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An Audit Report on

The Hidalgo County Water Improvement District No. 3

May 2012

Report No. 12-034



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Overall Conclusion

The Hidalgo County Water Improvement District No. 3 (District) has significant weaknesses in the management of its finances and operations. Those weaknesses exist largely because the District has not established a framework to provide for effective governance, oversight, and planning. Examples of specific weaknesses identified include a lack of financial controls; the absence of a formal, comprehensive, long-term master plan; noncompliance with procurement requirements; and noncompliance with certain requirements of the Texas Water Code.

Key Points

The District should implement significant financial controls.

Auditors did not find evidence of misappropriation of funds during testing at the District. However, the District's lack of financial controls over many of its financial transactions could affect its ability to operate within its means and could create opportunities for misappropriation to occur without detection.

From fiscal year 2008 through fiscal year 2011, the District's expenditures exceeded its revenue from customers (see text box). The District offset losses through the sale of assets; however, it cannot continue to sustain itself through the sale of assets. The District offset losses through the sale of nearly \$5.8 million of its assets in fiscal years 2009 through 2011.

Auditors also identified a lack of approval and supporting documentation for District financial transactions. For example, the District did not have supporting

Background Information

The Hidalgo County Water Improvement District No. 3 (District) was created in 1921. It is a political subdivision of the State of Texas and a public body with statutory duties to provide water for irrigation and other purposes (see Appendix 3 for additional details).

Senate Bill 978 (82nd Legislature, Regular Session) was introduced to dissolve the District and allow the transfer of all of the District's obligations, liabilities, and assets to the City of McAllen. The bill passed both houses of the Legislature, but the Governor subsequently vetoed it (see Appendix 3 for additional details).

The Governor requested that the State Auditor conduct an audit of the District's finances and practices (see Appendix 2 for additional details). The District is subject to Texas Water Code, Chapter 49, which authorizes the State Auditor to conduct audits of the financial transactions of water districts.

District Operating Revenues and Expenditures

<u>Fiscal Year</u>	<u>Revenues</u>	<u>Expenditures</u>
2008	\$1,346,481	\$1,375,478
2009	\$1,134,616	\$1,399,325
2010	\$1,310,266	\$1,408,647
2011	\$ 867,510	\$1,337,217

Source: The District's audited annual financial statements for fiscal years 2008 through 2011 (see Appendix 4 for additional information).

documentation for 6 (20 percent) of 30 expenditures tested; therefore, the appropriateness of those expenditures could not be determined.

In addition, the District spent more than \$6.0 million for capital improvement projects from fiscal year 2008 through fiscal year 2011. However, it has not developed a formal, comprehensive, long-term master plan that aligns its capital improvement projects with its mission and goals. Examples of capital improvement projects include the \$1.7 million reservoir that the District completed in 2011 and a boat ramp that was under construction during this audit at the District's pumping station on the Rio Grande River.

The District should implement a process to mitigate the risks associated with related-party transactions.

The District did not have a process to ensure compliance with requirements in Texas Local Government Code, Chapter 171 (regarding conflicts of interest) and Chapter 176 (regarding disclosure of relationships with certain government officers). From fiscal year 2008 through fiscal year 2011, the District spent \$106,000 for services provided by businesses that were owned by or controlled by the individual who is both the District's general manager and the president of the District's board. While the District may have received services from those businesses, auditors were unable to determine the appropriateness of the transactions associated with those services due to the District's lack of policies and inconsistent handling of issues regarding potential conflicts of interest.

The District should improve its management of professional services contracts.

The District substantially complied with most competitive bidding requirements for major construction and renovation contracts. However, it did not comply with the requirements of Texas Water Code, Section 49.199(a)(4), related to procuring professional services. The District did not comply with statutory requirements to have written policies and procedures for selection, monitoring, or review and evaluation of professional services; it procured more than \$500,000 in professional services in fiscal year 2008 through fiscal year 2011. The District also could not provide documentation demonstrating compliance with Texas Government Code, Chapter 2254, which requires the District to undertake a selection process for professional services.

Additionally, the majority of the professional and consulting services agreements, letters, and contracts that auditors reviewed did not contain adequate provisions to protect the District's financial interests and help ensure that the contractor delivered the expected services.

The District should comply with specific requirements of the Texas Water Code.

The District's board did not comply with certain requirements of the Texas Water Code. For example, as discussed above, the board has not developed written policies and procedures as required by Texas Water Code, Section 49.199. In

addition, neither the board nor District employees who handled cash were bonded as required by Texas Water Code, Sections 49.055 and 49.057.

Summary of Management's Responses

District management generally agreed with many of the issues and most of the recommendations in this report; it also disagreed with certain issues and recommendations in this report. When District management responded to this report, it provided additional documentation to auditors. After reviewing that documentation, auditors made modifications to certain portions of this report but made no modifications to other portions of this report.

The District's summary of its management's responses is presented in Appendix 13. The attachments that District management provided with its responses are not included in this report due to the confidential nature of some of the information in those attachments. The District informed auditors that it intends to post the attachments to its management's responses on the following Web site:
<http://www.waterlookout.org/fluid/>.

Summary of Information Technology Review

This audit did not include a review of information technology. The District contracts with outside firms to process its payroll and prepare its monthly financial information.

Summary of Objectives, Scope, and Methodology

The objectives of the audit were to:

- Determine whether the District has controls that are designed and operating to help ensure that financial transactions comply with applicable law, policies and procedures, and contract terms.
- Provide information on rates and fees the District charges.
- Provide information related to water use by the District.

The audit scope included a review of the District's financial processes, procurement of goods and services, governance processes, and rates and fees for fiscal years 2008 through 2011. The scope covered fiscal years 2007 through 2011 for water usage information.

The audit methodology consisted of conducting interviews; collecting and reviewing information; and performing tests, procedures, and analyses against predetermined criteria.

Auditors determined that the District's computer-generated data was reasonably accurate, complete, and consistent. The City of McAllen is the source of more than 90 percent of revenue for the District, which allowed auditors to trace the majority of the District's revenue to its primary customer.

Auditors assessed the reliability of the District's data by interviewing District staff and accountants knowledgeable about the data and systems and conducting testing to determine whether the information from the District's system reconciles to the information maintained by the accounting firm that prepares the District's monthly financial information. Auditors determined that the data was sufficiently reliable for the purposes of this audit.

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

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Detailed Results

Chapter 1

The District Should Strengthen Its Financial and Operational Controls

The Hidalgo County Water Improvement District No. 3 (District) has significant weaknesses in the management of its finances and operations. The District has not established a framework to provide for effective governance, oversight, and planning. Examples of specific weaknesses identified include a lack of financial controls; the absence of a formal, comprehensive, long-term master plan; noncompliance with procurement requirements; and noncompliance with certain requirements of the Texas Water Code.

Chapter 1-A

The District Should Implement Significant Improvements to Financial Controls

In testing, auditors did not find evidence of misappropriation of funds at the District. However, the District's lack of financial controls—including budgeting and internal controls—could create opportunities for misappropriation to occur without detection. In addition, continued losses in its operations could affect the District's long-term sustainability.

The District has significant deficiencies in its controls over accounting and financial reporting that could negatively affect its operations.

The District's independent auditor has repeatedly identified overall accounting control weaknesses and lack of oversight and review of the District's accounting processes. Those weaknesses include failure to properly record capital improvements, variances between budgeted expenses and actual expenses, and noncompliance with various provisions of the Texas Water Code.

The District's operating expenditures have exceeded its operating revenues.

From fiscal year 2008 through fiscal year 2011, the District's expenditures exceeded its revenue from customers (see text box). The District offset losses through the sale of assets; however, it cannot continue to sustain itself through the sale of assets. The District offset losses through the sale of nearly \$5.8 million of its assets in fiscal year 2009 through fiscal year 2011.

The District earns operating revenue by providing raw water from the Rio Grande River to customers. Although the District serves

District Operating Revenues and Expenditures

Fiscal Year	Revenues	Expenditures
2008	\$1,346,481	\$1,375,478
2009	\$1,134,616	\$1,399,325
2010	\$1,310,266	\$1,408,647
2011	\$ 867,510	\$1,337,217

Source: The District's audited annual financial statements for fiscal years 2008 through 2011 (see Appendix 4 for additional information).

farmers and other customers, its primary customer is the City of McAllen. The District relied on the City of McAllen for 91 percent of its operating revenue in fiscal year 2008 through fiscal year 2011.

Legal disputes and associated expenditures have negatively affected the District's financial condition.

Professional, legal, and consulting fees resulting from legal disputes with the City of McAllen and the District's efforts against legislation to dissolve the District have negatively affected its financial condition. In fiscal year 2011, those fees totaled more than \$450,000, an increase of 537 percent from fiscal year 2010. The District's operating revenues totaled \$867,510 in fiscal year 2011, a decrease of 34 percent from fiscal year 2010.

As discussed above, the District's operating revenue was insufficient to cover operating expenses. Although operating revenue was insufficient to cover operating expenditures, the District covered those expenditures through non-operating revenue, such as revenue from the sale of District assets. Specifically, the District sold nearly \$5.8 million in assets, including real property and water rights, from fiscal year 2009 through fiscal year 2011 (see Table 1).

Table 1

Assets the District Sold Fiscal Years 2008 - 2011		
Fiscal Year	Amount	Assets Sold
2008	\$ 0	
2009	2,827,117	Land
2010	20,200	Easement
2011	1,371,895	Land
	1,569,200	Water rights
Total	\$5,788,412	

Sources: District financial records and audited financial statements.

The District does not have a formal, comprehensive, long-term master plan that aligns its capital improvement projects with its mission and goals.

The District spent more than \$6.0 million for capital improvement projects from fiscal year 2008 through fiscal year 2011 (see Table 2). However, the District has not developed a formal, comprehensive, long-term master plan that includes all planned capital projects and aligns its capital improvement projects with its mission and goals. One example of a capital improvement project is the \$1,733,275.16 reservoir that the District completed in 2011. Auditors also observed the construction of a boat ramp during this audit in early fiscal year 2012 at the District’s pumping station on the Rio Grande River.

Table 2

District Capital Improvement Projects Fiscal Years 2008 - 2011		
Capital Project (as listed in the District’s Records)	Date in Service	Cost
Road Improvements	March 1, 2009	\$ 41,503.00
Improvement to Borrow Ditch	April 1, 2009	119,569.00
Levee Improvement	March 1, 2009	68,733.00
Embankment Improvement	November 1, 2008	40,210.00
Land Improvement - River Bank	November 1, 2008	3,250.00
New Reservoir	August 31, 2011	1,733,275.16
Buoy Reservoir Overflow	August 31, 2011	28,426.00
Canal Improvements	August 31, 2011	702,564.60
U.S. Fish and Wildlife Irrigation Line	August 31, 2011	70,003.23
Hackney Floodway Siphon Project	February 22, 2008	488,803.00
Major Pump Improvements - 2008	February 28, 2008	422,364.00
New Pump Station	June 1, 2009	825,853.90
Major Pump Improvements - 2009	June 10, 2009	132,443.52
Waterline to River Pump Station	February 11, 2009	20,499.00
200 HP Pump and Motor	January 10, 2010	107,291.00
Border Wall Gates	August 31, 2010	538,380.00
Pump Station Renovation	August 31, 2011	880,779.75
	Total	\$6,223,948.16

Source: The District’s accounting records.

To improve financial reporting and controls, the District has contracted with payroll and accounting firms.

In fiscal year 2009, the District began efforts to improve the accuracy of its financial reporting and to strengthen financial controls by contracting with a payroll firm to process its payroll and with an accounting firm to perform its

monthly accounting and balance sheet reporting. As a result, certain financial controls over revenues and expenditures were strengthened.

The District does not consistently maintain supporting documentation for its expenditures and document its review and approval of expenditures.

The expenditures auditors tested for which the District had supporting documentation were allowable and reasonable. However, the District should improve controls over maintaining supporting documentation and approval of payments. Auditors identified the following during testing of expenditures:

- The District did not have supporting documentation for 6 (20 percent) of 30 non-related-party expenditures tested and 2 (3 percent) of 64 related-party expenditures tested. While the District may have received services associated with those expenditures, auditors could not determine whether the District received best value for the funds expended (see additional discussion related to this issue below).
- For 5 (8 percent) of 62 related-party expenditures tested, the District recorded the expenditures in the incorrect general ledger accounts. (In this case, the sample size was 62 instead of 64 because 2 invoices could not be located and auditors could not determine whether those invoices were recorded correctly.)
- For 24 (38 percent) of 64 related-party expenditures tested and 6 (21 percent) of 29 non-related-party expenditures tested, there was no evidence of District review or approval of the invoice.

The District's compensation and reimbursements to board members did not comply with Texas Water Code, Section 49.060.

Texas Water Code, Section 49.060, limits compensation payments made to board members to \$150.00 per day and \$7,200.00 per year. For the time period that auditors tested (fiscal years 2008 through 2011 and the first two months of fiscal year 2012), annual compensation for board members did not exceed the annual \$7,200.00 limit. However, the District paid board members \$227.12 per day for duties they performed, which exceeded the \$150.00 daily statutory limit by \$77.12 per day. For the time period that auditors tested, the overpayments totaled \$24,275.84.

Table 3 presents additional details on compensation to board members in fiscal years 2008 through 2011 and the first two months of fiscal year 2012.

Table 3

District Compensation to Members of Its Board Fiscal Years 2008 through October 2011					
Board Member	Fiscal Year 2008	Fiscal Year 2009	Fiscal Year 2010	Fiscal Year 2011	Fiscal Year 2012 (through October 2011)
Othal Brand, Jr.	\$ 3,633.92	\$ 3,179.68	\$ 2,952.56	\$ 5,450.88	\$ 454.24
Othal Brand, Sr.	2,725.44	2,725.44	681.36	0.00 ^a	0.00 ^a
Chris Burns	2,725.44	2,952.56	2,725.44	4,088.16	454.24
Joe Corso	0.00 ^b	0.00 ^b	1,362.72	5,223.76	454.24
Leo Montalvo	3,179.68	3,179.68	2,952.56	4,542.40	227.12
W. D. Moschel	2,952.56	2,725.44	2,952.56	4,769.52	454.24
Totals	\$15,217.04	\$14,762.80	\$13,627.20	\$24,074.72	\$2,044.08
^a Othal Brand, Sr. was deceased in fiscal year 2010.					
^b Joe Corso was not a board member in fiscal years 2008 and 2009.					

Source: District accounting records.

Texas Water Code, Section 49.060(c), requires board members who receive fees of office or reimbursements to file with the District a verified statement showing the number of days spent in service of the District and a general description of the duties performed for each day of service. None of the compensation or reimbursements the District made to board members in fiscal years 2008 through 2011 were supported by verified statements from the board members. However, the reimbursements were allowable, reasonable, and supported by other documentation.

The District should strengthen controls over capital assets and preventive maintenance.

District capital asset balances that auditors tested were recorded accurately and were complete for fiscal year 2011. However, the District should improve controls over its asset list, capital improvements and board approval of asset acquisitions, and preventative maintenance. Auditors were not able to determine asset balances for fiscal years 2008 through 2010 because of a lack of sufficient asset documentation detail for those years.

Capital asset list. The District's asset list did not comply with the Commission on Environmental Quality's *Water District Financial Management Guide*¹

¹ All water districts subject to Texas Water Code, Chapter 49, (which includes the District) are subject to the *Water District Financial Management Guide*.

because the list did not provide sufficient detail to clearly identify the assets. For 5 (26 percent) of 19 assets that auditors tested, there was insufficient detail to clearly identify the asset, although the assets did exist. For example, items were labeled on the asset list as “Tractors” and “Ford Truck.” One large asset, an excavator, was incorrectly described as “2 Tractors” on the asset listing.

For 2 (11 percent) of 19 assets that auditors tested, the District did not calculate accumulated depreciation expense properly. As a result, the District underreported total accumulated depreciation by \$44,728.71 (3 percent of the value of the assets tested). This would also increase operating expenditures in the years when the District underreported related depreciation.

Capital improvements. The District’s capitalization policy states that “Significant repairs and betterments which extend the lives of existing capital assets are also capitalized.” For fiscal year 2011, 6 (55 percent) of 11 repair expenditures that auditors tested were not capitalized in accordance with the District’s policy. Those expenditures totaled \$83,806 (less than 1 percent of the total value of the District’s capital assets). Additionally, for 4 (29 percent) of 14 assets that auditors tested and that the District put into service in fiscal years 2008 through 2011, the District did not have evidence that its board properly approved the acquisition of these assets.

Preventive maintenance. The District did not have a preventive maintenance schedule or a plan to help ensure that it maintained its equipment properly. As a result, the District did not monitor necessary maintenance. The District had maintenance binders for heavy equipment and vehicles, but there was no documentation or evidence of maintenance on pumps or logs of failures and shutdowns. Not having a preventive maintenance schedule or plan impairs the District’s ability to ensure that its heavy equipment will continue to meet the District’s needs.

The District’s maintenance documentation also is incomplete. Auditors could not determine the completeness of maintenance documentation for 9 (75 percent) of 12 assets tested because the District’s asset list did not contain specific identifying information such as serial numbers, make, year, or license plate numbers.

The District did not have certain controls over revenues it receives from customers other than the City of McAllen.

From fiscal year 2008 through fiscal year 2011, the City of McAllen provided an average of 91 percent of the District’s revenue, and the District recorded that portion of its revenue properly. In addition, the District receives revenue from the sale of raw water to farmers and irrigators and from flat-rate fee assessments. The District accurately recorded revenue balances that auditors tested; however, the District could not readily identify the amounts that it had

billed customers or amounts that customers paid with regard to the flat rate assessment.

Additionally, the District's lack of policies and procedures for collection, notification, and tracking of amounts collected or due could adversely affect the amount and timeliness of revenue collection (see Chapter 3-B for additional information on flat-rate fee assessments).

The District has improved compliance with financial reporting requirements.

For fiscal year 2011, the District complied with Texas Water Code, Section 49.191, which requires it to obtain a financial audit within 120 days of the end of the fiscal year; it also complied with Texas Water Code, Section 49.194, which requires it to submit the audit report to the Commission on Environmental Quality within 135 days of the end of the fiscal year.

However, the District did not comply with those requirements for fiscal years 2008 through 2010. Although the District obtained financial audits for those years, the audit reports were not completed within 120 days of fiscal year end, and the District did not submit the audit reports to the Commission on Environmental Quality within 135 days of the end of the fiscal year. This occurred because of delays in closing the District's year-end accounting records.

Recommendations

The District should:

- Develop a formal, comprehensive, long-term master plan that aligns with the District's mission and goals.
- Develop realistic budgets to help ensure that revenue covers expenditures and that it does not need to sell assets to continue operations.
- Develop and implement policies and procedures required by the Commission on Environmental Quality's *Water District Financial Management Guide*.
- Seek assistance from professionals in setting up financial policies and providing training, as appropriate, for its staff and board.
- Implement controls to help ensure compliance with Texas Water Code requirements.
- Establish and implement a process to record revenue from flat-rate fee assessments and irrigation payments received to comply with the intent of the *Water District Financial Management Guide*.

- Provide necessary training and resources to District employees to enable them to use automated tools such as spreadsheets to track flat-rate fee assessments and prepaid deposits.
- Continue to submit required audit reports to the Commission on Environmental Quality within the required time frame.

Chapter 1-B

The District Should Implement a Process to Mitigate the Risks Associated with Related-party Transactions

The individual who is both the District’s general manager and the president of its board has multiple businesses that provided services to the District in fiscal

years 2008 through 2011. However, the District did not have a consistent process to manage related-party agreements and to help ensure compliance with requirements in Texas Local Government Code, Chapters 171 and 176 (see text box for additional details).

Records at the Office of the Secretary of State show that the District’s general manager and board president has ownership interests in or is a registered officer for multiple businesses with which the District conducts business. Those businesses performed multiple services for the District during fiscal years 2008 through 2011 such as providing labor, material, equipment, Internet services, and security systems. The District made payments totaling more than \$106,000 for those services. The District’s board was aware of this, and the general manager and board president abstained from voting on board decisions regarding those businesses.

Minutes from board meetings indicated that, on three occasions, board members approved the District’s obtaining

services from businesses in which the District’s general manager and board president had ownership interests or for which that individual was a registered officer. However, the scope of work and rates and costs for those services were not documented in the board meeting minutes, and the District also did not establish contracts detailing the scope of work and payment limits. As a result, auditors could not determine whether the District received the best value for those services and could not determine the appropriateness of the related-party transactions.

Although the board acknowledged the relationships between its general manager and board president and the businesses with which the District has done business, it has not set guidelines or developed a written policy that addresses related-party transactions and potential conflicts of interest. For

Selected Requirements of Texas Local Government Code, Chapters 171 and 176

Texas Local Government Code, Chapter 171, requires both an affidavit and abstention from voting if a public official has a substantial interest (10 percent or more of the voting stock or shares of the business entity, or owns either 10 percent or more or \$15,000 or more of the fair market value of the business entity) on a decision or any matter involving the business entity, and an affidavit stating the nature and the interest.

Texas Local Government Code, Chapter 176, applies to public officials, as well as individuals seeking to enter into a contract with a local government entity. A conflicts disclosure statement is required to be filed by a local government official if the individual seeking to conduct business with the local government entity has other business relationships with the official or is a family member. A person who does business with a local government entity is required to file a completed conflict of interest questionnaire if the person has a business relationship with the local government official or is a family member of the official.

that reason, the distinction between personal business interests and District work should be clarified. Without clearly defined policies and procedures and periodic monitoring for compliance, the District and its board risk the appearance of impropriety or actual impropriety.

Additionally, for at least one of the services obtained through the related-party transactions discussed above, the District may have been required to comply with procurement requirements in Texas Water Code, Section 49.273, which requires competitive bidding based on the value of the contract being awarded.

Recommendations

The District should:

- Ensure that all board members are fully aware of conflict of interest and disclosure requirements.
- Develop and implement policies for conducting business with related parties that comply with the Texas Water Code and the Texas Local Government Code.
- Prepare, document, and maintain in the District files all required disclosure affidavits and questionnaires.
- Clearly identify through written policy the duties of the general manager when that individual is also a board member.
- Use the *Water District Financial Management Guide* as a resource in developing policies and procedures regarding related-party transactions.

Chapter 1-C

The District Should Improve Compliance with Certain State Procurement Requirements

Although the District substantially complied with most competitive bidding requirements for major construction and renovation contracts, it did not comply with requirements regarding the contractor selection process for its procurement of professional services. The District also should improve the terms and provisions in its professional and consulting services contracts to better protect its interests.

The District substantially complied with most competitive bidding requirements for its major construction and renovation contracts; however, it should improve compliance with requirements for purchases of equipment and other services.

For the six major construction and renovation contracts that auditors tested, the District substantially complied with most competitive bidding requirements. Those six contracts totaled more than \$2.56 million. Because each of those contracts exceeded \$50,000, the District was required to comply with requirements for competitive bidding, public advertising, bid security, performance and payment bonds, and sealed bids. Additionally, the District had adequate documentation to demonstrate that it properly monitored those contracts to help ensure that the work conformed to plans and specifications and that District payments to contractors were properly approved and reflected the work performed.

Auditors identified certain issues related to equipment purchases exceeding \$50,000 and services that were less than \$50,000 in value. (Procurement requirements differ with the cost threshold of the work to be contracted.) Those issues were as follows:

- The District did not seek competitive bids for its purchase of three vehicles totaling \$60,184. The District should develop policies and procedures that identify when it should use a competitive process. Without policies and procedures and a competitive process, the District cannot ensure that it receives the best value.
- The District did not obtain a required payment bond from a contractor that performed \$49,560 in electrical work. Texas Government Code, Section 2253.021(a), requires payment bonds for contracts exceeding \$25,000.

The District should improve its management of professional services contracts.

The District did not comply with the requirements of Texas Water Code, Section 49.199(a)(4), related to professional services. That statute requires written policies and procedures for selection, monitoring, or review and evaluation of professional services. The District did not have policies and procedures, and it procured more than \$500,000 in professional services in fiscal year 2008 through fiscal year 2011. The District also could not provide documentation demonstrating compliance with Texas Government Code, Chapter 2254, which requires the District to undertake a selection process for professional services.

Table 4 shows payments the District made for professional fees in fiscal years 2008 through 2011.

Table 4

District Professional Fees Paid Fiscal Years 2008 - 2011				
Description	Fiscal Year			
	2008	2009	2010	2011
Professional Fees - Engineering	\$28,548	\$42,755	\$20,668	\$67,771
Professional Fees - Engineering/Survey	0	40,610	0	8,490
Professional Fees - Auditing and Accounting	16,399	20,475	29,783	36,898
Professional Fees - Survey/Appraisal	40,495	25,946	116,229	33,400
Totals	\$85,442	\$129,786	\$166,680	\$146,559
Total for fiscal years 2008 - 2011: \$528,467				

Source: District accounting records.

The District has not established certain policies and procedures for contracts.

The District has no policies and procedures for procuring, executing, and monitoring its contracts. In addition, the District does not maintain consistent documentation pertaining to contracting decisions. For example, the minutes from District board meetings did not consistently reflect all board approvals to bid for contracts and advertise for bid proposals; discussion and approval of bids; and decisions to award contracts, and the dollar amount of contracts. Texas Water Code, Section 49.057, specifies that the board is responsible for the management of all the affairs of the District, including all contracting.

The District's professional and consulting services agreements, letters, and contracts did not always contain certain provisions.

The majority of the District's professional and consulting services agreements, letters, and contracts that auditors tested did not contain provisions that would help to ensure that the contractor delivered the expected services. For example, only 3 of the 13 contracts that auditors tested contained provisions detailing the term of the contract (see Appendix 12 for a list from the *State of Texas Contract Management Guide*, which is a good resource for strengthening contracting practices).

Recommendations

The District should:

- Develop and implement written policies and procedures for procurement of services that address competitive bidding, and ensure that those policies and procedures comply with state law.
- Ensure that the District's board documents all contract approvals and complies with the requirements of Texas Water Code, Section 49.057.
- Develop and implement policies and procedures for selecting, monitoring, and reviewing and evaluating professional services in compliance with Texas Water Code, Section 49.199.
- Document compliance with Texas Government Code, Chapter 2254, when procuring all professional services.
- Consider using the *State of Texas Contract Management Guide* as a tool for identifying best practices in developing professional and consulting services contracts.

The District Should Establish a More Effective Governance Framework

The District did not comply with certain board governance and management requirements of Texas Water Code, Chapter 49. For example, the District's board has not developed required policies and procedures to address items such as a code of ethics for directors, officers, employees, and persons who are engaged in handling investments for the District; travel expenditures; and the selection, monitoring, or review and evaluation of professional services. In addition, neither the board nor District employees who handled cash were bonded as required by Texas Water Code, Sections 49.055 and 49.057.

Table 5 summarizes the District's compliance with selected Texas Water Code requirements.

Table 5

District Compliance with Selected Sections of Texas Water Code, Chapter 49			
Section in Texas Water Code	Statutory Requirement	Summary of District Compliance ^a	Auditor Comments
Requirements Regarding Sworn Statements and Bonds			
49.055(b)	Directors must make sworn statements after assuming office as prescribed by the State Constitution for public office before assuming duties.	Substantially Complied	Members of the District's board made sworn statements.
49.055(c)	Each director shall execute a bond before assuming office for \$10,000 payable to the district and conditioned on the faithful performance of that director's duties.	Did Not Comply	No members of the District's board executed a bond.
49.055(d)	Sworn statements shall be filed with the Secretary of State within 10 days after execution of the oath of office.	Did Not Comply	According to the Office of the Secretary of State, as of February 2012, no sworn statements had been filed. Individuals who were members of the District's board during this audit signed sworn statements from May 2008 to May 2010.
Requirements Regarding District Management			
49.057(b)	The board shall adopt an annual budget.	Substantially Complied	The District presented annual budgets to its board, and the board approved those budgets.
49.057(e)	The board shall require an officer, employee, or consultant, including a bookkeeper, financial advisor, or system operator, who routinely collects, pays, or handles any funds of the district to furnish good and sufficient bond, payable to the district, in an amount determined by the board to be sufficient to safeguard the district.	Did Not Comply	The District's board did not obtain bonds from any of the employees who collected, paid, or handled District funds.

District Compliance with Selected Sections of Texas Water Code, Chapter 49

Section in Texas Water Code	Statutory Requirement	Summary of District Compliance ^a	Auditor Comments
49.058	Conflicts of Interest. A director is subject to the provisions of Chapter 171, [Texas] Local Government Code, relating to the regulation of conflicts of interest of officers of local governments. [Section] 171.004 requires an affidavit and abstention from voting if a public official has a substantial interest in a business entity.	Partially Complied	The individual who is both the District's general manager and the president of its board has multiple businesses that provided services to the District in fiscal years 2008 through 2011. However, the District did not have a consistent process to manage related-party agreements (see Chapter 1-B for additional details).
49.060 (a)-(c)	Fees of Office - a director is entitled to receive fees of not more than \$150 a day for each day the director actually spends performing the duties of a director. A district may not set the annual limit greater than \$7,200. Each director must file a verified statement showing the number of days actually spent in service for the district and a general description of the duties performed for each day of service.	Partially Complied	The District exceeded the daily maximum amount but remained under the annual maximum amount for each board member (see Chapter 1-A for additional details). No board members filed verified statements explaining the services they provided and when they provided services.
49.199(a) (1)-(6)	Policies and audits of districts. The board shall adopt in writing: code of ethics for directors, officers, employees; policy on travel expenditure; policy on district investments; policy for selection, review and evaluation of professional services; policies for management information including budgets for use in planning and controlling costs.	Partially Complied	The District has not developed written policies and procedures for a code of ethics, travel expenditures, the procurement of professional services, or management information. The District has an investment policy; however, that policy does not include all of the required components.
49.271	Contracts for construction.	Substantially Complied	See Chapter 1-C for detailed information on the results of audit testing in this area.
49.065	The Board shall keep a complete count of all its meetings and proceedings and shall preserve its minutes, contracts, records, notices, accounts, receipts, and other records in a safe place.	Substantially Complied	Although the District's board consistently recorded its meeting minutes, some of the minutes do not include complete details of the Board's decisions and actions taken during Board meetings.
^a Definitions of the degrees of compliance: <ul style="list-style-type: none"> ▪ Substantially Complied: The District complied with all or most of the statutory requirement. ▪ Partially Complied: The District complied with at least one part of the statutory requirement. ▪ Did Not Comply: The District did not comply with any part of the statutory requirement. 			

Source: Auditor analysis of District and board documentation.

The District did not comply with Texas Water Code, Chapter 51, regarding the source of payments for maintenance and operating expenses.

Texas Water Code, Section 51.305, requires that "Not less than one-third nor more than two-thirds of the estimated maintenance and operating expenses shall be paid by assessment against all land in the district to which the district can furnish water through its irrigation system or through an extension of its irrigation system." However, as discussed in Chapter 1-A, the District relied on the City of McAllen for 91 percent of its operating revenue in fiscal years 2008 through 2011. The City of McAllen does not pay an assessment;

instead, it pays only for water that the District delivers to it. As a result, from fiscal year 2008 to fiscal year 2011, only 2 to 3 percent of the District's revenue was from flat-rate fee assessments.

Texas Water Code, Section 51.338, states that the District may adopt and enforce reasonable rules, regulations, and specific charges, fees, or rentals, in addition to taxes, for providing any District facility or service. The District has an irrigation water order and delivery policy; however, that policy relates only to supplying water for irrigation. The District has no policies or procedures regarding the collection, charge, or notification of flat-rate fee assessments to landowners within the District.

Recommendations

The District should:

- Comply with all requirements of the Texas Water Code.
- Coordinate with the Commission on Environmental Quality to determine whether modifications to Texas Water Code, Section 51.305, may be necessary.

Information on District Real Property Ownership, Rates and Fees, and Irrigable Acres Served

This chapter presents information on the District's real property ownership, the rates and fees the District charges, and irrigable acres the District serves.

Chapter 3-A

The District Asserts That It Has Protected Its Interests in Real Property Where Its Water Distribution Lines Are Located

According to the District, at the time the District was formed in 1921, county real estate records did not contain a complete description of the location of the canals and lateral water distribution lines throughout the District. Minutes from recent District board meetings reflect the board's concern about encroachment on District property and how to avoid having to relocate water lines in the future due to encroachment.

The District has initiated certain actions to protect its ownership interest in real property located within the District. Specifically:

- In November 2009, after conducting research, the District filed documents in the Hidalgo County real estate records to make known the District's ownership claim to real property adjacent to its water distribution lines. The District asserts that it has "fee simple" interest (see text box) and has notified certain property owners of its ownership interest and the property owners' encroachment.

Fee Simple Ownership

Fee simple ownership is absolute title to land, free of any other claims against the title.

Source:
http://www.law.cornell.edu/wex/fee_simple

- In February 2010, the District sent a letter to the city manager for the City of McAllen requesting that the City of McAllen continue to require subdividers of property to submit their subdivision plats to the District for review and approval to determine whether any of the District's facilities may be affected by a subdivision and whether that could affect District drainage.

The City of McAllen asserts that the District is claiming ownership of land that belongs to private citizens who are unaware of the cloud on their title. An affidavit from a local attorney expressed the belief that the District's filings cloud the title to more than 1,000 titles in the City of McAllen. According to the city attorney for the City of McAllen, that could be a source of revenue for the District because the property owners would have to pay the District to remove the cloud on their titles.

While the District has taken the actions described above to protect its real property interests, auditors did not verify the District's assertions about its title claims because that was not within the scope of the audit.

Chapter 3-B

The District's Rates and Fees are Generally Comparable to Other Districts in the Rio Grande Valley

The District's rates and fees are generally comparable to 15 other water districts in the Rio Grande Valley. As a result, auditors concluded that the District was not overcharging customers for irrigation in comparison to other districts' charges (see Appendix 5 for additional details).

Customers within the District who wish to irrigate their property must purchase water tickets from the District. Auditors tested 30 customer payments for purchases of irrigation water and determined that the District charged the customers appropriate rates.

The District also assesses an annual flat-rate fee of \$9.02 for each acre of land the customer owns within the District. Auditors tested 30 payments for the flat-rate fee assessments charged to District customers from October 2011 to December 2011 and determined that the District charged customers the appropriate rates. As discussed in Chapter 1-A, the District does not have policies or procedures regarding the collection, charge, or notification of flat-rate fee assessments to landowners within the District. The District collected \$23,963 (based on the audited financial statement prepared by the District's accounting firm) in fiscal year 2011.

Recommendation

The District should develop and implement policies and procedures regarding the collection, charge, or notification of flat-rate fee assessments to landowners within the District.

Chapter 3-C

The District's Conversion of Water Rights from Irrigation to Municipal Reflects the Changing Demographics of the District

The Texas Water Rights Commission, a predecessor agency of the Texas Commission on Environmental Quality, issued certificates of adjudication for water rights for approved claims that specified the ownership of water rights. The District was issued certificate of adjudication 23-848 in October 1971 with water rights categorized by municipal use and irrigation use. The water rights govern the amount of water that the District is allowed to pump (divert) from the Rio Grande River.

As the population of the City of McAllen has grown and the need for municipal water has increased, there has been a decrease in the rural land that needs to be irrigated. To adapt to that change, the District sought to amend its certificate of adjudication to change 10,000 acre-feet of irrigation rights to 5,000 acre-feet of municipal rights. Irrigation rights have a priority value, and when they are converted to municipal rights, the conversion factor is 2:1; therefore, the 10,000 acre-feet of irrigation rights were converted to 5,000 acre-feet of municipal rights. Those rights are still owned by the District, but their use has been changed to municipal. Those rights would be used to divert water to municipalities in the District, rather than for irrigation (see Appendix 6 for additional details and information on irrigable acres served by the District).

Definition of an Acre-foot

An acre-foot is the volume of water needed to cover 1 acre to a depth of 1 foot. It equals 325,851 gallons.

Source: *Rights to Surface Water in Texas*, Commission on Environmental Quality Publication G1-228.

In August 2011, the District conveyed 1,100 acre-feet of irrigation rights to the City of McAllen for approximately \$1.3 million. The 1,100 acre-feet of irrigation rights will convert into 550 acre-feet of municipal rights. That sale reduced the District's irrigation rights from 9,752.60 acre-feet to 8,652.60 acre-feet (see Appendix 6 for additional details).

Information on District Water Usage

This chapter presents information on the District's water use and water diversion.

The Commission on Environmental Quality did not identify waste of water by the district.

The Commission on Environmental Quality conducted an inquiry into alleged water waste by the District and did not find evidence of the waste of water by the District (see Appendix 8 for additional details.)

The District's general manager and board president acknowledged to auditors that he had devised a method to return water to the Rio Grande River after it had been pumped out; however, there is not a way to determine the amount of any water returned, if any, or whether it involved a waste of water.

Auditors did not perform work to determine whether the City of McAllen had any patterns of use that may have constituted a waste of water because that was not in the scope of the audit.

The District pumps (diverts) water from the Rio Grande River.

The Commission on Environmental Quality classifies the act of removing water from the Rio Grande River as "diversion."

The District's water diversion is segregated by use based on the type of water rights (municipal, mining, or irrigation). The municipal use recipient is the City of McAllen. Irrigation use recipients include farmers, homeowners, the Palm View Golf Course in McAllen, the McAllen Country Club, and the McAllen Cemetery Association (see Appendix 7 for additional details).

The District also diverts water for other owners of water rights such as the U.S. Department of Interior's Fish and Wildlife Service.

The City of McAllen's water needs are increasing.

See Appendix 9 for information on water allocated to the City of McAllen and related projections for the future.

Appendices

Appendix 1

Objectives, Scope, and Methodology

Objectives

The objectives of the audit were to:

- Determine whether the Hidalgo County Water Improvement District No. 3 (District) has controls that are designed and operating to help ensure that financial transactions comply with applicable law, policies and procedures, and contract terms.
- Provide information on rates and fees the District charges.
- Provide information related to water use by the District.

Scope

The audit scope included a review of the District's financial processes, procurement of goods and services, governance processes, and rates and fees for fiscal years 2008 through 2011. The scope covered fiscal years 2007 through 2011 for water usage information.

Methodology

The audit methodology consisted of conducting interviews; collecting and reviewing information; and performing tests, procedures, and analyses against predetermined criteria. This audit did not include a review of information technology.

Auditors assessed the reliability of the District's data by (1) interviewing District staff and accountants knowledgeable about the data and systems and (2) conducting testing to determine whether the information from the District's system reconciles to the information maintained by the accounting firm that prepares the District's monthly financial information. Auditors determined that the data was sufficiently reliable for the purposes of this audit.

Information collected and reviewed included the following:

- House Committee on Border and Intergovernmental Affairs and Senate Intergovernmental Relations Committee sub-committee testimony during the 82nd legislative session.
- District's audited financial statements and management letters for fiscal years 2008 through 2011.

- District policies and procedures.
- District bank statements and bank reconciliations from September 2007 through August 2011.
- District contracts from September 2007 through December 2011.
- District board meeting minutes from September 2007 through October 2011.
- Rates and fees charged by the District and 15 comparable water districts in the Lower Rio Grande Valley.
- District revenue and expenditure detail from September 2007 to October 2011.
- The District's 2011 Flat Rate Assessment Levy Report.
- Certificates of adjudication for water rights owned by the District.
- Various reports for water diversion and water use obtained from the Commission on Environmental Quality Water Master for fiscal years 2008 through 2011.
- The Commission on Environmental Quality's investigation of allegation of water waste by the District.
- *2012 State Water Plan* by the Water Development Board.
- Excerpts from the McAllen Public Utility Water and Wastewater System Master Plan.
- 2009 Water Conservation and Drought Contingency Plan by the City of McAllen.

Procedures and tests conducted included the following:

- Testing internal controls over the District's financial information.
- Testing selected expenditures and revenues for fiscal years 2008 through 2011 to determine whether the District's financial information was entered accurately and completely into the financial statements prepared by the District's accountant.
- Comparing rates charged by the District to rates in comparable districts in the Rio Grande Valley to determine whether the District had comparable rates or if it was overcharging customers.

- Testing District capital assets for existence, proper approval, if they are safeguarded and recorded accurately in accounting records for fiscal year 2011.
- Observed the District's process for handling cash to determine the adequacy of controls over cash receipts and petty cash.
- Testing payments to District board members for fiscal year 2008 through 2011 for compliance.
- Testing construction contracts for fiscal years 2008 through 2011 for compliance with procurement requirements and whether construction contractors' requests for payment were adequately supported and approved by the District's engineer prior to submission to the District's board of directors for review, approval, and payment.
- Testing contracts for construction and consulting and professional services to determine compliance with procurement requirements.
- Testing billings for non-municipal customers to determine whether the District charged the correct rates.
- Testing the City of McAllen's payments to the District for water for fiscal years 2008 through 2011 and flat rate invoices for fiscal year 2011 to determine whether the District charged the correct rates to the City of McAllen.
- Reviewed the District's preventative maintenance records to determine whether the District had an appropriate preventative maintenance schedule and monitoring process to meet the obligations of the District.

Criteria used included the following:

- Texas Water Code, Chapters 49 and 51.
- Commission on Environmental Quality *Water District Financial Management Guide*.
- Texas Government Code, Chapters 551, 552, and 2254.
- Texas Local Government Code, Chapters 171, 176, and 201.
- Title 30, Texas Administrative Code, Chapter 303.

Project Information

Audit fieldwork was conducted from January 2012 through March 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.

- Lucien Hughes (Project Manager)
- Kathy Aven, CIA, CFE (Assistant Project Manager)
- Shahpar Ali, CPA, MS
- Karen Mullen, CGAP
- Laura Nienkerk, MACy
- Sherry Sewell, CGAP
- Dennis Ray Bushnell, CPA (Quality Control Reviewer)
- Michael Stiernberg, MBA, JD, State Bar (Legal)
- Nicole M. Guerrero, MBA, CIA, CGAP (Audit Manager)

Governor's Request for This Audit

Below is the letter from Governor Rick Perry requesting this audit.



OFFICE OF THE GOVERNOR

RICK PERRY
GOVERNOR

June 20, 2011

John Keel, CPA
State Auditor
State Auditor's Office
P.O. Box 12067
Austin, Texas 78711-2067

RE: Audit relating to the Hidalgo County Water Improvement District No. 3

Dear Mr. Keel:

I am writing to request your assistance in ensuring that the Hidalgo County Water Improvement District No. 3 ("district") is still fulfilling its statutory purpose in providing raw water to its customers at reasonable rates. As you are aware, I vetoed Senate Bill 978, which would have allowed the residents of the City of McAllen as well as the members of the District to vote for the dissolution of the District. This would have set a troubling precedent. But the concerns that led to this legislation should not be ignored. Therefore, I am writing to request that your office look into the following issues and report back to the legislature:

- Any financial weaknesses or misappropriation of funds within the district.
- The district's practice of filing liens claiming fee simple ownership against hundreds of private residential and commercial properties.
- The total amount of actual irrigable acres served by the district, compared to the 9,752 acre-feet allocated for irrigation use under its water rights.
- The total amount of water diverted over the past five years by the district, by use, type and recipient.
- Any patterns of use by the city or the district that may constitute a waste of water.

POST OFFICE BOX 12428 AUSTIN, TEXAS 78711 (512) 463-2000 (VOICE)/DIAL 7-1-1 FOR RELAY SERVICES
VISIT WWW.TEXASONLINE.COM THE OFFICIAL WEB SITE OF THE STATE OF TEXAS

John Keel, CPA
June 20, 2011
Page 2

- The amount of water that is allocated to the city but not used, the city's current need and its projected 20-year need.

Please feel free to contact Terry Zrubek at (512) 463-1778, to request any help you may need in accomplishing this review. I truly appreciate your attention to this matter.

Sincerely,

A handwritten signature in black ink that reads "RICK PERRY" in a cursive, slightly slanted font.

Rick Perry
Governor

RP:trp

cc: The Honorable Juan "Chuy" Hinojosa, State Senator, Texas Senate
The Honorable Veronica Gonzales, State Representative, Texas House of Representatives
The Honorable Richard F. Cortez, Mayor, City of McAllen, Texas
Mr. Othal Brand, Jr., General Manager, Hidalgo County Water Improvement District No. 3

District Background Information

Created in 1921, the Hidalgo County Water Improvement District No. 3 (District) is a political subdivision of the State of Texas and a public body with statutory duties to provide water for irrigation and other purposes. The District pumps and delivers raw water from the Rio Grande River to farmers and citizens of the City of McAllen. The District maintains a system of canals, lateral water distribution lines, pipelines, and other water transportation and irrigation facilities on land owned by the District.

By resolution, on March 9, 1926, the District's board of directors voted to convert the District from a water improvement district to a water control and improvement district. Water control and improvement districts have broader powers than water improvement districts. For example, in addition to irrigation, a water control and improvement district is authorized to provide for the improvement of rivers, creeks, and streams to prevent overflows, permit navigation or irrigation, or aid in those purposes. A water control and improvement district also can provide for the construction and maintenance of pools, lakes, reservoirs, dams, canals, and waterways for irrigation, drainage, or navigation, or to aid those purposes.

Table 6 shows events that occurred during the 82nd legislative session related to the District. Senate Bill 978 was introduced to dissolve the District.

Table 6

Events That Occurred During the 82nd Legislative Session Related to the District	
Date	Event
February 25, 2011	Senate Bill 978 (SB978) received by the Secretary of the Senate.
March 8, 2011	SB978 referred to the Senate Intergovernmental Relations Committee.
April 7, 2011	SB978 passed in the Senate.
April 14, 2011	SB978 referred to the House Border and Intergovernmental Affairs Committee.
May 25, 2011	SB978 passed in the House of Representatives.
May 27, 2011	House amendment(s) laid before the Senate.
May 27, 2011	Senate concurs in House amendment(s).
May 29, 2011	SB978 signed in the Senate and the House.
May 30, 2011	SB978 sent to the Governor.
June 17, 2011	SB978 vetoed by the Governor.

Source: Texas Legislature Online.

Table 7 shows information on District office and field staff and their salaries as of December 31, 2011.

Table 7

District Office and Field Staff and Their Salaries (as of December 31, 2011)	
Position	Hourly Salary
Office Staff	
General Manager ^a	\$ 0.00
Bookkeeper	\$18.03
Clerical Assistant	\$12.13
Field and Maintenance Staff	
Canal Rider	\$ 8.00
Canal Rider	\$19.35
Foreman	\$16.84
Laborer	\$12.13
Laborers (5 positions)	\$ 8.90
Welder Assistant	\$11.00
Welder and Fabricator	\$20.00
^a The General Manager, who is also a member of the District's board, does not receive a salary.	

Source: The District.

District Revenue

Tables 8 and 9 summarize Hidalgo County Water Improvement District No. 3 (District) revenue for fiscal years 2008 through 2011.

Table 8

District Revenue Fiscal Years 2011 and 2010						
Source of Revenue	Fiscal Year 2011			Fiscal Year 2010		
	Amount of Revenue	Percent of Total Water Sales	Percent of Total Operating Revenue	Amount of Revenue	Percent of Total Water Sales	Percent of Total Operating Revenue
Water Sales to the City of McAllen	\$747,975	89%	86%	\$1,184,612	92%	90%
Water Sales to Other Customers	<u>95,572</u>	11%	11%	<u>101,618</u>	8%	8%
Total Water Sales	\$843,547			\$1,286,230		
Flat-rate Levies	\$23,963		3%	\$24,036		2%
Totals	\$867,510	100%	100%	\$1,310,266	100%	100%

Source: Commission on Environmental Quality.

Table 9

District Revenue Fiscal Years 2009 and 2008						
Source of Revenue	Fiscal Year 2009			Fiscal Year 2008		
	Amount of Revenue	Percent of Total Water Sales	Percent of Total Operating Revenue	Amount of Revenue	Percent of Total Water Sales	Percent of Total Operating Revenue
Water Sales to the City of McAllen	\$1,044,945	94%	92%	\$1,261,947	95%	94%
Water Sales to Other Customers	<u>65,616</u>	6%	6%	<u>60,214</u>	5%	4%
Total Water Sales	\$1,110,561			\$1,322,161		
Flat-rate Levies	\$24,055		2%	\$24,320		2%
Totals	\$1,134,616	100%	100%	\$1,346,481	100%	100%

Source: Commission on Environmental Quality.

District Rates and Fees for 2011

Table 10 shows Hidalgo County Water Improvement District No. 3 (District) rates compared to the highest and lowest rates charged in the region.

Table 10

Lower Rio Grande Valley Rates and Fees Comparison 2011			
Service	Lowest Rate in Region	Highest Rate in Region	Rate Charged by the District
In-district Irrigation (cost per acre)	\$7.25	\$26.00	\$7.25
Out-of-district Irrigation (cost per acre)	\$12.50	\$78.00	\$12.50
Floodway Irrigation (cost per acre)	\$7.65	\$11.50	\$9.70
Yard Irrigation (cost per yard - less than 1 acre)	\$8.00	\$40.00	\$18.70
Municipal (cost per acre-foot supply and delivery)	\$35.00	\$84.72	\$66.80
Municipal (cost per acre-foot delivery only)	\$30.00	\$55.39	\$35.84
Flat-rate Tax (cost per acre)	\$9.02	\$66.06	\$9.02

Source: Water districts in the Lower Rio Grande Valley.

District Water Rights and Acres Served

Table 11 shows water rights owned by and irrigable acres served by the Hidalgo County Water Improvement District No. 3 (District) before and after the District's sale of 1,100 acre feet of water rights to the City of McAllen on August 12, 2011. Irrigable acres served apply only to irrigation water rights. All water rights the District owns fall under certificate of adjudication 23-848.

Table 11

District Water Rights and Acres Served				
Type of Water Rights	Prior to Sale of Water Rights on August 12, 2011		As of August 12, 2011	
	Acre-feet	Irrigable Acres Served	Acre-feet	Irrigable Acres Served
Irrigation	9,752.60	3,200	8,652.60	3,901.04
Municipal	13,980	Not applicable	13,980	Not applicable
Mining	100	Not applicable	100	Not applicable

Source: Commission on Environmental Quality.

Table 12 shows the timeline of District-owned water rights by type since 1971 and amendments approved to change the use of the water rights from irrigation to municipal and mining rights. District irrigation water rights have decreased from 19,852.60 in 1971 to 8,652.60 in 2012, while total municipal rights have increased from 8,980.00 in 1971 to 13,980.00 in 2012.

Table 12

Time Line of District Water Rights Activity on Certificate of Adjudication 23-848 ^a					
As of Date	Type of Water Use (in acre-feet)				
	Irrigation	Municipal		Mining	Totals
		Dedicated for the City of McAllen	Not Designated for a Specific Municipality		
October 18, 1971 (The number of irrigable acres served was 7,941.04.)	19,852.60	8,980.00	0.00	0.00	28,832.60
October 10, 1978 (The number of irrigable acres served was 5,541.04.)	13,852.60	8,980.00	3,000.00	0.00	25,832.60
September 8, 1995 (The number of irrigable acres served was 3,901.04.)	9,752.60	8,980.00	5,000.00	100.00	23,832.60
January 5, 2012 (The number of irrigable acres served was 3,901.04.)	8,652.60	8,980.00	5,000.00	100.00	22,732.60

^a This table does include 1,100 acre-feet sold to the City of McAllen on August 12, 2011.

Source: Commission on Environmental Quality.

District Raw Water Diversion

Table 13 summarizes Hidalgo County Water Improvement District No. 3 (District) raw water diversion from 2007 through 2011.

Table 13

District Raw Water Diverted (in acre-feet)										
Use	2011		2010		2009		2008		2007	
	Amount	Percent of Water Diverted								
Municipal ^a	13,980.00	66%	17,124.90	59%	18,368.90	59%	17,192.72	69%	10,980.00	66%
Irrigation ^b	7,247.31	34%	11,817.21	41%	12,684.11	41%	7,688.28	31%	5,726.91	34%
Totals	21,227.31	100%	28,942.11	100%	31,053.01	100%	24,881.00	100%	16,706.91	100%

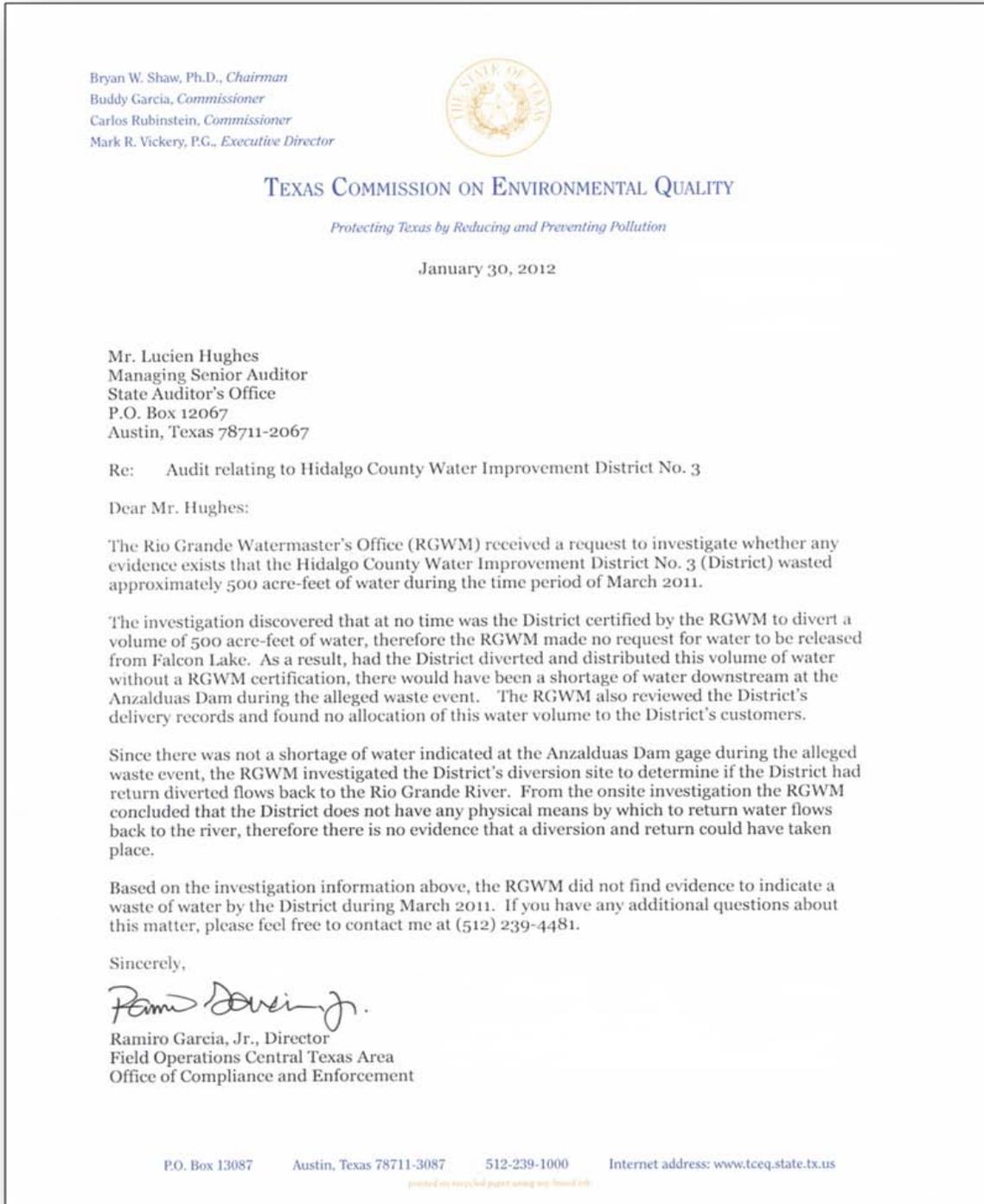
^a The municipal recipient is the City of McAllen.

^b Examples of irrigation recipients include farmers, homeowners, the Palm View Golf Course, the McAllen Country Club, and the McAllen Cemetery Association.

Source: Commission on Environmental Quality.

Commission on Environmental Quality Investigation

Below is the Commission on Environmental Quality's (Commission) summary regarding its investigation of allegations that the Hidalgo County Water Improvement District No. 3 wasted water. The summary states that the Commission did not find evidence of wasted water.



City of McAllen's Current and Projected Water Need

Table 14 shows the amount of water allocated to and used by the City of McAllen in 2011 by source.

Table 14

City of McAllen Water Allocation and Use 2011		
Source of Water	Amount of Water Allocated for Municipal Use (in acre-feet)	Amount of Water Used (in acre-feet)
Hidalgo County Water Improvement District No. 3	13,980.00	13,980.00
United Irrigation District	11,250.00	11,250.00
Hidalgo County Irrigation District No. 2	6,140.00	8,458.65
City of McAllen	678.84	678.84
Totals	32,048.84	34,367.49
Total Amount of Water Used Above Allocations		2,318.65

Source: Commission on Environmental Quality.

Table 15 shows the projected growth in the City of McAllen's retail population and peak hour water demand from 2009 through 2025. This table also includes water supplied by the City of McAllen to a wholesale customer, the City of Edinburg.

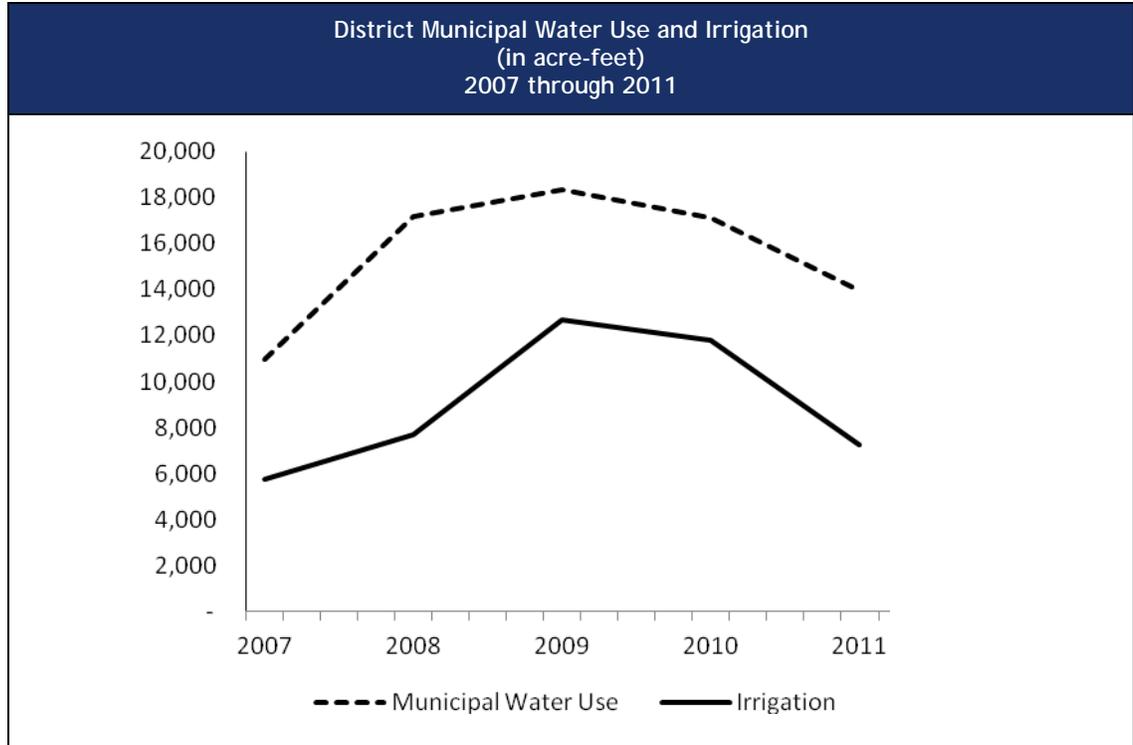
Table 15

City of McAllen Projected Retail Population and Peak Hour Water Demand 2009 through 2025			
Year	Retail Population	Peak Hour Water Demand (millions of gallons of water per day)	Total Average Daily Demand (millions of gallons of water per day)
2009	140,703	65.9	20.6
2010	144,394	67.5	21.1
2011	145,820	68.5	21.4
2012	147,247	69.4	21.7
2013	148,673	70.4	22.0
2018	155,805	78.6	25.3
2025	164,132	84.5	27.2

Source: City of McAllen *Public Utility Water and Wastewater System Master Plan*.

Figure 1 shows municipal water use and irrigation for the Hidalgo County Water Improvement District No. 3 (District) from 2007 through 2011.

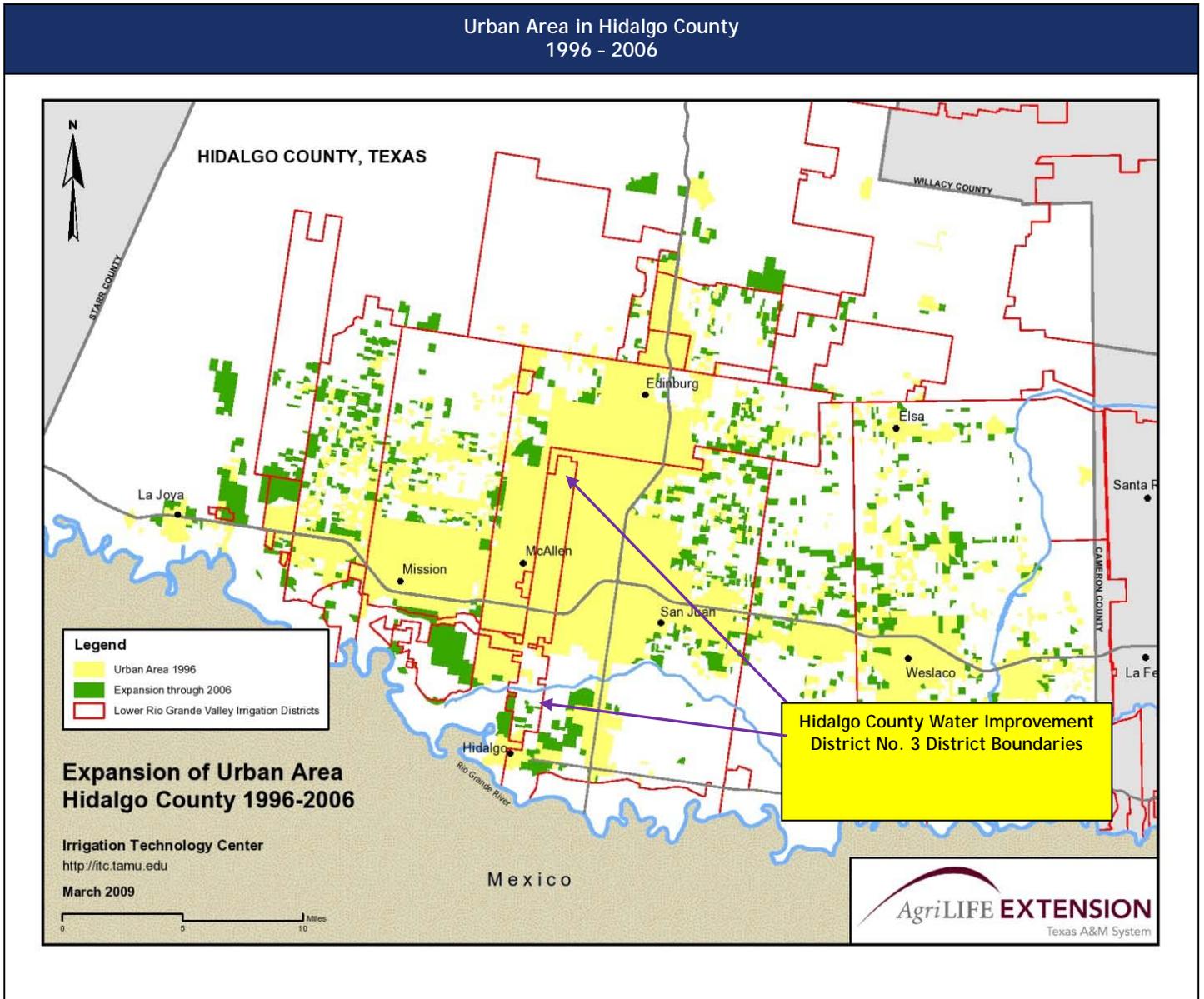
Figure 1



Source: Commission on Environmental Quality.

Figure 3 shows the expansion of the urban area in Hidalgo County from 1996 through 2006.

Figure 3

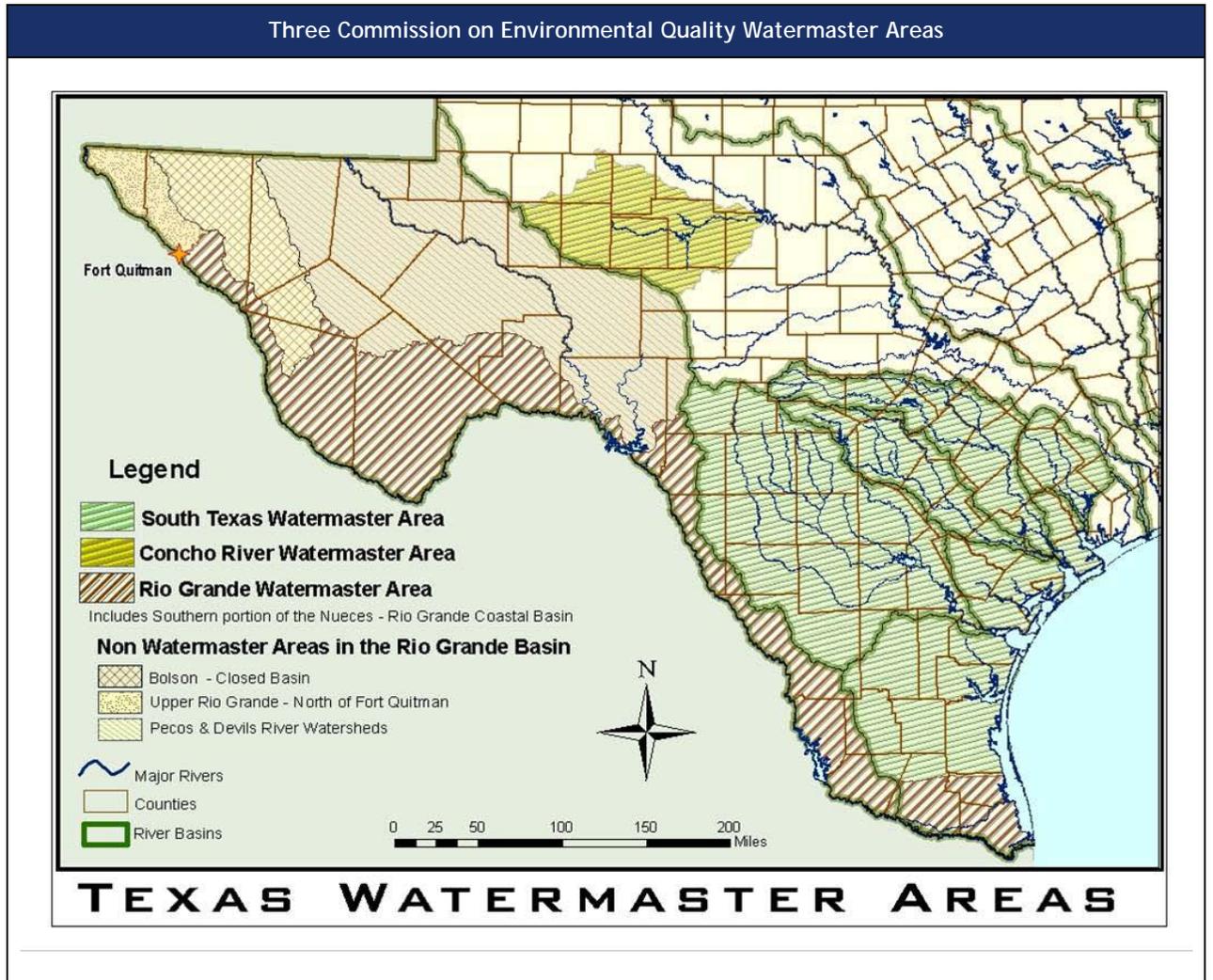


Source: The Irrigation Technology Center, Texas AgriLife Extension Service.

District Watermaster Area

Figure 4 shows three watermaster areas of the Commission on Environmental Quality. The Hidalgo County Water Improvement District No. 3 (District) is in the Rio Grande Watermaster Area.

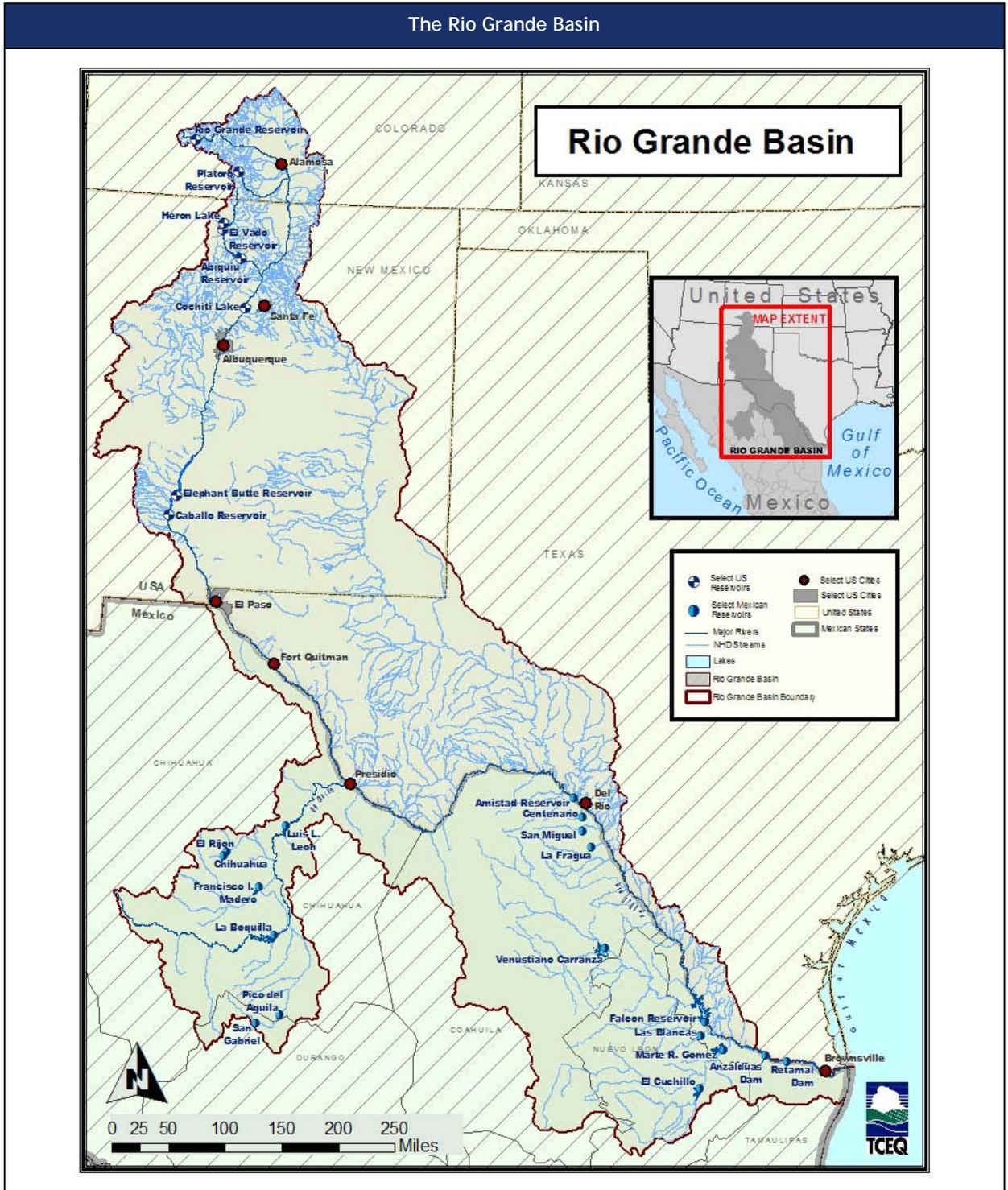
Figure 4



Source: Commission on Environmental Quality.

Figure 5 shows the Rio Grande Basin, the source of water for the District.

Figure 5



Source: Commission on Environmental Quality.

Comparison of District Contract Provisions for Professional and Consulting Services and Excerpts from State of Texas Contract Management Guide

The State Auditor's Office reviewed 13 professional and consulting services contracts that the Hidalgo County Water Improvement District No. 3 (District) executed with various attorneys and engineering firms and for other services such as public relations, accounting, and auditing. Auditors assessed the provisions of the contracts to determine their adequacy in protecting the District's interests by comparing them to selected best practices provisions listed in the *State of Texas Contract Management Guide* (Guide).

The Guide provides suggestions and best practices to improve statewide contracting practices. Although the District is not subject to the Guide, the Guide is a good resource for strengthening contracting practices. The Guide includes provisions and clauses considered essential in contracts.

Table 16 presents selected best practices provisions and clauses in the Guide, including suggested language or descriptions of the provision or clause. Auditors compared 13 of the District's professional and consulting services contracts to the best practices provisions and clauses, and Table 16 specifies whether the 13 contracts included the best practices provisions.

Table 16

Analysis of 13 District Professional And Consulting Services Contracts and Whether They Contained Provisions Recommended by the <i>State Of Texas Contract Management Guide</i>		
Provision	Number of District Contracts That Contained the Provision	Number of District Contracts That <u>Did Not</u> Contain the Provision
Introduction: Introduce all participants and identify agency and contractor key personnel.	7	6
Scope of Work: Discuss the scope of the contract (i.e., what the agency is buying). Although this may seem overly simplistic, a total and complete meeting of the minds on this point will avoid problems during the life of the contract.	13	0
Indemnification: Contractor shall defend, indemnify, and hold harmless the State of Texas, its officers, and employees, and (Agency Name), its officers, and employees and contractors, from and against all claims, actions, suits, demands, proceedings, costs, damages, and liabilities, etc.	3	10
Price: Total amount of contract or fee schedule.	8	5
Specifications: Defines the requirements of the request for proposal.	6	7

**Analysis of 13 District Professional And Consulting Services Contracts and
Whether They Contained Provisions Recommended by the
State Of Texas Contract Management Guide**

Provision	Number of District Contracts That Contained the Provision	Number of District Contracts That <u>Did Not</u> Contain the Provision
Antitrust: Neither Respondent nor firm, corporation, partnership, or institution represented by Respondent or anyone acting for such firm, corporation, or institution has (1) violated the antitrust laws of the State of Texas under Texas Business and Commerce Code, Chapter 15, or the federal antitrust laws; or (2) communicated the contents of this Proposal either directly or indirectly to any competitor or any other person engaged in the same line of business during the procurement process for this RFP [Request for Proposal].	0	13
Payment: Prior to authorizing payment to Contractor, {Insert agency name here} shall evaluate Contractor's performance using the performance standards set forth in all documents constituting this Contract. Contractor shall provide invoices to {Insert agency name here} for Commodities/Services provided/performed. Invoices must be submitted not later than the 15th day of the month after the Services are completed. No payment whatsoever shall be made under this contract without the prior submission of detailed, correct invoices.	1	12
Affirmation Clauses: All statements and information prepared and submitted in the response to this RFP are current, complete and accurate (example clause...many more to be included in contract).	0	13
Dispute Resolution: The dispute resolution process provided for in Texas Government Code, Chapter 2260 shall be used by {Insert agency name here} and Contractor to resolve any dispute arising under the Contract.	1	12
Term of Contract: CONTRACT TERM. The services requested shall be provided for a period of ____ [state initial term, ex. Two (2) years], beginning ____ [insert start date], or the last signature date, whichever is later, and ending ____ [Length of contract term should not extend past end of biennium in which execution of contract occurs, i.e. no later than August 31, 20XX]. [If applicable, include the following] This contract may be renewed for up to [state renewal options, ex. three (3) one (1) year renewal options] upon mutual agreement of the parties to be evidenced in writing prior to the expiration date of the initial term. [Length of renewal term should run so it expires within biennium] At the sole option of {Insert agency name here} the Contract may be extended as needed, not to exceed a total of {Insert extension period} months.	3	10
Confidential Information: Notwithstanding any provisions of this Contract to the contrary, Contractor understands that {Insert agency name here} will comply with the Texas Public Information Act, Texas Government Code, Chapter 552 as interpreted by judicial opinions and opinions of the Attorney General of the State of Texas. {Insert agency name here} agrees to notify Contractor in writing within a reasonable time from receipt of a request for information related to Contractor's work under this contract. Contractor will cooperate with {Insert agency name here} in the production of documents responsive to the request. {Insert agency name here} will make a determination whether to submit a Public Information Act request to the Attorney General. Contractor will notify {Insert agency name here} General Counsel within twenty-four (24) hours of receipt of any third party requests for information that was provided by the State of Texas for use in performing the Contract. This Contract and all data and other information generated or otherwise.	2	11
Abandonment or Default: If the contractor defaults on the contract, [agency name] reserves the right to cancel the contract without notice and either re-solicit or re-award the contract to the next best responsive and responsible respondent.	0	13
Right to Audit: Pursuant to [Section] 2262.003 of the Texas Government Code, the state auditor may conduct an audit or investigation of the vendor or any other entity or person receiving funds from the State directly under this contract or indirectly through a subcontract under this contract.	0	13

Analysis of 13 District Professional And Consulting Services Contracts and Whether They Contained Provisions Recommended by the State Of Texas Contract Management Guide

Provision	Number of District Contracts That Contained the Provision	Number of District Contracts That <u>Did Not</u> Contain the Provision
Force Majeure: Neither Contractor nor {Insert agency name here} shall be liable to the other for any delay in, or failure of performance, of any requirement included in any PO resulting from this RFP caused by force majeure.	0	13
Ownership/Intellectual Property: For the purposes of this Contract, the term "Work" is defined as all reports, statistical analyses, work papers, work products, materials, approaches, designs, specifications, systems, documentation, methodologies, concepts, research, materials, intellectual property or other property developed, produced, or generated in connection with this Contract. All work performed pursuant to this Contract is made the exclusive property of {Insert agency name here}.	1	12
Independent Contractor: Contractor or Contractor's employees, representatives, agents and any subcontractors shall serve as an independent contractor in providing the services under any PO resulting from this RFP. Contractor or Contractor's employees, representatives, agents and any subcontractors shall not be employees of {Insert agency name here}. Should Contractor subcontract any of the services required in this RFP, Contractor expressly understands and acknowledges that in entering into such subcontract(s), {Insert agency name here} is in no manner liable to any subcontractor(s) of Contractor. In no event shall this provision relieve bidder of the responsibility for ensuring that the services rendered under all subcontracts are rendered in compliance with this RFP.	0	13
Termination: This Contract shall become effective on the date signed by the appropriate official of {Insert agency name here} and shall expire on _____ unless otherwise sooner terminated as provided in this Contract. Notwithstanding the termination or expiration of this Contract, the provisions of this Contract regarding confidentiality, indemnification, transition, records, right to audit and independent audit, property rights, dispute resolution, invoice and fees verification, and default shall survive the termination or expiration dates of this Contract. {Insert agency name here} may, in its sole discretion, terminate this Contract upon thirty (30) days' written notice to Contractor. Such notice may be provided by facsimile or certified mail; return receipt requested and is effective upon Contractor's receipt.	2	11

Source: *State of Texas Contract Management Guide, Version 1.9, January 10, 2012*, Office of the Comptroller of Public Accounts.

Management's Responses

HIDALGO COUNTY WATER IMPROVEMENT DISTRICT NUMBER THREE

Board of Directors
President – Othal Brand, Jr.
Vice President – W. D. Moschel
Secretary – Chris Burns
Member – Leo Montalvo
Member – Joe Corso

1325 Pecan Blvd.
McAllen, Texas 78501
(956) 686-8303
Fax (956) 686-1022

May 21, 2012

Mr. John Keel, CPA
State Auditor
State Auditor's Office
P. O. Box 12067
Austin, Texas 78711-2067

Attn: Lucien Hughes

RE: Hidalgo County Water Improvement District No. 3 (the "District")

Dear Mr. Keel:

This will acknowledge receipt of what we understand to be the final draft version of *An Audit Report on The Hidalgo County Water Improvement District No. 3* (the "Audit Report"). This letter, together with the attachments hereto and our prior letter dated May 10, 2012 and the attachments to that earlier letter, constitute the District's response to and comments on the Audit Report. It is our understanding that the District's full responses will be incorporated into and published with the Audit Report including the version to be available for viewing on the website of the State Auditor's Office and any other distributed copies. In the event your office should make additional modifications to the Audit Report, the District reserves the right to amend or supplement its responses and comments with respect to those modifications.

It has been a pleasure to work with your office and audit staff who have been courteous, cooperative, and professional throughout this process. We recognize that undertaking and completing the task requested by Governor Perry in his letter, dated June 20, 2011, presented unusual challenges for your office and that some of the matters addressed in that request are outside the customary scope of a financial audit. In general, we believe that many of the findings and conclusions in the Audit Report are fair; and most of the suggestions and recommendations for changes in or improvements to procedures or operations are welcome and appreciated. A majority of the weaknesses or deficiencies identified in the Audit Report have already been addressed or corrected as noted in our responses. Those matters which relate to compliance with applicable requirements of the *Texas Water Code* or other statutes have also either already been addressed or will be corrected as quickly as is reasonably possible. To the extent that consideration of recommendations in the Audit Report may require the involvement of the

Mr. John Keel
State Auditor
May 21, 2012
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elected directors of the District, we can assure you that those matters will be presented to and addressed by the board in a deliberate but timely and responsible manner and implemented when determined to be feasible and appropriate.

Notwithstanding the many politically charged allegations made by proponents of dissolution of the District during the 82nd Texas Legislature, we appreciate and are pleased that your audit team found no evidence of any misappropriation of funds or any other actual misuse or waste of resources at the District and that the Audit Report confirms that result. We do appreciate that the focus of many of the findings, conclusions and recommendations in the Audit Report relate directly to the need to strengthen policies, procedures and controls to insure that no such events occur in the future and to provide transparency to the public regarding District transactions and operations. We share those goals and intend to consider and implement many of your audit team's suggestions for improved practices.

The Audit Report does include some findings and conclusions with which the District does not agree. We have described the basis for each of those disagreements in the attached responses. We respectfully request that your office either modify those findings and conclusions accordingly or incorporate the District's responses in their entirety into the Audit Report if you determine that a modification is not justified or appropriate. In a few instances, the disagreement with the Audit Report is based on the tone, emphasis, or arrangement of the report. In most instances, the disagreement is based on the District's judgment that a finding or conclusion is inaccurate because it is based on (i) erroneous information or data obtained by or provided to your office by third parties, (ii) an incorrect interpretation of accurate data or information provided by either third parties or the District, (iii) incomplete information, or (iv) the absence of information which may not have been requested by or furnished to your office during the audit process. In each of those cases, the District has attempted to supplement its attached responses with the accurate or additional information or data or the reason why available data may have been misinterpreted or misunderstood.

Finally, this letter also is intended to provide your office with representations from District management which are made in good faith and to the best of our knowledge and belief. By way of limitation, please understand that each of the directors whose signature appears below has been involved to a different degree and extent in the audit process. For most of the directors, that involvement has been limited to a single interview by one or more members of the audit team. Most of the directors have not been privy to or informed as to the specific data or information either requested by or furnished to the audit team by the District staff, accountants, attorneys, engineers, or other individual directors. Except to the extent disclosed in the Audit Report itself, none of the directors have been privy to or informed as to data or information requested by or furnished to the audit team by other third parties. Subject to the foregoing limitations, the good faith representations from District management are as follows:

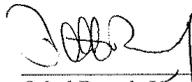
Mr. John Keel
State Auditor
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- (1) We understand that the objectives of your audit are to look into and report back to the legislature regarding those issues identified and set out in that certain letter request, dated June 20, 2011, from Governor Rick Perry to the State Auditor (Appendix 2 to the Audit Report). We further understand that you have determined that the scope of the audit would be limited to the District's fiscal years 2008 through 2011 as to financial matters and 2007 through 2011 as to water usage.
- (2) To the best of our knowledge and belief, the District has made available to you all information relevant to the foregoing objectives, within the applicable fiscal years, and requested by the audit team (together with such other information, whether or not requested, believed in good faith by the District to be relevant to the foregoing objectives) including:
 - (a) financial and program records, related data, and reports;
 - (b) notices, agendas, and minutes from District board meetings;
 - (c) policies and procedures;
 - (d) pumping reports and information;
 - (e) pertinent personnel records;
 - (f) information concerning related parties;
 - (g) bank statements for all District accounts; and
 - (h) significant contracts, grants, and agreements.
- (3) The District has primary responsibility for (i) program results, (ii) efficient use and protection of resources, (iii) identification of and compliance with applicable state and federal laws and regulations, (iv) collection, maintenance, reporting, dissemination, and use of accurate, complete, reliable and timely information, (v) the fair presentation of financial position and program results in District reports, and (vi) the internal controls associated with the foregoing responsibilities.
- (4) To the best of our knowledge and belief, the District has identified and disclosed to you all significant outstanding lawsuits filed against the District and/or settled or otherwise disposed of during the applicable fiscal years.
- (5) To the best of our knowledge and belief, the District has disclosed to you any known significant deficiencies in internal controls relevant to the foregoing audit objectives.
- (6) To the best of our knowledge and belief, there have been no known instances of fraud, illegal acts, or abuse involving management or employees of the District, and, to the best of our knowledge and belief, no such instances are currently under investigation.

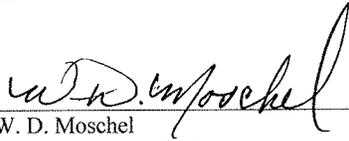
Mr. John Keel
State Auditor
May 21, 2012
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- (7) To the best of our knowledge and belief, the District has disclosed all plans, intentions, and actions that may significantly affect the audit results.
- (8) To the best of our knowledge and belief, the District has properly recorded all material transactions in the accounting records of the District.
- (9) To the best of our knowledge and belief, information provided by the District to the audit team is complete and correct.

Thank you for the courtesies extended to the District by your office and audit team and for the opportunity to review and respond to the Audit Report. If you require any additional information or clarification from the District, please feel free to contact the management staff. We hope the Audit Report and the District's responses will result in a better appreciation for and understanding of all issues regarding the operations of the District and its relationship with its water customers and users including the City of McAllen.



Othal Brand, Jr.
President, Director and General Manager



W. D. Moschel
Vice-President and Director



Chris Burns, Secretary and Director



Leo Montalvo, Director



Joe Corso, Director

**Hidalgo County Water Improvement District No. 3
Management's Responses to Audit Report**

Proposed Summary of District Management's Response to Overall Conclusion and Key Points section of Audit Report:

The audit of Hidalgo County Water Improvement District No. 3 (the "District") resulted from a request by Governor Rick Perry to investigate concerns expressed during the 82nd Texas Legislature. One of the most serious concerns arose from allegations of significant misappropriation, loss or waste of District funds or assets. Although the State Auditor's Office found no evidence of any misappropriation of funds and did not find or report any such losses or instances of unreasonable or wasteful expenditures, the Audit Report focuses instead on what are described as "significant weaknesses in the management of finances and operations" and a claimed failure to establish a "framework for effective governance, oversight, and planning". However, a thorough analysis of those findings demonstrates that they are more appropriately seen as recommendations for enhanced transparency and improved documentation to prevent any future problems rather than evidence of actual and detected past instances or events. The District and its directors appreciate the spirit of the recommendations and intend to seriously consider and implement many of them as appropriate to improve internal controls and management of its operations and to adopt better practices. To the extent that the Audit Report does identify areas of noncompliance with requirements of the Texas Water Code or other statutes, the District has either already taken steps to correct those deficiencies or will aggressively pursue and implement policies to insure future compliance.

Lastly, the District does believe that the Audit Report inaccurately concludes the District has been liquidating assets to cover operating losses and to sustain itself. The responses to specific sections of the Audit Report demonstrate instead that conservative management of resources and assets has enabled the District to fulfill its mission and obligations to both irrigation customers and the City of McAllen while, at the same time, maintaining substantial cash reserves, preserving essential and non-surplus land and water rights, and implementing and continuing an aggressive capital improvements program. In addition, the District has been able to meet those objectives despite a continuous and concerted effort by the City of McAllen to take over or dissolve the District, acquire the District's assets by means of actual or threatened condemnation proceedings, and deplete or diminish the District's cash reserves and water delivery and supply revenues through lawsuits and legislative initiatives.

The management of the District welcomes the Audit Report and the directors and officers are heartened by the overall findings which clearly demonstrate no misappropriations or waste of the District's assets and resources have occurred and also indicate a generally sincere and effective effort to guide the operations of the District in a good faith manner consistent with the statutory mission and fiduciary obligations to further the public trust and the purposes for which they were elected to serve.

Chapter 1-A Financial Controls

During the 82nd Texas Legislature, supporters of a bill to dissolve the District and turn its assets over to the City of McAllen made unfounded and untrue allegations of misappropriation of funds and waste of resources. The most incendiary of those allegations was a claim that almost \$8 million in District assets were missing or had somehow disappeared between 2009 and 2010. When Governor Rick Perry requested an examination of the District, he specifically requested, among other things, that the State Auditor look into and report back to the legislature whether there had been any misappropriation of funds within the District.

The State Auditor did not find evidence of any misappropriation of funds at the District and certainly did not uncover any evidence of a misappropriation, disappearance or loss of \$8 million in District assets. The financial statements of the District (as reviewed and prepared annually by Long Chilton L.L.P., an independent accounting firm) show that the net assets of the District were \$8,083,612 as of the Fiscal Year ending August 31, 2009 and were \$7,863,305 as of the Fiscal Year ending August 31, 2010 – a decrease of \$220,307. Because of progress or completion of various construction projects during FY 2010, the capital assets of the District actually increased by \$2.3 million during that same period.

On pages 4-5, the Audit Report describes compensation payments to directors which exceeded statutory daily limits by \$77.12 month but which were also well below the mandatory annual limits. Although the Audit Report points out that directors had not completed and filed verified statements supporting compensation and reimbursements, as required by the Texas Water Code, the State Auditor does conclude that all reimbursements reviewed were “allowable, reasonable, and supported by other documentation.” All of the District’s currently serving directors have repaid the District in full for any compensation which exceeded any statutory limits. The District promptly implemented a policy requiring the completion and filing of verified statements as a precondition to payment of any compensation or reimbursement to directors. True and correct copies of the receipts for director repayments, as well as the form of verified statement currently in use by the District, are attached as Exhibits 1 and 2 to this response.

Other than the director compensation payments described above, the State Auditor does not identify or reference anywhere in the Audit Report any instance in which the District has made an unreasonable or excessive expenditure from its funds or incurred any expenses inconsistent with or inappropriate to its statutory authority or purposes. Although there are no such findings or any evidence of misappropriation of funds or waste or loss of assets, the Audit Report emphasizes and focuses instead on what the State Auditor has described as “significant weaknesses in the management of its finances and operations” and concludes that the District has not established a “framework to provide for effective governance, oversight, and planning” (see pages i and 1). Among those “weaknesses”, the Audit Report criticizes the District for “noncompliance with various provisions of the Texas Water Code”.

Despite that latter criticism, the only references in the Audit Report to any failure by the District to comply with the Texas Water Code are:

- the absence of written policies and procedures for selection, monitoring, or review and evaluation of professional services as required by Section 49.199(a)(4), Texas Water Code (to be addressed and corrected although District has complied with substantive statutory requirements for procurement of professional services as discussed in letter from R. K. Whittington attached as Exhibit 3 to this response)
- the failure to obtain bonds and to file sworn statements for elected directors as required by Section 49.055(c)-(d), Texas Water Code (bond requirement already corrected as evidenced by true and correct copy of Hartford director bond attached as Exhibit 4 to this response; filing of sworn statements to be addressed and corrected)
- the failure to obtain a bond for District employees who handle cash as required by Section 49.057(e), Texas Water Code (already corrected as evidenced by true and correct copy of Hartford employee theft policy attached as Exhibit 5 to this response)
- exceeding daily limit on and inadequate documentation of director compensation as required by Section 49.060, Texas Water Code (already repaid and corrected as described above and evidenced by true and correct copies of verified statement form and receipts attached as Exhibits 1 and 2 to this response)
- late completion of annual financial audits for FY 2008-2010 and late filing of those audit reports with TCEQ as required by Sections 49.191 and 49.194, Texas Water Code (already corrected as all audit reports were completed and filed for FY 2008-2010 and were timely completed and filed for FY 2011)
- competitive bidding requirement of Section 49.273, Texas Water Code (not applicable except for construction and repair and renovation of district facilities and for the purchase of equipment, materials, machinery, and all things that constitute or will constitute the plant, works, facilities, or improvements of the district as discussed in memorandum from Glenn Jarvis attached as Exhibit 6 to this response)
- conflict of interest provisions of Section 49.058, Texas Water Code (complied with all requirements as evidenced by conflict of interest affidavits attached as Exhibits 7 and 8 to this response and abstention from voting as acknowledged on page 9 of Audit Report)
- payment of maintenance and operating expenses from assessments on irrigable land as required by Section 51.305, Texas Water Code (as acknowledged in the State Auditor's recommendations on page 17 of the Audit Report, this statute may require modification because urban or partially urban water control and improvement districts across the State of Texas are no longer able to comply with the "not less than 1/3 nor more than 2/3 limitations")

Except as discussed above with respect to excess director compensation (all of which has been repaid in full to the District), it is noteworthy that none of the foregoing compliance issues resulted in any loss of funds or other assets or resources of the District -- a fact which is not mentioned in the Audit Report. As indicated and as discussed below, neither the District nor any director or employee of the District failed to comply with any statutory requirement in the Texas Water Code, or otherwise, relating to conflicts of interest or competitive bidding.

During the audit process, the District made all financial and operational records available to the State Auditor's staff. As stated on page 23 of the Audit Report, the audit team requested and reviewed, among many other documents and records, all minutes of District board meetings from September 2007 through October 2011 and all bank statements and reconciliations from September 2007 through August 2011. In addition, the audit team conducted extensive interviews with the District's directors and management, staff, and outside accountants. The District's policies, procedures and customary practices with respect to review, monitoring, approval, and oversight of accounts payable and receivable, revenues and expenditures, contract management, and capital improvement projects are readily apparent from the information available to and gathered by the State Auditor's staff. Contrary to the conclusion that the District has not established a framework to provide for effective governance or oversight, the District and its board of directors have a well established and consistent process that includes, among other things, the following:

- (1) The board of directors meets regularly and at least monthly in meetings noticed and conducted in accordance with Chapter 551, Texas Government Code -- the "Open Meetings Act".
- (2) Each director is provided with a meeting packet which includes all bank statements for District accounts and a listing of all revenues and bank deposits and all expenses and checks written since the last board meeting.
- (3) The meeting packet for each director includes monthly financial statements (reflecting District assets and liabilities and revenues and expenses) prepared by an outside independent accounting firm.
- (4) Every expense and disbursement of the District is reviewed and approved by the board of directors.
- (5) The District general manager and outside engineer present written monthly reports to the board of directors regarding the status of purchase and construction contracts and capital improvement projects.
- (6) The board of directors reviews and approves all purchase and construction contracts including all change orders and all invoices and progress payments.

The Audit Report includes an erroneous finding that the District has been offsetting operating losses from FY 2008 through FY 2011 by selling assets and a conclusion that the District may not be able to sustain its operations (see pages 1-2 and Appendix 4). That finding is apparently based on (i) a calculation that the District's operating revenues and expenses for those years totaled \$4,658,873 and \$5,520,667, respectively, for a four-year cumulative operating loss of \$861,794 and (ii) an assumption that no other funds were available for the operations of the District except the \$5,796,212 in proceeds realized from the sale of land and water rights. That finding is in error because it does not take a number of relevant facts into account. First, as of September 1, 2007, the District had cash or cash equivalents in reserve in the amount of \$2,714,486 -- more than three times the total operating loss sustained over the following four years. Second, the operating shortfalls include depreciation expense -- a non-cash item. Third, none of the asset sales proceeds were used by the District to cover operating expenses -- even in FY 2011 when the total shortfall was \$469,707 (attributable entirely to more than \$450,000 in expenses resulting from legal and legislative disputes with the City of McAllen and a \$436,637 decrease in revenues caused by the predatory water purchase strategy adopted by McAllen and

its Public Utilities Board). Due to a resulting temporary cash flow shortage, the District arranged for an interim operating loan during the Spring of 2011. Fourth, at the end of FY 2011 and after the conclusion of the 82nd Texas Legislative session and the resumption of water purchases by McAllen, the District was able to repay the interim loan in full and to restore its reserves to \$2,041,723 including the \$500,000 line of credit (the net reduction being equivalent to the difference in the cost of new capital assets and improvements in excess of proceeds from the sale of surplus land and water rights).

In addition to the foregoing, during this same period of FY 2008 through FY 2011, the District was able to undertake and complete the purchase and construction of new and essential capital improvements costing \$6,585,527 -- paid for entirely from (i) the District's available cash reserve, (ii) proceeds from the sale of 1,300 acre-feet of surplus water rights from the District's adjudicated allocation for irrigation, and (iii) from the sale of surplus land which was no longer essential to the maintenance of either the District's irrigation system or its other facilities for water conservation and delivery.

By implication, the Audit Report seems to assume that the sale of land by the District was entirely voluntary and was done solely to cover operating losses. In fact, all of the land sales were to the City of McAllen and the majority of those sales were negotiated and conducted following either McAllen's actual initiation or threat of condemnation or eminent domain proceedings. With respect to the sale of irrigation water rights, those sales were consummated only after the District completed a detailed and well-documented investigation and determined that the water rights were actually surplus and would not be needed by the District to fulfill its obligations to either the City of McAllen or its irrigation customers. That entire process was conducted in compliance with the applicable requirements of the Texas Water Code.

Despite an Audit Report which details more than \$6.2 million in seventeen (17) separate capital improvement projects completed between February 2008 and August 2011 (see Table 2 on page 3), the State Auditor concludes that the District does not have a formal, comprehensive, long term master plan for capital improvements or other objectives. Although that conclusion is erroneous, it also does not account for some of the realities and need for ad hoc flexibility necessary to operate a water control and improvement district along the Rio Grande River and in a hurricane and flood-prone area with a mission including water conservation and protection and both the irrigation of rural farmland and the supply and delivery of water to a rapidly growing municipality such as McAllen. In fact, many if not most of the listed projects listed (i) were either conceived and planned before the Audit Report period, (ii) resulted from the need to accomplish remediation from Hurricane Dolly in 2008 or Hurricane Alex in 2010 or preventive measures and structures in anticipation of future hurricanes and flooding, or (iii) became necessary in response to initiatives undertaken by other governmental entities and outside the control of the District (eg., construction of the border wall by the federal government, construction of a new reservoir and Bicentennial Boulevard expansion by the City of McAllen).

The District's governing body and staff were continuously and intimately involved in the planning, monitoring and management of the capital improvement projects listed on Table 2 and are similarly involved in the planning for current and future projects. Based on nothing more than a review of the District's board meeting agendas, director meeting packets, and minutes, the

State Auditor's staff is or should be aware that the outside engineers attend virtually every board meeting and deliver regular and detailed written and oral reports to the directors regarding capital improvement needs and planned and ongoing purchases and construction projects essential to meeting those needs. On February 11, 2009, the engineers presented a detailed written *Capital Improvements Program* and proposed budget for the consideration of the board of directors. A copy of the minutes of that board meeting and the 2009 program and budget were provided to the State Auditor's staff and are attached as Exhibits 9 and 10 to this response. Again on May 24, 2011, the District general manager and engineers presented a detailed and comprehensive oral report and written budget to the board of directors regarding the status and plans for \$3.1 million in capital improvement projects. A copy of the minutes of that board meeting and the attached budget report were also provided to the auditors and are attached as Exhibit 11 to this response. In addition to the above-described capital improvement programs, as part of its master planning efforts, the District has developed and approved a detailed *Water Conservation and Drought Management Plan*.

Although the Audit Report includes a finding that a small sampling (a total of no more than 94 transactions from a period of 48 months) revealed a lack of some supporting documentation for invoices or review and approval, there was no evidence or finding that any of those transactions resulted in an improper expenditure. In fact, as discussed above and as reflected in the agendas, meeting packets, and minutes for board minutes, the District's directors review and approve every check and disbursement by the District for both operating and capital expenses. That review and approval process is documented in those materials.

The Audit Report describes cite a small number of errors detected in identifying and recording capital assets, recording depreciation of capital assets, and recording the capitalization of certain repairs and betterments to capital assets. Although the State Auditor cites those errors as evidence of a control weakness, District management does not believe the examples cited are indicative of an opportunity for misappropriation or waste of District funds or assets. All capital addition expenditures by the District must be properly authorized and approved by the board of directors before disbursement. The District's board members receive copies of all bank statements and bank reconciliations. A few of the errors noted in the Audit Report in recording of capital additions are the result of charging the disbursement to the wrong ledger account. The authorization and support for the capital expenditure are not at issue. The State Auditor did not find any instances of missing capital equipment. Importantly, the District's capital assets are substantially comprised of infrastructure improvements which are not subject to any risk of misappropriation, theft, waste or loss. The District believes the internal controls in existence are properly designed to address any risks associated with the possibility of misappropriation or waste of District funds or other assets.

District management acknowledges the findings on page 6 of the Audit Report that a preventive maintenance plan and documentation of maintenance activities for District equipment and facilities have either been absent or inadequate. The District intends to promptly develop such a plan and written policies to insure that the plan is effectively implemented. Management has already taken affirmative steps to correct deficiencies in documentation including routine and regular entries in inspection and maintenance logs on all District equipment.

Finally on page 7 in Chapter 1-A of the Audit Report, the State Auditor states that the District is unable to identify amounts of billings and payments of flat rate assessments and lacks policies and procedures for collection, notification, and tracking of flat rate billings, payments and balances. As a result, the State Auditor concludes that the foregoing could adversely affect the District's revenue collections.

First, the District's total annual flat rate assessments for the current FY 2012 are \$28,068.33 which is approximately two percent (2%) or less of the District's projected operating revenue for the year. More importantly, using its current software program, the District is able to track and document flat rate assessment billings, payments, adjustments, and balances. The District is required to comply with the procedures for assessing, notifying, and collecting flat rate assessments as set out in the Texas Water Code rather than in any other policies or procedures the District might elect to adopt.

The District utilizes computer software developed by Eclipse Consulting & Technical Services, Inc. (ECTS) to manage its flat rate assessment billings and collections. An account is established for each owner of assessable irrigable acreage in the District. The computer record for each account reflects the original amount of the flat rate assessment billed to the land owner and the date of the assessment, the amount of any interest or penalty added to delinquent assessments, the amount and date of any payments on the account, and the total amount, if any, of the balance due on the account. Account information is reportable in a variety of formats. Two separate report forms on individual flat rate assessment accounts (account names redacted) are attached as Exhibits 12 and 13 to this response. The attached exemplar for a "View Detail Transactions" report (Exhibit 12) shows a balance due including interest of \$16.81 for 2010 and \$18.55 for 2011. The attached exemplar for an "A/R Transaction Inquiry" report (Exhibit 13) shows an account for which all assessments have been timely paid by check with no balance owed. In addition to individual account information, the District can access an "Accounts Receivable Totals Summary" to determine total amounts by year of the flat rate assessments, interest, payments and unpaid balances due. An exemplar report as of May 12, 2012 is attached as Exhibit 14 to this response. The first full year of use for this software was 2007 so the totals for 1974 through 2006 are posted amounts reflecting balances as of 2007 for those prior years. To the best of the District staff's knowledge, the State Auditor's staff did not request or review the reports available from the ECTS software before making the findings reflected in the Audit Report.

The procedures for assessing and collecting flat rate assessments are set out in Sections 51.306 *et seq.*, Texas Water Code, and are followed by the District. Currently, the flat rate assessment imposed by the District is \$9.02 per acre. Bills for assessments are mailed to landowners on or about October 1 and are considered delinquent if not paid by the next January 31. Interest is added to each unpaid account as of February 1. Delinquent notices are sent in June to each landowner with an unpaid balance. No landowner with an unpaid assessment is allowed to purchase water for irrigation from the District until the assessment, together with any interest, is paid in full.

Chapter 1-B Related Party Transactions

The State Auditor has concluded that the District does not have a consistent process to manage related-party agreements and to insure compliance with Chapters 171 and 176, Texas Local Government Code. That conclusion appears to be based upon the circumstances surrounding transactions between the District and three companies in which the President and General Manager of the District has a substantial interest as defined in Section 171.002(a), Texas Local Government Code. Both the District and the official in question disagree with that conclusion and believe that there was full compliance with the applicable statutory requirements and that the transactions in question actually benefited the District and conserved its resources by providing for the purchase of comparable or better services and materials at a lower price or cost than would have otherwise been available.

Each of the District's directors have been made aware of and complied with the requirements of Chapters 171 and 176, Texas Local Government Code. The official record keeper of the District maintains a folder of conflict of interest affidavits and disclosure statements filed with the District. A complete copy of that folder and its contents have been provided to the State Auditor's staff prior to the completion of the Audit Report.

Othal Brand, Jr., the President and General Manager and a director of the District, has a substantial interest in Brandwood Wireless, O. E. Investments, and Rioplex Wireless, each of which companies has provided goods or services to the District for compensation. As required by Section 171.004, Texas Local Government Code, before any vote or decision on any matter involving those business entities, Mr. Brand filed an affidavit stating the nature and extent of his interest. Two separate affidavits were filed with the official record keeper of the District on or about October 9, 2007 and October 14, 2009 and have been maintained in the above-described folder for such records and kept in the offices of the District. True and correct copies of those affidavits were provided to the State Auditor's staff and are attached as Exhibits 7 and 8 to this response. As required by the statute and as acknowledged on page 9 of the Audit Report, Mr. Brand abstained from participation in matters relating to those three entities including voting on any board decisions regarding transactions with those businesses. On each occasion, Mr. Brand disclosed his substantial interest in the entity to the other directors and, based on a comparison and review of prior transactions, the board of directors determined that the District would be able to obtain the services and/or materials at a lower price or cost than it had otherwise been paying for similar or comparable services or materials.

As is the case with all other expenditures of the District, information regarding the amount of each disbursement to the entities in question is routinely provided to and reviewed and approved by the District's directors. District records relating to transactions with these entities were made available to and were reviewed by the State Auditor's staff during the audit process. Significantly, the Audit Report does not reference any evidence that any of the prices or costs of these related-party transactions were unreasonable or unfair to the District.

Section 49.273, Texas Water Code, requires contracts to be competitively bid only if the contract is for construction and repair and renovation of district facilities or for the purchase of equipment, materials, machinery, or things that constitute or will constitute the plant, works,

facilities, or improvements of the district and if the amount of the contract exceeds \$25,000 (see memorandum from Glenn Jarvis attached as Exhibit 6 to this response). None of the transactions with the entities in which Mr. Brand has a substantial interest, even if aggregated, exceeded that amount and were subject to competitive bidding requirements.

Chapter 1-C Procurement Requirements

The Audit Report references a purchase by the District of three vehicles which was not based on competitive bids (page 11). In connection with the description of that transaction, the State Auditor concludes that the District should develop policies and procedures that identify when the District should use a competitive process. Although a competitive bidding process may be a preferred practice under certain circumstances, the District is not required by Section 49.273, Texas Water Code, to obtain competitive bids for the purchase of vehicles which do not or will not constitute the plant, works, facilities or improvements of the District. The referenced transaction did not violate the Texas Water Code or any other procurement statute applicable to the District. See memorandum from Glenn Jarvis attached as Exhibit 6 to this response.

The Audit Report describes a transaction with a company for electrical work in which the District failed to require and obtain a payment bond. Such companies would ordinarily provide services and materials to the District as a subcontractor and through a general contractor. Although prime contractors are required to furnish a payment bond on contracts over \$50,000, subcontractors are not required to provide a payment bond regardless of the contract amount. Because the electrical contractor was dealing directly with the District in this case, it was considered a "prime contractor" within the meaning of Section 2253.001, Texas Government Code, and the District inadvertently overlooked the payment bond requirement. The District has since obtained a payment bond from the electrical contractor. A true and correct copy of the Texas Statutory Payment Bond from Old Republic has been furnished to the State Auditor's office and is attached as Exhibit 15 to this response.

With respect to the procurement of professional services for engineering and surveying and for accounting and auditing, the Audit Report states that the District (i) does not have written policies and procedures as required by Section 49.199(a)(4), Texas Water Code, and (ii) could not provide the audit team with documentation of compliance with Chapter 2254, Texas Government Code, although no such documentation was either identified nor is it required by the statute.

The District is in the process of gathering and reviewing written policies and procedures from other districts and will address and correct its noncompliance with Section 49.199, Texas Water Code.

The District disagrees with the conclusion in the Audit Report that the District is required "to undertake a selection process for professional services" under Chapter 2254 (see letter from R. K. Whittington attached as Exhibit 3 to this response). Section 2254.003, Subchapter A, Chapter 2254, Texas Government Code, expressly prohibits the selection of a provider of professional services through competitive bidding and imposes only two requirements on the governmental entity making a selection. Those requirements are that the selection be made (i) on

the basis of demonstrated competence and qualifications to perform the services and (ii) for a fair and reasonable price. Neither Section 2254.003 nor Section 2254.005 describes, sets out, specifies, requires or even references a "process" or any particular procedure or procedures for making the required determinations of competence, qualifications, or fairness or reasonableness of price. Neither section requires public notices, advertising, requests for proposal, requests for qualifications, or any other of many possible methods for identifying and selecting a competent and qualified professional. The only process described in or required by Section 2254.005 is not a selection process but rather a process for negotiating with alternate providers if contract negotiations with the selected provider are unsuccessful.

Although no selection process is actually required, both the outside engineering and surveying firm and the independent auditing firm currently performing services for the District were selected through a process involving a request for qualifications and interviews. In 2005, the District invited professional engineers to respond to a request for qualifications. Ferris & Flinn, LLC submitted its qualifications and was selected based on its demonstrated competence and experience. The District and the engineering firm subsequently negotiated a contract which was approved by the District's board of directors. A true and correct copy of the board minutes authorizing the request for proposals, selecting Ferris & Flinn, LLC, and approving the engineering contract have been provided to the State Auditor's staff and are attached as Exhibits 16, 17 and 18 to this response. The contract includes compensation rates and terms and a provision that allows the District to cancel the contract for any reason at any time. The District's board reviews and approves every invoice, each of which includes a description of the work performed and detail of hours spent and expenses. Ferris & Flinn, LLC has separated its billing into twenty-seven (27) different projects over the last six-year period.

It is noteworthy that the Audit Report does not include any findings that any of the professional service providers selected by the District are either incompetent or unqualified or have charged or been paid amounts which are either unreasonable or unfair. Although the Audit Report includes recommendations that the District insure compliance with Sections 49.057 and 49.273, Texas Water Code, and Chapter 2254, Texas Government Code, there are no suggestions in the report that the District has either violated or failed to comply with those statutes.

Chapter 2 Governance Framework

With respect to those matters identified in Table 5 on pages 15-16 and for which the Audit Report states that the District either did not comply or partially complied, the District has either already corrected any deficiency or initiated steps to bring the District into compliance. The only exception is the conclusion that the President and General Manager of the District may have only partially complied with Chapters 171 and 176, Texas Local Government Code, with respect to conflicts of interest and related-party transactions or that the District did not have a consistent process in place to manage such agreements. The District disagrees with any such conclusion for the reasons described in the response to Chapter 1-B above.

As applied to water control and improvement districts located in urban or partially urban areas and which engage in the dual capacity as a supplier of irrigation water for farmland and the deliverer of raw water for municipal purposes, the limitations contained in Section 51.305, Texas

Water Code, are archaic and impossible to attain. There are very few, if any, such districts in the Rio Grande Valley or in other regions of Texas which do or can comply with the statutory requirement that not less than one-third (1/3) nor more than two-thirds (2/3) of maintenance and operations expenses be paid from flat rate assessments. The District agrees with the suggestion in the Audit Report that modifications to the statute may be necessary and appropriate and is currently working with the Texas Irrigation Council and the Valley Water Managers Association to achieve a legislative solution.

The Audit Report suggests that the District has (i) no rules, regulations or policies relating to the delivery and supply of water to the City of McAllen and (ii) no policies or procedures relating to the collection, charge, or notification of flat rate assessments to landowners within the District. The terms and conditions regarding the use of District facilities for delivery of raw water to the City of McAllen and the charges for that service are governed by a written contract between the District and McAllen. Therefore, no other rules, regulations, charges, fees, or policies are necessary. The policies and procedures relating to the billing and collection of flat rate assessments are clearly set out in Chapter 51 of the Texas Water Code. Those policies and procedures, as well as the regular and customary practices of the District in compliance with the statutory provisions, are described in detail in the response to Chapter 1-A above.

Chapter 3-A Protection of Real Property Interests

During the 82nd Texas Legislature, proponents of dissolution of the District claimed that the District has filed liens which clouded the title of hundreds of private residential and commercial property owners within the municipal boundaries of McAllen. In his letter request resulting in this audit (Appendix 2), Governor Rick Perry asked the State Auditor to look into and report back to the legislature regarding “the district’s practice of filing liens”.

The District acquired and owns the land on which its irrigation and water delivery system is located (including pumping facilities, reservoirs, canals and laterals) and has a legitimate interest in protecting that system and property interest for the benefit of its water users and customers. A few years ago, the City of McAllen stopped requiring developers and landowners to submit proposed subdivision plats to the District for review and approval -- a process which allowed the District to identify and inform landowners of the existence and location of its facilities and to negotiate agreements and easements, as appropriate, to accommodate and protect those system components. Once McAllen stopped requiring District review and approval, the District’s ownership interests were frequently overlooked or ignored and its facilities were often built over, damaged, or even destroyed or removed. Unable to persuade McAllen to include the District in the review and approval process, in 2009 the District caused a detailed and accurate legal description of the boundaries of its irrigation system to be recorded in the official real estate records of Hidalgo County, Texas. The recorded instrument was not and could not be a cloud on the title of any other property unless it represented an unfounded or inaccurate claim of a non-existent ownership interest. That was not the case.

Other than the 2009 recorded instrument, the District has not filed any liens of any type against any property interests at any time since it was established in the early 1920’s. See letter

from R. K. Whittington describing results of title search for lien filings by District dating back to 1921 and attached as Exhibit 19 to this response.

Chapter 3-B District Rates and Fees

Once again, the Audit Report states that the District has no policies or procedures relating to the collection, charge, or notification of flat rate assessments to landowners within the District. To the contrary, the policies and procedures relating to the billing and collection of flat rate assessments are clearly set out in Chapter 51 of the Texas Water Code. Those policies and procedures, as well as the regular and customary practices of the District in compliance with the statutory provisions, are described in detail in the response to Chapter 1-A above.

Chapter 3-C Conversion of Water Rights from Irrigation to Municipal Use

The water rights downstream of Falcon Dam, including those of the District, were originally adjudicated by a state district court in the Valley Water Suit rather than under the Water Rights Adjudication Act of 1967. The Valley Water Suit was filed in the 1950's and finally disposed of by a final judgment in 1969. See *State of Texas, et al. v. Hidalgo County Water Control and Improvement District No. 18, et al.*, 443 S.W.2d 728 (Tex.Civ.App.-Corpus Christi 1969, writ ref'd. n.r.e.). The adjudication was based on the unusual circumstances of the Rio Grande River and the resulting water rights are of different types than the rest of the State of Texas or even those areas of the Rio Grande River upstream from Falcon Dam.

An application to convert the 1,100 acre-feet of irrigation water rights sold by the District to the City of McAllen in August 2011 to municipal use water rights is currently pending before the Texas Commission on Environmental Quality (TCEQ).

Chapter 4 Information on District Water Usage (including data on District Raw Water Diversion in Appendix 7 and City of McAllen's Current and Projected Water Need in Appendix 9)

The data and information contained in Table 13 regarding the quantity of water diverted by the District to the City of McAllen for municipal use is not accurate for the years 2007, 2008 and 2011. Based on the pumping records of the District, the actual metered water volumes diverted and delivered to the City of McAllen for the period from 2007 through 2011 are as follows:

District Raw Water Diverted (in acre-feet)					
Use/User	2007	2008	2009	2010	2011
Municipal/McAllen	14,373.80	19,098.20	18,368.90	17,248.20*	18,436.80**

* McAllen purchased almost no water from the District from November 2010 through June 2011
 ** The District deliveries of water to McAllen included the entire 13,980 acre-feet of municipal water allocation held by the District, 1,608 acre-feet of water transferred from United Irrigation District, 678.84 acre-feet of McAllen water allocation, and 1,237.10 acre-feet of "no charge" water

The discrepancy between these diversion volumes and those reported by the Rio Grande Water Master through TCEQ is most likely the result of water allocations pumped and delivered by the District but charged to the account of the actual holder of the certificate of adjudication. TCEQ's records reflect the identity of the certificate holder rather than the actual entity pumping the water.

For the same reason, as well as other factors, the volumes of water shown to be diverted and delivered to and used or resold by the City of McAllen in 2011 (as reflected in Table 14) are erroneous and do not reflect wasteful practices engaged in by the City of McAllen and its Public Utilities Board to deprive the District of water delivery revenues under the existing contract. The actual allocations and deliveries of water for 2011 (based on actual diversion records obtained directly from each of the four districts) are as follows:

City of McAllen Water Allocation and Use 2011		
Source of Water	Water Allocated for Municipal Use (in acre-feet)	Water Actually Diverted to McAllen (in acre-feet)
Hidalgo County Water Improvement District No. 3	13,980.00	18,436.80*
United Irrigation District	11,250.00	9,570.74**
Hidalgo County Irrigation District No. 2	10,111.02***	13,059.64****
City of McAllen	678.84	
Totals	36,019.86	41,067.18*****

- * Includes the entire 13,980 acre-feet of municipal water allocation held by the District, 1,608 acre-feet of water transferred from United Irrigation District, 678.84 acre-feet of McAllen water allocation, and 1,237.10 acre-feet of "no charge" water
- ** Includes 8,635.69 acre-feet of allocation held for McAllen by United Irrigation District and 935.05 acre-feet of "no charge" water (and excludes 2,540.86 acre-feet transferred to District and 73.45 acre-feet of unpumped allocation)
- *** Includes 2,000 acre-feet of water leased by McAllen from Brownsville Irrigation District
- **** Includes 8,229.86 acre-feet of allocation held for McAllen, 2,000 acre-feet of water leased by McAllen from Brownsville Irrigation District, and 2,829.98 acre-feet of "no charge" water
- ***** 5,047.32 acre-feet of water diverted to McAllen in excess of municipal use allocation is made up almost entirely by 5,002.13 acre-feet of "no charge" water pumped by three districts and resulting from excess water in Rio Grande River which was not charged to the districts' or McAllen's allocation accounts

During the 80th Texas Legislature in 2007, the City of McAllen made its first unsuccessful attempt to take over the District through a proposed bill. In October 2007, McAllen entered into a contract with Brownsville Irrigation District to lease 2,000 acre-feet of municipal water rights for a term of 20 years. Rather than annual or periodic lease payments, the City of McAllen paid Brownsville Irrigation District \$2.2 million in advance for the leased rights and for the entire 20-year lease term. Although Hidalgo County Irrigation District No. 2 had the highest delivery charges and loss percentage of the three districts supplying municipal water in the area, the City of McAllen elected to arrange for District No. 2 to pump the leased water under the "take or pay" contract. During several of the subsequent years including the latter part of 2010 and first part of 2011, the City of McAllen left substantial portions of its water allocation held by District No. 3 unused and chose instead to take delivery of its leased water from District No. 2. Because of the

high lease rate coupled with District No. 2's delivery charges and 20% loss calculation, each acre foot of the leased water cost the McAllen and its water customers approximately \$131 (a total of approximately \$263,000 per year) -- more than 3.5 times the cost to take delivery of and use water rights it already owned from District No. 3. The cost incurred by the City of McAllen to divert revenues from District No. 3 in this manner does not include the interest cost attributable to paying the lease for twenty years in advance to Brownsville Irrigation District and depriving McAllen of the use of those funds. At an average interest rate of three percent (3%) per year over twenty years, the cost of the water rights leased from Brownsville Irrigation District almost doubles.

Although Table 15 in the Audit Report is apparently intended to project the future water needs of the residents and businesses in McAllen, the measure used is inappropriate for that purpose. The table uses Peak Hourly Demand figures obtained from the *City of McAllen Public Utility Water and Wastewater System Master Plan* for the years 2009 through 2025. Those demands are the maximum expected hourly demand during the highest demand period. A peak hour demand is normally used to size pumping and storage facilities and distribution lines in a potable water system and does not indicate a municipality's water supply needs in terms of acre feet per year or any other measure of either volume or quantity. The City of McAllen Master Plan likely contains information on projected water supply needs on an annual basis. Those figures or projected Rio Grande Water Right needs would be more useful information to predict McAllen's future water use and the demand which might be imposed on the District for water supply and delivery.

**HIDALGO COUNTY WATER IMPROVEMENT
DISTRICT NUMBER THREE**

Board of Directors	1325 Pecan Blvd
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Vice President-W.D. Moschel	(956) 686-8303
Secretary-Chris Burns	Fax (956) 686-1022
Member-Leo Montalvo	

May 10, 2012

Mr. Lucien Hughes
Managing Senior Auditor
State Auditor's Office
P. O. Box 12067
Austin, Texas 78711

Via Electronic Transmission

Dear Mr. Hughes:

This is to follow up on our telephone conference call Wednesday morning with Cathy Aven, Nicole Guerrero, and Sharpar Ali of your staff relating to the District's comments and current responses to some of the issues contained in the SAO Draft Report which you forwarded to me in your email of April 19, 2012. During the telephone conference we discussed the tone of the Report and some specific information that we believe you should consider with respect to certain parts of the SAO Draft Report.

We have previously forwarded to you information relating to documentation that the 3 payments to directors of \$681.36 was for attending Board meetings (pages 4-5 of the Report).

With respect to the issues discussed during our telephone conference and in the interest of promptness in forwarding the information to you, I am attaching with this letter, information that has been compiled by the District, its attorneys, accounting, and engineer since receiving the SAO Draft Report, with respect to issues described in each submittal:

1. Copy of a letter dated May 9, 2012, to Mr. John Keel, State Auditor, from R. K. Whittington, one of the District's attorneys which discusses identified portions of the Report pertaining generally to the District's method of selection and management of providers of professional services and consulting contracts.
2. Copy of memorandum from Glenn Jarvis, an attorney for the District, dated May 8, 2012, to the effect that the purchase of equipment such as vehicles or

other materials and machinery does not require bidding and advertisement in accordance with § 49.273, Texas Water Code, because vehicles do not constitute or will constitute the plant, works, facilities, or improvements of the District as provided in § 49.273(a). This refers to the statement that the District did not seek competitive bids for its purchase of three (3) vehicles.

3. Comments of Mr. Frank Ferris, an engineer for the District, dated May 11, 2012, containing his comments regarding the District's Capital Improvement Plan discussed on Page 3 of the Report; explanation of the reason that the District did not solicit quotes for the water well cleaning and testing because they were scoped at different types under separate contracts; the clay liner because it was a sole source procurement (see Report, page 11); circumstances dealing with the payment bond noted on page 11 of the Report which has been corrected; other issues pertaining to the procurement of professional services; and the Districts' title to land.
4. A memorandum from the District resulting from discussion with the District Auditors, which comments upon the references in Chapter 1 of the Report pertaining to the District's financial controls which could create opportunities for misappropriation of funds; comments on the District's operating expenditures for the years 2008-2011; use of asset sales for capital improvements and not for operational purposes; and the District's control over flat rate assessments.

The District does have a method to track flat rates as described in the attached letter from The Eclipse Consulting and Technical Services, Inc. Flat Rate, assessed in October, is delinquent in February and delinquent statements are promptly issued. Accounts delinquent on flat rate are not allowed to purchase water and delinquent taxes are collected when a property owner desires water or clear title.

Attached is a letter from Ewing, Lara explaining the discrepancy in the flat rate identified in the draft audit. There was an increase in the flat rate on July 25, 2011.

5. Copy of the District's signature card authorization and resolution to its Depository Bank, which authorizes signatures on District checks. This is in reference to the Report's findings on page 4 stating that there is no documentation to indicate that the Board had designated responsibility for signing checks to the Board member. In practice, at least two (2) Board members sign checks at a District meeting.

As discussed during the telephone conference, the District understands the unusual nature of this audit, the fact that it was initiated by a letter from Governor Perry and the State Auditor has the authority to audit water districts like the District. The District would note, however, that the tone of the Report could focus initially on the issues

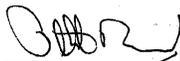
Mr. Lucien Hughes
May 10, 2012
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raised in the Governor's letter in one portion of the Report, and that in other portions of the Report to the normal audit compliance review conducted by the State Auditor in such circumstances.

Please note that related party comments will be submitted under separate cover.

We appreciate the opportunity of conferring with the State Auditor staff on these issues and your attention to them. As discussed during the telephone conference, we do reserve the right to make further responses as the Draft Report is revised and ultimately becomes the final Report.

Respectfully,



Othal E. Brand, Jr., President
Board of Directors

Encl.

Copies of this report have been distributed to the following:

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The Honorable David Dewhurst, Lieutenant Governor, Joint Chair

The Honorable Joe Straus III, Speaker of the House, Joint Chair

The Honorable Steve Ogden, Senate Finance Committee

The Honorable Thomas “Tommy” Williams, Member, Texas Senate

The Honorable Jim Pitts, House Appropriations Committee

The Honorable Harvey Hilderbran, House Ways and Means Committee

Office of the Governor

The Honorable Rick Perry, Governor

Hidalgo County Water Improvement District No. 3

Members of the Board of Directors

Mr. Othal Brand Jr., President and General Manager

Mr. W. D. Moschel, Vice President

Mr. Chris Burns, Secretary

Mr. Joe V. Corso

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