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An Audit Report on

The Water Infrastructure Fund at the Water Development Board

July 2012

Report No. 12-042

The Water Infrastructure Fund at the Water Development Board

Overall Conclusion

The Water Development Board (Agency) has processes for the Water Infrastructure Fund that are designed to help ensure that the Agency:

- Provides loans from the Water Infrastructure Fund to financially sound recipients.
- Prioritizes projects that receive loans from the Water Infrastructure Fund in accordance with statute.
- Provides Water Infrastructure Fund loans to eligible projects and monitors projects that receive loans from the Water Infrastructure Fund.

Although the Agency generally has adequate processes, it did not consistently adhere to some of those processes, and it could not provide evidence that it performed certain review functions as designed. For example:

- The Agency has developed policies, procedures, and other tools for assessing the creditworthiness of applicants for Water Infrastructure Fund loans. Because the Agency does not always use and document those tools, however, it cannot ensure that it consistently determines applicants' credit risk scores in accordance with guidelines.
- Although the Agency prioritizes funding decisions for the Water Infrastructure Fund in accordance with statute, it should develop documented policies and procedures to determine how to prepare some of the information it uses in its prioritization process. Specifically, it should develop documented policies and procedures to determine how to compile water use data, calculate water conservation savings, and identify the decade in which the demand for water will exceed the supply (referred to as "decade of need"). This would help to ensure that the Agency prioritizes funding decisions based on accurate calculations and data that it analyzes consistently.
- While the Agency provides Water Infrastructure Fund loans to eligible projects and monitors those projects in accordance with requirements, it should consistently use additional review processes required by its internal policies and procedures.

Background Information

In 2001, the 77th Legislature established the Water Infrastructure Fund to provide affordable financing for water conservation and development projects in the Regional or State Water Plan. The Water Development Board (Agency) administers the Water Infrastructure Fund.

Political subdivisions of the State can receive loans from the Water Infrastructure Fund at a subsidized interest rate. Examples of those political subdivisions include municipalities, counties, river authorities, special law districts, water improvement districts, water control and improvement districts, irrigation districts, groundwater districts, and non-profit water supply corporations.

As of February 2012, the Agency had committed 40 Water Infrastructure Fund loans for 30 projects totaling nearly \$898 million.

Key Points

The Agency has processes to determine applicants' ability to repay Water Infrastructure Fund loans, but it should apply those processes consistently.

The Agency's documented procedures for assessing an applicant's ability to repay a loan from the Water Infrastructure Fund include completing a financial application review checklist, completing an evaluation criteria matrix, and assessing an applicant's credit risk score. While the Agency consistently uses its financial application review checklist, it should improve its processes by consistently using its evaluation criteria matrix, clarifying how it assigns credit risk scores to applicants, and performing a secondary review of its work in determining applicants' ability to repay loans.

The Agency prioritizes Water Infrastructure Fund loans in accordance with statute, but it should document and consistently follow its processes and strengthen the accuracy of water use survey data it used to prioritize loans.

The Agency appropriately prioritized Water Infrastructure Fund loans in March 2011 and September 2011. The Agency's processes for prioritizing are designed to meet statutory requirements. However, the Agency has not formally documented those processes, and it does not consistently apply them when performing calculations using water use survey data.

The Agency has processes to monitor projects that receive Water Infrastructure Fund loans, but it should improve certain aspects of its internal review process.

The Agency generally follows its processes to monitor projects that receive Water Infrastructure Fund loans. While the Agency has well-developed written policies and procedures to help guide those processes, it should consistently follow its procedures to perform secondary reviews, which help to ensure that processes operate as the Agency intended and that the Agency monitors projects appropriately.

The Agency provides Water Infrastructure Fund loans to eligible projects, but it should strengthen and document its processes to help ensure that loan recipients continue to meet requirements.

The Agency provides Water Infrastructure Fund loans to eligible projects in accordance with statute and Agency requirements. The Agency assesses loan applications for eligibility through financial reviews, as well as environmental, engineering, and legal reviews. The Agency should document procedures for performing legal reviews and ensure that it performs a secondary review of these legal reviews.

Summary of Management's Response

The Agency agreed with the recommendations in this report.

Summary of Information Technology Review

Auditors performed a limited review of controls over the Agency's Inspection and Field Support System and Financial Information System. The Agency uses those systems to track its project construction monitoring and its financial stability reviews, respectively. Audit work included reviewing general information technology controls and user access and conducting tests of data completeness and reasonableness. Auditors determined that controls and data were sufficiently reliable for the purposes of this audit.

Summary of Objective, Scope, and Methodology

The objective of this audit was to determine whether the Agency has processes and controls for the Water Infrastructure Fund that are designed and operating to help ensure that the Agency:

- Provides financial assistance to projects that are eligible for Water Infrastructure Fund funding.
- Prioritizes funding decisions in accordance with statute and Agency policy.
- Determines that loan recipients meet criteria for financial soundness.
- Adequately monitors projects.

The scope of this audit was fiscal years 2008 through 2012 for project eligibility and financial soundness and fiscal years 2011 and 2012 for project prioritization and monitoring.

The audit methodology included reviewing project files for selected loan applicants; conducting interviews with Agency staff; and reviewing Agency policies and procedures, the Texas Water Code, and the Texas Administrative Code. Specifically, auditors analyzed and tested processes and controls related to prioritization, eligibility, financial soundness of loan applicants, project and construction monitoring, and financial monitoring.

Auditors communicated other, less significant issues to Agency management separately in writing.

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Detailed Results

Chapter 1

The Agency Has Processes to Determine Applicants' Ability to Repay Water Infrastructure Fund Loans, But It Should Apply Those Processes Consistently

The Water Development Board (Agency) has designed a process to help ensure that it provides Water Infrastructure Fund loans to financially sound applicants. The Agency documented that process in written policies and procedures that guide its assessment of an applicant's ability to repay a loan. Those policies and procedures require the Agency to complete a financial application review checklist, use an evaluation criteria matrix, and make a final assessment of an applicant's credit risk score. According to the Agency, since it began making loans from the Water Infrastructure Fund in fiscal year 2008, no loan recipient has defaulted on a loan.

While the Agency consistently uses its financial application review checklist as required by its policies and procedures, it should improve its processes by consistently using its evaluation criteria matrix, clarifying how it assigns credit risk scores to applicants, and performing a secondary review of its work in determining applicants' ability to repay loans.

The Agency has documented procedures for assessing an applicant's ability to repay a loan from the Water Infrastructure Fund. Those procedures require the Agency to review and assess each applicant's financial soundness by completing a financial application review checklist. That checklist identifies missing information and issues that may require further discussion or analysis. The Agency also performs calculations in its evaluation criteria matrix using financial information an applicant submits and analyzes the results of those calculations to assign the applicant a credit risk score.

Each of the eight project files that auditors tested contained a completed financial application checklist. This indicates that the Agency determined that each applicant submitted all required documentation necessary for the Agency to assess the applicant's ability to repay a loan.

Financial Soundness Elements in the Agency's Evaluation Criteria Matrix

In testing for an applicant's financial soundness, this audit focused on the following criteria:

General Obligation Debt Compared to Assessed Valuation: A large percentage of tax-supported debt (greater than 10 percent) compared to the tax base can indicate a diminished ability to pay.

Collection Rate (5 Year Trend): A rise in delinquency rate for two consecutive years can be problematic.

Top 10 Customers of the System: Increased risk is noted if the revenue generated from the top 10 largest customers is greater than 15 percent.

Number of Connections in the System (five years): This has a direct impact on revenue generation.

Pro forma for Debt Repayment: This displays the financial feasibility of the proposed project.

Total Debt Authorized but Not Issued: This provides the Agency with a snapshot of the applicant's ability to issue debt for needed projects.

Fund Balance: This is cash available for operations or capital improvement and is considered favorable when an applicant has 10 percent unrestricted cash balances available.

Type of Pledge/Security: This defines the pledge and proposed security for repayment of the loan. The type of pledge/security is dependent on the type of entity applying for the loan, which is also defined in the Agency's guidelines.

Source: The Agency.

The Agency's Credit Risk Score Definitions

Risk Score 1: The applicant's capacity to meet its financial commitments is extremely strong.

Risk Score 2A: The applicant's repayment capacity is strong.

Risk Score 2B: The applicant's repayment capacity is adequate.

Risk Score 2C: The applicant's repayment capacity is sufficient to cover the existing and proposed debt.

Risk Score 3: The applicant's capacity to meet principal and interest payments is predominately speculative.

Source: The Agency.

The Agency should apply its procedures to determine financial soundness consistently. According to its procedures, the Agency must use loan applicants' financial information to perform various calculations described in the Agency's evaluation criteria matrix. That matrix describes the significance of those calculations and includes benchmarks to create a framework for assessing an applicant's financial soundness or creditworthiness.

Auditors reviewed eight project files to determine whether the Agency accurately performed eight key calculations in its evaluation criteria matrix (see text box) and found that:

- The evaluation criteria matrix was missing, blank, or modified for 4 (50 percent) of the 8 project files tested.
- Three (75 percent) of the 4 project files that contained an evaluation criteria matrix had inaccurate calculations or incomplete supporting documentation for those calculations. This prevented auditors from determining the accuracy of those matrices.

By not completing an evaluation criteria matrix for each loan applicant or not accurately performing calculations, the Agency is not consistently following its process. This increases the risk that the Agency could determine an applicant's creditworthiness incorrectly.

After the Agency completes an evaluation criteria matrix, it assigns a credit risk score to the applicant using Agency-developed credit risk score definitions (see text box). The credit risk score is the result of the Agency's assessment of an applicant's ability to meet repayment requirements and other terms and conditions of a loan.

Since the agency began making loans from the Water Infrastructure Fund in fiscal year 2008, the Agency has committed to 40 loans for 30 projects totaling nearly \$898 million. For those loans:

- The Agency awarded 67 percent of those loans to applicants with a credit risk score of 2A, which means that the Agency concluded the recipients' repayment capacity was strong.
- The Agency awarded 33 percent of those loans to applicants with a credit risk scores of 2B, which means that the Agency concluded the recipients' repayment capacity was adequate.

Agency procedures for completing the evaluation criteria matrix and assigning a credit risk score also indicate that Agency staff must use professional judgment in performing a financial analysis and assessing an applicant's credit risk score. However, auditors were unable to identify a clear association between the financial analysis the Agency performs using the evaluation criteria matrix and the credit risk score the Agency assigns to an applicant. Having specific guidance for how to use the results of financial analyses to assign a credit risk score to an applicant would help ensure that the Agency consistently assigns appropriate credit risk scores. Adhering to specific, documented procedures would help reduce the risk of errors and non-compliance with established criteria.

The Agency indicated that it has an informal process for a team leader to review financial analysts' work. In addition, the Agency's procedures require an internal credit committee review to help ensure that the Agency assigns credit risk scores consistently. However, for the eight project files tested, auditors found no evidence of team leader review or credit committee review. Regularly reviewing work increases the potential for detecting and correcting errors and improving accuracy.

Recommendations

The Agency should:

- Consistently maintain a completed evaluation criteria matrix in the project file for each Water Infrastructure Fund loan applicant.
- Expand its procedures and strengthen documentation of the credit risk score assessment to include an explanation of how the Agency considers quantitative factors in the evaluation criteria matrix and qualitative factors in determining an applicant's credit risk score.
- Expand the oversight of its financial review process to verify that the Agency makes accurate calculations that are supported by documentation. The Agency also should maintain evidence of that oversight by documenting team leader and credit committee sign off on each applicant's evaluation criteria matrix results and assigned credit risk score.

Management's Response

We agree that complete files are important and that while financial assessment staff completes an evaluation matrix as part of its review, it has not always maintained it in the appropriate work paper file. Financial management is in the process of enhancing its quality assurance procedures to include checking the work paper file for completeness. This is expected to be implemented by June 30, 2012. In response to TWDB Internal Audit's

Review of the Loan Application Process, management is also working to incorporate key evaluation criteria within TxWISE, which is expected to be in place by September 30, 2012. (Individual Responsible: Director – Project Development)

As noted, the Agency considers both quantitative and qualitative factors, including the quality of the entity's management, internal control environment, debt management experience and history with the Board, in its credit risk score assessment. Beginning February 2012, the Agency has enhanced its documentation of the financial review and the information presented to the Board.

The financial assessment team is in the process of enhancing its quality assurance procedures to include documentary evidence of supervisory review. Peer and Credit Committee reviews are informal and not intended as supervisory approval. Eventually, this will be accomplished through the use of electronic checklists, evaluations and secondary reviews (by the Team Lead and/or the Director) within TxWISE by September 30, 2012. (Individual Responsible: Director – Project Development)

The Agency Prioritizes Water Infrastructure Fund Loans in Accordance with Statute, But It Should Document and Consistently Follow Its Processes and Strengthen the Accuracy of Water Use Survey Data It Used to Prioritize Loans

The Agency appropriately prioritized Water Infrastructure Fund loans in March 2011 and September 2011. The Agency's processes for prioritizing projects for loans are designed to meet statutory requirements. However, the Agency has not formally documented those processes, and it does not consistently apply them when performing calculations using water use survey data.

The Agency prioritized projects for loans in accordance with statute. The Agency followed statutory requirements to appropriately prioritize projects submitted for the Water Infrastructure Fund loans during the funding rounds that occurred in March 2011 and September 2011. However, the Agency did not have documented procedures for its prioritization process.

Texas Water Code, Section 15.9751, Priority for Water Conservation

The Agency is required to give priority to applications for funds for the implementation of water supply projects in the Regional or State Water Plan to entities that (1) have already demonstrated significant water conservation savings or (2) will achieve significant water conservation savings by implementing the proposed project for which the financial assistance is sought.

Title 31, Texas Administrative Code, Section 363.1208, Prioritization Criteria

The Agency is required to consider the following factors when ranking Water Infrastructure Fund loan applications:

- (1) Projects which have the earliest identified decade of need, as identified in the water plan; and
- (2) Entities that:
 - (A) have already demonstrated significant water conservation savings, as determined by comparing the highest rolling five-year average gallons per capita per day since 1980 to the average gallons per capita per day for the most recent 4-year period; or
 - (B) will achieve significant water conservation savings by implementing the proposed project for which the financial assistance is sought, as determined by comparing the conservation to be achieved by the project with the average gallons per capita per day for most recent four-year period.

The Agency prioritizes, or ranks, applicants seeking loans from the Water Infrastructure Fund twice annually using criteria in the Texas Administrative Code and the Texas Water Code (see text box). The prioritization process starts when the Agency verifies that a project is part of the Regional or State Water Plan and identifies the decade in which the demand for water will exceed the supply (referred to as the "decade of need"). Next, the Agency considers an applicant's demonstrated water conservation savings by comparing the applicant's recent water use to its historical water use. The Agency performs that analysis using water use survey data that water supply entities submit to the Agency annually. An applicant earns certain point values for a project's decade of need and the amount of demonstrated water conservation savings. The Agency assigns higher values to earlier decades of need and higher levels of conservation. Finally, the Agency totals each applicant's points, ranks applicants' projects from the highest to lowest point value, and generates the list of prioritized projects that the Agency submits to the members of the Water Development Board for approval.

Having and following documented policies and procedures for the prioritization process would help to ensure that the Agency continues to prioritize loans in a consistent manner.

The Agency should strengthen the accuracy of water use survey data and its water conservation savings calculations. The Agency does not

perform a secondary review for accuracy of the water use survey data that it manually enters into its water use survey database. The Agency surveys political subdivisions annually to determine the amount of ground water and surface water their populations use. The Agency uses that self-reported, unverified data to calculate applicants' demonstrated water conservation savings as part of its prioritization process. The Agency does not perform a secondary review of those calculations.

Determining an applicant's water conservation savings requires the Agency to calculate the gallons per capita used daily based on historical water use data since 1980. However, sometimes that data is incomplete, and the Agency does not have a consistent process for dealing with incomplete data. For example:

- In some cases, the Agency performs the water conservation savings calculations using data an applicant submitted for the previous year.
- In some cases, the Agency uses no value at all in its water conservation savings calculations.

Requiring a secondary review of data entry and water conservation savings calculations would help to ensure that the Agency follows its processes consistently and that its processes produce accurate results. In addition, having a documented process for dealing with incomplete and inaccurate water use survey data would help to ensure that the Agency calculates water conservation savings consistently.

Recommendations

The Agency should:

- Develop and implement written procedures for prioritization of Water Infrastructure Fund loans, including procedures for how to (1) compile water use data, (2) calculate water conservation savings, (3) address limitations due to incomplete or missing data for calculating water conservation savings, and (4) identify an applicant's decade of need.
- Develop and implement a review process to help ensure that it enters water use data accurately into its water use database and that its calculations of water conservation savings are correct

Management's Response

Management agrees with the need for improved documentation of the prioritization process. Written documentation with detailed descriptions of all processes noted has now been completed. In addition, an updated Water Use

Survey Program guide, detailing the improved quality assurance/quality control processes inherent in the new Water Use Survey database application, will be completed by September 30, 2012. (Individual Responsible: Deputy Executive Administrator)

The Agency Has Processes to Monitor Projects That Receive Water Infrastructure Loans, But It Should Improve Certain Aspects of Its Internal Review Process

The Agency generally follows its processes to monitor projects that receive Water Infrastructure Fund loans from the projects' planning phase through the projects' construction phase; it also monitors loan recipients' financial condition until they repay loans (see text box). While the Agency has well-developed written policies and procedures to help guide those processes, it should consistently follow its procedures to perform secondary reviews, which help to ensure that processes operate as the Agency intended and that the Agency monitors projects appropriately.

In addition, Title 31, Texas Administrative Code, Section 363.42, outlines the escrow requirements for Water Infrastructure Fund loan recipients that help to ensure that escrow or trust agents release funds only with proper authorization. However, the Agency does not always enforce compliance with those escrow requirements.

Chapter 3-A

The Agency Has Processes to Monitor Projects Through Planning and Construction, But It Should Improve Its Monitoring of Compliance with Escrow Requirements

The Agency generally follows its processes to monitor projects that receive Water Infrastructure Fund loans from planning through construction. Those monitoring processes include:

- Completing checklists that help to ensure that loan recipients meet requirements before the Agency authorizes the release of funds.
- Reviewing loan recipients' plans and specifications.
- Reviewing and approving change orders.
- Conducting on-site inspections as needed.
- Issuing certificates of approval authorizing a loan recipient to release a final payment to its contractors.

Agency Project Monitoring

The Agency performs the following types of monitoring:

- The Agency's Project Engineering and Review Division reviews project plans and specifications to determine the feasibility of a project and its adherence to program requirements. Environmental reviewers then assess the environmental impact of the project. The Project Engineering and Review Division authorizes the release of funds for projects. The Agency releases funds for the next phase when a loan recipient has met all requirements for the previous phase of a project. The Project Engineering and Review Division also must approve any changes to the original project plans.
- The Agency's Inspection and Field Support Division reviews project plans and specifications to determine whether they are adequate for the bidding process. During the construction phase of a project, the Inspection and Field Support Division conducts regular on-site inspections; it also documents progress and documents issues in an inspection report that the Agency sends to the loan recipient.
- The Agency's financial monitoring team reviews annual audited financial statements the loan recipients are required to submit. The financial monitoring team calculates certain ratios and compares them to loan documentation to determine whether a loan recipient continues to comply with requirements and will be able to repay the loan. Agency financial examiners also may conduct site visits at loan recipients that do not comply with requirements or that require additional review.

Auditors tested eight projects in various stages of completion and identified the following:

- The Agency completed monitoring checklists for each applicable phase of the eight projects tested. In addition, the Agency appropriately approved all memos authorizing the release of funds for those projects.
- The Agency reviewed and approved loan recipients' plans and specifications for the six projects tested that required plans and specifications, as required by Title 31, Texas Administrative Code, Section 363.41 (the remaining two projects tested were not required to have plans and specifications).
- Three (38 percent) of the 8 projects tested had a total of 8 change orders. The Agency approved 7 (88 percent) of those 8 change orders as required by Texas Water Code, Section 17.186.
- Five (63 percent) of the 8 projects tested were in the construction phase, and the Agency conducted on-site inspections and issued inspection reports to the loan recipients for those 5 projects as required by Agency policy.
- Three (38 percent) of the 8 projects tested required certificates of approval during the time period tested. For those three projects, the Agency issued six certificates of approval in accordance with requirements.

Monitoring of Compliance with Escrow Requirements

While the Agency follows its processes to authorize the release of funds, it should make improvements to effectively monitor the release of funds. Title

**Excerpts from Escrow Requirements in
Title 31, Texas Administrative Code,
Section 363.42**

To close a Water Infrastructure Fund loan, a recipient must submit the following:

(2) A certified copy of the ordinances or resolutions adopted by the governing body authorizing issuance of debt sold to the board which has received prior approval by the executive administrator and which shall have sections providing:

(A) That an escrow account, if applicable, shall be created which shall be separate from all other funds and that:

(i) The account shall be maintained at an escrow agent bank or maintained with the trust agent;

(ii) Funds shall not be released from the escrow account without written approval by the executive administrator;

(iii) The escrow account bank statements or trust account statement will be provided on a monthly basis to the executive administrator's office.

31, Texas Administrative Code, Section 363.42, specifies the escrow requirements for Water Infrastructure Fund loan recipients (see text box). Loan recipients must enlist an escrow or trust agent to manage an escrow bank account for their projects. In accordance with an escrow agreement, the escrow or trust agent can release funds only with Agency approval.

Auditors tested six projects for which the Agency deposited Water Infrastructure Fund loan funds into an escrow bank account and determined the following:

- Three (50 percent) of the six projects had a bond ordinance or resolution that did not include the escrow bank account statement provisions that the Texas Administrative Code requires.

- The Agency did not consistently enforce the requirement that loan recipients submit escrow bank account statements to the Agency on a monthly basis.

When the Agency does not consistently require loan recipients to submit escrow bank account statements, it is unable to examine statements to determine whether the escrow or trust agent released funds with proper authorization.

Recommendations

The Agency should:

- Ensure that Water Infrastructure Fund loan recipients include language in all bond ordinances or resolutions requiring the recipients to maintain an escrow bank account, submit escrow bank account statements, and comply with requirements in Title 31, Texas Administrative Code, Section 363.42.
- Review Water Infrastructure Fund loan recipients' escrow bank account statements to verify that escrow or trust agents release Water Infrastructure Fund funds only with proper authorization.

Management's Response

The Agency is in the process of revising relevant rules and legal documents to include a requirement for borrowers to provide escrow statements upon request. These are expected to be implemented by September 2012. (Individual Responsible: Director – Debt and Portfolio Management).

The release of funds is a contractual agreement between the borrower and the escrow agent. The Agency will verify with requested statements, as necessary. This is expected to be in place by September 2012. (Individual Responsible: Director – Debt and Portfolio Management).

Chapter 3-B

The Agency Should Consistently Perform Secondary Reviews of Its Project and Construction Monitoring

The Agency's internal procedures require certain parts of the project and construction monitoring process to undergo a secondary review for accuracy. Staff engineers perform the initial assessment of project documentation, and team leaders perform a secondary review of that work. Although the Agency's procedures require a secondary review, the Agency did not always have evidence that it performed that process consistently. For example:

- Auditors tested 6 projects that comprised 17 separate construction contracts. For 10 (59 percent) of the 17 construction contracts, there was no evidence of the Agency's secondary review of its staff engineer's assessment that the projects were feasible, biddable, and constructible.
- Auditors tested 8 contracts with change orders and, for 5 (63 percent) of those 8 contracts, there was no evidence of the Agency's secondary review of the change orders. Additionally, the Agency had not approved one of those change orders. It is important to note that all five contracts were associated with the same project.
- For 3 (60 percent) of the 5 projects tested that were in construction, Agency team leaders both prepared and approved inspection reports. For 2 (67 percent) of the 3 projects tested that had completed construction contracts, team leaders both prepared and approved the certificates of approval.

Consistently performing secondary reviews would help to ensure that processes operate as the Agency intended and that the Agency appropriately monitors projects.

Recommendation

The Agency should consistently perform and document secondary reviews of Water Infrastructure Fund loan recipient project and construction monitoring activities, including engineer assessments, change orders, and inspection reports.

Management's Response

The Agency is in the process of enhancing its project review and monitoring procedures by strengthening its secondary review procedures. The new procedures will require documentary evidence of the secondary review, and that it is performed by someone other than the original reviewer or inspector. The new procedures are expected to be implemented by September 30, 2012. (Individual Responsible: Deputy Executive Administrator).

Chapter 3-C

The Agency Monitors Loan Recipients' Financial Stability and Ability to Repay Loans

The Agency has policies and procedures for financial monitoring of projects that receive Water Infrastructure Fund loans. Specifically, the Agency performs an annual financial stability review using information in a loan

recipient's audited financial statements to assess the loan recipient's financial stability and its ability to repay loans. The financial stability review process requires analysts to calculate various financial ratios to assess whether the loan recipient has complied with Agency requirements to meet agreed-upon debt coverage ratios. The ratios the Agency calculates show whether the loan recipient has adequate bond revenue to cover its debt and whether it will have adequate funds after paying its debt service.

The Agency uses its Financial Information System to track its receipt of annual financial statements from loan recipients. The Financial Information System also generates letters to notify loan recipients when they do not submit financial statements in a timely manner.

The Agency performed a financial stability review for all seven Water Infrastructure Fund projects tested and appropriately assessed the loan recipients' compliance with requirements for key calculations. While auditors noted discrepancies involving certain calculations for two projects, those discrepancies did not have an effect on the Agency's determination regarding compliance with requirements.

The Agency Provides Water Infrastructure Fund Loans to Eligible Projects, But It Should Strengthen and Document Its Processes to Help Ensure That Loan Recipients Continue to Meet Requirements

The Agency provides Water Infrastructure Fund loans to eligible projects in accordance with statute and Agency requirements. To be considered eligible for loans, projects must first meet the requirements for prioritization

(discussed in Chapter 2). Within 30 days of being prioritized for funding, loan applicants must submit a completed written application including general, legal, and fiscal information (see Appendix 2 for a description of the loan application and approval process).

In testing eligibility, auditors focused on certain requirements in the Texas Administrative Code and the Texas Water Code (see text box). All eight projects that auditors tested met those eligibility requirements.

The Agency assesses loan applications for eligibility through financial reviews (discussed in Chapter 1), as well as environmental, engineering, and legal reviews (discussed below).

Environmental and engineering reviews. Agency environmental reviewers and professional engineers perform environmental and engineering reviews of applications according to written procedures. The written procedures require the use of a checklist to help ensure that loan applicants are consistently reviewed and meet all requirements. Seven (88 percent) of the 8 applications auditors tested had completed environmental and engineering checklists, but the remaining application tested did not.

Legal reviews. Agency attorneys are responsible for performing the legal reviews. While the Agency has not developed documented procedures for its legal review process, it generally uses a checklist to guide that review.

Six (75 percent) of the 8 applications that auditors tested had a completed legal review checklist. For the two projects without a completed legal review checklist, auditors could not determine whether the Agency appropriately reviewed the applications according to its legal review process.

Secondary reviews. According to the Agency's internal procedures, after completion of the environmental, engineering, and legal reviews, the environmental reviewer, professional engineer, or attorney who performed the

Water Infrastructure Fund Loan Eligibility Criteria

In testing eligibility, this audit focused on the following eligibility requirements:

- The project the applicant proposes is consistent with the Regional or State Water Plan (Title 31, Texas Administrative Code, Section 363.1209(3)).
- The applicant submits an application that includes the following (Title 31, Texas Administrative Code, Section 363.12(2)(A)):
 - ♦ The amount of financial assistance requested.
 - ♦ A description of the project.
 - ♦ The source of repayment and the status of legal authority to pledge selected revenues.
 - ♦ The financing plan for repaying the total cost of the project.
 - ♦ A notarized affidavit from an authorized representative verifying compliance with federal and Agency requirements.
- The applicant submits a preliminary engineering feasibility report (Title 31, Texas Administrative Code, Section 363.12(B)).
- The applicant submits an environmental assessment (Title 31, Texas Administrative Code, Section 363.12(C)).
- The applicant submits a water conservation plan (Title 31, Texas Administrative Code, Section 363.12(D), and Texas Water Code, Section 15.106).
- The applicant submits information regarding funding from other sources (Title 31, Texas Administrative Code, Section 363.12(E)).
- The applicant submits a water use survey (Texas Water Code, Section 16.012(m)).
- The applicant submits information regarding water rights (Texas Water Code, Section 15.975).

review summarizes the results in a memo. Team leaders performed a secondary review of that memo and the accompanying checklist for the eight environmental and engineering reviews tested. However, the Agency did not perform a secondary review of the legal reviews that auditors tested. Performing complete secondary reviews would increase the likelihood of detecting errors and omissions in the legal review process.

Recommendations

The Agency should:

- Consistently perform complete environmental, engineering, and legal reviews of all Water Infrastructure Fund loan applications it receives, document those reviews using required checklists, and include the checklists in Agency project files.
- Develop and implement written procedures for the legal review process for Water Infrastructure Fund loan applications, including a requirement for secondary review.

Management's Response

TWDB environmental and engineering application review procedures require the reviewer to complete a quality control checklist before the application is presented to the Board for financial commitment. Agency management believes the one application file whose engineering commitment memo checklist was missing a check on one out of the twenty-three review steps represents an isolated incident, and that this issue has already been addressed, with the implementation of TxWISE in September 2011. These checklists are automated within TxWISE, which aids in ensuring reviewer documentation is complete and consistent and that secondary reviews are performed. Individual Responsible: Deputy Executive Administrator.

We agree that while the Agency has procedures and review checklists for the review of applications, the legal review is not always adequately documented in the TxWise checklist, which is not the official work paper file. However, the Legal office is in the process of fully documenting its written procedures in all areas, not just the Water Infrastructure Fund program. This is expected to be completed by December 31, 2012. In addition, legal review procedures will document the level of secondary review that is provided. Individual Responsible: General Counsel.

Appendices

Appendix 1

Objectives, Scope, and Methodology

Objectives

The objectives of this audit were to determine whether the Water Development Board (Agency) has processes and controls for the Water Infrastructure Fund that are designed and operating to help ensure that the Agency:

- Provides financial assistance to projects that are eligible for Water Infrastructure Fund funding.
- Prioritizes funding decisions in accordance with statute and Agency policy.
- Determines that loan recipients meet criteria for financial soundness.
- Adequately monitors projects.

Scope

The scope of this audit was fiscal years 2008 through 2012 for project eligibility and financial soundness and fiscal years 2011 and 2012 for project prioritization and monitoring.

Methodology

The audit methodology included reviewing project files for selected loan applicants; conducting interviews with Agency staff; and reviewing Agency policies and procedures, the Texas Water Code, and the Texas Administrative Code. Specifically, auditors analyzed and tested processes and controls related to prioritization, eligibility, financial soundness of loan applicants, project and construction monitoring, and financial monitoring.

Auditors assessed the reliability of the Agency's project construction monitoring system (the Inspection and Field Support System or IFSS) and the Agency's financial monitoring system (the Financial Information System or FIS) and determined that the data in those systems was sufficiently reliable for the purposes of this audit. To make that determination, auditors performed data reliability tests on IFSS and FIS and reconciled that data with hard-copy documentation.

Auditors also assessed the reliability of the Agency's water use survey database and concluded that the reliability of that data was undetermined

because water supply entities self-report the data in that database. Auditors were unable to validate that data; however, auditors reviewed how the Agency uses that data and performed calculations to verify appropriate use of that data.

Information collected and reviewed included the following:

- Information from interviews with Agency management and staff.
- Selected Agency information regarding applicants for two funding rounds for the Water Infrastructure Fund.
- Selected water use survey database information.
- Selected Water Infrastructure Fund project files.
- Selected loan and project information from IFSS and FIS.

Procedures and tests conducted included the following:

- Interviewed management and staff at the Agency.
- Recalculated project prioritization for two funding rounds for the Water Infrastructure Fund based on earliest decade of need and water conservation savings as prescribed in the Texas Water Code and the Texas Administrative Code.
- Reviewed the Agency's prioritization process for compliance with the Texas Water Code and the Texas Administrative Code.
- Reviewed eight Water Infrastructure Fund project files for compliance with the Texas Water Code, the Texas Administrative Code, and Agency policies and procedures for eligibility, financial soundness, project and construction monitoring, and financial monitoring.
- Reviewed monthly construction monitoring data in IFSS for Water Infrastructure Fund projects.

Criteria used included the following:

- Texas Water Code, Chapter 15, Water Loan Assistance Program.
- Texas Water Code, Chapter 15, Water Infrastructure Fund.
- Texas Water Code, Chapter 16, Duties of the Executive Administrator.
- Texas Water Code, Chapter 17, Provisions Generally Applicable to Financial Assistance.
- Title 31, Texas Administrative Code, Chapter 363.

- Agency policies and procedures.

Project Information

Audit fieldwork was conducted from March 2012 through May 2012. We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

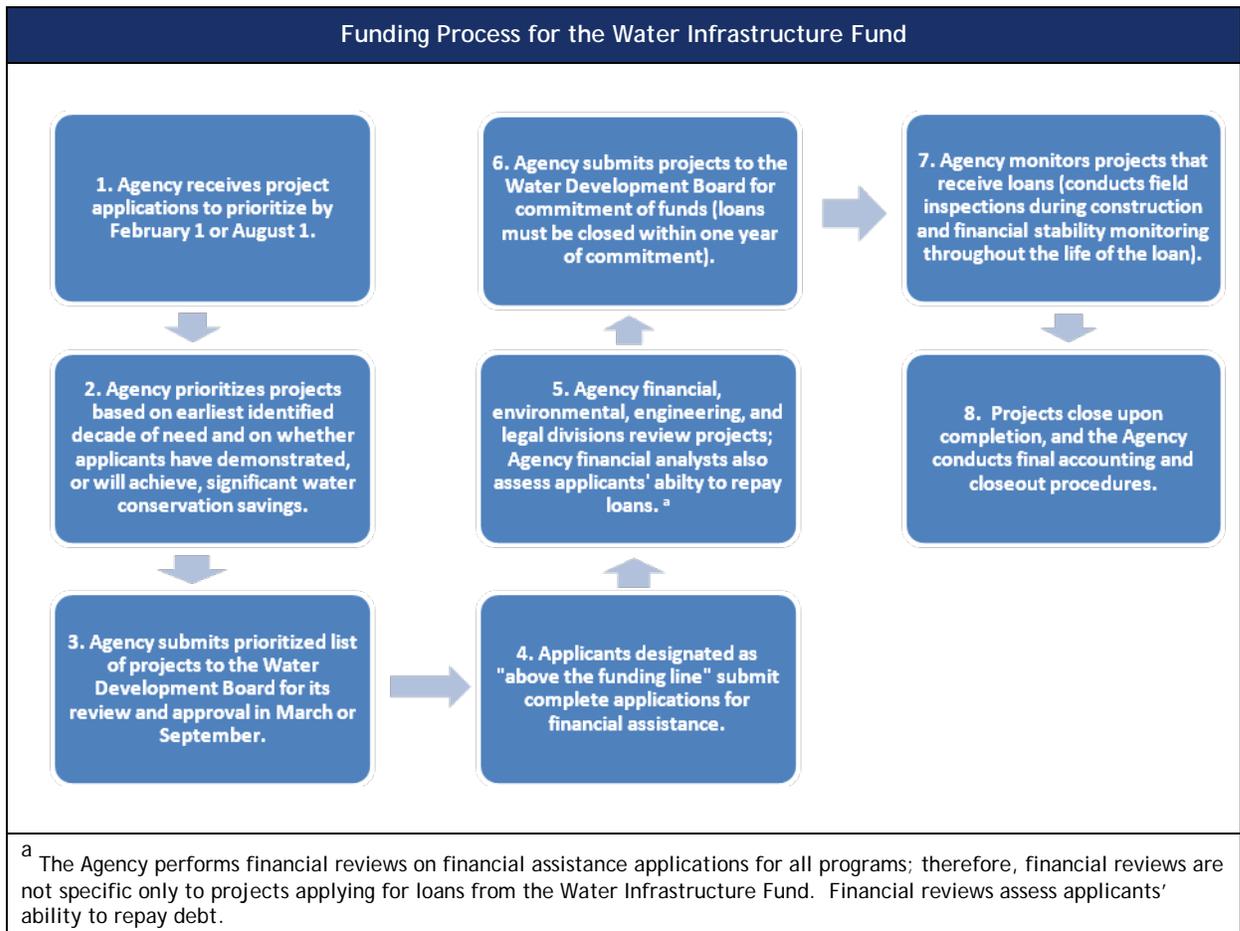
The following members of the State Auditor's staff performed the audit:

- Courtney Ambres-Wade, CGAP (Project Manager)
- Michael F. Boehme, CIA, PHR (Assistant Project Manager)
- Kathryn K. Hawkins, CFE
- Sarah Miller, MS
- Steven M. Summers, CPA, CISA
- Cecilia Ann Wallace, CPA
- J. Scott Killingsworth, CIA, CGAP, CGFM (Quality Control Reviewer)
- James Timberlake, CIA (Audit Manager)

Funding Process for the Water Infrastructure Fund

The Water Development Board (Agency) has developed a process for providing Water Infrastructure Fund loans to projects that are considered eligible and meet other closing conditions. Figure 1 summarizes that process.

Figure 1



Source: Prepared by auditors based on Agency information.

Amounts of Funds Available in and Loans Made from the Water Infrastructure Fund

According to the Water Development Board (Agency), the 2007 State Water Plan estimated that regional and local water supply entities would need to spend \$30.7 billion between 2007 and 2060 to meet the water supply needs of the State.

Since fiscal year 2008, the Agency has requested approximately \$1.1 billion for the Water Infrastructure Fund and has provided nearly \$898 million in loans from the Water Infrastructure Fund. Table 1 provides additional information on the Water Infrastructure Fund since fiscal year 2008.

Table 1

Summary of Water Infrastructure Fund Available Funds and Loan Information				
Category	Biennium			Totals
	2008-2009	2010-2011	2012-2013	
Available Funds				
Amount appropriated in the General Appropriations Act	\$ 449,253,188	\$ 473,365,000	\$200,000,000	\$1,122,618,188
Reduction in appropriations based on reduced debt service ^a	0	0	100,000,000	100,000,000
Total Available Funds	\$ 449,253,188	\$ 473,365,000	\$100,000,000	\$1,022,618,188
Loans				
Total Water Infrastructure Fund loans requested by applicants	\$1,131,369,176	\$1,369,176,000	\$ 51,607,700 ^b	\$ 2,552,152,876
Total Water Infrastructure Fund projects to which the Agency committed funds	\$ 437,339,000	\$ 413,050,000	\$ 47,500,000 ^b	\$ 897,889,000
Total bonds issued for loans the Agency provided	\$ 438,579,000	\$ 411,810,000	\$ 47,500,000 ^b	\$ 897,889,000
^a According to Agency information, during the 2012-2013 biennium, the Legislature appropriated the Agency half the requested debt service for the issuance of \$200 million in Water Infrastructure Fund bonds. As a result, the Agency reduced the amount of Water Infrastructure Fund bonds issued by half to cover its debt service.				
^b This amount is for fiscal year 2012 only.				

Source: The Agency.

List of Water Infrastructure Fund Loan Recipients and Associated Projects

Table 2 lists the recipients of Water Infrastructure Fund loans and provides descriptions of the associated projects.

Table 2

Water Infrastructure Fund Loan Recipients and Projects for Projects Committed between March 2008 through December 2011				
	Loan Recipient	Project Name	Loan Commitment Amount	Project Description
1	City of Amarillo	Potter County Well Field (2)	\$ 86,285,000	Construct 18 to 30 water wells, 15 to 20 miles of collection line, a pump station, and approximately 18.5 miles of 48-inch transmission line. Water would be delivered to the City of Amarillo's 24th Street pump station. The expected capacity is 20 million gallons per day.
2	Brazos River Authority	Lake Granger Deep Water Intake	\$ 22,000,000	Construct a new deepwater intake structure on Lake Granger, a pump station, and a transmission line. The intake will supply the East Williamson County Regional Water System Water Treatment Plant.
3	Central Harris County Regional Water Authority	Surface Water Supply System	\$ 22,050,000	Complete a series of projects to convert the Central Harris County Regional Water Authority's 11-member districts from ground water to surface water.
4	City of Cleburne	Surface Water Treatment Plant Expansion (2)	\$ 15,680,000	Expand the City of Cleburne's Lake Pat Cleburne surface water treatment plant from 15 million to 20 million gallons per day to meet projected municipal and industrial needs through 2020. The expanded plant will also treat flow from the Lake Whitney Water Supply Project, a project to pipe water from Lake Whitney to the Barkman Pipeline.
5	City of Cleburne	Lake Whitney Water Supply Project	\$ 4,750,000	Planning and design of a deep water intake facility in Lake Whitney, a raw water pump station, a water treatment facility, blending tanks, a booster pumping station, and a pipeline to connect the new supply to the existing Barkman Pipeline for delivery to Cleburne. This would be the first of several phases, capable of delivering 1.9 million gallons per day.
6	Coastal Water Authority	Luce Bayou Interbasin Transfer (2)	\$ 33,115,000	Plan and permit a raw water conveyance system from the Trinity River in Liberty County to tributaries of Lake Houston in the San Jacinto River Basin in northeastern Harris County.

**Water Infrastructure Fund
Loan Recipients and Projects for Projects Committed between
March 2008 through December 2011**

	Loan Recipient	Project Name	Loan Commitment Amount	Project Description
7	Colorado River Municipal Water District	Ward County Well Field Expansion	\$ 11,685,000	Purchase and expand the Ward County well field owned by Luminant Power and integrate it with the Colorado River Municipal Water District's existing Ward County transmission and delivery facilities. The Colorado River Municipal Water District will add 8 wells, upgrade the infrastructure to a capacity of 26.3 million gallons per day, and connect to the existing Ward County system.
8	Colorado River Municipal Water District	Big Spring Water Reclamation Plant	\$ 11,970,000	Construct a 2.5-million-gallons-per-day water reclamation facility to treat effluent from the City of Big Springs's wastewater treatment plant to drinking water standards and a pump station and transmission line to inject treated water into the Colorado River Municipal Water District's E. V. Spence pipeline.
9	City of Corpus Christi	Garwood Water Supply Project	\$ 8,000,000	Planning and design of a pipeline and pump station to transport water from a new intake on the Colorado River near Bay City in Matagorda County to the West Delivery System south of Lake Texana in Jackson County. The City of Corpus Christi provides water for much of the Coastal Bend Region through its own distribution system, or through regional water suppliers, the San Patricio Municipal Water District, and the South Texas Water Authority.
10	City of Corsicana	Lake Halbert Water Treatment Plant	\$ 1,935,000	Fund the planning and design of a 16-million-gallons-per-day water treatment plant to replace and expand the City of Corsicana's aging Lake Halbert water treatment plant.
11	City of Dallas	Lake Ray Hubbard Water Augmentation	\$ 8,280,000	Fund the pre-construction phase of the Lake Ray Hubbard Indirect Recycled Water Supply Augmentation project. The project will augment the City of Dallas's water supply with recycled wastewater.
12	City of Dallas	Cedar Crest Recycled Water Pipeline	\$ 15,100,000	Construct a six-mile extension to the Cedar Crest recycled water pipeline, a water line that originates at the Dallas Central Wastewater Treatment Plant. The project will augment the City of Dallas's water supply by replacing potable water use with recycled wastewater.
13	City of Dallas	East Side Water Treatment Plant Expansion	\$ 94,723,000	Expand the City's East Side Water Treatment Plant from 440 million to 750 million gallons per day. The project will include four clear wells with related flumes and filter piping. The plant has been in operation for approximately 40 years and treatment capacity expanded incrementally from 100 million to 440 million gallons per day.
14	City of Grand Prairie	Mansfield Supply Line	\$ 4,995,000	Construct a water transmission line to be shared with the City of Mansfield that will serve the rapidly developing southern areas of the City of Mansfield and the City of Grand Prairie.

**Water Infrastructure Fund
Loan Recipients and Projects for Projects Committed between
March 2008 through December 2011**

	Loan Recipient	Project Name	Loan Commitment Amount	Project Description
15	Greater Texoma Utility Authority	Gainesville Surface Water Treatment Plant Expansion (3)	\$ 7,235,000	Expand the City of Gainesville's Moss Lake Surface Water Treatment Plant from 1.0 million to 2.0 million gallons per day and construct 12,100 feet of 18-inch pipeline and 18,050 feet of 16-inch pipeline from the plant on the northwest side of the city.
16	Greater Texoma Utility Authority	Lake Texoma Water Storage	\$ 21,230,000	Purchase an additional 50,000 acre-feet of water storage space in Lake Texoma authorized through Section 838 of the Water Resource Development Act of 1986. That act required the U.S. Army Corps of Engineers to conduct a reallocation study on Lake Texoma.
17	Guadalupe Blanco River Authority	Mid-Basin Project	\$ 4,400,000	Perform a feasibility study to identify transmission and delivery options for an intake and pump station on the Guadalupe River below Gonzales, major raw water transmission lines, storage facilities and booster stations, possible additional ground water supplies, and expansions and enhancements to treatment facilities in Luling and San Marcos. The project will directly supplement supplies to customers in Hays and Caldwell counties; and it will indirectly supplement supplies to customers in Comal, Guadalupe, and Kendall counties by replacing or reducing Canyon Reservoir supplies currently delivered to the San Marcos Water Treatment Plant.
18	City of Lubbock	Lake Alan Henry Water Project	\$ 83,560,000	Plan, design, and acquire land, and construct a system to convey water from Lake Alan Henry.
19	North Texas Municipal Water District	Lower Bois d'Arc Creek Permit	\$ 9,930,000	Plan and permit a new dam and reservoir on Bois d'Arc Creek northeast of Bonham in Fannin County to increase supplies for the North Texas Municipal Water District's regional customers.
20	North Texas Municipal Water District	Wylie and Tawakoni Water Treatment Plant Pipelines	\$ 43,980,000	Construct two regional pipeline projects: (1) the Wylie Water Treatment Plant Pipeline, which is the final section of a series of lines to serve rapidly growing areas in and near the Cities of Allen, Plano, Frisco, and McKinney, and (2) the Tawakoni Water Treatment Plant Pipeline, which will provide water to North Texas Municipal Water District's south system and will provide a looped transmission system through which water can be delivered to the Cities of Terrell, Forney, and Mesquite.
21	Palo Pinto Co. Municipal Water District No. 1	Turkey Peak Reservoir	\$ 3,200,000	Planning and permitting for the Turkey Peak Reservoir. Also known as the Lake Palo Pinto Storage Restoration Project, the project would include a new dam below Lake Palo Pinto on Palo Pinto Creek.

**Water Infrastructure Fund
Loan Recipients and Projects for Projects Committed between
March 2008 through December 2011**

	Loan Recipient	Project Name	Loan Commitment Amount	Project Description
22	City of San Angelo	Hickory Aquifer Well Field	\$ 120,000,000	Fund the study, development, design, and construction of a new ground water source. Major components include additional development at the City of San Angelo's Hickory aquifer well field in McCulloch and Menard counties, a pump station, transmission lines, and a new treatment train at the City of San Angelo's water treatment plant.
23	San Antonio Water System	Brackish Groundwater Desalination (2)	\$ 59,550,000	Develop a reverse osmosis water treatment facility, transmission pipelines, a well field and collection system, concentrate management facilities, and integration system to provide a new source of potable water for the City of San Antonio to offset demands. Facilities will be located in Bexar, Wilson, and Atascosa counties.
24	San Jacinto River Authority	Alternative Water Supply Project	\$ 21,500,000	Fund the planning and design of Phase I of the Montgomery County Alternative Water Supply Project. The project will include a raw water intake and pump station on Lake Conroe, a 30-million-gallons-per-day surface water treatment plant, finished water storage facilities, high-service pump stations, and 60 miles of transmission lines to provide wholesale water to users in Montgomery County.
25	Somervell County Water District	Wheeler Branch Reservoir Water Treatment Plant (2)	\$ 18,861,000	Fund the design and construction of the Wheeler Branch Reservoir Water Treatment Plant and expansion of its treated water distribution system to deliver water to wholesale and retail customers. The proposed project has 13 phases.
26	Tarrant Regional Water District	Richland Chambers Wetland Design	\$ 3,135,000	Complete engineering and design work on the full-scale Richland Chambers Wetland Facility. A recommended water management strategy is to divert water from the Trinity River and treat it in constructed wetlands for storage in Richland-Chambers Reservoir and delivery via pipeline to the Tarrant Regional Water District system in Tarrant County.
27	Tarrant Regional Water District	Cedar Creek Wetland Design	\$ 6,755,000	Determine the most cost-effective manner of diverting water from the Trinity River and delivering it by pipeline to the Cedar Creek Wetland Facility.
28	Tarrant Regional Water District	Integrated Pipeline Project (2)	\$ 101,620,000	Fund the planning, engineering management, and environmental services for the Integrated Pipeline Project. The project is a cooperative effort between the Tarrant Regional Water District and the City of Dallas Water Utilities to build a transmission pipeline system to connect water supply reservoirs in north central and northeast Texas to treatment and storage facilities in Dallas and Tarrant counties.

**Water Infrastructure Fund
Loan Recipients and Projects for Projects Committed between
March 2008 through December 2011**

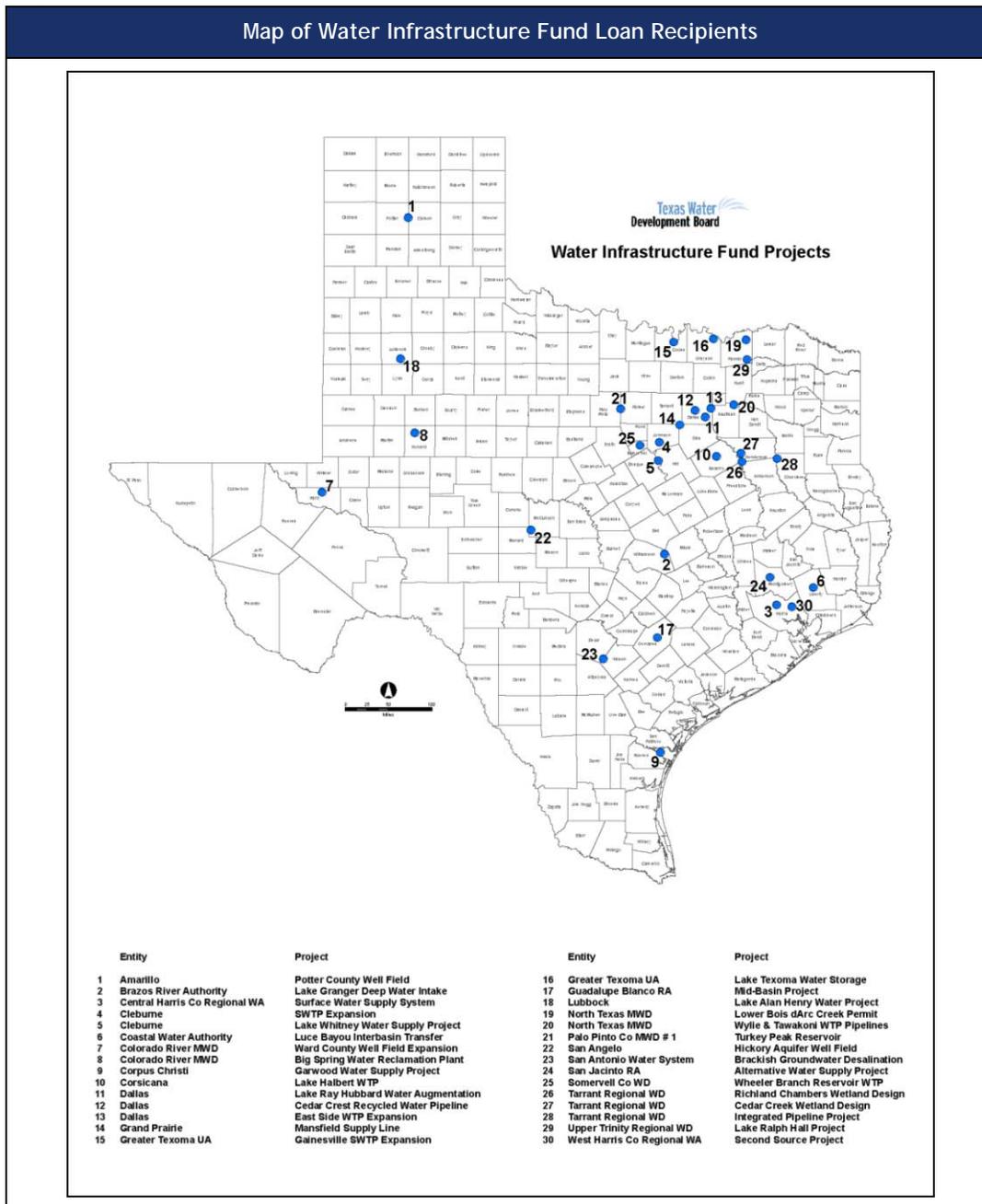
	Loan Recipient	Project Name	Loan Commitment Amount	Project Description
29	Upper Trinity Regional Water District	Lake Ralph Hall Project	\$ 10,400,000	Plan and permit Lake Ralph Hall, a proposed water supply reservoir on the North Sulphur River in Fannin County. Funds will be used to identify impacts on aquatic and terrestrial habitat, existing stream corridors, and cultural resources, and prepare an environmental impact statement if needed. Funds will also be used to conduct a raw water pipeline alignment study, develop a property owner database, prepare a roadway and utility relocation plan, develop a land acquisition plan, and support water rights permitting.
30	West Harris County Regional Water Authority	Second Source Project	\$ 41,965,000	Fund the planning, engineering design, and other expenses related to the Second Source Project. With expected participation by the North Fort Bend Water Authority, the project will include a 40-mile water line from the City of Houston's Northeast Water Purification Plant located on the west side of Lake Houston and two pump stations. The project will convey 150 million gallons per day to approximately 880,000 people in the 2 water authorities. The project is needed to meet the requirements of the Harris-Galveston and Fort Bend Subsidence Districts to protect aquifers and reduce subsidence by limiting groundwater production in northwest Harris and northern Fort Bend counties.
Total			\$897,889,000	

Source: Self-reported by the Agency.

Map of Water Infrastructure Fund Loan Recipients

The Water Development Board (Agency) provided the map in Figure 2, which shows the location of recipients of Water Infrastructure Fund loans. Recipients that have multiple projects are listed only once.

Figure 2



Source: The Agency.

Related State Auditor's Office Work

Related State Auditor's Office Work		
Number	Product Name	Release Date
12-028	An Audit Report on Selected Groundwater Conservation Districts	April 2012
12-555	State of Texas Financial Portion of the Statewide Single Audit Report for the Year Ended August 31, 2011	February 2012
12-328	State of Texas Federal Portion of the Statewide Single Audit Report for the Fiscal Year Ended August 31, 2011	February 2012
12-022	A Report on State of Texas Compliance with Federal Requirements for Selected Major Programs at the Water Development Board for the Fiscal Year Ended August 31, 2011	February 2012

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