



THE METROPOLITAN WATER DISTRICT
OF SOUTHERN CALIFORNIA

Board Report

Office of the General Auditor

• General Auditor's Report for April 2025

Summary

This report highlights significant activities of the Office of the General Auditor for the month ended April 30, 2025.

Purpose

Informational

Attachments

Two reports were issued during this period:

1. Operational Audit: Fallowed Land (Board Directed)
2. Advisory Brief: Mutual Benefit Leases Rapid Review

Detailed Report

Audit & Advisory Projects

Twenty-four projects are in progress:

- Six audit projects are in the report preparation phase.
 - No management responses are outstanding.
 - One new audit project was added this month per Board direction:
 - Conjunctive Use
- Eighteen projects are in the execution phase, including nine audits and nine advisories.

Work priority is being given to the seven carryforward audits.

Report Details

1. **Operational Audit: Fallowed Land** issued April 28, 2025.
 - Audit scope included the review of the fallowed land process for the period August 1, 2023 through June 30, 2024.
 - Three (3) recommendations with the following rating: three **Priority 3**.
2. **Advisory Brief: Mutual Benefit Leases Rapid Review**
 - Advisory scope included the review of mutual benefit leases, specifically office space leases.
 - Nine (9) advisory recommendations.

Date of Report: May 13, 2025

Board Report (General Auditor's Report for April 2025)

Follow-Up Reviews

Thirteen audits are in the follow-up phase:

- Nine follow-up reviews are in progress.
- Four follow-up reviews have not been started.

No follow-up review forms are overdue.

Other General Auditor Activities

1. Customer Service Survey

Post-audit engagement customer survey developed and issued for two recently completed audits. The survey will be issued for all new audits going forward.

2. Annual Risk Assessment

Completed. The General Auditor's risk assessment methodology was refreshed and presented at the April meeting of the Audit Committee. Board input on risk areas and internal control concerns was solicited. Additionally, meetings with management have concluded, and input received has been incorporated into the risk assessment.

3. Annual Audit Plan

The FY 2025/26 audit plan is in development and will be presented to the Board for approval at the June meetings of the Audit Committee and Board of Directors.

4. Senior Audit Manager Recruitment

Recruitment brochure finalized, job posted, and recruitment actively in progress.

5. External Resources RFQ

Collaboration with Contracting Services and General Counsel to draft and issue an RFQ for specialty internal audit services is ongoing.

6. Global Internal Audit Standards

Evaluation and adoption of the updated standards issued by the Institute of Internal Auditors, effective January 9, 2025, is in progress. Board roles and responsibilities, per the Standards, will be presented as an information item at the September meeting of the Audit Committee.

7. Training

Audit staff attended Generative AI Case Studies: Lessons Learned in Public Sector Audit Shops, Controlling the Risk of Asset Misappropriation, and fraud training.



Office of the General Auditor

Operational Audit: Fallowed Land

Project Number: 23-13
April 28, 2025



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Executive Summary

BACKGROUND

In August 2004, Metropolitan entered into an agreement with the Palo Verde Irrigation District (PVID) to implement a 35-year forbearance and fallowing program (Program). The Program developed a flexible water supply of up to 125,000 acre-feet per year through non-irrigation of qualified farmlands in the Palo Verde Valley area, which occupies approximately 190 square miles in Riverside and Imperial Counties. PVID encompasses approximately 131,000 acres.

From 2005 to 2006, Metropolitan entered into long-term agreements with PVID and 99 landowners to fallow the qualified farmlands through July 2040. Under the terms of the agreements, at Metropolitan's discretion, participants would not irrigate up to 35% of their land and the water savings from this fallowing would be made available to Metropolitan. In exchange, Metropolitan makes payments to these landowners for fallowing their lands and to PVID to compensate them for related administrative costs. The agreements allow Metropolitan and PVID to enter onto and inspect the fallowed land to monitor and enforce contract compliance.

The annual payment to the landowners for Contract Year (CY) 23/24 was \$1,002.65 per fallowed acre. The CY 23/24 started on August 1, 2023 and went through July 31, 2024. As of June 30, 2024, Metropolitan paid \$18.2 million to landowners for a 100% call under the current Program and approximately \$311,000 to PVID for related administration costs.

Metropolitan presently owns approximately 29,180 acres of land within the PVID, having added the acquisition of land from Verbena LLC in 2015 to the land purchased in 2001 from San Diego Gas & Electric Co., making Metropolitan the largest landowner in the valley. Metropolitan leases approximately 18,100 acres to six agricultural tenants. These leases allow Metropolitan to call for fallowing of up to 50% of the land under the Program. During a fallowing call, Metropolitan reimburses tenants the prorated rent of up to the agreed-upon rate per irrigated acre (currently \$150 or \$175) and a water toll of up to \$80 per irrigated acre. The tenant reimbursements were approximately \$2.6 million for CY 23/24.

The total amount of water conserved by the Program in calendar year 2023 was 87,256 acre-feet, of which 15,749 acre-feet was water made available to Metropolitan, and the remaining balance of 71,507 acre-feet was water left in Lake Mead, behind Hoover Dam, as system conservation water.

WHAT WE DID

Our audit scope for this Board-directed engagement included the fallowed land process from August 1, 2023 to June 30, 2024.

Our audit objectives were to:

- (1) Evaluate Water Resource Management monitoring procedures for the fallowed land process, from fallowing call notification to inspection of fallowed land.
- (2) Determine if defined fallowed land acreage matches actual fallowed land acreage on the ground.

WHAT WE CONCLUDED

- (1) Some monitoring procedures for the fallowed land program should be improved.
- (2) Defined fallowed land acreage matched actual fallowed land acreage on the ground.

WHAT WE RECOMMEND

We recommend Metropolitan: (1) conduct formal reviews of PVID fallowed land inspections, document these reviews, and develop associated procedures; (2) review fallowed land reports prepared by Water Resource Management staff, document reviews of fallowed land reporting, and prepare associated procedures; and (3) ensure General Manager reviews of fallowed land call notices are documented before issuance and prepare associated procedures.

Management agreed with our observations and recommendations.

NUMBER OF RECOMMENDATIONS



PRIORITY 1
Response time:
Immediate



PRIORITY 2
Response time:
Within 90 days



PRIORITY 3
Response time:
Within 180 days



THE METROPOLITAN WATER DISTRICT
OF SOUTHERN CALIFORNIA

Date: April 28, 2025
To: Audit Committee
From: Scott Suzuki, CPA, CIA, CISA, CFE, General Auditor
Subject: Operational Audit: Fallowed Land
(Project Number 23-13)

This report presents the results of our audit of the fallowed land process as directed by the Board.

Results, including our observations and recommendations, follow this letter. Supplemental information, including our scope and objectives, is included in Appendix A. Appendix B includes a description of our new recommendation priority rating system. Finally, management's response to our audit is now included in Appendix C.

We appreciate the cooperation and courtesies provided by the Water Resource Management Group.

The results in this report will be summarized for inclusion in a status report to the Board. If you have any questions regarding our audit, please do not hesitate to contact me directly at 213.217.6528 or Assistant General Auditor Kathryn Andrus at 213.217.7213.

Attachments

cc: Board of Directors
General Manager
General Counsel
Ethics Officer
Office of the General Manager Distribution
Assistant General Managers
Water Resource Management Group Distribution
External Auditor

RESULTS

RECOGNITION

Positive aspects observed during our audit include:

- Water Resource Management (WRM) conducted inspections of fallowed land twice a year and prepared inspection reports.
- Palo Verde Irrigation District (PVID) conducted inspections of fallowed land throughout the contract year.
- WRM prepared the annual verification reports jointly with PVID and the United States Bureau of Reclamation (USBR).

RESULTS OVERVIEW

	OBSERVATION	RISK	RECOMMENDATION	MANAGEMENT AGREEMENT
PRIORITY 1				
	None			
PRIORITY 2				
	None			
PRIORITY 3				
1	PVID fallowed land inspections were not formally reviewed by the district.	Land not fallowed per contractual requirements Contractor not fulfilling duties Financial loss	Conduct formal reviews of PVID fallowed land inspections. Document reviews. Develop procedures.	Agree
2	Management did not review reporting prepared by staff for fallowed lands.	Staff oversight/unaccountability Financial loss Land not fallowed as contracted for	Review fallowed land inspection reports. Document reviews. Prepare procedures.	Agree
3	Fallowing call notice approval by the General Manager was documented after the notices were issued.	Fallowing call not aligning with organizational objectives/strategies	Document approval for fallowed land call notices prior to issuance. Prepare procedures.	Agree



OBSERVATIONS & RECOMMENDATIONS

1 Contractor Monitoring

PVID fallowed land inspections were not formally reviewed by the district.

Priority 3

Reviewing contractor land inspections and formalizing database review reduces the risk of land not fallowed per contractual requirements, the contractor not fulfilling their duties, and financial losses from inaccurate/incomplete landowner and fallowing data.

PVID completes fallowed land inspections; however, the district does not formally review these inspections.

Additionally, WRM staff reviews information in the PVID database as part of semi-annual inspections; however, there are no procedures for this review.

Recommendation 1

We recommend management:

- (1) Conduct formal reviews of PVID fallowed land inspections.
- (2) Document reviews of the inspections.
- (3) Develop associated procedures for reviewing PVID inspections and information in the PVID database.

Management Response

Agree.

Prior to WRM conducting field inspections, WRM and PVID will meet and review PVID's inspection activities.

As part of WRM's field inspection report, WRM will include PVID's inspection results of fields that WRM are inspecting. WRM will develop a flowchart procedure.

The estimated implementation date is the fourth quarter of calendar year 2025.

2 Management Monitoring

Management did not review reporting prepared by staff for fallowed lands.

WRM staff perform and document the inspections of fallowed land semi-annually; however, there was no management review of these reports.

Additionally, a fallowed land verification report is prepared annually in conjunction with USBR that includes fallowing call information, fallowed land data, and estimated conserved water. There was no documented management review of the fallowed land verification report.

Finally, there are no procedures for completing these management reviews nor the collaborative process involved with USBR in preparing the fallowed land verification report.



Priority 3

Management review of reports prepared by staff and formalizing these reviews reduces the risk of staff oversight/unaccountability, financial loss from inaccurate reported water savings, and land not being fallowed as contracted for.

Recommendation 2

We recommend management:

- (1) Review fallowed land inspection reports prepared by staff.
- (2) Document review of these reports and the fallowed land verification report.
- (3) Prepare procedures for these reviews and the joint fallowed land verification process with USBR.

Management Response

Agree.

WRM staff will submit report to management for review and management will reply with a response of the report. WRM will prepare a flowchart outlining the collaboration among WRM, PVID and USBR preparing the report.

The estimated implementation date is in the 2nd half of calendar year 2025.

3 Following Call Notice Review

Following call notice approval by the General Manager was documented after the notices were issued.

Following call notices are the first step in notifying landowners of Metropolitan's desire to effect fallowed land. There is a process where staff prepare a notice template that is reviewed by the General Manager, and then customized for each landowner; however, there are no procedures for this process.

For the Contract Year 2023/24 following call notice, the General Manager's review and approval was obtained verbally before the notices were sent out, but the routed document was formally approved by the General Manager approximately two months after the following call notices were issued.

Priority 3

Documenting General Manager approval of fallowing call notices before issuance reduces the risk of the fallowing call not aligning with organizational objectives/strategies.

Recommendation 3

We recommend management:

- (1) Ensure General Manager approval for fallowed land call notices is documented prior to issuance.
- (2) Prepare procedures for preparation, authorization, and issuance of fallowed land call notices.



Management Response
Agree.

An additional step will be added to the current WRM SharePoint surnaming procedure such that when the General Manager has given approval outside of the established procedure, WRM will reply in an email message that includes the General Manager in the message that the following call notice was approved by the General Manager before sending the notice.

The estimated implementation date is July 2025.

EVALUATION OF MANAGEMENT'S RESPONSE

Internal Audit considers management's response appropriate to the recommendations and their corrective actions should resolve the conditions identified in the report.

AUDIT TEAM

Leo Roldan, CPA, CIA, CGMA, Principal Auditor (retired)
Neena Mehta, Senior Auditor



APPENDIX A: SUPPLEMENTAL INFORMATION

ADDITIONAL INFORMATION

On August 12, 2021, Metropolitan entered into a Funding Agreement with the United States Bureau of Reclamation (USBR), the Central Arizona Water Conservation District (CAWCD), and the Southern Nevada Water Authority (SNWA). The Funding Agreement funds fallowing in the Palo Verde Valley that is within the Program limits but is in excess of Metropolitan's minimum fallowing calls, and water conserved by this additional fallowing is left in Lake Mead as system conservation water.

Fallowing under the Funding Agreement began on August 1, 2021, but was terminated as of July 31, 2023, to allow Metropolitan and PVID to conserve water under USBR's Lower Colorado Conservation Program, which started on August 1, 2023. From January 1, 2023 to July 31, 2023, the Program's fallowing level was at 75%, with conservation from the equivalent of a 25% call being made available to Metropolitan, and the conservation from the equivalent of a 50% call being used to create system conservation water.

On December 20, 2023, under the USBR's Lower Colorado Conservation Program, Metropolitan entered into a System Conservation Implementation Agreement (SCIA) with USBR. The SCIA funds the full Program for three contract years, starting August 1, 2023, and continuing through July 31, 2026. During these three years, the Program is fallowing at the maximum level, and all conserved water is to be left in Lake Mead as system conservation water pursuant to the terms of the SCIA.

SCOPE & OBJECTIVES

Our audit scope included the fallowed land process from August 1, 2023 to June 30, 2024.

Our audit objectives were to:

- (1) Evaluate Water Resource Management monitoring procedures for the fallowed land process, from fallowing call notification to inspection of fallowed land.
- (2) Determine if defined fallowed land acreage matches actual fallowed land acreage on the ground.

EXCLUSIONS

Our audit scope did not include: (1) Metropolitan fallowing calls prior to CY 23/24; (2) Landowner's qualified land for fallowing; (3) Land ownership and tenant subordination agreements; (4) Landowner payments of taxes and tolls; (5) Land management measures; (6) Payment and recording of PVID reimbursable costs; (7) annual payments to landowners and their recording; (8) Amortization of participation rights (one-time signup payments); (9) Intentionally Created Surplus (saved water from fallowing banked at Lake Mead); (10) Metropolitan lease lands; (11) Funding agreement with USBR, CAWCD, and SNWA; (12) System conservation implementation agreement with USBR; (13) Joint USBR reporting.

PRIOR AUDIT COVERAGE

We completed the following audit with a similar scope: Metropolitan Leased Lands in PVID, Project Number 19-2500-00, issued on February 20, 2020.



AUTHORITY

We performed this audit as directed by the Board and in accordance with our FY 2023/24 Audit Plan approved by the Board.

PROFESSIONAL INTERNAL AUDIT STANDARDS

Our audit was conducted in conformance with the International Standards for the Professional Practice of Internal Auditing issued by the International Internal Audit Standards Board.

FOLLOW-UP REVIEWS

The Office of the General Auditor has implemented a new follow-up process to ensure management has effectively implemented corrective action related to our recommendations. Management is required to report recommendation implementation status to our office within six months following the issuance of this report, and a first follow-up review will occur shortly thereafter. All audit recommendations are expected to be implemented within a year of this report, and if necessary, a second follow-up review will occur approximately six months after issuance of the first follow-up review report. Any audit recommendations not implemented after the second follow-up review will be shared with the Board/Audit Subcommittee of the Executive Committee at its next scheduled meeting.

INTERNAL CONTROL SYSTEM

An internal control system is a continuously operating and integrated component of Metropolitan's operations. Internal controls are implemented by the Metropolitan management and seek to provide reasonable (not absolute) assurance that Metropolitan's business objectives will be achieved. However, limitations are inherent in any internal control system, no matter how well designed, implemented, or operated. Because of these limitations, errors or irregularities may occur and may not be detected. Specific examples of limitations include, but are not limited to, poor judgment, carelessness, management override, or collusion. Accordingly, our audit would not necessarily identify all internal control weaknesses or resultant conditions affecting operations, reporting, or compliance. Additionally, our audit covers a point in time and may not be representative of a future period due to changes within Metropolitan and/or external changes impacting Metropolitan.

METROPOLITAN'S RESPONSIBILITY FOR INTERNAL CONTROL

It is important to note that Metropolitan management is responsible for designing, implementing, and operating a system of internal controls. The objectives of internal controls are to provide reasonable assurance as to the reliability and integrity of information; compliance with policies, plans, procedures, laws, and regulations; the safeguarding of assets; the economic and efficient use of resources; and the accomplishment of established goals and objectives. In fulfilling this responsibility, management judgment is required to assess the expected benefits and related costs of internal control policy and procedures and to assess whether those policies and procedures can be expected to achieve Metropolitan's operational, reporting, and compliance objectives.



APPENDIX B: PRIORITY RATING DEFINITIONS

The Office of the General Auditor utilizes a priority rating system to provide management a measure of urgency in addressing the identified conditions and associated risks. We assess the significance of each observation identified during the audit using professional judgment and assign priority ratings to each recommendation using the criteria listed below. Factors taken into consideration in assessing the priority include the likelihood of a negative impact if not addressed, the significance of the potential impact, and how quickly a negative impact could occur.

PRIORITY			
Definition	Observation is <i>serious</i> enough to warrant <i>immediate</i> corrective action. The condition may represent a <i>serious</i> financial, operational, or compliance risk. A priority 1 recommendation may result from a <i>key</i> control(s) being absent, not adequately designed, or not operating effectively.	Observation is of a <i>significant</i> nature and warrants <i>prompt</i> corrective action. It may represent a moderate financial, operational, or compliance risk. A priority 2 recommendation may result from a <i>process</i> or less critical control(s) not being adequate in design and/or not operating effectively on a consistent basis.	Observation involves an internal control issue or compliance lapse that can be corrected in the <i>timely</i> course of <i>normal</i> business. A priority 3 recommendation may result from a <i>process</i> or control that <i>requires</i> enhancement to better support Metropolitan's objectives and manage risk.
Response Time	Immediate	Within 90 Days of report issuance	Within 180 Days of report issuance



APPENDIX C: MANAGEMENT'S RESPONSE

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THE METROPOLITAN WATER DISTRICT
OF SOUTHERN CALIFORNIA

Date: March 27, 2025

To: Scott Suzuki, General Auditor

From: Brandon Goshi, Interim Group Manager, Water Resource Management

cc: Deven Upadhyay, General Manager
Mohsen Mortada, Chief of Staff
John Bednarski, Interim Assistant General Manager, Water and Technical Resources

Subject: Management Response to Audit Number 23-13

The General Manager has reviewed and concurs with the following response.

Please find below the Water Resource Management Group Manager response to the Operational Audit: Fallowed Land (23-13). Since the audit was conducted, the Supply Acquisition Team has discussed strategies for reporting and documenting the program activity. We appreciate the Audit Team time invested to evaluate the progress of the Palo Verde Irrigation District Fallowing Program (Program). The feedback provided by the Audit Team will help improve the administration of the Program. We also appreciate the Audit Team guidance and patience as we navigated through the new audit process. Your partnership will continue to be important as we implement the recommendations.

Thank you for your continued partnership and please do not hesitate to contact me if you would like to discuss the response or any other matters related to this audit.

A handwritten signature in black ink, appearing to be "B. Goshi".

Brandon Goshi, Interim Group Manager – Water Resource Management

Signed by:

A handwritten signature in black ink, appearing to be "John V. Bednarski".

John Bednarski, Interim Assistant General Manager – Water and Technical Resources

A handwritten signature in black ink, appearing to be "Deven Upadhyay".

Deven Upadhyay, General Manager



Docusign Envelope ID: 3A92B5EB-F5E4-4002-875B-CFC2B9ABE694

Operational Audit: Fallowed Land Project Number 23-13 Management Response

OBSERVATION 1		Contractor Monitoring PVID completes fallowed land inspections; however, the district does not formally review these inspections. Additionally, WRM staff reviews information in the PVID database as part of semi-annual inspections; however, there are no procedures for this review.
RECOMMENDATION 1 PRIORITY 3		We recommend management: (1) Conduct formal reviews of PVID fallowed land inspections. (2) Document reviews of the inspections. (3) Develop associated procedures for reviewing PVID inspections and information in the PVID database.
X	AGREE	MANAGEMENT ACTION PLAN Prior to WRM conducting field inspections, WRM and PVID will meet and review PVID's inspection activities. As part of WRM's field inspection report, WRM will include PVID's inspection results of fields that WRM are inspecting. WRM will develop a flowchart procedure.
		ESTIMATED IMPLEMENTATION The fourth quarter of calendar year 2025.
	PARTIALLY AGREE	EXPLANATION [insert]
	DO NOT AGREE	

FORM

MANAGEMENT RESPONSE FORM

PAGE

1 OF 5

NOVEMBER 2023 (Rev. N/A)



Docusign Envelope ID: 3A92B5EB-F5E4-4002-875B-CFC2B9ABE694

OBSERVATION 2		Management Monitoring	
		WRM staff perform and document the inspections of fallowed land semi-annually; however, there was no management review of these reports.	
		Additionally, a fallowed land verification report is prepared annually in conjunction with USBR that includes fallowing call information, fallowed land data, and estimated conserved water. There was no documented management review of the fallowed land verification report.	
		Finally, there are no procedures for completing these management reviews nor the collaborative process involved with USBR in preparing the fallowed land verification report.	
RECOMMENDATION 2		We recommend management:	
PRIORITY 3		(1) Review fallowed land inspection reports prepared by staff.	
		(2) Document review of these reports and the fallowed land verification report.	
		(3) Prepare procedures for these reviews and the joint fallowed land verification process with USBR.	
X	AGREE	MANAGEMENT ACTION PLAN	WRM staff will submit report to management for review and management will reply with a response of the report. WRM will prepare a flowchart outlining the collaboration among WRM, PVID and USBR preparing the report.
		ESTIMATED IMPLEMENTATION	2 nd half of calendar year 2025.
	PARTIALLY AGREE	EXPLANATION	[insert]
	DO NOT AGREE		

FORM

MANAGEMENT RESPONSE FORM

PAGE

2 OF 5

NOVEMBER 2023 (Rv. N/A)



Docusign Envelope ID: 3A92B5EB-F5E4-4002-875B-CFC2B9ABE694

OBSERVATION 3		Fallowing Call Notice Review	
		<p>Fallowing call notices are the first step in notifying landowners of Metropolitan's desire to effect fallowed land. There is a process where staff prepare a notice template that is reviewed by the General Manager, and then customized for each landowner; however, there are no procedures for this process.</p> <p>For the Contract Year 2023/24 fallowing call notice, the General Manager's review and approval was obtained verbally before the notices were sent out, but the routed document was formally approved by the General Manager approximately two months after the fallowing call notices were issued.</p>	
RECOMMENDATION 3		We recommend management:	
PRIORITY 3		<p>(1) Ensure General Manager approval for fallowed land call notices is documented prior to issuance.</p> <p>(2) Prepare procedures for preparation, authorization, and issuance of fallowed land call notices.</p>	
X	AGREE	MANAGEMENT ACTION PLAN	An additional step will be added to the current WRM SharePoint surnaming procedure such that when the General Manager has given approval outside of the established procedure, WRM will reply in an email message that includes the General Manager in the message that the fallowing call notice was approved by the General Manager before sending the notice.
		ESTIMATED IMPLEMENTATION	[July/2025]
	PARTIALLY AGREE	EXPLANATION	[insert]
	DO NOT AGREE		

FORM

MANAGEMENT RESPONSE FORM

PAGE

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NOVEMBER 2023 (Rv. N/A)





OFFICE OF THE GENERAL AUDITOR

Advisory Brief

Rapid Review: Mutual Benefit Leases

April 30, 2025

Project No. 24-49

INTRODUCTION

The Office of the General Auditor (Internal Audit) and the Office of Ethics collaborate on contemporary district topics and recently discussed mutual benefit leases, specifically office space leases. Consistent with the purpose of the internal audit, which is to provide value-added advice to management, we performed a Rapid Review to evaluate certain aspects of the district's mutual benefit leasing practices. This review aims to answer the following questions about mutual benefit leasing of office space (excluding day permits, short-term use of facilities, or similar arrangements):

1. Does the district have sufficient policies and procedures for administering mutual benefit leases?
2. Are avoided costs and acquired benefits appropriately documented and disclosed for mutual benefit leases?
3. Is the district fairly compensated for the lease revenue foregone?
4. Are mutual benefit leases issued transparently and fairly?
5. Are mutual benefit leases properly accounted for?
6. Do mutual benefit leases appropriately address conflicts of interest and other ethics considerations?

Internal Audit is piloting Rapid Reviews, which aim to swiftly examine a contemporary subject, offer analysis, and provide recommendations. This Rapid Review, an advisory service governed by professional internal auditing standards, involves procedures that are substantially less in scope than an audit. Issues identified may not be as fully developed had traditional audit procedures been performed.

BACKGROUND

Mutual benefit leases are arrangements in which Metropolitan allows an external party to use its facilities or properties, typically in exchange for non-monetary contributions (in-kind benefits) rather than traditional rental payments. These in-kind contributions must provide a tangible benefit to the district, such as reduced costs, enhanced services, or other advantages aligned with Metropolitan's mission and strategic objectives. As of this report date, management stated that the district has only one mutual benefit lease involving the use of office space.

On August 28, 2023, the Engineering Services Group provided a Mutual Benefits Justification memorandum to the Real Property Group concerning a lease agreement with AECOM that allows AECOM to occupy 2,954 square feet of office space (and two parking spaces) at Metropolitan's headquarters facility under the following terms:

- Lease Term: May 1, 2024 to April 30, 2027; the total lease period is three years, with an option to extend the lease for an additional two years.
- Lease Compensation: The rental value of the office space is waived in exchange for in-kind contributions under AECOM's professional services agreement.
- Tenant Obligations: AECOM is responsible for paying personal property taxes on any fixtures they place in the leased premises.

The rental value of the office space, calculated at \$106,344 annually (not evaluated by Internal Audit but based upon a recently executed market rate lease with the San Diego County Water Authority for office space at Union Station) by the Land Management Unit (Office of Sustainability, Resilience, and Innovation), is documented in the Property Use Request Form.

The lease was signed on July 10, 2024, under authority delegated to the General Manager by Administrative Code Section 8230.

INTERNAL AUDIT ASSESSMENT

Policies and Procedures

While management indicated they followed existing guidelines and tools (e.g., Property Use Request Form) in compliance with the Administrative Code, Metropolitan does not have policies explicitly outlining the criteria for entering into mutual benefit leases, nor are there detailed procedures for administering mutual benefit leases. Finally, no policy discusses how mutual benefit leases will be made available to third parties. This creates potential inconsistencies in the screening/evaluation, selection, and approval of mutual benefit leases.

Documentation and Disclosure

While the Property Use Request Form documents avoided costs (e.g., reduced overhead rates for consultant services) and acquired benefits (e.g., facilitating collaboration by being at district headquarters), there is no process in place to ensure that the benefits of mutual benefit leases are quantifiable, appropriately disclosed to senior management and the Board, or supported with adequate documentation and justification. A failure to formally assess and document compensation to the district could make it difficult to prove that the lease terms are fair, leaving Metropolitan vulnerable to legal challenges asserting that public funds were improperly allocated.

Metropolitan's lease agreement with AECOM for office space at Metropolitan's headquarters was reported to the Board by Real Property in their Quarterly Report for FY 2024/25 Q1 as a mutual benefit lease. However, it does not specifically mention the complete waiver of rent. Note that this quarterly report is a non-agenda report.

Compensation

The lease agreement with AECOM does not clearly define the services provided, the monetary value of these services, or performance expectations in lieu of rent paid. While the clause gives Metropolitan sole discretion to evaluate the mutual benefits, the reduced overhead rates were not included in the original lease and were negotiated separately, which lacks transparency. Additionally, monitoring mechanisms to track the realization of anticipated benefits over the lease term are insufficient. This could result in the district not recovering rent waived on the premise of mutual benefit.

Transparency and Fairness

Metropolitan issued a request for proposal (RFP) for Pure Water Southern California management services in 2022 that included language stating the district would negotiate the provision of office space at the district headquarters outside of the RFP process. The RFP provision to defer office space negotiations outside the procurement process could influence vendor bids due to differing assumptions among bidders on how their proposals will be assessed. Additionally, conducting negotiations after the RFP process may raise concerns about preferential treatment, potentially creating the perception that negotiations deviated from competitive procurement criteria. It also raises questions as to whether all costs were properly evaluated. The current process creates ambiguity and raises questions about transparency and fairness.

Accounting

There are no procedures to notify or consult the district controller regarding mutual benefit clauses in lease agreements. As a result, key financial information, such as the market value of waived rent or reduced overhead rates, may not be consistently recorded in the district's financial statements. While likely immaterial to the financial statements as a whole, this omission understates expenses and does not align with generally accepted accounting principles.

Separately, a federal grant from the United States Bureau of Reclamation to advance Pure Water Southern California will reimburse program management expenses with a 3-to-1 non-federal cost share. Unless the waived rent is separately tracked and added back to the project cost later, waiving the rent in return for a reduced labor fee will lead to understated project costs and less reimbursement from the grant.

Conflicts of Interest and Other Ethics Considerations

Mutual benefit leases could involve organizations with district employees and/or Board members on the organization's governing board. Unlike professional services and other district agreements, Metropolitan lacks formal policies or procedures for identifying and addressing potential conflicts of interest in mutual benefit leases (e.g., there are no documented processes to ensure transparency when Metropolitan employees or Board members hold dual roles or have relationships with organizations involved in lease agreements; there are no screening processes to assess whether there is a prohibitive conflict of interest). The result of this may lead to the appearance of favoritism/inequity. In some cases, a Board member or employee having a financial interest (as defined by state law) could prevent the lease altogether or render an already executed lease void (Government Code 1090). Note that directors are not allowed to discuss real estate transactions or contract selection matters outside of public meetings with staff (Administrative Code 7125).

INTERNAL AUDIT CONCLUSION

Metropolitan's mutual benefit leasing practices should be updated to improve governance, transparency, and accountability.

1. There are insufficient policies and procedures for administering mutual benefits leases.
2. There is no standardized process to ensure that mutual benefits leases are properly documented and disclosed to senior management and the Board.
3. There is no monitoring of avoided costs to ensure the district is fairly compensated for lease revenue forgone.
4. The process for issuing mutual benefits leases may result in leases not being issued transparently and fairly.
5. Current practices could result in mutual benefit leases not being properly accounted for.
6. The mutual benefit lease process does not appropriately address potential conflicts of interest.

The lack of formal policies, vague lease terms, insufficient monitoring, and absence of conflict-of-interest procedures increase risks, namely related to public trust.

INTERNAL AUDIT RECOMMENDATIONS

Develop Policies and Procedures. Written policies that formalize criteria for mutual benefit leases should be developed. The policy should require these leases to serve the district's authorized purposes and be documented. Other elements should include acceptable documentation of the nature and value of in-kind contributions, evaluation standards and screening requirements, monitoring requirements, approval processes, and how mutual benefit leases are to be made available. Adequate compensation in a lease includes financial compensation or other tangible benefits commensurate with the value of the property being leased. The policy framework should also incorporate existing tools, such as the Property Use Request Form.

Revise RFP Process. When applicable, all potential mutual benefit arrangements, such as reduced rent or rent-free office space (including space and value), should be disclosed to all potential respondents and evaluated as part of the RFP process. Respondents should be required to quantify the value of in-kind contributions in their proposals for transparency and comparability.

Enhance Lease Agreement Language. Lease agreements should clearly define in-kind contributions, including specific deliverables, timelines, and monetary valuations, and leases with mutual benefit provisions should replace discretionary language, such as "sole discretion to evaluate benefits," with objective performance criteria. Further, there should be an evaluation of potential legal issues related to terminating a mutual benefit lease if non-monetary/in-kind benefits are not provided as anticipated.

Revise Administrative Code. Administrative Code Section 8230 should be revised so the Board approves all office space-related mutual benefit leases regardless of dollar amount or term.

Strengthen Documentation and Justification. In-depth cost-benefit analyses should be developed for all mutual benefit leases, demonstrating that in-kind contributions equal or exceed waived rent. Additionally, documentation of all agreements and justifications should be maintained.

Implement Performance Metrics and Monitoring. Measurable and quantifiable criteria for evaluating tenant contributions should be established, compliance should be monitored throughout the lease term, and periodic audits or reviews should be conducted to ensure mutual benefits are realized.

Improve Public Disclosure. The terms, benefits, and justifications for mutual benefit leases should be discussed in Board meetings or presented in Board reports with specific mutual benefit lease details (e.g., term, reduced/waived rent) unless confidentiality is legally required.

Collaborate with Finance. The district's controller should be notified and consulted regarding mutual benefit leases. Specifically, this could include recording the mutual benefit as a project expense equivalent to the market value of the lease to account for the reduced burdened rates provided by the consultant/contractor.

Establish Conflict of Interest Policies and Procedures. Policies should be developed for identifying, managing, and disclosing conflicts of interest in mutual benefit leases. Specifically, procedures should ensure that district employees and Board members with potential conflicts of interest are not involved in the associated lease negotiations or discussions. Finally, consultation with the Office of Ethics should be sought for guidance on lease involvement (e.g., lease negotiation, signing) by district employees before any participation by an employee and any future Board action.

By implementing the above recommendations, Metropolitan can strengthen its leasing process, improve internal controls, and enhance its reputation for responsible governance and public stewardship. When properly managed, mutual benefit leasing can support the district's strategic objectives by reducing costs, fostering greater collaboration with partnering organizations, and maximizing the use of underutilized office space. These agreements can potentially advance Metropolitan's mission while maintaining transparency, accountability, and public trust.

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OFFICE OF THE GENERAL AUDITOR COMMUNICATIONS

This Advisory Brief was prepared by the Office of the General Auditor, an internal audit function of the Metropolitan Water District of Southern California serving the Board of Directors and management. Questions regarding this communication may be directed to General Auditor Scott Suzuki at ssuzuki@mwdh2o.com or Assistant General Auditor Kathryn Andrus at kandrus@mwdh2o.com.