

**Examination of Certain Policies, Procedures, Controls,
and Financial Activity of Mountain Water District**



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CRIT LUALLEN
AUDITOR OF PUBLIC ACCOUNTS

January 27, 2011

Rhonda James, Chairman
Mountain Water District
6324 Zebulon Highway
Meta, Kentucky 41501

RE: Examination of Certain Policies, Procedures, Controls, and Financial Activity of Mountain Water District

Dear Ms. James:

We have completed our examination of certain policies, procedures, controls, and financial activity of Mountain Water District (MWD). The enclosed report identifies eight findings and offers approximately 40 recommendations to strengthen MWD's management and oversight procedures to ensure the public's trust going forward.

Examination procedures included interviews with current and former MWD Board members, MWD contract attorney and accountant, MWD contract engineering firms, and Utility Management Group, LLC (UMG) staff. In addition, records of 10 different construction projects were reviewed and analyzed, including the bidding process, change orders, and payments to vendors. MWD policies, Board meeting minutes, and payments to UMG were also reviewed. The scope of our examination encompasses records and information for the period July 1, 2004 through May 2010, unless otherwise specified. To accomplish this examination, the following objectives were developed:

- Examine MWD policies, procedures, and internal controls;
- Examine the MWD procurement process and oversight related to the operation and management contract;
- Examine the MWD procurement process and oversight related to construction projects; and,
- Examine payments and other financial activities of MWD to determine whether payments were appropriate, sufficiently documented, and properly monitored.

Due to the nature of certain findings resulting from this examination, we have referred this report to the Kentucky Attorney General's Office and the Legislative Ethics Commission.



Ms. James
January 27, 2011
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The Auditor of Public Accounts requests a report from the MWD Board on the implementation of audit recommendations within (60) days of the completion of the final report. If you wish to discuss this report further, please contact Brian Lykins, Executive Director of the Office of Technology and Special Audits, or me.

Respectfully submitted,


Crit Luallen
Auditor of Public Accounts



Examination of Certain Policies, Procedures, Controls, and Financial Activity of Mountain Water District

Examination Objectives

Pursuant to a resolution passed by the Pike County Fiscal Court requesting an audit of the Mountain Water District (MWD) and due to issues raised publicly regarding the management contract of MWD, the Auditor of Public Accounts (APA) began an examination of the policies, procedures, financial activities, and contracts of MWD. To accomplish this examination, the following objectives were developed:

- Examine MWD policies, procedures, and internal controls;
- Examine the MWD procurement process and oversight related to the operation and management contract;
- Examine the MWD procurement process and oversight related to construction projects; and,
- Examine payments and other financial activities of MWD to determine whether payments were appropriate, sufficiently documented, and properly monitored.

To address these objectives, the APA interviewed current and former MWD Board members, the MWD contract attorney, the MWD contract accountant, Utility Management Group, LLC (UMG) staff, MWD contract engineering firms, the CPA firm conducting the annual financial statement audit of MWD, and various state and federal oversight personnel. The records of 10 different construction projects were reviewed and analyzed, including the bidding process, change orders, and payments to vendors. The period reviewed for most construction documents was July 1, 2004 to May 2010, though some construction projects included in the review preceded July 1, 2004. An extensive review of Board meeting minutes, MWD policies, and any payments to UMG was also conducted.

Background

MWD was established on July 1, 1986, through a merger of three separate water districts serving different sections of Pike County, including Marrowbone Water District, Shelby Valley Water District, and Pond Creek Water District. MWD serves all of the unincorporated areas of Pike County. At the time of the merger, MWD had approximately 40 miles of water lines, a treatment plant producing 750,000 gallons of water per day, and served about 4,800 people. Since that time, MWD has

grown to 890 miles of water main lines, a treatment plant producing 2.4 million gallons of water per day, and serves approximately 52,456 people. When combining water produced and water purchased from nearby water districts, MWD distributes 80 to 90 million gallons of water per month.

MWD has over 50 miles of sewer lines that serve approximately 6,800 people. In total, MWD treats approximately 10.5 million gallons of wastewater per month with 17 different wastewater treatment plants.

MWD operations are primarily funded from the usage fees paid by water and sewer customers. The rates for these fees are set by MWD, but must have the approval of the Public Service Commission (PSC). All MWD rates are established through a PSC required document known as a Tariff. This document outlines all rates charged by MWD for either water or sewer.

At times, the rates charged by MWD need to be changed due to increased costs. This additional revenue is typically required due to the overall increase in operational costs over time or it may be due to an increase in debt from construction projects. For the year ending December 31, 2009, MWD's operating revenue was \$9,251,799 and operating expenses were \$10,101,835.

Two primary avenues exist by which MWD may seek a rate increase. A general rate increase can be requested by MWD directly through PSC, which conducts a rate study of actual operational costs. The last general rate increase approved for MWD was in August 1996.

The second avenue by which MWD may seek a rate increase is under the provisions of KRS 278.023(1), when a construction project has been funded by a federal agency. These provisions allow MWD to be approved for a rate increase through the federal agency that funded the construction project. While PSC has some cursory oversight over these types of rate increases, it cannot modify or reject any portion of the agreement on its own authority. Through the federal agencies' funding projects, MWD was approved for a rate increase in 2005 and 2008 for water and one in 2006 for sewer.

The business and affairs of MWD are to be managed by its Board of Commissioners (Board) with the duties and powers as set out in KRS 74.070. Commissioners are appointed pursuant to KRS 74.020 for a term of four years, unless appointed to fill a seat vacated before the term expires. This statute requires the Board to be composed of three to five members as determined by the Pike County Judge/Executive. Members of the Board must be residents of the MWD service district, selected by the Pike County Judge/Executive, and approved by the Pike County Fiscal Court. According to MWD's By-Laws, Rules, and Regulations, the County Judge/Executive is provided with recommendations of district members from which to select a commissioner. Any vacancies are also filled by the County Judge/Executive.

Beginning July 3, 2005, the MWD Board entered into a management contract with UMG to perform the operations, management, and maintenance of MWD. The contract between MWD and UMG was for a five-year term with an initial annual fee of \$6,819,000, subject to adjustment based on an increase in water and sewer customers and an annual change in the Consumer Price Index (CPI). This contract transferred all MWD personnel to UMG. District equipment and infrastructure remained the property of the district; however, UMG had possession of and was responsible for the maintenance of these assets. From the inception of the contract in July 2005 through June 2010 MWD paid UMG over \$36 million.

In July 2008, three years after the contract began, the MWD Board decided to review its contract with UMG and renegotiate the terms of the contract. The first amendment to the MWD and UMG contract was signed April 29, 2009.

The contract between MWD and UMG has been amended two additional times since April 29, 2009. The first of these additional amendments was made on February 24, 2010, to extend the contract six months to December 31, 2010. The last amendment to the contract was approved on August 26, 2010, to allow the district to benefit from its tax exempt status on purchases made for repair and maintenance.

UMG limited auditor's access to its records

MWD is a local public agency and a "public works" that owns and provides for the operation of water, wastewater and related treatment, collection and distribution facilities, which are public, governmental operations and facilities.

UMG is a Kentucky, for-profit, limited liability company organized in August 2004. On July 3, 2005, UMG entered into an "Agreement for Operations, Maintenance and Management Services" with MWD, to operate, maintain, and manage the operations of MWD, a "public works." By contract, therefore, UMG manages and operates MWD, a public water works.

KRS 43.050(2)(c) requires the Auditor to "[e]xamine periodically the . . . management . . . of all . . . public works . . . in the conduct or management of which the state has any financial interest or legal power" MWD receives state funds to partially fund water and sewer construction projects. Because UMG manages the operations of MWD that are partially funded by the state, the state has a financial interest over UMG's management and operation of MWD. UMG, therefore, is subject to the Auditor's authority to conduct an examination of UMG's management and operation of MWD. KRS 43.080 authorizes the Auditor to access the records it needs to conduct its audits and examinations of public works.

During the course of this examination, however, when the Auditor sought financial and other records from UMG pertinent to UMG's operation and management of MWD, UMG, through its legal counsel, refused to disclose certain records it deems private, confidential, or proprietary, claiming it is a private entity not subject to the Auditor's authority to access records. UMG did provide the Auditor with some records requested by the Auditor that UMG did not consider private, confidential, or proprietary, but did not fully disclose to the Auditor all the records the Auditor needed to conduct a thorough examination of the management and operation of MWD. The Auditor was also advised that UMG does not receive annual financial statement audits.

UMG receives substantial revenues from its contracts with two local authorities, MWD and Pikeville, and derives at least 25 percent of the funds it expends in Kentucky from these two local authorities. The Auditor advised UMG that this circumstance would appear to bring UMG under the coverage of Kentucky's Open Records Act (Act), per KRS 61.870(1)(h), and subject it to disclose its records, upon request, in accordance with the Act. UMG, however, claimed that it, as a private entity, is not covered by the Act and does not have to disclose its records in accordance with the Act.

Auditors took into consideration the limited documentation provided by UMG. However, the documentation provided was not responsive to the APA request that would have allowed this office to perform an analysis of the actual cost to operate MWD.

Findings and Recommendations

Finding 1: The MWD Board entered into a privatization contract with insufficient planning to determine the benefits to or financial impact on MWD.

The MWD Board did not formally or openly discuss or document the anticipated benefits expected from privatizing the water and sewer operations of the district, nor did the Board conduct an analysis to determine what impact the contract would have on the financial stability of MWD. According to the minutes of the March 30, 2005 Board meeting, the MWD Superintendent at that time stated that it may be necessary to hire “new management and/or support staff” after noting the many in-house construction projects that MWD had scheduled for the next 12 to 15 months. Through Resolution 05-03-013, the Board approved advertising a RFQ/P for “management assistance” without any further discussion regarding the details of the services that should be included in the RFQ/P or the potential contract cost and benefit to MWD.

Recommendations: We recommend the MWD Board ensure that any significant contracts are properly evaluated for the benefits they will provide to the district and its customers. Further, discussions concerning these contracts should be conducted in an open and public process. We recommend a complete and thorough analysis of the financial benefit to MWD be performed prior to finalizing a management contract. The Board should have sufficient information to properly plan all aspects of the decision to privatize service and to ensure that the contract requires detailed financial and other information necessary for the Board to appropriately oversee the management of the district. Finally, we recommend MWD follow the best practices required in statute for privatizing public services.

Finding 2: The Cost to Operate MWD Services Are Unknown Due to the Lack of Financial Information Provided by the Vendor.

The actual cost to operate MWD water and sewer services is not known by the MWD Board. This prevents the MWD Board from ensuring that the district is being managed in the most efficient manner possible and is financially responsible to the public it serves. Under the management and operations contract with UMG, there is no provision that the actual costs incurred by UMG to operate MWD water and sewer services be reported to the Board or be made available upon request of the Board. The lack of this significant financial information makes it impossible for the MWD Board to perform an analysis and determine the financial benefit of the UMG management contract or the extent to which the management fee paid to UMG exceeds the actual district operational costs. The lack of financial information also diminishes the possibility

of any future competition for the management contract, as any other contractor would be at a competitive disadvantage to UMG given that historical operational costs could not be provided to other contractors. In addition to the lack of financial information received by the Board, it is currently impossible for MWD to obtain approval for general water or sewer rate increases from the PSC because actual costs of the utility must be submitted for review to request a rate increase. This could result in a difficult financial situation if the MWD Board has a justifiable need to request a rate increase to generate additional revenue.

Recommendations: We recommend the MWD Board ensure that any privatization contract for management and operations services contains a provision that will allow for access to cost information about the operations of MWD. The contract could require the vendor to report MWD operational costs information on a monthly and annual basis. We recommend the Board consider a management fee structure to operate and maintain MWD and to provide an agreed upon margin of profit.

Finding 3: The initial contract for management services had a detrimental impact on MWD, and the Board failed to act in a timely manner to address the issues.

The MWD Board did not sufficiently consider the terms and language of the management contract with UMG to ensure there were adequate safeguards protecting MWD interests, nor did Board members react in a timely manner to address the terms of the contract that had a detrimental effect on MWD. The original terms of the management contract resulted in a rapid increase in the fees MWD was required to pay to UMG. After the contract was executed, operating costs for MWD began to escalate at a faster rate creating increasingly higher operating losses for the district despite increasing revenues. Increasing monthly payments made to UMG limited the ability of MWD to continue to meet other necessary financial obligations, including the ability to make existing bond payments. In addition, the contract did not clearly define the administrative duties to be performed by UMG leading to potential conflicts of interests between the interests of MWD and the interests of UMG as a private contractor.

Recommendations: We recommend the Board ensure any future contracts for operations, management and maintenance are closely examined before entering into an agreement with a contractor to perform those services. In its examination of the final contract, the Board or its representatives should ensure that desired provisions in the draft contract are actually included in the final contract for services. We recommend the Board avoid provisions increasing fees automatically to the district. If the cost of providing services increases

due to an increase in the district's customer base or an increase in the cost of materials or supplies to provide the service, the increased cost should be justified, reviewed by the Board or its independent representative, and the approval to increase the fees should be documented. We recommend that the Board ensure that contract terms are clear, concise, and well defined. This includes the roles and responsibilities of the contractor and the district.

We recommend the Board take a more proactive approach to overseeing the operations and management of the district. The Board should have an administrative employee working at the direction of the Board, representing the interests of the Board, reporting directly to the Board, and to oversee its projects and other financial affairs. The Board has not been able to fill this position in the past due to a lack of funding; the Board should consider its need for funding as it negotiates any future contracts for operations, management, and maintenance.

We also recommend the Board create a finance committee, from its membership, to meet regularly with its representative to discuss the district's finances. The meetings should include review of all bills, along with supporting documentation, discussion of the bond reserve levels and any other financial matters it deems necessary. This committee should report its activity and discussion to the full Board. This committee could also serve as the contact for the CPA performing the district's annual financial audit.

We recommend the Board require an annual financial statement audit of its contractor and that the audit, including the management letter, be provided to the district. Financial information that should be required by the contract includes that the vendor receive an annual audit of its financial statements that will be provided to the Board within a determined time period.

Lastly, we recommend any contract for operation, management, and maintenance of the district require the contractor to follow all internal control policies established by MWD.

Finding 4: Irregularities were identified in the initial MWD contract for operations, management, and maintenance and the established contract bid process was not followed.

An examination of the documentation from the RFQ/P process followed in 2005 by MWD in contracting for operations, management, and maintenance of the district along with Board meeting minutes dating back to July 2004, and through interviews of many former and current Board members, auditors identified several

irregularities in the RFQ/P and bid process. These irregularities include:

- Discrepancies between the Board's approval to advertise an RFQ/P for "management assistance" and the actual RFQ/P issued for complete operation and management.
- An extensive RFQ/P was issued nine days after the Board's approval to advertise, but there is no evidence Board members saw the RFQ/P at the time of the meeting. This is a very short period of time to create such a detailed document, making it appear the RFQ/P may have been created before the Board's resolution to be ready to advertise and the RFQ/P may not have been provided to the Board for input or review.
- In examining the draft contract provided by UMG, auditors found a date on the contract indicating UMG may have already been aware of the RFQ/P at least two months prior to the Superintendent making a presentation to the Board to discuss the possibility of additional management or personnel. At the top of the draft contract presented by UMG to MWD on April 25, 2005, it reads, "THIS AGREEMENT is entered into this 12th day of January, 2005."
- Inability to reconcile the estimated costs presented in a bid analysis process comparing the proposals of UMG and another vendor.
- Due to the former Superintendent's ownership interest in UMG, a conflict of interest may have existed because of the opportunity for him to personally benefit financially from MWD entering into a contract with UMG.

Recommendations: We recommend the Board review and ensure its understanding of any RFQ/P before voting to approve advertisement of such. The Board should be actively involved in determining the content of the document and directing its process. Because the Board may consider employing someone in the future that will directly report to the Board, we recommend the Board require conflict of interest statements and disclosure statements for management employees reporting directly to the Board to ensure full disclosure of any interests by its management. We recommend MWD ensure that proposals are fully graded consistent with the criteria stated in its RFQ/Ps. If MWD allows more time to contractors to provide additional information, impacting their proposals, the district should ensure proposals are graded only after all information has been received, as long as the receipt of the information is made within the approved deadline dates and times. We recommend any calculations used in the analysis of bid proposals be adequately supported and the supporting documentation maintained to eliminate or address any dispute that may arise as a result of the calculations.

Finding 5: UMG received payments for services not specified in the contract with MWD without approval by the MWD Board.

In reviewing payments made to UMG by MWD, auditors found payments made in addition to the bi-monthly fees paid to UMG. No documentation was found that the Board approved the additional payments. In one case, UMG received payment for work performed by another contractor.

Recommendations: We recommend the Board carefully examine bills before approving them for payment. The Board should ensure that payments are made in compliance with its contract. Any additional payments to contractors should be for services that were discussed and agreed upon by the Board in writing. The Board should then approve the payments in an open meeting. We again recommend the Board hire an individual that will report directly to the Board and will provide more direct oversight of the district's day-to-day operations. This individual would be in the position to be more aware of the projects and services provided by each contractor and could assist the Board by ensuring that payments are made to the appropriate parties and in accordance with established contracts. We also recommend the Board specifically discuss the payments to its contractor for providing water to Elkhorn City. If the Board agrees to continue these payments to the contractor for this service, we recommend the Board formally approve the terms of this agreement and document in writing those terms agreed upon by the Board and the contractor for this service.

Finding 6: Procurement requirements appear to have been circumvented, resulting in over \$171,000 for services provided with no contract.

MWD paid over \$171,000 for electrical work provided by a vendor that did not have a contract with MWD or participate in either of the two bidding processes for the service. In addition, the vendor stated that the former MWD Superintendent instructed him to submit invoices that would not exceed \$20,000, which is the small purchase authority limit above which competitive bidding and a contract are required. Given that there is no discussion in the MWD Board meeting minutes that the Board approved this vendor or that the vendor was to provide this service, it appears MWD management conducted this activity without the involvement or knowledge of the Board. Auditors also noted that a Kentucky State Representative who assisted in obtaining coal severance funds for MWD that could be used to pay for this service was the owner of the business that performed the work.

Recommendations: The MWD Board should ensure that the procurement process is fully documented in a policy and procedures manual. MWD Board members, staff, or staff of vendors performing administrative

work on behalf of MWD should receive a copy of the manual and training on the requirements contained in the manual. The MWD Board should ensure a process is established to ensure the requirements of the manual are followed by MWD staff and vendors providing administrative services to MWD. This includes the Board requesting further information regarding the services provided by vendors scheduled to receive payment from MWD. The MWD Board should ensure that a competitive bidding process is used when the aggregate amount of payments to a vendor for a project will exceed \$20,000. The MWD Board should also ensure that written contracts are established with vendors detailing the service to be performed, payment details, and other necessary documentation to protect the interests of MWD. The MWD Board should ensure that agreements with vendors to provide services are based on objective criteria such as price and qualifications of the vendor.

Finding 7: MWD had not adopted a method to adequately track construction project payments.

MWD does not have a formal method to easily track and review vendor payments related to water and sewer construction projects. Currently, three separate parties track payments to construction project vendors. The MWD Board does not require any tracking method for construction payments.

Recommendations: The MWD Board should formally adopt a format for tracking construction project payment and funding information consistent with those used by the engineers. At a minimum, the format adopted by the Board should ensure reporting of the payments include the funding source, the date of the payment, the check number, the vendor name, the amount, and reference to the associated contract under which this payment was made. A document related to each construction project should be presented at each monthly board meeting.

Finding 8: MWD did not comply with Kentucky's Open Meetings Law when discussing the decision to contract out the operations of a public entity or the renegotiations of that contract.

Based on a review of board meeting minutes, there were several instances in which the MWD Board did not fully comply with Kentucky's Open Meetings Law when it went into a closed session. These instances included the meetings in which the MWD Board approved the operating contract with UMG, terminated the UMG contract, rescinded the termination of the UMG contract, and approved the amended UMG contract. According to the Kentucky Supreme Court ruling in *Floyd County Board of Education v. Ratliff*, "the exceptions to the open meetings laws are not to be used to shield the agency from unwanted or unpleasant public input, interference or scrutiny." The public was

not included in discussions concerning how their water district would be operated, which could lead the public to conclude that deals were done behind closed doors.

Recommendations: We recommend that the MWD Board ensure that, prior to going into a closed session, the specific exception contained in the statute is documented. There must be specific and complete notification in the open session of any and all topics which are to be discussed in the closed session and the specific statutory exemption allowing the reason why they need to go to closed session. The specific topic given for the closed session should be the only topic of discussion in the closed session. We also recommend that discussions related to significant operating decisions should not be conducted in a closed session to avoid public distrust and ensure that the board's decisions are supported and well documented.

Chapter 1

Introduction and Background

Scope

Pursuant to a resolution passed by the Pike County Fiscal Court requesting an audit of the Mountain Water District (MWD) and due to issues raised publicly regarding the management contract of MWD, the Auditor of Public Accounts (APA) began an examination of the policies, procedures, financial activities, and contracts of MWD. To accomplish this examination, the following objectives were developed:

- Examine MWD policies, procedures, and internal controls;
- Examine the MWD procurement process and oversight related to the operation and management contract;
- Examine the MWD procurement process and oversight related to construction projects; and,
- Examine payments and other financial activities of MWD to determine whether payments were appropriate, sufficiently documented, and properly monitored.

To address these objectives, the APA interviewed current and former MWD Board members, the MWD contract attorney, the MWD contract accountant, Utility Management Group, LLC (UMG) staff, MWD contract engineering firms, the CPA firm conducting the annual financial statement audit of MWD, and various state and federal oversight personnel. The records of 10 different construction projects were reviewed and analyzed, including the bidding process, change orders, and payments to vendors. The period reviewed for most construction documents was July 1, 2004 to May 2010, though some construction projects included in the review preceded July 1, 2004. An extensive review of Board meeting minutes, MWD policies, and any payments to UMG was also conducted.

Background

MWD was established on July 1, 1986, through a merger of three separate water districts serving different sections of Pike County, including Marrowbone Water District, Shelby Valley Water District, and Pond Creek Water District. MWD serves all of the unincorporated areas of Pike County. At the time of the merger, MWD had approximately 40 miles of water lines, a treatment plant producing 750,000 gallons of water per day, and served about 4,800 people. Since that time, MWD has grown to 890 miles of water main lines, a treatment plant producing 2.4 million gallons of water per day, and serves approximately 52,456 people. When combining water produced and water purchased from nearby water districts, MWD distributes 80 to 90 million gallons of water per month.

In addition to the increase in the size of the water infrastructure and distribution area, MWD has constructed over 50 miles of sewer lines that serve approximately 6,800 people. The majority of these lines are force main lines rather than gravity, requiring more extensive equipment than most other sewer systems. In total, MWD treats approximately 10.5 million gallons of wastewater per month with 17 different wastewater treatment plants.

Chapter 1

Introduction and Background

MWD operations are primarily funded from the usage fees paid by water and sewer customers. The rates for these fees are set by MWD, but must have the approval of the Public Service Commission (PSC). All MWD rates are established through a PSC required document known as a Tariff. This document outlines all rates charged by MWD for either water or sewer. These rates may vary based on the size of water line used by the customer and the number of gallons used during a month. A minimum fee is established for all water and sewer usage until customers reach a preset limit, which for most customers is 2,000 gallons per month. Once that limit is reached, an additional rate for each 1,000 gallons is charged to the customer.

At times, the rates charged by MWD need to be changed due to increased costs. This additional revenue is typically required due to the overall increase in operational costs over time or it may be due to an increase in debt from construction projects. For the year ending December 31, 2009, MWD's operating revenue was \$9,251,799 and operating expenses were \$10,101,835. Two primary avenues exist by which MWD may seek a rate increase. A general rate increase can be requested by MWD directly through PSC. In order to get approval for a general rate increase, MWD must undergo a rate study conducted by PSC personnel. This rate study reviews the actual operational costs of MWD over a period of several years. If PSC determines that MWD does not have sufficient revenue to pay its operational costs, PSC then reviews expenditures to determine the legitimate operational costs and will approve a rate increase if warranted. PSC may also approve a rate increase less than that initially requested by MWD. The last general rate increase approved for MWD was in August 1996.

The second avenue by which MWD may seek a rate increase is when a construction project has been funded by a federal agency. Under the provisions of KRS 278.023(1),

Because federal financing of such projects entails prior review and oversight by the federal agency and obligates the utility to certain actions, and because conflicting requirements by the federal agency and the Public Service Commission may place the water utility in an untenable position and delay or jeopardize such projects, it is declared to be the policy of the Commonwealth that such agreements shall be accepted by the Public Service Commission, and that the commission shall not prohibit a water utility from fulfilling its obligations under such an agreement.

KRS 278.023(5) further states,

If the federal agency approves a surcharge to the water bills of customers who receive service through an extension of water facilities under this section, which is in lieu of an assessment against the customer for the cost of the extension, then the Public Service Commission shall allow collection of the surcharge to continue for the period of years for which the surcharge was established.

Chapter 1

Introduction and Background

This allows MWD to be approved for a rate increase through the federal agency that funded the construction project. While PSC has some cursory oversight over these types of rate increases, it cannot modify or reject any portion of the agreement on its own authority. In these situations PSC must act no later than 30 days after the filing of the agreement to approve any agreement between the federal agency and MWD. Through the federal agencies' funding projects, MWD was approved for a rate increase in 2005 and 2008 for water and one in 2006 for sewer.

MWD Board Structure and Composition

The business and affairs of MWD are to be managed by its Board of Commissioners (Board) with the duties and powers as set out in KRS 74.070. Commissioners are appointed pursuant to KRS 74.020 for a term of four years, unless appointed to fill a seat vacated before the term expires. This statute requires the Board to be composed of three to five members as determined by the Pike County Judge/Executive. Members of the Board must be residents of the MWD service district, selected by the Pike County Judge/Executive, and approved by the Pike County Fiscal Court. According to MWD's By-Laws, Rules, and Regulations, the County Judge/Executive is provided with recommendations of district members from which to select a commissioner. Any vacancies are also filled by the County Judge/Executive.

The officers consist of a chairman, vice-chairman, a secretary, and a treasurer, each elected by the Board. Any two of the offices can be held by the same person, except the Chairman and the Secretary. The officer holds office until his successor is elected or until the officer's death, resignation, or removal. In the event that an election is not held, the officer continues to hold the office until an election is requested by a commissioner. A commissioner may be removed from office as provided by KRS 65.007 or KRS 74.455. According to KRS 65.007, a commissioner can be removed by the appointing authority, after a hearing with notice, for inefficiency, neglect of duty, malfeasance, or conflict of interest. KRS 74.455 gives PSC the authority to remove any water commissioner for good cause, including incompetency, neglect of duty, gross immorality, and failure to comply with rules, regulations, and orders issued by PSC. MWD's By-Laws, Rules, and Regulations establishes that the fees paid to the Board commissioners will be the same as those allowed in KRS 74.020, which requires an annual salary of \$3,600. If a commissioner receives six instructional hours, this statute allows the commissioners to be paid a maximum annual salary of \$6,000.

The MWD Board has the authority to establish and revise water and sewer rates and make reasonable regulations for the operation of the water and sewer services. The Board is authorized to award construction contracts and can finance the acquisition and construction of authorized works of improvement by the issuance of bonds, payable primarily from water revenue. This Board has all powers granted to water districts by the Kentucky Revised Statutes including those set out in KRS Chapters 74 and 106.

Chapter 1
Introduction and Background

The following table reflects the current membership of the MWD Board, along with their respective term dates:

Table 1: Current MWD Board of Commissioners

| Commissioner | Office | Date Initial Term Began | Date Current Term Expires |
|-----------------------|----------------------------|--------------------------------|----------------------------------|
| Rhonda James | Chairperson | September 2008 | July 31, 2010 |
| John Collins | Vice-Chairperson/Secretary | September 2003 | July 31, 2010 |
| Kelsey E. Friend, III | Treasurer | July 30, 2009 | July 31, 2013 |
| Ancie Casey | Commissioner | September 30, 2009 | July 31, 2013 |
| Prentis Adkins | Commissioner | September 30, 2009 | July 31, 2011 |

Source: Auditor of Public Accounts based on applicable statutes, MWD’s By-Laws, Rules, and Regulations, and the MWD website.

Contracting for operation, management, and maintenance of the district

Beginning July 3, 2005, the MWD Board entered into a management contract with UMG to perform the operations, management, and maintenance of MWD. According to documentation submitted as part of its proposal to MWD, UMG was organized August 10, 2004 and incorporated in February 2005. MWD became the first client of UMG. The contract between MWD and UMG was for a five-year term with an initial annual fee of \$6,819,000, subject to adjustment based on an increase in water and sewer customers and an annual change in the Consumer Price Index (CPI) for the percentage amount it exceeds each year over 2.5 percent. The specific CPI to be used for this calculation was not identified in the contract. As required by MWD, this contract transferred all MWD personnel to UMG. District equipment and infrastructure remained the property of the district; however, UMG had possession of and was responsible for the maintenance of these assets. From the inception of the contract in July 2005 through June 2010 MWD paid UMG over \$36 million. See Exhibit 1 for payment details.

The decision by the MWD Board to proceed to contract for services was made unanimously through resolution on March 30, 2005. The contract was entered into on June 10, 2005, which was approximately two months after the Board initially discussed contracting for new management and/or support staff. The table below documents the process followed by the district to enter into a management contract for its operations, management, and maintenance.

Table 2: Timeline of the 2005 MWD RFQ/P for Operation, Management, and Maintenance

| | |
|----------------|---|
| March 30, 2005 | <p>MWD Superintendent approaches Board and suggests the need for “new management and/or support staff.”</p> <p>MWD Board makes motion and unanimously approves resolution to authorize the advertisement for Request for Proposals (RFP) and the assembly of a five member advisory committee. Resolution 05-03-013, states “the Board of Commissioners of the Mountain Water District votes to approve the advertisement of Request for Qualifications/Proposals (RFQ/P) for management assistance.”</p> |
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| April 8, 2005 | RFQ/P is advertised in two newspapers, one state circulated and the other a local/regional circulated newspaper. |
| April 18, 2005 | Potential bidders attend a mandatory pre-proposal conference and inspection tour of MWD's facilities. |
| April 25, 2005 | 2 p.m. deadline established by the RFQ/P. Two bid responses received by MWD. UMG's competitor response states, "your RFQ/P schedule does not provide sufficient time for preparation of a quality, detailed, and firm priced proposal" and asks to "meet with the Management Advisory Team and interested Board Members to discuss your needs and desires in detail." |
| April 27, 2005 | MWD Superintendent informs Board that two preliminary proposals have been received. Advisory committee members are named; the advisory committee will be comprised of MWD Legal Counsel, MWD Accountant, Board Chair, a representative of a local engineering firm, and two MWD employees. |
| May 4, 2005 | Management Advisory Committee (Committee) meets to review and discuss proposals. Additional time is granted to both contractors to supplement their responses. Committee grades the two proposals on five of the six criteria stipulated in the RFQ/P. The Committee does not grade the proposals on pricing as one contractor has not yet submitted a price proposal. |
| May 11, 2005 | Deadline for contractors to submit additional information to MWD. |
| May 13, 2005 | Committee met for the 2 nd time and reviewed the price proposals. |
| May 18, 2005 | Date of Committee memorandum to the Board with recommendation on selection of winning bidder. Committee recommends UMG. Committee memorandum states that the Committee was comprised of MWD Legal Counsel, MWD Accountant, MWD Board Vice-Chair, a representative of a local engineering firm, and three MWD employees. |
| May 25, 2005 | UMG makes presentation to the Board. Motion made and approved unanimously by the Board to accept the Committee's recommendation to contract out management services to UMG. Board work session scheduled for June 6, 2005, to review the contract with UMG. |

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| June 6, 2005 | Special Board meeting held to discuss the UMG contract. The Board enters into and then reconvenes from Executive Session. Motion then made and unanimously approved by the Board to approve the agreement for operation, maintenance and management services with UMG pending changes outlined in Executive Session. |
| June 10, 2005 | Contract between MWD and UMG signed by both parties. |
| July 3, 2005 | Contract services to be provided by UMG begin. All MWD employees transfer employment to UMG. |

Source: Auditor of Public Accounts based on information and documents provided by MWD.

In July 2008, three years after the contract began, the MWD Board decided to review its contract with UMG and renegotiate the terms of the contract. On October 29, 2008, after attempting to make certain revisions to its contract with UMG, the MWD Board announced an agreement could not be reached and voted to terminate the contract in accordance with the contract terms.

Months after announcing the termination of its contract, UMG approached MWD with an offer and the termination of the contract was rescinded. The first amendment to the MWD and UMG contract was signed April 29, 2009. This amendment to the initial contract provided for a \$500,000 forgivable loan to be provided by UMG to MWD, reduction of the annual fee by \$46,000 a month, forgiveness of \$30,940 in repair and maintenance costs owed to UMG and removal of an original contract provision to pay UMG a set amount for each water and sewer customer once the customer base exceeded a specified level.

The contract between MWD and UMG has been amended two additional times since April 29, 2009. The first of these additional amendments was made on February 24, 2010, to extend the contract six months to December 31, 2010. The last amendment to the contract was approved on August 26, 2010, to allow the district to benefit from its tax exempt status on purchases made for repair and maintenance. Prior to this last amendment, MWD reimbursed UMG for all its repair and maintenance costs including tax. The tax was reimbursed because UMG was not entitled to tax exempt status when making purchases causing the district to pay the tax despite MWD having a tax exempt status. The following table summarizes the renegotiation process followed by the district along with the resulting amendments to the MWD contract with UMG.

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Table 3: Timeline of Contract Renegotiations

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| July 30, 2008 | MWD Board request Legal Counsel to perform a review of the contract with UMG. |
| September 24, 2008 | MWD Board approves renegotiating contract with UMG. |
| September 2008 | MWD proposes a one-time \$450,000 refund be made by UMG to MWD and a reduction of the monthly fee by \$76,250 (\$915,000 annually). |
| October 2008 | UMG rejects the MWD proposal. |
| October 29, 2008 | MWD Board made motion to notify UMG of its intent to terminate its contract pursuant to the contract. The motion passed unanimously. |
| Exact Date Unknown | MWD began negotiations with its former Superintendent, who was at that time the UMG Project Manager over MWD to assume his former responsibilities as Superintendent. Negotiations were not successful. |
| March 2009 | Renegotiations between MWD and UMG resumed by UMG. UMG offer was rejected. |
| April 2009 | MWD submits counteroffer, terms of which according to its Attorney were effectively incorporated in the April 29, 2009 amendment to the contract. |
| February 24, 2010 | MWD Board approves a six-month extension of its contract with UMG. Contract will now end on December 31, 2010. |
| August 26, 2010 | MWD Board approves amending contract whereby repair and maintenance purchases will be made directly by MWD and the amount of the purchases will be deducted from the monthly payment to UMG. |

Source: Auditor of Public Accounts based on information and documents provided by MWD.

*UMG limited
 auditors' access
 to its records*

MWD is a local public agency and a “public works” that owns and provides for the operation of water, wastewater and related treatment, collection and distribution facilities, which are public, governmental operations and facilities.

UMG is a Kentucky, for-profit, limited liability company organized in August 2004. On July 3, 2005, UMG entered into an “Agreement for Operations, Maintenance and Management Services” with MWD, to operate, maintain, and manage the operations of MWD, a “public works.” By contract, therefore, UMG manages and operates MWD, a public water works.

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KRS 43.050(2)(c) requires the Auditor to “[e]xamine periodically the . . . management . . . of all . . . public works . . . in the conduct or management of which the state has any financial interest or legal power . . .” MWD receives state funds to partially fund water and sewer construction projects. Because UMG manages the operations of MWD that are partially funded by the state, the state has a financial interest over UMG’s management and operation of MWD. UMG, therefore, is subject to the Auditor’s authority to conduct an examination of UMG’s management and operation of MWD. KRS 43.080 authorizes the Auditor to access the records it needs to conduct its audits and examinations of public works.

During the course of this examination, however, when the Auditor sought financial and other records from UMG pertinent to UMG’s operation and management of MWD, UMG, through its legal counsel, refused to disclose certain records it deems private, confidential, or proprietary, claiming it is a private entity not subject to the Auditor’s authority to access records. UMG did provide the Auditor with some records requested by the Auditor that UMG did not consider private, confidential, or proprietary, but did not fully disclose to the Auditor all the records the Auditor needed to conduct a thorough examination of the management and operation of MWD. The Auditor was also advised that UMG does not receive annual financial statement audits.

UMG receives substantial revenues from its contracts with two local authorities, MWD and Pikeville, and derives at least 25 percent of the funds it expends in Kentucky from these two local authorities. The Auditor advised UMG that this circumstance would appear to bring UMG under the coverage of Kentucky’s Open Records Act (Act), per KRS 61.870(1)(h), and subject it to disclose its records, upon request, in accordance with the Act. UMG, however, claimed that it, as a private entity, is not covered by the Act and does not have to disclose its records in accordance with the Act.

Auditors took into consideration the limited documentation provided by UMG. However, the documentation provided was not responsive to the APA request that would have allowed this office to perform an analysis of the actual cost to operate MWD.

Findings and Recommendations

Finding 1: The MWD Board entered into a privatization contract with insufficient planning to determine the benefits to or financial impact on MWD.

The MWD Board did not formally or openly discuss or document the anticipated benefits expected from privatizing the water and sewer operations of the district, nor did the Board conduct an analysis to determine what impact the contract would have on the financial stability of MWD. According to the minutes of the March 30, 2005 Board meeting, the MWD Superintendent at that time stated that it may be necessary to hire “new management and/or support staff” after noting the many in-house construction projects that MWD had scheduled for the next 12 to 15 months. Through Resolution 05-03-013, the Board approved advertising a RFQ/P for “management assistance” without any further discussion regarding the details of the services that should be included in the RFQ/P or the potential contract cost and benefit to MWD.

It was not until the May 25, 2005 Board meeting that the management contract was more fully discussed after a presentation by the president of UMG. During this meeting, the Board entered into an executive session to discuss the contract proposal. Upon exiting the executive session, the Board approved the proposal with no further discussion or explanation of the rationale for approving the contract.

In discussions with the MWD Board members serving at the time the management contract was initiated, a variety of reasons to enter into the management contract were provided. Certain Board members stated that the contract was to provide financial savings for MWD, while others believed that entering into the management contract would shift certain MWD liabilities, legal risks, and insurance responsibilities to the private vendor. Other Board members also noted that transferring MWD employees to a private vendor would alleviate political pressures to employ certain individuals with personal connections. None of the reasons offered by the Board members were noted in MWD Board meeting minutes or were documented as discussion items by the Board as part of the contracting process.

According to the Background and General Information section of the RFQ/P, “[t]he Board takes this action in order to save the District money, operate in compliance with public health, environmental and business management regulations, improve services to its customers and to assure good stewardship in protecting the public investment in the District’s facilities.” However, there is no documentation that the Board ever reviewed or discussed the RFQ/P prior to its advertisement.

Findings and Recommendations

Though Board members mentioned to auditors during interviews that cost savings and efficiencies were a reason for privatizing operations, no analysis was performed prior to or during the contracting process to determine whether the contract would result in any potential savings. In addition, while the MWD accountant conducted a cost comparison of the proposals submitted by the two vendors responding to the RFQ/P, no documentation shows the cost proposals were compared to past operational costs incurred by MWD or to future projected costs for MWD to operate the district. By not performing these analyses, the MWD Board did not have sufficient information to ensure that entering into a management contract was acting in the best financial interests of the district and the public that it serves.

While not a requirement for the type of privatization contract entered into by MWD, there are laws governing privatization that outline specific procedures that require public agencies to fully and openly justify a privatization contract. This type of privatization contract entered into by MWD is not governed by the local privatization statute, KRS 107.710 to 107.760, because the contract does not transfer the ownership of MWD infrastructure. This contract is also exempt from the state privatization statute because MWD is not a state agency. Though not directly required, these laws provide examples of best practices that should have been implemented when the MWD Board was considering contracting MWD operational services.

KRS 45A.551 provides procedures for state agencies to follow in the event of privatization, but many of the procedures included in the statute could be implemented by any public agency. KRS 45A.551(2) states that in considering privatizing a public service an agency “shall determine and set forth in writing:

- (a) The necessity for the service and the intended goals of the service;
- (b) Problems and inefficiencies existing with the current governmental operation of the services; and,
- (c) Whether the services can efficiently be provided by the agency.”

If it is determined through this analysis that privatization is still desired, the agency must document in writing various justifications for the privatization. This includes:

1. Tangible benefits of privatizing;
2. The availability of multiple qualified and competitive vendors;
3. A cost-benefit analysis comparing the total costs of the agency operations with the private vendor contract;
4. A plan of assistance for the employees affected by privatization; and,
5. A process for monitoring, evaluating, and enforcing the contract.

Findings and Recommendations

KRS 107.720 outlines procedures for privatization that involves the transfer of ownership of the actual water and wastewater infrastructure to the private vendor. Under this scenario, the law requires that the public agency notify the public at least two weeks in advance of a public hearing concerning the proposed privatization.

Though neither of these laws directly pertains to the privatization of operations at MWD, it is a public agency that is responsible to the public it serves. The laws developed to govern privatization contracts demonstrate that when privatizing a public service it is important to have a contracting process that is thorough and well documented. This ensures that all facets of such an action have been fully considered, that all decisions related to privatizing are transparent, and that the best interests of the public are the primary concern.

As the leaders of a public agency, it is the fiduciary duty of the MWD Board members to protect MWD and its customers. By fulfilling their fiduciary duty, the Board would have ensured the contracting process was well documented and fully justified in a transparent manner. Instead, the contracting process was conducted with little oversight or discussion by the Board. The discussions that were held were conducted in closed meetings, which provide no record of Board members' statements or rationale for the decision to enter into a management contract. Further discussion of the contracting process can be seen in Findings 4 and 8.

Recommendations We recommend the MWD Board ensure that any significant contracts are properly evaluated for the benefits they will provide to the district and its customers. Further, discussions concerning these contracts should be conducted in an open and public process.

We recommend a complete and thorough analysis of the financial benefit to MWD be performed prior to finalizing a management contract. The Board should have sufficient information to properly plan all aspects of the decision to privatize service and to ensure that the contract requires detailed financial and other information necessary for the Board to appropriately oversee the management of the district.

Finally, we recommend MWD follow the best practices required in statute for privatizing public services.

Findings and Recommendations

Finding 2: The Cost to Operate MWD Services Are Unknown Due to the Lack of Financial Information Provided by the Vendor.

The actual cost to operate MWD water and sewer services is not known by the MWD Board. This prevents the MWD Board from ensuring that the district is being managed in the most efficient manner possible and is financially responsible to the public it serves. Under the management and operations contract with UMG, there is no provision that the actual costs incurred by UMG to operate MWD water and sewer services be reported to the Board or be made available upon request of the Board. The lack of this significant financial information makes it impossible for the MWD Board to perform an analysis and determine the financial benefit of the UMG management contract or the extent to which the management fee paid to UMG exceeds the actual district operational costs. The lack of financial information also diminishes the possibility of any future competition for the management contract, as any other contractor would be at a competitive disadvantage to UMG given that historical operational costs could not be provided to other contractors. In addition to the lack of financial information received by the Board, it is currently impossible for MWD to obtain approval for general water or sewer rate increases from the PSC because actual costs of the utility must be submitted for review to request a rate increase. This could result in a difficult financial situation if the MWD Board has a justifiable need to request a rate increase to generate additional revenue.

MWD is at a disadvantage in contract negotiations

The management contract between MWD and UMG was designed to encompass all aspects of the operation of water and sewer services, including the transfer of all MWD employees to UMG. Payment for this service is based on a schedule of fees agreed upon in the contract. These fees are not based upon costs, but rather a price negotiated between the two parties at the time the contract is signed. This approach could allow UMG to implement efficiencies in the operation of MWD services in order to increase profit margins with MWD and the public realizing no benefit from potential cost reducing efficiencies. While a for-profit corporation is entitled to ensure it receives sufficient payment for its services, MWD is a public agency and the MWD Board remains responsible to the public to ensure resources are used as efficiently and effectively as possible. A public agency should ensure that expenses are justified and reasonable.

The initial contract with UMG was established in June 2005. At that time, MWD operated all water and sewer systems internally and was aware of the costs to provide the services to the public. Once the contract began, MWD no longer had access to this cost information. Though the initial management fees may have been generally based on the operational cost incurred by MWD, the contract also included provisions that allowed the fees paid to UMG to increase. After the contract was in place for over one year, the monthly fee paid to UMG increased from \$568,250 in July 2005 to \$588,643 in September 2006, for an additional amount of \$20,393. After three and one-half years, the monthly fees paid to UMG had increased by over \$70,000. By April 2009, MWD renegotiated the contract with UMG and removed the added fees, but during the renegotiation increased the base management fee paid to UMG by \$23,672 per month over the original contract management fee. See Exhibit 1 for monthly contract fees paid to UMG.

While MWD was able to reduce the overall amount paid to UMG through a renegotiation, the negotiated amount was not based on the costs incurred by UMG to operate MWD in addition to a reasonable profit. Instead the negotiations appeared to simply involve a determination of the amount MWD was capable of paying and the fee amount UMG was willing to accept. According to the MWD contract accountant, during the renegotiation process he could only “guesstimate” the UMG costs based on MWD financial audits performed prior to the contract. This placed the MWD Board at a disadvantage in the negotiation process and may have resulted in excess payments for the service being provided.

As an alternative to negotiating with UMG, MWD could choose to open the service for competitive bidding in order to obtain a lower price; however, without actual costs to provide to a prospective vendor it would be difficult for them to provide an accurate cost proposal. This gives UMG an advantage over any other vendor that would make any bidding process a non-competitive event. Further, during the 2009 renegotiation, MWD accepted a \$500,000 loan from UMG with the loan forgiven over the next five years if the contract remains with UMG. If the contract is terminated, MWD must repay UMG the remaining unforgiven amount of the loan. MWD does not have the financial resources to make such a payment and has little choice but to continue the contract with UMG.

In general, a lack of financial information to operate and maintain the MWD infrastructure places the district in a detrimental position unable to determine whether services provided under the management contract could be provided for a lower fee, and if so, the means to determine a reasonable fee. As the oversight body for a public agency, the MWD Board should have ensured that the best possible bargaining position is held by MWD and not the contractor with which it conducts business.

No general rate increases possible due to limited cost information

As a public utility, MWD obtains the majority of its funding from the fees paid by water and sewer customers. As costs increase, a utility may require an increase in the rate of those fees to ensure a sufficient revenue stream to continue operations. These rates cannot be increased at the will of the utility because public utilities such as MWD are regulated by PSC. All rates charged by MWD must have the final approval of PSC but several rate increases were approved for MWD through the United States Department of Agriculture Rural Development (RD) program. PSC only performs a cursory review prior to approval of rate increase through the RD program. If there is a direct request to PSC for a general rate increase, the request is reviewed in much greater detail, requiring a review of actual operating costs. As funding for RD projects have been diminishing, the potential necessity for a general rate increase through PSC may increase.

Findings and Recommendations

A significant aspect of the PSC review includes an evaluation of the costs incurred by the utility to provide the service. Currently, MWD has no access to the actual costs to provide either water or sewer services. Only the cost of the management contract with UMG is known and the PSC has stated that the contract costs are not sufficient to perform a cost evaluation. PSC staff must be able to determine what costs are allowable before determining if a rate increase can be justified. This review cannot be performed under the current arrangement between UMG and MWD. This means MWD does not have sufficient information to present to PSC in the event it requests an overall rate increase for either water or sewer services. Further, without access to this information, it is not possible to determine whether UMG has excessive or unusual expenditures.

While a rate increase is never desirable for utility customers, it is occasionally a necessity to ensure that a utility has sufficient financial health to continue to provide the public with essential services. By not being able to obtain a rate increase, MWD potentially risks the stability of the district and the ability to continue to provide effective water and sewer services.

*No cost data
provided to APA*

In an attempt to determine if the contract for management services between MWD and UMG was financially beneficial to MWD, the APA requested that UMG provide the costs incurred to provide water and sewer services for MWD. UMG declined to provide such information stating that it is “confidential and proprietary information.” UMG noted that the contract with MWD is based on the concept that the vendor assumes the cost of the operations. It is then incumbent upon UMG to implement efficiencies and control internal costs in order to make a profit. If UMG fails to do so, then they would incur a loss. Similar to the MWD, this lack of information means it was not possible for the APA to make any clear determinations whether the management contract saves MWD money and if the contract fee is excessive.

Recommendations

We recommend the MWD Board ensure that any privatization contract for management and operations services contains a provision that will allow for access to cost information about the operations of MWD. The contract could require the vendor to report MWD operational costs information on a monthly and annual basis.

We recommend the Board consider a management fee structure to operate and maintain MWD and to provide an agreed upon margin of profit.

Findings and Recommendations

Finding 3: The initial contract for management services had a detrimental impact on MWD, and the Board failed to act in a timely manner to address the issues.

The MWD Board did not sufficiently consider the terms and language of the management contract with UMG to ensure there were adequate safeguards protecting MWD interests, nor did Board members react in a timely manner to address the terms of the contract that had a detrimental effect on MWD. The original terms of the management contract resulted in a rapid increase in the fees MWD was required to pay to UMG. After the contract was executed, operating costs for MWD began to escalate at a faster rate creating increasingly higher operating losses for the district despite increasing revenues. See Exhibit 2. Increasing monthly payments made to UMG limited the ability of MWD to continue to meet other necessary financial obligations, including the ability to make existing bond payments. In addition, the contract did not clearly define the administrative duties to be performed by UMG leading to potential conflicts of interests between the interests of MWD and the interests of UMG as a private contractor.

Based on a review of available documentation, it appears the lack of consideration of contract terms is due in part to the expedited contract process to hire UMG as a private manager of MWD. On March 30, 2005, the MWD Board passed resolution 05-03-013, at the suggestion of the former MWD superintendent, to advertise a RFQ/P “for management assistance.” The contract awarded to the winning bidder was signed on June 10, 2005. The entire process followed by the Board to procure the management services for a five-year, multi-million dollar management and operations contract took just over two months to complete.

The brief contracting process followed by the Board to complete the contract with UMG did not allow sufficient time for the Board members to adequately consider the potential impact of the contract on MWD or to provide sufficient safeguards to protect MWD’s interests. Despite the extent of the management contract, there is no significant discussion among MWD Board members documented in the Board meeting minutes prior to the approval of the contract. While carefully analyzing the contract terms and language, auditors identified contract areas that should have received further scrutiny by the Board resulting in better negotiated contract terms to ensure no negative financial impact and that monitoring safeguards were established.

Financial impact of MWD contract with UMG

During the examination of MWD, former and current Board members, the MWD contract attorney, the MWD contract accountant, and other staff consistently cite an unexpected large increase in the customer base as one of the primary factors in the cost of the contract with UMG increasing significantly. This issue primarily results from a provision in Section 7.1 of the management contract that states,

commencing with the one-thousand-one (1001) new water or four-hundred-one (401) new sewer customer is connected, UMG will be entitled to an additional continuing monthly fee (which shall be added to and thereafter considered a part of the Annual Fee for all purposes of this Agreement and paid on a monthly basis with the payment of the Annual Fee at the end of each month as provided in Section 8.1 hereof) equal to (i) \$23.50 multiplied by the number of new water customers connected during such month, plus (ii) \$19.00 multiplied by the number of new sewer customers connected during such month.

Due to this section of the contract, the monthly fees paid to UMG began rapidly increasing after the contract was in effect for one year. By April 2009, water customers had increased by 3,376 and sewer customers by 680. The monthly fees paid by MWD for the increase in water and sewer customers discussed in Section 7.1 of the contract initially increased by \$11,301 in September 2005, and eventually increased to \$61,156 in extra fees paid per month in April 2009. In total, invoices from the contractor show that MWD paid UMG an additional \$1.34 million between September 2006 and April 2009 due to the increase in MWD's customer base.

This section of the contract was not included in the draft contract proposed by the contractor in response to the RFQ/P, and was only added after the Board agreed to award the contract to UMG on May 25, 2005. This indicates the Board spent very little time evaluating the impact of the terms of this new section prior to the contract signing date of June 10, 2005.

While Section 7.1 appears to have been added to the contract to allow UMG to receive additional payments to offset an increase in operational costs from an increase in the customer base, the future financial effect on MWD does not appear to have been considered. The rate being paid to UMG for every new water customer over 1,000 was \$23.50, while the minimum monthly bill that MWD was allowed to charge a water customer according to the Tariff filed with PSC was only \$18.06 at the time the management contract was signed. This means for any customer paying the minimum monthly bill MWD was losing \$5.44 per customer per month.

MWD representatives have stated that typically water customers use more than the minimum amount of 2,000 gallons per month, and it was estimated that this contract provision would not have an adverse effect on MWD. For those customers using more than the 2,000-gallon minimum, the charge at the time the contract was signed was \$6.03 per additional 1,000 gallons. A customer using 3,000 gallons would then be charged \$24.09, leaving MWD with only \$.59 in revenue per customer after paying UMG. Any additional use of water would continue to increase the MWD revenue by \$6.03 per 1,000 gallons. This trend continued even after MWD implemented a rate increase through RD under the provisions of KRS 278.023, with the minimum water charge increasing to \$20.02 in March 2008, still below the monthly customer payment amount to UMG.

While the average customer payments may be more than the amount paid to UMG, the revenue remaining for MWD was minimal in comparison. In addition, the majority of the new water customers added since the start of the UMG contract were under the Low and Moderate Income (LMI) Tap program. This program allowed residents with low to moderate incomes to have a free water tap placed on their property for the purpose of connecting to MWD water lines. As part of the program, the recipients were required to pay the minimum monthly bill to MWD, but were not required to hook their homes to the newly placed tap and to actually use MWD water. This resulted in an inordinate number of new MWD customers that were only paying the minimum monthly payment in order to receive a free water tap.

In total, 3,376 new customers were added from July 2005 to April 2009, with MWD paying UMG \$23.50 for 2,376 of those each month. For the majority of these customers, MWD was losing revenue. Since the LMI program was discussed at the same time the initial contract with UMG was being developed, the details were known to the MWD Board and staff. Had the demand from this program been considered when establishing the contract terms, the resulting financial impact could have been avoided by specifying additional contract terms that better protected MWD.

In the initial RFQ/P, MWD included a protective provision intended to be included in the final signed contract, but the Board failed to ensure the language brought forward from the RFQ/P to the actual contract. Under section III. PROVISIONS TO BE INCLUDED IN A SERVICE CONTRACT, I.13 the RFQ/P stipulates the following provision should be included in the agreement:

[p]rovision for the District and Contractor to negotiate an increase or decrease in the annual price in the event any significant change occurs in the system affecting the level of services covered in the contract. Such changes may result from new regulations, significant increase or decrease in the number of system customers or other cause.

While section 9.2 of the management contract between MWD and UMG does require the annual fee to be increased or decreased by the additional or reduced cost associated with the change in scope plus ten percent if certain scope changes do occur, a significant increase or decrease in the number of system customers is not one of the specific scope changes that would trigger such action. Rather, the contract addresses changes in the customer base under Section 7.1. Had the district proceeded with its initial provision as outlined in the RFQ/P, UMG would have had to present its costs for providing additional services to the increased customer base rather than automatically receiving a predetermined amount as was established under Section 7.1 of the contract. After months of renegotiations between MWD and UMG, the contract language addressing additional customer fees was removed from the contract in April 2009.

Further terms in Section 7.1 of the contract included other requirements for MWD to pay UMG beyond the original management fee. Specifically, the contract terms state the annual fee will be increased “if and to the extent that the percentage increase in the CPI as published by the Bureau of Labor Standards during the immediately preceding Agreement Year exceeds 2.5%.” This term in the contract is not clearly specific to which CPI indexes would be monitored and used in this calculation.

The Bureau of Labor Statistics provides general guidelines to consider when developing a contract using the CPI. According to these guidelines, one should identify precisely which CPI index series will be used to increase the base contract payment. CPI indexes can be specific to regions of the country and can be very specific in their measure of changes of goods in certain categories, such as utilities or rent. Neither the contract language nor the contractor’s invoices to MWD identify the CPI to apply to the annual fee paid to UMG. This is a significant issue, as MWD should ensure that the CPI used fairly represents the inflation cost for this specific industry and for this geographic area.

Like the previously discussed terms of Section 7.1 of the management contract, this increase in fees does not appear to have been sufficiently considered and eventually added to the financial hardship of MWD. Beginning in September 2006, MWD paid a monthly fee of \$9,092 due to an increase in the CPI. As the CPI continued to increase, the fee paid by MWD increased to \$9,660.26 per month. Overall, MWD paid an additional \$295,490.08 between September 2006 and April 2009 before the management contract was renegotiated and this fee is not charged.

The combined fees resulting from additional customers and the CPI adjustments increased the total payments to UMG by \$1,640,391.58 between the period of September 2006 and April 2009. See Exhibit 1 for monthly contract fees paid to UMG. These expenditures are beyond the original management fee and repair and maintenance fee paid to UMG from the beginning of the contract. Based on a review of the MWD Board meeting minutes, the Board expressed a growing concern regarding the district’s ability to meet the district’s bond debt repayment obligations. The Board ultimately authorized the use of most of the MWD reserve funds to make these bond payments. Had these additional fees not been included in the contract, MWD may not have had to resort to the use of reserve funds to make ongoing bond payments. The additional fees paid to UMG could have been used to pay the required debt payments during that time period. By finalizing the contract in such a short period of time and allowing these terms to be in the initial contract, MWD was subject to contract terms that were financially detrimental.

Findings and Recommendations

While Section 7.4 of the initial contract states: “[t]he Annual Fee (and Maintenance and Repair Limit included therein) shall be negotiated each Agreement Year at least six (6) months prior to the anniversary of this Agreement’s effective date.” MWD did not renegotiate the initial contract with UMG until April 29, 2009 to remove the additional fees. Board meeting minutes document that the MWD Board was routinely informed of the impending difficulties in meeting bond payments. Rather than monitoring and discussing the increase in fees being paid to UMG, discussions were held to determine if a rate increase to customers was required. This appears to indicate members were slow to act despite evidence of impending financial problems.

UMG operational costs are necessary to determine reduction in management fee

Auditors also found that while the contract did allow for a decrease in the fees to be paid to the contractor in the event of certain scope changes identified in section 9.2 of the contract, the opportunity for MWD to reduce the annual fee would require UMG to share its costs with MWD and further MWD would rely on the contractor to notify it if one of the qualifying changes led to a reduction in its costs. It was understood by both the former and current Board members interviewed by auditors that the contractor is a for-profit business with the objective to make a profit and as such will make efforts to reduce UMG costs in different areas. Given that the contract does not specifically require cost information to be shared or disclosed to the district on a periodic basis and MWD does not require UMG to submit annual financial audits, we find this term to be insufficient and ineffective. Even if MWD believed a cost reduction had occurred due to certain scope changes and UMG willingly provided MWD with its costs, MWD would have no independent means by which to validate the costs presented to them by the contractor. Further discussion of this issue is found in Finding 2.

Contract does not provide for monitoring of UMG financial stability

In addition, the contract did not include language that provided any means by which to verify the financial viability of UMG through a financial audit opinion or through another form of independent review. Given that MWD outsourced its operations and management of vital public services to UMG, a new entity with no prior clients, MWD had a responsibility to the public to ensure the company they contracted with was financially secure and could function for a five-year period without adding additional costs to the district.

According to MWD’s contract accountant, the district would know if UMG had financial problems because UMG representatives would have come to the Board and requested additional funding before reaching that point. While the contractor approaching the Board for additional funding would be a possible indicator that the contractor was not able to support its own operations, MWD should not hold itself in a situation where it may be required to act in a rushed manner to make a determination on how to proceed in ensuring the district’s operations continue without interruption of service to its customers.

Chapter 2

Findings and Recommendations

Management contract lacked clear requirements for many administrative duties, resulting in potential conflicts between the interests of MWD and UMG

In addition to the financial issues, through the quick contracting process the Board failed to consider how contracting the operation and management of MWD, including the complete transfer of all of its employees to the contractor, would affect the roles and responsibilities of the Board and its former employees, and how that should be addressed in the contract language.

The contract between MWD and UMG transferred employment of all MWD employees to UMG, including the MWD Superintendent, who then became the UMG Project Manager over MWD. Section 2.18 of the contract states that UMG would “provide all the administrative and financial functions as currently provided by the DISTRICT’S staff, and any and all other administrative and financial functions necessary to effectively operate the business affairs of the DISTRICT.”

In his capacity as an employee of MWD, the Superintendent was heavily involved in new construction projects including the bidding process, project inspection, and other project details. The Superintendent would report directly to the Board and make presentations to the Board with recommendations for action by the Board. After becoming a UMG employee, the former Superintendent no longer reported solely to the Board but also to his new employer. However, the former Superintendent continued to perform his old job duties as he had previously. Former and current Board members interviewed indicated that the Board relied heavily on this individual as he served in both capacities. The current UMG Project Manager has noted that there are certain duties that were performed by his predecessor that he believes are not duties he should be performing in his capacity, such as reporting to the Board on MWD financial activity.

In reviewing Board minutes, auditors found that the Board acknowledged in late 2006 the need for an administrative position to report directly to the Board, independent of UMG. After selecting a committee to discuss the position and its responsibilities, the discussion of moving forward in the process ended by July 2007. During MWD’s contract renegotiations with UMG in 2009, MWD amended the contract language to state “the DISTRICT may, at its discretion, hire an individual to provide administrative and financial oversight for the DISTRICT, and report directly to the Board of Commissioners.” While the new language was placed into the contract amendment, the Board has not acted to fill that position due to a lack of funds.

In addition to the former Superintendent, all other staff that were transferred from MWD to UMG continued to perform their regular duties; however, just as with the Superintendent all other employees were now to report to UMG rather than the district. After the initiation of the contract, UMG employees are still responsible for receiving MWD invoices, writing checks from MWD accounts, including checks to itself, and presenting the checks to the Board for approval and signature.

Findings and Recommendations

In discussing the presentation of checks to the Board, former Board members interviewed stated that they were presented with a list of bills to be paid and if they had questions they would discuss the issue at the time of the meeting and if they wanted to see supporting documentation for any bill on the list they could ask for the documentation. Once approved, any two Board members could sign the checks.

The former Board members interviewed stated that any questions or discussion of bills would be documented in the Board meeting minutes. A review of Board meeting minutes, between July 1, 2004 and January 27, 2010, found no discussion by Board members regarding the payment of checks other than the Board acknowledging receipt of the bills and motions made to approve payment of the bills.

In discussing the check process with the accountant on contract with the district, he stated that he did not reconcile MWD checks to the invoices or billing statements during the period under review. He relies on the CPA conducting the MWD annual financial statement audit to perform that type of review. The CPA firm auditing MWD acknowledged testing expenditures annually on a sample basis. It is our understanding that the bill payment process has changed recently and that the Board is now receiving the supporting documentation for the payments.

Finally, the contract between MWD and UMG does not require UMG employees to follow all internal control policies established by MWD. According to the Board chair, UMG is an independent contractor that can perform the work any way they want. Although UMG is an independent contractor, MWD is still responsible for the fiscal affairs of the district and as such can and should provide some guidelines by which the contractor fulfills its obligations per the contract.

While the Board has contracted the majority of its management and operations to UMG, it retains the responsibility to perform responsible oversight and administrative duties.

Recommendations

We recommend the Board ensure any future contracts for operations, management and maintenance are closely examined before entering into an agreement with a contractor to perform those services. In its examination of the final contract, the Board or its representatives should ensure that desired provisions in the draft contract are actually included in the final contract for services.

Findings and Recommendations

We recommend the Board avoid provisions increasing fees automatically to the district. Any increase in fees should be open to discussion and not automatically applied. If the cost of providing services increases due to an increase in the district's customer base or an increase in the cost of materials or supplies to provide the service, the increased cost should be justified, reviewed by the Board or its independent representative, and the approval to increase the fees should be documented.

We recommend that the Board ensure that contract terms are clear, concise, and well defined. The Board should avoid terminology that is not clearly defined so as to avoid potential disputes between the contractor and the district. This includes the roles and responsibilities of the contractor and the district.

We recommend the Board take a more proactive approach to overseeing the operations and management of the district. The Board should have an administrative employee working at the direction of the Board, representing the interests of the Board, reporting directly to the Board, and to oversee its projects and other financial affairs. The Board has not been able to fill this position in the past due to a lack of funding; the Board should consider its need for funding as it negotiates any future contracts for operations, management, and maintenance. This position is vital to ensure proper checks and balances are in place to safeguard the district's interests.

We also recommend the Board create a finance committee, from its membership, to meet regularly with its representative to discuss the district's finances. The meetings should include review of all bills, along with supporting documentation, discussion of the bond reserve levels and any other financial matters it deems necessary. This committee should report its activity and discussion to the full Board. This committee could also serve as the contact for the CPA performing the district's annual financial audit.

We recommend the Board require an annual financial statement audit of its contractor and that the audit, including the management letter, be provided to the district. Financial information that should be required by the contract includes that the vendor receive an annual audit of its financial statements that will be provided to the Board within a determined time period.

Lastly, we recommend any contract for operation, management, and maintenance of the district require the contractor to follow all internal control policies established by MWD.

Findings and Recommendations

**Finding 4:
Irregularities were
identified in the
initial MWD
contract for
operations,
management, and
maintenance and
the established
contract bid
process was not
followed.**

An examination of the documentation from the RFQ/P process followed in 2005 by MWD in contracting for operations, management, and maintenance of the district along with Board meeting minutes dating back to July 2004, and through interviews of many former and current Board members, auditors identified several irregularities in the RFQ/P and bid process. These irregularities cause significant concern pertaining to the initiation of the RFQ/P and the bidding process followed by MWD in contracting with UMG.

On March 30, 2005, the MWD Board voted unanimously to begin a RFQ/P process that led to a five-year contract for the operation, management, and maintenance of the district. The motion and vote by the Board came immediately after the now former Superintendent made a presentation to the Board stating, “with all the projects that the District has for the next 12-15 months, it may be necessary to hire new management and/or support staff.” In response to the Superintendent’s comment, the Board made a motion and passed Resolution 05-03-013, authorizing an RFQ/P for “management assistance.”

The minutes do not indicate that the Board ever received a copy of the RFQ/P it approved to be advertised. In discussing this matter with some former Board members, they could not recall if they received the RFQ/P, but the former Board Chair stated that if it wasn’t recorded in the minutes she would have to say that it wasn’t presented to the Board.

Review of Board meeting minutes from July 28, 2004 through February 28, 2005 do not document any discussion by the Board regarding its interest or desire to contract for operation, management, and maintenance of MWD prior to its March 2005 meeting. Further, the description of the services stated by the Superintendent, as recorded in the meeting minutes, and the services described in the resolution, do not agree to the magnitude of the services ultimately requested in the RFQ/P.

In addition to the discrepancies between the meeting minutes, the resolution, and the RFQ/P in describing the services to be provided, the detailed RFQ/P was issued nine days after the Board’s approval to advertise. Given that the Board did not review a RFQ/P at the time of its meeting, and there was no discussion recorded in the minutes prior to the March 30, 2005 that the Board directed the preparation of a RFQ/P, nine days does not appear to be sufficient time to create such a detailed document. It appears the RFQ/P may have been created before the Board’s resolution to be ready to advertise and the RFQ/P may not have been provided to the Board for input or review.

In discussing this issue with MWD representatives, including but not limited to, its former Board members, no one was certain who wrote the detailed RFQ/P or when it was written. The RFQ/P itself indicates that it was created sometime in “March, 2005.” Some assumed the Superintendent or the Attorney on contract with MWD may have written it. However, with no previous discussion of contracting for such services noted in the Board minutes dating back to July 2004, and no indication that the Board saw the RFQ/P prior to its advertisement on April 8, 2005, it is clear that the Board did not formally approve or discuss what the district would want or need in an RFQ/P.

While one former Board member recalled the topic of MWD contracting with a vendor to operate the district once before around 1999 or 2000, he could not recall if a RFQ/P had been issued at that time. He stated that he remembered a representative from an out-of-town company, perhaps from Louisville, appearing before the Board and presenting them with a sales pitch detailing services their company could provide to MWD and that he didn’t see the benefit at that time of contracting with that company for services. Others we spoke with could only recall the subject of contract management had been discussed before but could not recall when those discussions took place, who was included in the discussions, and whether the discussions occurred during a formal Board meeting or through informal conversations.

From discussions with former Board members and a review of the documentation maintained by MWD relating to the process followed to initiate a contract for operation, management, and maintenance of MWD, it appears that the Board had little actual involvement in or understanding of the process. However, it is clear that the process proceeded rapidly.

The proposals to be provided to the district by 2 p.m. on April 25, 2005, were to include a draft contract. In examining the draft contract provided by UMG, auditors found a date on the contract indicating UMG may have already been aware of the RFQ/P at least two months prior to the Superintendent making a presentation to the Board to discuss the possibility of additional management or personnel. At the top of the draft contract presented by UMG to MWD on April 25, 2005, it reads, “THIS AGREEMENT is entered into this 12th day of January, 2005.”

One former Board member confirmed the involvement of UMG prior to the Board’s decision to advertise an RFQ/P in March 2005, stating that he specifically recalled the COO of UMG speaking with him about his new company and trying to gain support on the Board for UMG working for MWD. Ultimately, this former Board member credited the COO for convincing the Board to initiate the RFQ/P.

Auditors identified another irregularity in the bidding process during a review of the actual bid analysis performed by the Management Advisory Committee (Committee). This Committee was comprised of one Board member, contract attorney, contract accountant, contract engineer, and three MWD employees. The bid analysis process was created to evaluate the proposals submitted to MWD. On May 4, 2005, after receiving the initial proposals from the two contractors, the Committee met to review and discuss the proposals. Because the contractor competing against UMG for the contract had expressed to MWD that the “RFQ/P schedule does not provide sufficient time for preparation of a quality, detailed, and firm priced proposal,” the Committee offered both contractors additional time to respond to the RFQ/P. Rather than waiting for the additional information from both contractors to be provided, the Committee proceeded at the May 4, 2005 meeting to grade the two proposals on five of the six criteria stated in the RFQ/P, not grading the proposals on pricing.

In its memorandum to the Board, the Committee states, “[w]hile it initially appeared that AWR’s proposal was substantially cheaper, an apples to apples comparison was made which reflected that the pricing was essentially the same.” The memorandum indicates that the comparison was prepared by the MWD contract accountant and “[t]here was not a vote on pricing as totals would not have otherwise changed as AWR fee were higher based on the additional fee for the first six months.”

According to the MWD contract accountant, he performed an analysis of the costs associated with each contract because certain costs included within UMG’s proposed annual fee were not covered as part of the costs proposed by the other contractor and those additional costs would remain the responsibility of the district. While the explanation for the analysis is logical, auditors examined the analysis and were unable to determine the validity of all the amounts used by the accountant to adjust the pricing of the competing contractor’s proposed annual fee. The accountant was not able to provide documentation for specific amounts in his analysis, noting that he did not maintain a file pertaining to the initial contract and that the MWD contract attorney would have maintained a file.

We contacted the MWD contract attorney to determine if any additional information pertaining to the analysis existed. Their attorney did have a file pertaining to the Committee’s review and recommendation to the Board, including the analysis which was referenced as an exhibit to the memorandum to the Board; however, the file did not include any further information pertaining to the source of the amounts used in the accountant’s analysis.

The accountant stated that the numbers the auditors had difficulty reconciling to supporting records, would have likely come from prior MWD audit reports or simply be costs known by MWD at the time of the analysis. After examining MWD budget reports and prior year audit reports, auditors were still unable to verify the total amounts used to adjust UMG’s annual fee.

Findings and Recommendations

In 2009, after the UMG Project Manager over MWD was released from his position with UMG, local media reported testimony of a UMG representative identifying the former Project Manager as having ownership in the company. While still serving as Superintendent of MWD, this individual was also shown as a UMG representative who would serve as the contract project manager. Upon beginning this examination, in a meeting with representatives of MWD, including its Board Chair and Vice-Chair, the Vice-Chair stated that the former MWD Superintendent was very persuasive in the initiation of the contract process with UMG. The Vice-Chair is the only current Board member who served on the Board at the time MWD began the process that led to the 2005 contract with UMG.

Considering the irregularities identified through the course of this examination pertaining to the initiation of the RFQ/P and the process followed by MWD in awarding the contract, the former UMG Project Manager/MWD Superintendent's ownership interests in UMG, and the statement by the Vice-Chair regarding that the former Superintendent was very persuasive in his recommendation to the Board, auditors question the process followed to initiate the management contract with UMG. Further, due to the former Superintendent's ownership interest in UMG, a conflict of interest may have existed because of the opportunity for him to personally benefit financially from MWD entering into a contract with UMG.

Auditors made several attempts to interview both the former UMG Project Manager/MWD Superintendent and the UMG COO to address these and other issues related to the examination. The former UMG Project Manager/MWD Superintendent stated that he was advised by his attorney not to speak with our office due to recent litigation settlements with both MWD and UMG.

Recommendations We recommend the Board review and ensure its understanding of any RFQ/P before voting to approve advertisement of such. The Board should be actively involved in determining the content of the document and directing its process.

Because the Board may consider employing someone in the future that will directly report to the Board, we recommend the Board require conflict of interest statements and disclosure statements for management employees reporting directly to the Board to ensure full disclosure of any interests by its management.

We recommend MWD ensure that proposals are fully graded consistent with the criteria stated in its RFQ/Ps. If MWD allows more time to contractors to provide additional information, impacting their proposals, the district should ensure proposals are graded only after all information has been received, as long as the receipt of the information is made within the approved deadline dates and times.

We recommend any calculations used in the analysis of bid proposals be adequately supported and the supporting documentation maintained to eliminate or address any dispute that may arise as a result of the calculations.

Findings and Recommendations

Finding 5: UMG received payments for services not specified in the contract with MWD without approval by the MWD Board.

In reviewing payments made to UMG by MWD, auditors found payments made in addition to the bi-monthly fees paid to UMG. No documentation was found that the Board approved the additional payments. In one case, UMG received payment for work performed by another contractor.

On July 15, 2005, just a few days after finalizing the contract for management and operations, UMG submitted an invoice to MWD for “100% of Administration Cost for Phelps Phase I Sewer Project” in the amount of \$35,682.50. The invoice was paid from the sewer project’s Coal Severance funds on September 15, 2005. According to UMG’s office staff onsite at MWD, the administrator of each construction project is selected by the Board and is paid from funding for each project. The administrator of each project is to handle the financial paperwork for the project with the majority of the work typically performed at the beginning of the project.

In the case of the Phelps Phase I Sewer Project, an employee of the MWD contract accountant on contract with MWD performed the administration for that project. In June 2005, the accountant’s employee was hired as a full-time employee of UMG. When the individual changed her employment to UMG, the administration responsibilities for the Phelps Phase I Sewer Project were transferred along with her to UMG.

While examining the invoice and payment from UMG for administration of the Phelps Phase I Sewer Project, auditors questioned the appropriateness of paying the entire amount for administration of the project to UMG when the services were previously provided by the administrator in her capacity as an employee of the accountant’s firm. In discussing this matter with the accountant, he stated that he was unaware of that payment and would look into the matter further. The accountant contacted his former employee to discuss the issue and later reported to our auditors that she had billed UMG for one-half of the \$35,682.50 on behalf of the accountant in September 2005.

According to the accountant, his former employee explained to him that she had been instructed by the former UMG Project Manager to split the administration fee in that manner, one-half to the accountant and the other half would be retained by UMG. However, in discussing the matter directly with the former employee, she told auditors that she did not recall billing on behalf of the accountant and believed he must have done that since she was not his employee at that time. She assumed that the accountant must have talked to the UMG Project Manager at that time to work out the payment. The accountant provided our office with an invoice and a bank statement showing that a deposit of \$17,841.25, exactly one-half of the amount paid to UMG, was made into his account on September 23, 2005, eight days after Board members signed a check made to UMG for \$35,682.50.

While the statements are conflicting, and we are not able to discuss any matters directly with the former UMG Project Manager on the advice of his attorney, the documentation provided clearly shows that UMG received payment for services not included as part of its contract with MWD. However, the check to UMG was signed by two Board members indicating their approval for the payment. Board meeting minutes do not include any discussion of this matter and former Board members could not recall assigning the responsibility for the administration of the Phelps Phase I Sewer project to UMG. It appears that the Board approved a payment that should have been directed to another contractor. By its action, the Board failed to demonstrate proper fiscal responsibility.

On September 13, 2005, MWD entered into a three-year contract with Elkhorn City (City) to provide wholesale water. Two months later, on November 15, 2005, UMG submitted its first monthly invoice to MWD for water production costs associated with providing wholesale water to the City. Between November 2005 and December 2009, UMG received an additional \$200,000 for producing wholesale water to the City.

The monthly invoices from UMG contain a notation referring back to the UMG and MWD operation, management, and maintenance contract, indicating that the cost is in agreement with their contract. While the contract between UMG and MWD does allow for additional payments to be made to UMG for additional services, discussion of this additional service or cost was not formally documented in Board meeting minutes.

On November 3, 2010, we discussed this matter with the accountant. He stated that he had recently looked at payments made to UMG and he also had questioned the payments for supplying water to the City. The accountant stated that he researched the issue and was provided with a Board resolution from UMG office staff that addressed the matter. He believed the payment to UMG for this service was supported by this resolution. The accountant was not able to provide our auditors with a copy of the resolution as he thought he had thrown it away after looking into the matter but suggested we contact UMG staff to get a copy of the resolution.

Auditor's contacted UMG office staff to request a copy of the resolution that had been provided to the district's accountant relating to this issue, along with a copy of the contract between the City and MWD. In response, auditor's received a copy of resolution 05-09-014 and a copy of the contract between MWD and the City. Resolution 05-09-014 is a resolution authorizing legal counsel to "expand the fee schedule in the agreement with Elkhorn City to account for the additional cost of purchasing from Pikeville." Neither this resolution nor the contract between MWD and the City provide authorization to pay UMG to provide water to the City.

Findings and Recommendations

After further review of Board minutes between July 2005 and November 2005, auditors found no evidence to support the Board's discussion or approval to make additional payments to UMG for providing water to the City. The current UMG Project Manager for MWD believed the additional payments were made to offset the cost to UMG for producing additional water to be supplied to the City.

It is understandable that water production costs would increase due to a significant increase in water demand. It appears the district was still able to make a profit from the sale of water to the City. Auditors found no documentation that the Board discussed the matter or approved the additional payments to UMG.

Recommendations

We recommend the Board carefully examine bills before approving them for payment. The Board should ensure that payments are made in compliance with its contract. Any additional payments to contractors should be for services that were discussed and agreed upon by the Board in writing. The Board should then approve the payments in an open meeting.

We again recommend the Board hire an individual that will report directly to the Board and will provide more direct oversight of the district's day-to-day operations. This individual would be in the position to be more aware of the projects and services provided by each contractor and could assist the Board by ensuring that payments are made to the appropriate parties and in accordance with established contracts.

We also recommend the Board specifically discuss the payments to its contractor for providing water to Elkhorn City. If the Board agrees to continue these payments to the contractor for this service, we recommend the Board formally approve the terms of this agreement and document in writing those terms agreed upon by the Board and the contractor for this service.

**Finding 6:
Procurement
requirements
appear to have
been
circumvented,
resulting in over
\$171,000 for
services provided
with no contract.**

MWD paid over \$171,000 for electrical work provided by a vendor that did not have a contract with MWD or participate in either of the two bidding processes for the service. In addition, the vendor stated that the former MWD Superintendent instructed him to submit invoices that would not exceed \$20,000, which is the small purchase authority limit above which competitive bidding and a contract are required. Given that there is no discussion in the MWD Board meeting minutes that the Board approved this vendor or that the vendor was to provide this service, it appears MWD management conducted this activity without the involvement or knowledge of the Board. Auditors also noted that a Kentucky State Representative who assisted in obtaining coal severance funds for MWD that could be used to pay for this service was the owner of the business that performed the work.

As part of an ongoing sewer construction project at MWD, electrical work needed to be completed at each home wanting to connect to a new sewer line project. Funding for this electrical work was not included in the budget of the construction project, so homeowners were expected to hire and pay for an electrician to perform the necessary work. Due to the lack of participation of the homeowners and the limited timeframe required to complete the electrical work, the MWD Board worked with the contracted project engineers in April 2004 to allocate \$100 to reimburse each homeowner to have the electrical work completed. In the May 26, 2004 Board meeting, the former MWD Superintendent stated that their State Representative had suggested that there would be funds in the miscellaneous coal severance projects of the state budget beginning July 1, 2004, to reimburse the homeowners for the cost of the electrical work, up to an unspecified amount.

On June 6, 2004, MWD advertised an invitation to bid on the electrical work in the local newspaper. In addition, the former MWD Superintendent sent a fax to two vendors specifically requesting that they submit a bid for the project, including BMM, Inc. a business owned by the State Representative who had stated coal severance funds were available for the project. Only one vendor, not BMM, returned a response by the 15th response date. The invitation to bid on the electrical work was advertised once again on June 18. A single vendor responded by the June 25th response date, which again was not BMM. On July 26, 2004, BMM submitted the first invoice for the electrical work on the project. There are no records to explain why the vendors that responded to the bids were rejected or how BMM was eventually selected to perform the work. There is also no discussion within the MWD Board meeting minutes of the vendor that is performing the work, indicating that the MWD Board was not made aware of which vendor was providing the work or how they were chosen.

In an interview with the owner of BMM, he stated that the former MWD Superintendent contacted him directly to perform the necessary electrical work and that he was not aware that there had been a prior competitive bidding process for the work. According to the BMM owner, the former Superintendent only informally provided BMM with the specifications for the work to be completed and requested a price. There was no resulting contract agreement that contained the agreed upon price or the services to be provided; however, BMM invoices show that the cost was \$300 per house. In comparison, the vendor that responded to the first invitation to bid proposed to perform the electrical work for \$275 per house. The vendor responding to the second invitation to bid proposed a cost of \$450 per house.

Findings and Recommendations

The owner of BMM further stated that the former MWD Superintendent requested that any invoices submitted to MWD for the work should be less than \$20,000. According to the business owner, the former Superintendent told him that \$20,000 was the maximum amount that he could personally approve at MWD. This resulted in six out of the ten invoices submitted by BMM for the electrical work to be just below \$20,000. The following provides a listing of these invoices for the services provided at each home and any required Disconnect Boxes (DCB):

Table 4: BMM, Inc Invoices Sent to MWD for Electrical Work

| Invoice Date | Unit | Unit Price | Total Invoice |
|---------------------|-------------|-------------------|----------------------|
| 07/26/2004 | 66 homes | \$300/home | \$19,800 |
| 08/20/2004 | 66 homes | 300/home | 19,800 |
| 09/09/2004 | 66 homes | 300/home | 19,800 |
| 09/17/2004 | 66 homes | 300/home | 19,800 |
| 12/01/2004 | 61 homes | 300/home | 18,300 |
| 12/29/2004 | 114 DCB | 175/unit | 19,950 |
| 02/07/2005 | 53 DCB | 175/unit | 9,275 |
| 02/07/2005 | 46 homes | 300/home | 13,800 |
| 05/18/2005 | 66 homes | 300/home | 19,800 |
| 05/18/2005 | 66 DCB | 175/unit | 11,550 |
| | | | \$171,875 |

Source: Invoice records provided by MWD.

By keeping invoices below \$20,000, the former Superintendent appears to have been ensuring the payments were below the small purchase authority to avoid another competitive bid for the work. According to KRS 45A.385, which MWD claimed to follow at that time, a local public agency may avoid using a competitive bid process if the aggregate total of a service is less than \$20,000. While each of the invoices is less than this amount, they are all related to the same project, making the aggregate total over \$171,000. This amount is more than enough to have required that MWD obtain the service through a competitive bidding process and establish a contract with the vendor.

Had MWD management followed the appropriate procurement practice for this service, it would have involved the knowledge of the MWD Board, including the final approval of a contract with the vendor. Instead, the MWD Board meeting minutes never indicate that the former MWD Superintendent discussed with the Board that MWD retained a vendor to perform the electrical work at each of the homes. If a contract was established with the vendor it would have required the approval of the MWD Board.

Findings and Recommendations

The only approval by the MWD Board of this vendor would have been through the monthly approval by the Board of payments scheduled to be made by MWD. A review of the Board meeting minutes reflect no discussion by the Board concerning any of the monthly payments, including payments made to BMM for this service. This indicates the Board had no active role in monitoring and overseeing the more than \$171,000 paid to a vendor for a service provided without a competitive bidding process and no contract agreement between the two parties.

Another concern is the involvement of the State Representative to obtain coal severance funding for a service his company provided through a non-competitive process. While it is the entire Kentucky General Assembly that must approve a state budget bill, local legislators select the projects for their legislative districts that are to be included in the budget bill. This would allow the State Representative to work with the other legislators with districts in Pike County to seek funding for the project. Once the Representative was chosen to provide this service without a required competitive bidding process and no contract, it presents a strong perception of a conflict of interest.

Recommendations

The MWD Board should ensure that the procurement process is fully documented in a policy and procedures manual. MWD Board members, staff, or staff of vendors performing administrative work on behalf of MWD should receive a copy of the manual and training on the requirements contained in the manual. The MWD Board should ensure a process is established to ensure the requirements of the manual are followed by MWD staff and vendors providing administrative services to MWD. This includes the Board requesting further information regarding the services provided by vendors scheduled to receive payment from MWD.

The MWD Board should ensure that a competitive bidding process is used when the aggregate amount of payments to a vendor for a project will exceed \$20,000. The MWD Board should also ensure that written contracts are established with vendors detailing the service to be performed, payment details, and other necessary documentation to protect the interests of MWD.

The MWD Board should ensure that agreements with vendors to provide services are based on objective criteria such as price and qualifications of the vendor.

Findings and Recommendations

Finding 7: MWD had not adopted a method to adequately track construction project payments.

MWD does not have a formal method to easily track and review vendor payments related to water and sewer construction projects. Currently, three separate parties track payments to construction project vendors. The MWD Board does not require any tracking method for construction payments.

The accountant contracted by MWD, UMG administrative staff, and project engineers all track MWD payments to construction project vendors. Only the project engineers can provide summarized documentation of all vendor payments over the life of a construction project. While the trial balances of the accountant and the funding draw information retained by UMG employees are needed for proper operation of the projects, they do not provide readily accessible information that could be quickly reviewed by MWD Board members to properly oversee or be informed of the various projects.

MWD typically uses three engineering firms to provide construction planning and oversight, including working with MWD to secure and monitor funding sources. Based on a review of project files, two of the engineering firms use a similar spreadsheet that allows a quick review of all payments related to a particular construction project by vendor, MWD check number, funding source, and contract number. These documents are also updated to reflect the balances of each funding source remaining as the project progresses. While the engineers obtain the information in their spreadsheets from MWD records, it does not appear that the spreadsheets are required to regularly be submitted to MWD Board members for review at monthly meetings.

Since MWD Board members are appointed to perform functions such as general oversight and not day-to-day administrative responsibilities, Board members require summarized payment tracking information that quickly demonstrates the detail of project expenditures. In order to properly oversee the millions of dollars in funding spent on construction projects, this detail should be as thorough while still providing a user-friendly format. The project spreadsheets created by two of the engineers appears to provide this, but the format has never been formally adopted by MWD or required of other engineers. By adopting a specific format for all engineers to follow and requiring that update spreadsheets be presented at each MWD Board meeting, members could better ensure projects are operated consistent with MWD policies and Board decisions.

A consistent and thorough project payment tracking system will allow Board members to be more informed and can lead to requesting additional information. Had such a document been used in previous years, Board members may have discovered the situation identified in Finding 6. Payments to that vendor are clearly listed on the engineer's spreadsheet, but are not associated with any particular contract for the project. An observant Board member could have asked for further information regarding payments that consistently fall slightly below the small purchase authority to a vendor that does not appear to have a contract.

Findings and Recommendations

Recommendations The MWD Board should formally adopt a format for tracking construction project payment and funding information consistent with those used by the engineers. At a minimum, the format adopted by the Board should ensure reporting of the payments include the funding source, the date of the payment, the check number, the vendor name, the amount, and reference to the associated contract under which this payment was made. A document related to each construction project should be presented at each monthly board meeting.

Finding 8: MWD did not comply with Kentucky’s Open Meetings Law when discussing the decision to contract out the operations of a public entity or the renegotiations of that contract.

Based on a review of board meeting minutes, there were several instances in which the MWD Board did not fully comply with Kentucky’s Open Meetings Law when it went into a closed session. These instances included the meetings in which the MWD Board approved the operating contract with UMG, terminated the UMG contract, rescinded the termination of the UMG contract, and approved the amended UMG contract. According to the Kentucky Supreme Court ruling in *Floyd County Board of Education v. Ratliff*, “the exceptions to the open meetings laws are not to be used to shield the agency from unwanted or unpleasant public input, interference or scrutiny.” The public was not included in discussions concerning how their water district would be operated, which could lead the public to conclude that deals were done behind closed doors.

KRS 61.815 provides that, prior to going into a closed session, the public body must state the specific exception contained in the statute, which is relied upon in order to permit a closed session. KRS 61.815(1) requires that:

- (a) Notice shall be given in regular open meeting of the general nature of the business to be discussed in closed session, the reason for the closed session, and the specific provision of KRS 61.810 authorizing the closed session;
- (b) Closed sessions may be held only after a motion is made and carried by a majority vote in open, public session;
- (c) No final action may be taken at a closed session; and,
- (d) No matters may be discussed at a closed session other than those publicly announced prior to convening the closed session.

KRS 61.815(2) states that public agencies and activities of public agencies identified in paragraphs (a), (c), (d), (e), (f), but only so far as (f) relates to students, (g), (h), (i), (j), (k), and (l) of subsection (1) of KRS 61.810 shall be excluded from the requirements of subsection (1) of this section.

Findings and Recommendations

According to OAG 01-OMD-181, the Attorney General has wrestled with an interpretation of KRS 61.815(2) that does not entirely defeat the purpose and intent of KRS 61.815(1). This opinion refers to OAG 80-248 that states that,

“[s]uch a literal interpretation would mean that an agency could go into closed session without any of the formalities set forth in KRS 61.815 under the eight exceptions listed. However, ...we do not believe that the literal interpretation comports with legislative intent. We believe that the legislative intent is that agencies, per se, which are exempt from complying with the Open Meetings Law, such as the Parole Board, juries, the Governor’s cabinet, committees of the General Assembly and other agencies exempted by statute or by the Constitution do not have to go through the formalities set forth in KRS 61.815, and that agencies which are not exempt per se but which go in closed session to deal with an excepted subject matter must observe those formalities.”

OAG 80-248 also observes that,

[f]or such an agency, convened in a regular or special meeting in accordance with KRS 61.820-61.825, to go into closed session without first giving notice in open session of the general nature of the business to be discussed and without first passing a motion in open session, would create doubt in the minds of members of the public as to whether the Open Meetings Law was being properly observed and could, in fact, lead to laxity in observing the law.

From July 28, 2004 through December 30, 2009, the MWD Board went into executive session 33 times out of 79 Board meetings, which was 42 percent of the board meetings. For 13 of these closed sessions, no reason at all was provided as to the general nature of the business to be discussed in closed session or the reason why it is exempt from an open meeting. There were other instances where the minutes state that they are going into a closed session “to discuss a legal matter” or a “personnel issue” but the reason that it is an exception to Kentucky’s Open Meeting Law is not documented. The following table illustrates the increased frequency of closed sessions and the number of closed sessions in which no reason was provided.

Chapter 2
Findings and Recommendations

Table 5: MWD Board Meeting Minutes Analysis of Closed Sessions

| Calendar Year | Number of Board Meetings | Number of Closed Sessions | Percent of Closed Sessions | Number of Closed Sessions Without a Reason Cited |
|----------------------|---------------------------------|----------------------------------|-----------------------------------|---|
| 2004* | 6 | 3 | 50% | 0 |
| 2005 | 13 | 4 | 31% | 1 |
| 2006 | 13 | 0 | 0% | 0 |
| 2007 | 13 | 2 | 15% | 1 |
| 2008 | 14 | 8 | 57% | 7 |
| 2009 | 20 | 16 | 80% | 4 |
| Total | 79 | 33 | 42% | 13 |

Source: Auditor of Public Accounts based on the board minutes provided by the Mountain Water District.

* This is not a complete year. Our review started at the July 28, 2004 board meeting.

As stated earlier, a closed session was held prior to the MWD Board approving the operating contract with UMG, terminating the UMG contract, rescinding the termination of the UMG contract, and approving the amended UMG contract. The reason provided for the closed session prior to approving the operating contract with UMG was to “discuss the contract for management services.” It is not clear which exception listed in KRS 61.810 is applicable to this discussion. No reason at all was provided for the closed sessions prior to rescinding the termination of the UMG contract, and approving the amended UMG contract.

The MWD Board did comply with the requirements that a motion be passed by majority vote in open session before a closed session is held and it appears that any actions are taken after the Board has reconvened from the closed session. The MWD Board began to better document the reasons and the issues to be discussed in executive session at the April 29, 2009 Board meeting by providing a list of litigation issues either in the board minutes or the applicable agenda. This type of documentation continued for the rest of the calendar year.

Without documenting the need and general nature of the closed session, the public cannot evaluate whether these meetings were closed appropriately. When closed sessions are held prior to major management decisions, it appears that the board members did not want others involved in the discussions. Operating and management decisions related to a public water district should be discussed openly to ensure transparency and avoid the appearances of secret meetings.

Findings and Recommendations

The Board meeting minutes from the April 3, 2009 meeting illustrate how the use of closed sessions can be harmful to the board's relationship with the public. Several Pike County magistrates attended this meeting to determine why the MWD Board decided to extend the UMG contract. After the magistrates left the meeting, one Board member complained, "they don't get to come in and set in the executive sessions where the issues are hammered out." He went on to say that, "there are certain things that the Board talks about in executive session that are not made known to the public and things that cannot be discussed because it gets heated, even in executive session, and people don't really understand the problem and are only hearing the gossip."

Recommendations We recommend that the MWD Board ensure that, prior to going into a closed session, the specific exception contained in the statute is documented. There must be specific and complete notification in the open session of any and all topics which are to be discussed in the closed session and the specific statutory exemption allowing the reason why they need to go to closed session. The specific topic given for the closed session should be the only topic of discussion in the closed session. We also recommend that discussions related to significant operating decisions should not be conducted in a closed session to avoid public distrust and ensure that the board's decisions are supported and well documented.

EXHIBIT

MWD Payments of Management Fees to UMG by Month

Exhibit 1

| Fiscal Year/Month | Repair and Maintenance | Operation and Management | Total Base Fee | Change in CPI Fee | Fee for Additional Water Customers | Fee for Additional Sewer Customers | Total Additional Fees | Total Fees Paid |
|--------------------------|-------------------------------|---------------------------------|-----------------------|--------------------------|---|---|------------------------------|------------------------|
| July 2005 | \$38,012 | \$530,238 | \$568,250 | | | | | \$568,250 |
| August 2005 | 38,012 | 530,238 | 568,250 | | | | | 568,250 |
| September 2005 | 38,012 | 530,238 | 568,250 | | | | | 568,250 |
| October 2005 | 38,012 | 530,238 | 568,250 | | | | | 568,250 |
| November 2005 | 38,012 | 530,238 | 568,250 | | | | | 568,250 |
| December 2005 | 38,012 | 530,238 | 568,250 | | | | | 568,250 |
| January 2006 | 38,012 | 530,238 | 568,250 | | | | | 568,250 |
| February 2006 | 38,012 | 530,238 | 568,250 | | | | | 568,250 |
| March 2006 | 38,012 | 530,238 | 568,250 | | | | | 568,250 |
| April 2006 | 38,012 | 530,238 | 568,250 | | | | | 568,250 |
| May 2006 | 38,012 | 530,238 | 568,250 | | | | | 568,250 |
| June 2006 | 38,012 | 530,238 | 568,250 | | | | | 568,250 |
| FY 06 Total | \$456,144 | \$6,362,856 | \$6,819,000 | \$0.00 | \$0.00 | \$0.00 | \$0.00 | \$6,819,000 |
| July 2006 | \$38,012 | \$530,238 | \$568,250 | | | | | \$568,250 |
| August 2006 | 38,012 | 530,238 | 568,250 | | | | | 568,250 |
| September 2006 | 38,012 | 530,238 | 568,250 | \$9,092 | \$7,520 | \$3,781 | \$20,393 | 588,643 |
| October 2006 | 38,012 | 530,238 | 568,250 | 9,092 | 10,857 | 12,768 | 32,717 | 600,967 |
| November 2006 | 38,012 | 530,238 | 568,250 | 9,092 | 14,429 | 12,692 | 36,213 | 604,463 |
| December 2006 | 38,012 | 530,238 | 568,250 | 9,092 | 21,879 | 5,928 | 36,899 | 605,149 |
| January 2007 | 38,012 | 530,238 | 568,250 | 9,092 | 23,759 | 5,833 | 38,684 | 606,934 |
| February 2007 | 38,012 | 530,238 | 568,250 | 9,092 | 24,182 | 6,023 | 39,297 | 607,547 |
| March 2007 | 38,012 | 530,238 | 568,250 | 9,092 | 24,276 | 6,156 | 39,524 | 607,774 |
| April 2007 | 38,012 | 530,238 | 568,250 | 9,092 | 25,122 | 7,600 | 41,814 | 610,064 |
| May 2007 | 38,012 | 530,238 | 568,250 | 9,092 | 27,190 | 6,897 | 43,179 | 611,429 |
| June 2007 | 38,012 | 530,238 | 568,250 | 9,092 | 30,166 | 6,593 | 45,851 | 614,101 |
| FY 07 Total | \$456,144 | \$6,362,856 | \$6,819,000 | \$90,920 | \$209,377 | \$74,271 | \$374,568 | \$7,193,568 |

MWD Payments of Management Fees to UMG by Month

Exhibit 1

| Fiscal Year/Month | Repair and Maintenance | Operation and Management | Total Base Fee | Change in CPI Fee | Fee for Additional Water Customers | Fee for Additional Sewer Customers | Total Additional Fees | Total Fees Paid |
|--------------------------|-------------------------------|---------------------------------|-----------------------|--------------------------|---|---|------------------------------|------------------------|
| July 2007 | \$38,012 | \$530,238 | \$568,250 | \$9,092 | \$27,895 | \$6,992 | \$43,979 | \$612,229 |
| August 2007 | 38,012 | 530,238 | 568,250 | 9,092 | 28,646 | 6,688 | 44,426 | 612,676 |
| September 2007 | 38,012 | 530,238 | 568,250 | 9,092 | 28,505 | 0 | 37,597 | 605,847 |
| October 2007 | 38,012 | 530,238 | 568,250 | 9,092 | 30,362 | 0 | 39,454 | 607,704 |
| November 2007 | 38,012 | 530,238 | 568,250 | 9,092 | 31,772 | 0 | 40,864 | 609,114 |
| December 2007 | 38,012 | 530,238 | 568,250 | 9,092 | 31,890 | 0 | 40,982 | 609,232 |
| January 2008 | 38,012 | 530,238 | 568,250 | 9,092 | 32,101 | 0 | 41,193 | 609,443 |
| February 2008 | 38,012 | 530,238 | 568,250 | 9,092 | 50,384 | 0 | 59,476 | 627,726 |
| March 2008 | 38,012 | 530,238 | 568,250 | 9,092 | 50,690 | 855 | 60,637 | 628,887 |
| April 2008 | 38,012 | 530,238 | 568,250 | 9,092 | 50,831 | 912 | 60,835 | 629,085 |
| May 2008 | 38,012 | 530,238 | 568,250 | 9,092 | 51,865 | 1,786 | 62,743 | 630,993 |
| June 2008 | 38,012 | 530,238 | 568,250 | 9,092 | 51,371 | 1,710 | 62,173 | 630,423 |
| FY 08 Total | \$456,144 | \$6,362,856 | \$6,819,000 | \$109,104 | \$466,310 | \$18,943 | \$594,357 | \$7,413,357 |
| July 2008 | \$38,012 | \$530,238 | \$568,250 | \$9,092 | \$51,935 | \$1,672.00 | \$62,699 | \$630,949 |
| August 2008 | 38,012 | 530,238 | 568,250 | 9,092 | 51,935 | 1,672.00 | 62,699 | 630,949 |
| September 2008 | 38,012 | 530,238 | 568,250 | 9,660 | 53,087 | 1,748.00 | 64,495 | 632,745 |
| October 2008 | 38,012 | 530,238 | 568,250 | 9,660 | 53,721 | 2,888.00 | 66,269 | 634,519 |
| November 2008 | 38,012 | 530,238 | 568,250 | 9,660 | 54,544 | 2,850.00 | 67,054 | 635,304 |
| December 2008 | 38,012 | 530,238 | 568,250 | 9,660 | 55,554 | 3,306.00 | 68,520 | 636,770 |
| January 2009 | 38,012 | 530,238 | 568,250 | 9,660 | 55,437 | 3,990.00 | 69,087 | 637,337 |
| February 2009 | 38,012 | 530,238 | 568,250 | 9,660 | 54,873 | 5,624.00 | 70,157 | 638,407 |
| March 2009 | 38,012 | 530,238 | 568,250 | 9,660 | 54,920 | 5,092.00 | 69,672 | 637,922 |
| April 2009 | 38,012 | 530,238 | 568,250 | 9,660 | 55,836 | 5,320.00 | 70,816 | 639,066 |
| May 2009 | 46,862 | 497,916 | 544,778 | | | | | |
| June 2009 | 42,741 | 549,181 | 591,922 | | | | | |
| FY 09 Total | \$469,723 | \$6,349,477 | \$6,819,200 | \$95,466 | \$541,839 | \$34,162 | \$671,467 | \$7,490,667 |

MWD Payments of Management Fees to UMG by Month

Exhibit 1

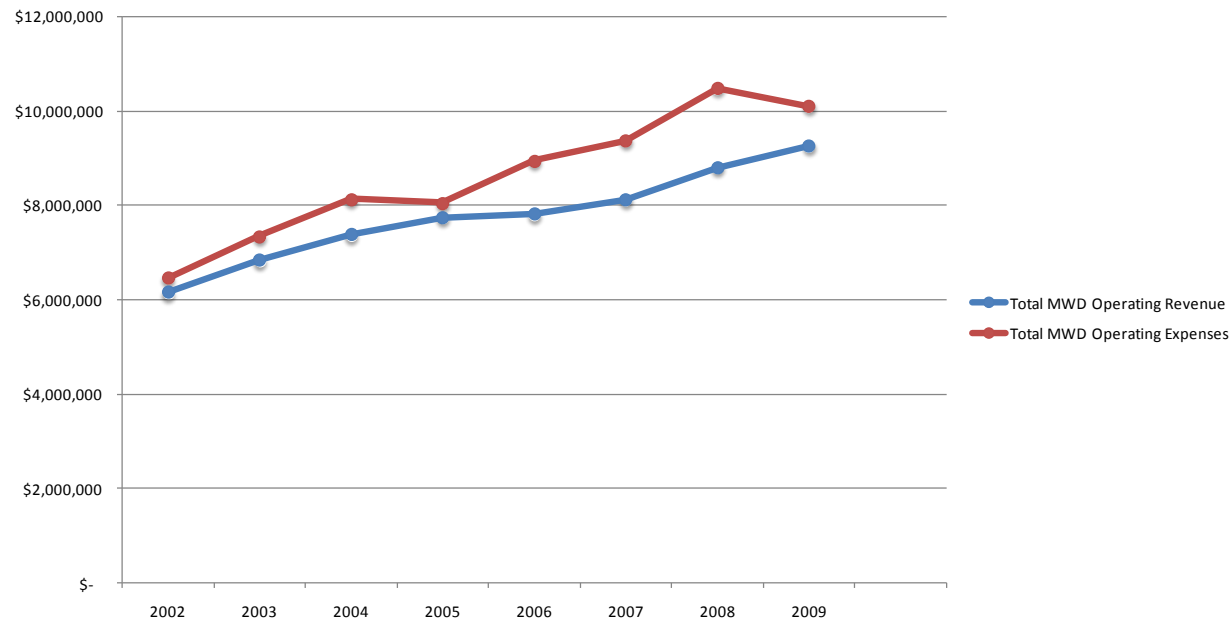
| Fiscal Year/Month | Repair and Maintenance | Operation and Management | Total Base Fee | Change in CPI Fee | Fee for Additional Water Customers | Fee for Additional Sewer Customers | Total Additional Fees | Total Fees Paid |
|--------------------------|-------------------------------|---------------------------------|-----------------------|--------------------------|---|---|------------------------------|------------------------|
| July 2009 | \$42,741 | \$549,181 | \$591,922 | | | | | \$591,922 |
| August 2009 | 42,741 | 549,181 | 591,922 | | | | | 591,922 |
| September 2009 | 42,741 | 549,181 | 591,922 | | | | | 591,922 |
| October 2009 | 42,741 | 549,181 | 591,922 | | | | | 591,922 |
| November 2009 | 42,741 | 549,181 | 591,922 | | | | | 591,922 |
| December 2009 | 42,741 | 549,181 | 591,922 | | | | | 591,922 |
| January 2010 | 42,741 | 549,181 | 591,922 | | | | | 591,922 |
| February 2010 | 42,741 | 549,181 | 591,922 | | | | | 591,922 |
| March 2010 | 42,741 | 549,181 | 591,922 | | | | | 591,922 |
| April 2010 | 42,741 | 549,181 | 591,922 | | | | | 591,922 |
| May 2010 | 42,741 | 549,181 | 591,922 | | | | | 591,922 |
| June 2010 | 42,741 | 549,181 | 591,922 | | | | | 591,922 |
| FY 10 Total | \$512,892 | \$6,590,172 | \$7,103,064 | \$0.00 | \$0.00 | \$0.00 | \$0.00 | \$7,103,064 |
| | | | | | | | | |
| Total All Years | \$2,351,047 | \$32,028,217 | \$34,379,264 | \$295,490 | \$1,217,526 | \$127,376 | \$1,640,392 | \$36,019,655 |

Total MWD Operating Revenue and Expenses

Exhibit 2

| Calendar Year | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 |
|---|--------------------|--------------------|--------------------|--------------------|----------------------|----------------------|----------------------|---------------------|
| Total MWD Operating Revenue | \$6,153,535 | \$6,834,570 | \$7,371,956 | \$7,747,829 | \$7,807,174 | \$8,119,813 | \$8,802,369 | \$9,251,799 |
| Account Expenditures Retained by MWD * | \$2,396,237 | \$2,383,328 | \$2,722,043 | \$2,715,057 | \$2,535,565 | \$2,658,315 | \$3,116,229 | \$3,582,018 |
| Account Expenditures to be Assumed by UMG * | 4,068,148 | 4,962,860 | 5,413,675 | 2,812,250 | 79,776 | 0 | 0 | 0 |
| UMG Management Fee | 0 | 0 | 0 | 2,521,578 | 6,332,862 | 6,718,222 | 7,366,703 | 6,519,817 |
| Total MWD Operating Expenses | \$6,464,385 | \$7,346,188 | \$8,135,718 | \$8,048,885 | \$8,948,203 | \$9,376,537 | \$10,482,932 | \$10,101,835 |
| Operating Income (Loss) for MWD | (\$310,850) | (\$511,618) | (\$763,762) | (\$301,056) | (\$1,141,029) | (\$1,256,724) | (\$1,680,563) | (\$850,036) |

* All of these expenses were incurred and paid by MWD. However, starting in July 2005, MWD contracted with UMG to manage specific costs. The "Account Expenditures Retained by MWD" row contains the operating expenses that MWD incurred and continued to incur even after the UMG management contract. The "Account Expenditures to be Assumed by UMG" row contains the amount of operating expenses incurred by MWD but were designed to be assumed by UMG once the UMG management contract went into effect.



Source: Auditor of Public Accounts based on MWD audited financial statements.

Note: The July 2005 contract with UMG was renegotiated in April 2009 reducing or eliminating certain fees.

MOUNTAIN WATER DISTRICT RESPONSE

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H. EDWARD MADDOX(1946-2003)

January 14, 2011

Mr. Brian Lykins, CISA, CSE
State Auditor's Office
209 St. Claire Street
Frankfort, Kentucky 40601

Re: Mountain Water District Audit

Dear Brian:

On behalf of the Mountain Water District Board ("Board"), please be advised this letter is our formal response to the findings and recommendations contained in your Audit of Mountain Water District ("District").

The goal of this response is to address the findings and recommendations presented, and in doing so it is not our intent to either defend or criticize any actions by the prior Board, other than to say that we believe they were dedicated Commissioners who acted in what they believed was the best interest of District at the time when they made the decisions they did.

Further, the Board takes no position on any actions that were taken or not taken by Utility Management Group ("UMG") as we believe it is more appropriate for them to address any issues raised in the audit concerning their actions.

All references in this letter to the new UMG contract refers to a proposed agreement that has been negotiated by the District representatives, but as of this date, has not yet been approved by the Board.

Chapter I
Introduction and Background

The facts set forth in Chapter 1 accurately reflect the chronology of events leading up to the contract with UMG and subsequent amendments thereto. We are not in position to comment one way or the other as to whether or not the auditor had authority to access UMG's records.

STRATTON, HOGG & MADDOX, P.S.C.

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**Chapter II
Findings and Recommendations**

Finding 1:

“MWD Board entered into a privatization contract with insufficient planning to determine the benefits to or the financial impact on MWD.”

The Board relied on the recommendation of its superintendent to contract out operations. The Board requested a RFQ/P, as was appropriate. The Board appointed a committee to review the responses to the RFQ/P and they made a recommendation to the Board, which was accepted. A Board can reasonably rely on the recommendations of its management and committees in making a business decision.

The Board does take strong exception to the implications raised that it is bound by KRS 45A.551, being the statute for state agencies to follow in the event of privatization. The contract with UMG is not a privatization of the District, but a management contract. Therefore, KRS 45A.551 is not applicable. While the analysis required under that statute may or may not have been beneficial to MWD, because it is not an applicable statute, there was no basis for considering it.

Recommendation 1:

We agree that any significant contracts should be properly evaluated for the benefits that they will provide to MWD and its customers.

Recommendation 2:

We agree that there should be a complete and thorough analysis of the financial benefit to the District prior to the finalization of a management contract.

Recommendation 3:

We do not concur with the recommendation that MWD follow the “best practices” required in the statute for privatization of public services for the reasons set forth above.

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Finding 2:

“The costs to operate MWD services are unknown due to the lack of financial information provided by the vendor.”

While the detail costs to operate the District are not known by the Board, the Board, based on its prior experience and financial records, had a reasonable understanding of what the basic costs were to operate the District. The Board acknowledges that this information would be less reliable over time. Accordingly, prior to the Audit, the Board has provided in its new contract with UMG that the District would be provided monthly and year to date analysis of the costs UMG incurs to operate the district.

The District further provided in its new contract with UMG that prior to any application for a rate increase to the Public Service Commission that UMG would provide all necessary information for such application. The contract also provides that the District would have the opportunity to verify the same during the course of a rate study or an application to the PSC for a rate increase. The District recognizes, and UMG has acknowledged, that prior to any rate increase that the cost information required by the PSC would have to be compiled and verified in order to have a successful application.

Recommendation 1:

We agree that the Board should have access to its costs information and that has been provided for in the new contract.

Recommendation 2:

We respectfully disagree with the recommendation that the Board consider a management fee structure, which provides for an agreed profit margin. While it is a valid option to consider, it doesn't provide the contractor an incentive to control costs, as it turns into a costs plus contract.

In the alternative, the Board has selected a structure that guarantees the District sufficient margin to meet its obligations, and then pays a fixed fee to UMG. Any increase (or decrease) in UMG's fee will be based on future District revenue. Future revenue will be shared on a percentage split (70/30 UMG/MWD). This protects the District from any fee increase in excess of our revenue. There are

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some exceptions to this payment structure such as, a change in scope for the contract and natural disaster. This plan insures the District a margin upon which it needs to operate and provides an incentive to UMG to grow revenues and increase efficiencies.

Finding 3:

“Initial contract for management services had a detrimental impact on MWD and the Board failed to act in a timely manner to address the issue.”

The original contract provided that UMG’s fees would be increased based on an increase in the customer base. The rationale being that additional customers would increase their costs of operations and that they should reasonably be compensated for that growth in the customer base. As has been explained from the beginning, between July 2005 and April 2009 the District added 3,376 new customers, of which 2,376 were “LMI” customers (lower in moderate income.) The new customer fee paid UMG for each account was \$23.50, base average cost of an account. The District’s expenses grew substantially faster than its revenue, because the average monthly “LMI” revenue was only \$18.06, being the minimum fee, verses an average payment of \$28.00 by other customers. This led to the financial issues experienced by the District. It was not reasonable to foresee that we would have this amount of growth in LMI customers and that most of them would be paying the minimum fee which would not cover the cost of servicing the account.

The Board’s first meaningful opportunity to act on this issue was three (3) years into the contract when it had the option of cancellation. Until that option became a reality, the ability to effectively negotiate any changes in the contract were deminimus. After the Board did its review of the contract at the end of the three year period, it did elect to renegotiate the contract and upon failing to successfully do so, it terminated the contract. Subsequently UMG came back to the table with a counter-proposal that both sides could accept, so the contract was amended.

The audit correctly finds that the District did not require UMG to provide an audited financial statement to verify its financial stability. While this would be nice to have, UMG, as a private company, has elected not to have an independent audit. An audit in and of itself offers no security to the District. The true protection for the District is provided in UMG’s surety bond which is paid to the District if UMG fails to perform under the contract.

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The finding that the management contract lacked clear requirements for many administrative duties resulting in potential conflicts between the interest of MWD and UMG, it is not totally correct. The contract provides that UMG was to operate the District as it had been operated before, assuming all duties of prior management. It is impossible to list everything, as it is easy to leave out important matters. By having a general all inclusive provision then everything is covered. During the term of the first contract, issues arose concerning potential conflicts between the District and UMG. These have been sorted out over time and resolved amicably. It would have been impossible to have anticipated all of such events and these are things that have to be simply worked out over the course of time as they arise. Prior to receipt of this report, the Board had agreed that it was in the best interest of the District to hire an administrator and the Board is developing a job description to that end. Further, we have amended the contract to require UMG's employees to follow all internal controls and policies established by the District and to certify their compliance with the same to the Board at each monthly meeting.

Recommendation 1:

We agree to closely examine all future contracts for compliance with the District's needs.

Recommendation 2:

We respectfully disagree to the recommendation of avoiding automatic fee increases to the extent that it is intended to limit what the District has proposed in its new contract. If we had to renegotiate the fee each year then we are in effect living in a year by year contract. We believe the new structure of shared revenue over a base line protects the best interest of the District.

Recommendation 3:

We agree that the contract terms should be clear, concise and well defined and have tried to do that in the new agreement.

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Recommendation 4:

We agree with the recommendation that the Board should take a more proactive approach to overseeing the operations and management of the District and that the Board should have an administrator working at the direction of the Board and have taken steps in that direction.

Recommendation 5:

We agree with the recommendation to create a finance committee, which is being developed. In addition, the Board is considering the development of an operations committee to oversee operations and new construction.

Recommendation 6:

We understand the recommendation to require an audit of UMG, but we believe the surety bond in the new contract provides actual financial protection to the District, while the audit does not.

Recommendation 7:

We agree that the contractor should follow all internal control policies established by the District. This has not been an issue, but a provision on this issue has been placed in the new contract.

Finding 4:

“Irregularities were identified in the initial MWD contract for operations, management and maintenance and the establishment of the contract bid process was not followed.”

The Board is not in position to agree or disagree with the findings set forth in this section, other than to state that they believe the then Board acted in what the believed was the best interest of the District.

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Recommendation 1:

We agree to review and ensure its understanding of any future RFQ/P before voting to approve advertisement of such.

Recommendation 2:

We agree there should be a conflict of interest policy requiring statements from Board Members and contractors. This policy was developed over a year ago.

Recommendation 3 and 4:

We agree to grade future RFQ/P, consistent with the criteria stated therein. We agree that any analysis of bid proposals should be adequately supported by proper documentation.

Finding 5:

“UMG received payments for services not specified in the contract with MWD without approval by the MWD Board.”

The issues raised concerning payments to District’s CPA and UMG were not known to the Board at that time and it was impossible for the Board to know that there was an issue concerning these invoices. It is clear, however, that there was no dispute as to the total amount due and that the Board paid the obligation due and did not pay any more than it should have done under the arrangement.

As to the Elkhorn City Wholesale Contract, while the records do not reflect that compensation for the same was approved, it’s the understanding of the Board that there would be additional compensation paid to UMG.

Recommendation 1:

We agree the Board should carefully examine bills before approving them. Creation of a finance committee to review bills in detail prior to the meeting will assist in that process. Starting about a year ago, all bills were attached to checks to be signed.

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Recommendation 2:

We agree MWD should have an administrator. The Board is currently developing a job description, and we now have funding for the position.

Recommendation 3:

We agree the Elkhorn City water issue should be addressed, and under the new contract, UMG will be paid one base fee which will include services to Elkhorn City.

Finding 6:

“Procurement requirements appear to have been circumvented resulting in \$171,000 for services provided with no contract.”

While the Board does not dispute the findings made herein, it notes that there is no finding that any Board Member knew of or condoned the actions by the then superintendent concerning these events. The Board agrees such actions are improper.

Recommendation 1:

We agree the procurement process should be fully documented. Prior to the Audit, the procurement policy was fully documented and set out in our procedures manual. The Board is also setting up a committee to oversee operations and construction projects which will provide additional oversight to this process, along with the addition of an administrator to help oversee issues such as this.

Recommendation 2 & 3:

We agree that all contract over \$20,000 should be competitively bid, and such agreements based on objective criteria, such as price and qualifications.

Finding 7:

“MWD had not adopted a method to adequately track construction project payments.”

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The Board believes it can rely on the representations and reports of its engineers. While the Board did not review engineering reports and spread sheets on every project, it did receive verbal reports at the Board meeting from the engineers on all projects.

Recommendation 1:

We agree the tracking of construction projects can be improved. To do so, the Board is creating an operations and construction committee that will provide a better tracking method of projects.

Finding 8:

“MWD did not comply with Kentucky Open Meetings Law when discussing the decision to contract out the operations of a public entity or renegotiations of the contract.”

The minutes of the meetings speak for themselves as to what occurred at that time. Over a year ago, the Board held a work session at which the Board was provided educational materials concerning the Open Meetings Laws and Open Records Laws. Since that time, there has been no issue or dispute as to the appropriateness of any executive sessions.

Recommendation 1:

We agree that the specific exceptions contained in the Open Meeting Laws should be stated prior to going into executive session.

**Chapter III
Conclusion**

In closing, on behalf of the Board, while we were disappointed in how long it took to complete this audit, we are glad it's finished and the District can move forward with its business. The findings did not show any improper activity on behalf of the Board, with the exception of the Open Meetings procedures. Reasonable minds can differ as to whether the Board made the right decision on all the findings presented, but that can be said about any entity, especially in hind sight.

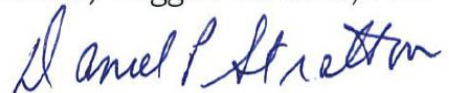
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The Board has already, or is in the process of, adapting all but three of your recommendations, with the exceptions being: 1) application of KRS 45A.551; 2) the structure of the UMG contract; and 3) requiring UMG to do an Audit. The concerns raised by these recommendations have otherwise been addressed.

Sincerely,
Stratton, Hogg & Maddox, PSC



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