer to pg. 8).

1G. Chemical Purchases of \$40,000 & \$50,000

DOU files contain no documentation of competitive bidding for “Chemical Zeta AS920’ during fiscal years 2005 and 2006, for contracts of \$50,000 and \$40,000 respectively. “A Justification for Blanket (“Open”) Purchase Order” form was completed by DOU, but lacked the Procurement Official’s approval signature as required by API 1 (refer to pg. 9).

1H. No Standardized Process for Project Filing or Document Retention

The DOU did not follow a standardized process to organize project records and files (refer to pg. 9). 93% of the projects examined were missing correspondence documents.

2. RECOMMENDED REVISIONS TO CITYWIDE POLICIES, PROCEDURES, AND GUIDELINES BASED UPON DOU PRACTICES

2A. Revising the City Manager’s Administrative Policy Instructions

A reoccurring theme throughout the last several years of audits has been the need for a comprehensive overhaul of policies, procedures, and guidelines (refer to pg. 10).

2B. Inadequate Separation of Duties – DOU Project Managers are Permitted to Receive, Open, and Evaluate bids, RFPs, and RFQs

DOU’s operating practices allowed Project Managers to receive, open, and evaluate RFPs and RFQs (refer to pg. 10).

2C. Change Orders for Projects Under \$100,000

No established policy exists for approval of change orders aggregating \$25,000 or more for projects under \$100,000. DOU’s operating practices required only Department Director approval. A potential conflict may arise between the City Codes when a change order is \$25,000 or greater, but the price of the original contract plus the change order(s) remains less than \$100,000 (refer to pg. 11).

2D. Compliance with Apprenticeship Requirements

As requested by City Councilmember Hammond during the passage of the 2007 audit workplan, compliance with Apprenticeship requirements were examined. City Code Section 3.60.190 authorizes, but does not mandate, contractors to use the state apprenticeship program when performing work on a City public works project. DOU included provisions for compliance with the apprenticeship requirements of state law for contracts of \$100,000 or greater (refer to pg. 12).

2E. No “Right to Audit Clause” in Construction Contracts

DOU contracts reviewed did not have a “right to audit clause” (refer to pg. 12).

2F. Contracts and Change Orders Not Dated

16 of 22 contracts sampled were not dated by the signators (refer to pg. 12).

Executive Summary of Recommendations
Contracting Processes Review:
The Department of Utilities
Report Number 2007-02

This report provides the Mayor, City Council, and the City Manager with an objective evaluation of the Department of Utilities' ("DOU") contracting processes.

The City Auditor recommends that:

1. The Director of Utilities or his representatives take immediate action to significantly increase managerial oversight of contracts and projects; and
2. The City Manager or his representatives perform a comprehensive overhaul and update of the City's *Administrative Policy Instructions*.

City Auditor's Recommendations	Action Taken by Management	Estimated Completion Date
1. The Director of Utilities or his representatives take the following actions to increase managerial oversight of projects (refer to pg. 9):	Management's actions are listed below by recommendation.	Listed below by recommendation.
i) Establish a quality control system to verify the complete disclosure and accuracy of information provided in staff reports to the City Council.	The Interim Director of the Department of Utilities ("IDDOU") stated that staff report accuracy would be made a top priority. The Engineering Division Manager noted that a quality control system have been installed and is in the process of being improved.	Completed
ii) Create a management oversight system to ensure compliance with the terms of the vendor contract, budgetary funding, City Code, and APIs.	The IDDOU agreed that the DOU would begin development of a management oversight system to ensure required compliance.	09/30/08
iii) Use a standardized process to organize project records and files.	The Engineering Division Manager noted that a standardized system have been installed and recently reinforced to better manage project files.	Completed

City Auditor's Recommendations	Action Taken by Management	Estimated Completion Date
iv) Notify the City Manager and the City Council of significant departures from planned spending.	The IDDOU stated that departures of spending greater than \$250,000 would be reported to the City Council.	Completed
v) Immediately contact the Mayor and City Council to obtain authorization for the payment of outstanding Badger Water Meter invoices.	The IDDOU agreed. Also, the Field Services Division Manager noted that on 05/27/08, the Mayor and City Council had authorized payment of the outstanding water meter invoices.	Completed
2. The City Manager or his representatives take the following actions (refer to pg. 13):	Management's actions are listed below by recommendation.	Listed below by recommendation.
i) Conduct a comprehensive overhaul and update of the City Manager's Policies, Procedures, and Guidelines.	The IDDOU noted that a consultant had been hired to assist in the updating of APIs. Additionally, he added that numerous procedural problems would be resolved with the implementation of the City's new financial/HR system, which will require specific protocols before allowing a transaction to process.	12/31/08
ii) Revise City Manager's Policies, Procedures, and Guidelines to include the City Clerk as the official recorder for bids, RFPs, and RFQs of \$25K or greater.	Representatives of the City Manager's Office concurred and agreed to direct the revision of the City Manager's policies, procedures, and guidelines to include the City Clerk as the official recorder for RFPs and RFQs of \$25K or greater.	12/31/08
iii) Establish a policy regarding authorization for change orders of \$25,000 or greater, when the original contract plus the change orders are less than \$100,000.	Representatives of the City Manager's Office noted that policies, procedures, and guidelines are in the process of being revised. He stated that this item would be examined as part of that process.	12/31/08

City Auditor's Recommendations	Action Taken by Management	Estimated Completion Date
iv) Modify the City's procedures for contracts to include a requirement for a "right to audit" clause in all contracts.	Representatives of the City Manager's Office agreed to work with the City Attorney's Office to develop appropriate language.	Completed
v) Require all contracts and change orders to have a dateline for signators.	Representatives of the City Manager's Office agreed to work with the City Attorney's Office to develop a dateline for signators on all contracts.	09/30/08
vi) Require that the new financial system limit vendor payments to not to exceed the approved contract monetary limits.	Representatives of the City Manager's Office agreed to include this item on the list of items to be added to the functionality of the new financial system, ECAPS.	12/31/08

Due to the serious nature of the management control weaknesses identified in this audit, a Departmental quarterly report-back to the Mayor and City Council is recommended. Additionally, a follow-up internal audit is recommended within the next 24 months.

Preliminary Section
Contracting Processes Review:
The Department of Utilities
Report Number 2007-02

INTRODUCTION

In accordance with the approved Calendar Year 2007 Audit Workplan, the City Auditor completed a limited scope examination of the Department of Utilities' contracting processes.

TWO AUDIT REPORTS

Two audit reports were issued due to the complexity and nature of findings discovered during the completion of audit fieldwork. This report addresses the Department of Utilities' contracting processes. A separate audit report addresses the Department's inventory and debit card usage.

OBJECTIVE & SCOPE

This report provides the Mayor, City Council, and the City Manager with an objective evaluation of the Department of Utilities' contracting processes.

Contracts Sampled

A sample of nineteen Department of Utilities' contract files was conducted. Based upon the City Manager's concurrence for the need to implement critical changes, the audit examination was limited to these nineteen projects.

Records Examined

The audit included, but was not limited to the following:

- Examination of the Department of Utilities' contract files;
- Review of invoices, vendor payments, and purchasing card payments for fiscal years 2005, 2006, and 2007;
- Physical observations of internal controls, operations, and practices;
- Analytical examinations of financial data;
- Examination and verification of general ledger data; and
- Interviews and discussions with personnel from the City Clerk's Office, the Department of Utilities, the Finance Department, the City Attorney's Office, the Labor Relations Department, the Police Department, and the City Manager's Office.

This examination was conducted in accordance with the City Council's core values and guiding principles of fiscal responsibility and accountability, as well as applicable standards contained in Government Auditing Standards, issued by the Comptroller General of the United States, with the exception of a peer review.

The audit report is intended for the information and use of the Mayor, City Council, City Manager, and City Management.

Findings and Conclusions
Contracting Processes Review:
The Department of Utilities
Report Number 2007-02

The findings for this report were grouped in the following three areas:

1. DOU CONTRACTS/PROJECTS REVIEW;
2. REVISING ADMINISTRATIVE POLICY INSTRUCTIONS; and
3. OTHER CONCERNS.

Report Structure for Conclusions

Conclusions are presented at the end of each of the three areas of audit findings.

1. DOU CONTRACTS/PROJECTS REVIEW

1A. Badger Meter, Inc.

1A1. Resolutions and Staff Reports to the Mayor and City Council

Background

Table One
 Sole Source Contracts
 Badger Meter, Inc.
 5/1998 to 10/2007

Resolution Number	Contact Years	Authorized Spending
98-174	05/1998 to 05/2001	\$1,050,000
2001-547	08/2001 to 06/2004	4,050,000
2004-833	10/2004 to 10/2007	9,000,000
Authorized Total		\$14,100,000

Source: City Clerk's Files

1A1a. Resolution 98-174, Suspended Competitive Bidding, 5/12/1998

Resolution 98-174 required that competitive bidding ensue once technology developed for radio frequency reading water meters.

1A1b. Resolution 2001-547, Suspended Competitive Bidding, 8/9/2001

Resolution 2001-547 required that competitive bidding ensue once technology developed for radio frequency reading water meters.

The Department of Utilities' ("DOU") staff report stated:

At this time, no other meter or radio read technology is compatible with the Badger Meter system.

City Auditor's Comments

The statement that no other meter or radio read technology was compatible with the Badger system was inaccurate. The radio read technology used by Badger Meter, Inc. was purchased from a third party and specifically designed to be mounted on any utility's meter. The radio read technology, *Trace Automated Meter Reading System*, was designed by American Meter Company and available as early as 1997.

1A1c. Resolution 2004-833, Suspended Competitive Bidding, 10/26/2004

DOU's staff report recommended suspending competitive bidding and awarding the contract to Badger Meter, Inc. to standardize the purchase of radio frequency reading water meters.

City Auditor's Comments

The staff report recommended sole sourcing the contract to Badger Meter, Inc. in order to standardize the purchase of radio frequency reading water meters. The older Badger water meters continue to use the Trace Automated Meter Reading System, while, the new Badger water meters use the relatively new Orion Meter Reading System, developed by Badger Meters, Inc. **Although both software systems are compatible with DOU's billing system, the staff report failed to disclose that two separate and non-compatible download systems would now be required to extract the radio reading data.**

1A2. Authorized & Actual Spending for Badger Meter, Inc.

Table Two
Authorized and Actual Spending
Badger Meter, Inc.
5/1998 to 10/2007

Contact Years	Authorized Spending	Actual Spending	<Overspent>/ Underspent
05/1998 to 05/2001	\$1,050,000	\$2,167,876	\$<1,117,876>
08/2001 to 06/2004	4,050,000	4,062,813	<12,813>
10/2004 to 10/2007	9,000,000	4,267,437 ¹	4,732,563
Total	\$14,100,000	\$10,498,126	\$ 3,601,874

Source: The City of Sacramento's Financial System, purchase orders, payment vouchers, and the City Clerk's files.

1A2a. Unauthorized Purchases

The DOU spent \$1,117,876 and \$12,813 in excess of the Mayor and City Council approved contracts for radio frequency reading water meters for contract years 5/1998 to 5/2001 and 08/2001 to 06/2004.

City Code 3.56.060, Unauthorized Purchases-Exceptions

It is unlawful for any officer or employee to purchase or contract for supplies or nonprofessional services in behalf of the city, other than as herein prescribed....Any purchases, contract, or obligations to pay made contrary to the provisions of this chapter shall be null and void.

¹ The total does not include \$764,693 of unpaid invoices; refer to finding number 1A5, pg. 5 of this report.

Utilities staff members were not authorized to make purchases in excess of the City Council approved contracts for water meters.

Additionally, financial system internal controls failed to detect this breakdown in purchasing oversight.

The Finance Director acknowledged flaws in the financial system that previously would have allowed the use of multiple purchase orders and payment vouchers that could circumvent financial controls, particularly in the late 1990's and early 2000's. He then noted that the City's new financial system has the functionality to correct these financial control weaknesses. However, this functionality has not been fully implemented.

1A2b. Purchase Orders Received Prior to Obtaining a City Council Approved Contract

DOU staff requested and received two purchase orders totaling \$88,475 for Badger Meter, Inc. These purchase orders were received twenty-one days before the August 9, 2001 award of a contract by the City Council to Badger Meter, Inc.

DOU staff did not have a City Council approved contract for purchases from a vendor, as required by City Code 3.56.090 or API 1.

1A3. Failure to notify the City Manager and City Council of Significant Departures from Planned Spending.

The DOU made a sound business decision in fiscal year 2007 by electing to use excess water meter inventory before placing additional orders. **Although not required by City Code, prudent business practices dictate notifying the City Manager's Office, the Finance Department, and the Mayor and City Council of significant departures from planned spending, such as expending \$4,732,563 less than anticipated on water meter purchases.**

1A4. Water Meters Purchased Outside of Sole Source Contract

On June 2, 2005, Utilities staff members purchased 16 Badger water meters, costing \$9,676, outside of the City's sole source contract. The Badger water meters were purchased from the vendor Underground Express. However, the sole source contract was with Badger Meters, Inc.

City Council Resolution 2004-833 suspended competitive bidding for radio frequency reading water meters and granted a three year, \$9,000,000 sole source contract to Badger Meter, Inc.

Obtaining City Council approval for a sole source contract and then buying from another vendor violates City Code and defeats the contracting purpose of gaining the terms and conditions most advantageous to the City. DOU staff was unable to explain why these meters were purchased from the vendor.

1A5. \$764,693 of Unpaid Badger Meter, Inc. Invoices

Background

The Badger Meter, Inc. contract expired on 10/25/07. DOU Staff ordered and received \$764,693 of water meter inventory from the period 09/28/07 through 02/27/08. The invoices associated with these orders were unpaid as of 04/30/08.

On 01/25/08, \$558,019 of the \$764,693 invoiced water meters were returned to Badger Meter, Inc. to separate the meter register and radio frequency reading feature. The vendor credit memorandum stated that "Registration Returned As Not What Customer Was Expecting..."

The vendor's sales representative stated that the meters' rework had been completed and the product was awaiting shipping to the City of Sacramento. The Company representative stated that if the City refused shipment, the rework request by the City would have to be reversed before returning the water meters back into the Company's inventory.

1A5a. Unpaid Vendor Invoices

Table Three
Unpaid Invoices
Badger Meter, Inc.
Contract Ending 10/26/07

Order Dates	Invoice Dates	Invoice Totals ²
09/28/07 - 10/02/07	11/29/07 – 01/09/08	\$725,559
11/26/07 - 02/27/08	01/08/08 – 02/29/08	39,134
Subtotal		764,693
Credit Memos	01/25/08	<558,019>
Balance Due		\$206,674

Source: The City of Sacramento's Financial System and paid vendor invoices.

The Badger Meter, Inc. invoices were denied for payment by the Finance Department because a valid purchase order had not been obtained before the expiration of the vendor's three year contract on 10/25/07, as required by the City's financial processes. Although, sufficient contracting authority and funding remained on the expired contract, a new purchase order could not be issued because the contract had already expired. DOU's management did not take action and contact the City Manager's Office for resolution. **The Department Director explained that until notified by the Internal Audit Division, he was unaware of these unpaid invoices.**

Since DOU representatives did not follow the City's procurement processes, the Finance Department lacked authority to approve payment for invoices totaling in excess of \$100,000.

² Includes sales tax in totals.

City Auditor's Comments

The City's procurement internal controls operated as designed and prevented the payment of invoices that did not have a valid purchase order or a current contract.

1A5b. Purchase of Water Meters without a Contract

DOU staff ordered \$39,134 of the \$764,693 invoiced water meters from Badger Meters, Inc. during the period 11/26/07 through 02/27/08. A contract did not exist for the purchase of water meters following the expiration of the existing contract with Badger Meter, Inc. on 10/26/07.

API 1, Section 4, requires a contract for purchases of \$25,000 or greater and City Code Section 3.56.090 requires the City Council to award contracts of \$100,000 or greater. Expenditures for water meters for fiscal year 2008 are expected to exceed \$100,000.

1B. North Natomas Pump Station, Architectural/Aesthetic Design

1B1. Project was Not Closed in a Timely Manner

This project remained opened for approximately 3 years past the final payment to the vendor. The project had a remaining fund balance of \$46,707. Prudent business practices dictate closing a contract when the work is completed and returning the unused funds to fund balance.

A completed project, with available funding not returned to fund balance provides opportunities to circumvent the City's system of internal controls over project funding, spending, and contracting.

DOU representatives stated that this project was used to fund an open-ended contract with the vendor.

1B2. Contract Used to Fund Five Other Projects

The remaining project fund balance of \$46,707 was used for five other projects³. Utilities staff members improperly commingled contract funding for four projects, totaling \$27,239, within the North Natomas Pump Station, Architectural/Aesthetic Design contract funding source.

Additionally, \$19,468 of funding for the Basin 26 project was charged to the North Natomas Pump Station, Architectural/Aesthetic Design contract funding source.

1B3. A \$9,999 Supplemental Agreement was Made to the Wrong Contract

A \$9,999⁴ supplemental agreement for the Basin 26 project was incorrectly made to the North Natomas Pump Station, Architectural/Aesthetic Design. The supplemental agreement needed to be made to the project where the work was performed, Basin 26. The supplemental agreement was made to the correct vendor, but the wrong project.

³ \$19,468 for Basin 26 Detention (W171) + \$13,462 for Sump 52 Electrical (WJ46) + \$12,954 for North Natomas CFP #2 (44AD)+ \$607 for CFP #4 SP Tax Zone (50AD)+ \$216 for North Natomas Basin 8C (48AD) = \$46,707

⁴ The \$9,999 supplemental agreement was included in the aggregate contract total of \$99,999 noted above in Finding 1B3.

City Auditor Comments

The City Auditor notes that a \$9,999 supplemental agreement for this project brought the contract balance to \$99,999. City Council approval was not required or obtained since the project was under \$100,000. However, the project where the work was actually performed did exceed \$100,000 as a result of this supplemental agreement, as noted below.

1C. Basin 26 Detention: City Council Authorization Not Obtained for a \$103,407 Project.

City Council authorization was not obtained for a \$103,407 project, the Basin 26 Detention project. As previously cited, \$19,468 of project funding from the North Natomas Pump Station, Architectural/Aesthetic Design was used on this project.

City Code 3.60.090, Award of Contracts by City Council

Unless otherwise provided herein, all contracts for public projects involving an expenditure of one hundred thousand dollars (\$100,000) or more shall be awarded by the city council.

City Council authorization was not obtained as required by City Code.

1D. Backhoe Services of \$99,900 Not Competitively Bid

The DOU contract files contained no documentation of competitive bidding for backhoe services for fiscal 2006. No files were located for bid solicitations or receipts. The City's bidding website showed no bids received and states the winner as "Not yet determined". The actual contract with Jensen Backhoe was dated 12/2/2005.

API 1, Section 4, Purchases Between \$25,000 and \$100,000

Invitations for bids (IFB) and advertising on the City's web site for Contracting Opportunities are required for purchase of supplies and nonprofessional services when the total estimated cost exceeds \$25,000...Competitive bids shall be in writing, and all prospective vendors must be given the same information...Documentation must be maintained detailing all bids solicited and received.

DOU staff did not solicit or document bid as required by API 1.

1E. Sump 28, 70, and 111 Outfall Stabilization

Background

The sump 28, 70, and 111 Outfall Stabilization contract was awarded to the lowest bidder, for the amount of \$77,800, on 08/16/05. The contract work was required to be completed by 11/01/05. The Project Manager stated that when the river level finally receded to a level needed to complete the work in 09/06, the low bidder closed the contract.

The project was neither awarded to the next lowest bidder nor re-bid. Instead, the contract was split into three parts; all three parts were awarded to a contractor that had not originally bid. The three parts were collectively awarded to the non-bidding contractor for \$81,450, before change orders. Originally this work had been awarded to the low bidder for \$77,800.

Table Four
Sump 28, 70, & 111
Contract Awards

Sump Number	Contact Date	Contract Award
28	10/26/06	\$37,250
70	11/14/07	22,250
111	01/23/07	21,950
Total		\$81,450

The Project Manager stated the project was not competitively bid due to tight time constraints.

API 48, Section 7, Exceptions to Competitive Bidding

...Competitive bids are not required to award contracts with a value less than \$100,000 when:...

It is in the City's best interest (must be documented with appropriate justification)...

Note: Written justifications are to be signed by the Department Director or delegated authority of the requisitioning organization.

The Department Director's authorization or written justification was not obtained.

1F. Pocket Road Emergency Contracts

1F1. All Emergency Contractor Work was Performed without a Contract

All emergency work performed by Pacific Liners, Inc. and Geo Grout, Inc. occurred prior to obtaining the signed contract, the worker's compensation insurance certification, the declaration of compliance with the City's non-discrimination in employee benefits by City Contractors, the certificate of liability insurance, and the performance bond.

Table Five
Dates of Contractor
Emergency Work Performed

<u>Company</u>	<u>Work performed</u>	<u>Contract Signed</u>	<u>Amount</u>
Pacific Liners, Inc.	04/18/06 to 4/27/06	05/24/2006	\$75,000
Geo Grout, Inc.	04/29/06 to 05/17/06	06/07/2006	\$99,000

Source: Vendor Invoices and 06/08/2006 staff report to City Council.

City Auditor Comments

The City Auditor readily acknowledges the need to resolve emergency situations immediately. However, obtaining signed contracts and paperwork after the fact provides little, if any, managerial control, transference of risk, or financial protection for the City.

A truncated agreement for true emergencies should be investigated to expedite the process and provide the City with some measure of risk transference.

1F2. 30 Day Contracts Left Open for 16 Months

The Pacific Liners, Inc. and Geo Grout contracts, 30 days each, were not closed for over 16 months due to administrative errors.

City Auditor Comments

Prudent business practices dictate closing a contract when the work is completed and returning the unused funds to Fund Balance. As previously noted, a completed project, with available funding not returned to fund balance provides opportunities to circumvent the City's system of internal controls over project spending, funding, and contracting.

1G. Chemical Purchases of \$40,000 & \$50,000

The DOU contract files contain no documentation of competitive bidding for "Chemical Zeta AS920", for \$50,000 and \$40,000 during fiscal years 2005 and 2006, respectively. "A Justification for Blanket ("Open") Purchase Order" form was completed by DOU. However, the form was lacking the required Procurement Official's approval signature, API 1 Section 8B&C, Exceptions to Competitive Bidding, Other Exceptions. Procurement officials were unable to locate signed exception forms for these items.

DOU staff stated that the current practice was to send an unsigned exception form to the Procurement Division. DOU staff explained that the issuance of a purchase order was interpreted as approval from the Procurement Division.

A contract with the vendor for either fiscal year could not be located. API 1 requires written contracts for all purchase of \$25,000 or greater.

1H. No Standardized Process Followed for Project Filing or Document Retention

The DOU did not follow a standardized process to organize project records and files. Files regarding request for bidding or proposal process and the contracts were not maintained in a uniform manner, including the retention of bonding documents, insurance papers, contract award letters, the notice to proceed notification, and financial information. 93% of the projects examined were missing correspondence documents and 61% of the projects examined were missing Notice to Proceed letters.

Prudent business practices dictate that the Department follows a standardized system to organize project records and files, such as checklist of required documentation. Without a standardized system, a managerial control does not exist to ensure that records are obtained and retained as required by City Code and APIs.

1. CONCLUSIONS: DOU CONTRACTS/PROJECTS REVIEW

The City Auditor recommends that the Director of Utilities or his representatives:

- i. Establish a quality control system to verify the complete disclosure and accuracy of information provided in staff reports to the City Council.
- ii. Create a management oversight system to ensure compliance with the terms of the vendor contract, budgetary funding, City Code, and APIs.

- iii. Use a standardized process to organize project records and files.
- iv. Notify the City Manager and the Mayor and City Council of significant departures from planned spending.
- v. Immediately contact the Mayor and City Council to obtain authorization for the payment of outstanding water meter invoices.

1. STATUS OF MANAGEMENT ACTION

DOU management took numerous steps to correct items noted in the audit:

- The Field Services Division of DOU increased the physical security of inventory, including restricting access and the installation of chain link fencing;
- New policies and procedures are being developed;
- A physical inventory of all water meters in the City is underway;
- Investigation and corrective action on inaccurate inventory reports occurred;
- Submitted a staff report to the Mayor and City Council on 05/27/08 regarding obtaining an authorization for the payment of outstanding Badger Water Meter invoices;
- Radio read technology will be standardized and independent of meters, while the water meters will be competitively bid for each contract; and
- Contracted backhoe services are restricted to emergency use with Superintendent's approval.

2. RECOMMENDED REVISIONS TO CITYWIDE POLICIES, PROCEDURES, AND GUIDELINES BASED UPON DOU PRACTICES

2A. Revising the City Manager's Administrative Policy Instructions ("APIs")

A reoccurring theme throughout the last several years of internal audits has been the need for a comprehensive overhaul and update of the City's APIs. Municipal management has been in widespread agreement regarding the need for a comprehensive overhaul and update of APIs. Numerous efforts have occurred and a consultant was recently hired to assist in the process. However, a significant update to the City Manager's policies, procedures, and guidelines has not been completed.

2B. Inadequate Separation of Duties - DOU Project Managers are Permitted to Receive, Open, and Evaluate bids, RFPs, and RFQs

A DOU Project Manager prepared, received, opened, and evaluated RFPs, for a \$499,586 project for the South Sacramento Reservoir. Additionally, there was no documentation of the final interviews of the top two firms. Engineering Services Staff stated that notes of the interviews were not made. As a result, no interview documentation of the top firm selection was available.

The practice of allowing project staff to prepare, receives, open, and evaluate proposals, represented inadequate separation of duties. Separation of duties is the managerial control of assigning different people the responsibilities for authorizing transactions and then recording the results of those transactions. This control reduces the opportunity of any person to be in a position to both perpetrate and conceal errors or irregularities in the normal course of an individual's duties.

Both City Code and APIs require that bids of \$100,000 or greater on public projects, supplies, and nonprofessional services be opened and recorded by the City Clerk.

However, City Code does not specifically require RFPs or requests for qualifications ("RFQs") of \$100,000 or greater be opened and recorded by the City Clerk. In addition, the APIs do not specifically require bids, RFPs or RFQs of under \$100,000 to be opened and recorded by the City Clerk.

DOU's operating practices allowed Project Managers to receive, open, and evaluate bids, RFPs, and RFQs for contracts under and over \$100,000.

The internal audit report titled *The Bidding and Contract Processes Examination: The General Services Department and the Office of the City Clerk*, dated 04/18/2006, recommended establishing a new practice of requiring the City Clerk's Office to open all bids, RFPs, and RFQs of \$25,000 or greater.

2C. Change Orders⁵ for Projects Under \$100,000

No established policy exists for approval of change orders aggregating \$25,000 or more for projects under \$100,000. **DOU's operating practices have required only Department Director approval for change orders of \$25,000 or greater, provided the total amount of the contract and change orders is less than \$100,000.**

**Table Six
Examples of Contracts with Change
Orders of \$25,000 or Greater with a
Aggregate Cost of Under \$100,000**

Project Description	Original Contact	All Change Orders	Final Contact	% Increased
Sacramento River, Water In-Take Structure, Debris Removal	\$10,000	\$69,800	\$79,800	698%
Water Wise Pest Control	19,000	76,000	95,000	400%
Stormwater Quality Program – Student Assistants	25,000	62,961	87,961	252%
Sacramento River Watershed Public Service Announcement	22,500	30,500	53,000	136%
Integrated Pest Management	42,999	52,000	94,999	121%
North Natomas Architectural Design Standards	50,000	49,999	99,999	100%
Vacuum Excavation Pot Holes - 2006	37,275	32,723	69,998	88%
Multi-Hazard Plan	66,150	33,815	99,965	51%
Total	\$272,924	\$407,798	\$680,722	149%

Source: DOU Contract Files

City Code Section 3.60.090, Award of Contracts by City Council, authorized the City Manager to execute contracts involving an expenditure of less than \$100,000 without obtaining the approval of the City Council.

City Code Section 3.60.210(A), Authority of the City Manager
For contracts originally awarded for a price of less than two hundred fifty thousand dollars (\$250,000.00), the city manager shall have the authority to issue change orders for an increase in contract price of up to twenty-five thousand dollars (\$25,000), provided that the sum of all such change orders for any single contract shall not exceed twenty-five thousand dollars (\$25,000).

⁵ For reporting purposes, supplemental agreements are considered to be change orders.

API 22, City Manager's Delegation of Contract Authority, delegates the City Manager's authority for change orders and supplemental agreements to Department Directors. API 22 also limits Department Directors change order authority to the limits established by City Code.

City Auditor Comments

City Code Section 3.60.090 grants the City Manager authority to execute contracts under \$100,000. However, City Code Section 3.606.210(A) requires City Council authority for change orders of \$25,000 or greater.

Potentially conflict may arise between the City Codes when a change order is \$25,000 or greater, but the price of the original contract plus the change order(s) remains less than \$100,000.

2D. Compliance with Apprenticeship Requirements

As requested by City Councilmember Hammond during the passage of the 2007 audit workplan, compliance with Apprenticeship requirements were examined.

City Code Section 3.60.190 authorizes, but does not mandate, contractors to use the state apprenticeship program when performing work on a City public works project. DOU included provisions for compliance with the apprenticeship requirements of state law for contracts of \$100,000 or greater.

The apprenticeship requirement applies only to those trades and crafts for which an apprenticeship program has been established, approximately thirty trades or crafts.

In a sample of ten DOU public projects found that the four projects over \$100,000 contained the *Excerpts from the California Labor Code Relating to Apprentices on Public Works, Apprentices on Public Projects* within the City's contract. However, none of the six projects under \$100,000 contained the Apprentices provisions.

2E. No "Right to Audit Clause" in Construction Contracts

DOU construction contracts reviewed did not have a "right to audit clause". A best practice among municipalities is to include a "right to audit clause" within construction contracts. This practice allows municipal representatives to examine contractor books and supporting expenses to validate expenses billed to the City.

The internal audit report titled *The Bidding and Contract Processes Examination: The General Services Department and the Office of the City Clerk*, dated 04/18/2006, recommended including a "right to audit" clause in all construction contracts.

2F. Contracts and Change Orders Not Dated

Contracts and change orders were not dated by the signators. As a result, it was frequently not possible to determine if work occurred prior to authorization.

In a sample of twenty-two DOU contracts, 16 contracts, 73%, did not have a date of the signator. The internal audit report titled *The Bidding and Contract Processes Examination: The General Services Department and the Office of the City Clerk*, dated 04/18/2006, also noted that contracts and change orders were not dated.

2. CONCLUSIONS: BASED UPON DOU PRACTICES, RECOMMENDED REVISIONS to CITYWIDE POLICIES, PROCEDURES, AND GUIDELINES

The City Auditor recommends that the City Manager or his representatives:

- i. Conduct a comprehensive overhaul and update of the City Manager's policies, procedures, and guidelines.
- ii. Revise City Manager's Policies, Procedures, and Guidelines to include the City Clerk as the official recorder for bids, RFPs, and RFQs of \$25K or greater.
- iii. Establish a policy regarding the authorization for change orders of \$25,000 or greater, when the original contract plus the change orders are less than \$100,000.
- iv. Modify the City's procedures for contracts to include a requirement for a "right to audit" clause in all contracts.
- v. Require all contracts and change orders to have a date line for signators.
- vi. Require that the new financial system limit vendor payments to not to exceed the approved contract monetary limits.

2. STATUS OF MANAGEMENT ACTION

A consultant was hired to assist in the updating of APIs. Additionally, management anticipates that numerous procedural problems would be resolved with the implementation of the City's new financial/human resources system, which will require specific protocols before allowing a transaction to process.

3. OTHER CONCERNS

Our review of purchase orders noted the potential to decrease costs by consolidating numerous smaller purchases into bid opportunities, for example for plumbing supplies, tools, and equipment.

City Auditor's Comments

The City Auditor proposes exploring decreasing costs by consolidating numerous smaller purchases into larger bid opportunities, particularly for plumbing supplies.

APPENDIX

Department of Utilities' Response



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CITY MANAGER

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MEMORANDUM

DATE: May 30, 2008

TO: Martin Kolkin, City Auditor

FROM: Marty Hanneman, Assistant City Manager / Interim Director of the Department of Utilities *MH*

SUBJECT: **RESPONSE TO THE INTERNAL AUDIT OF THE DEPARTMENT OF UTILITIES**

The Department of Utilities ("DOU") acknowledges the findings contained in the internal audit report. DOU concurs with the audit findings and supports the report's recommendations. These recommendations include actions to significantly increase managerial oversight of contracts and projects, physical and organizational improvements to enhance processes and internal controls, and a strong commitment to inter-departmental collaboration in support of the City's core values of accountability, fairness, and transparency in procurement practices and oversight.

The Department of Utilities has already undertaken a wide range of improvements designed to improve business practices, and increase management oversight of projects, procurement practices, and compliance with City policies.

Management Action

The Department of Utilities took numerous steps to correct items noted in the audit:

- The Field Services Division of Department of Utilities increased the physical security of inventory, including restricting access and the installing fencing;
- New policies and procedures are being developed;
- A physical inventory of all water meters in the City is underway;
- Investigation and corrective action on inaccurate inventory reports occurred;
- A staff report was submitted to the Mayor and City Council on 05/27/08 regarding the payment of outstanding Badger Water Meter invoices;
- Sole sourcing of water meters will be discontinued. A request for proposal is planned to solicit proposals for meter reading technology;
- Contracted backhoe services are restricted to emergency use with Superintendent's approval;
- A consultant was hired to assist in the updating of APIs; and
- The Department of Utilities anticipates that numerous procedural problems would be resolved with the implementation of City's new financial/human resource system, which requires specific protocols before allowing a transaction to process.

Staff Report 28