



**REPORT OF
THE
STATE AUDITOR**

**COLORADO WATER CONSERVATION BOARD
CONSTRUCTION FUND PERFORMANCE AUDIT**

FEBRUARY 1993

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February 23, 1993

Members of the Legislative Audit Committee:

This report contains the results of a performance audit of the Colorado Water Conservation Board's Construction Fund. This audit was conducted pursuant to Section 2-3-103, C.R.S., which authorizes the State Auditor to conduct performance audits of state agencies.

This report presents our findings, conclusions, and recommendations, and the responses of the Colorado Water Conservation Board.

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**STATE OF COLORADO
OFFICE OF STATE AUDITOR**

REPORT SUMMARY

**TIMOTHY M. O'BRIEN
State Auditor**

**COLORADO WATER CONSERVATION BOARD
CONSTRUCTION FUND PERFORMANCE AUDIT
FEBRUARY 1993**

Authority, Purpose, and Scope

This audit of the Colorado Water Conservation Board's Construction Fund was conducted at the request of the Department of Natural Resources and under authority of Section 2-3-103 C.R.S., which authorizes the State Auditor's Office to conduct performance audits of state agencies. This audit was conducted according to generally accepted government auditing standards. Audit work was performed from November through December 1992.

The purpose of this report is to provide the results of the State Auditor's Office review of the Colorado Water Conservation Board's Construction Fund. As part of this audit, our review included the following areas:

- Project and activity planning
- Short- and long-term financial planning
- Administration of the project approval process

Our conclusions and recommendations and the responses of the Colorado Water Conservation Board are addressed below. We gratefully acknowledge the cooperation and assistance of the members of the Board, staff, and others contacted during our review.

Background

The Colorado Water Conservation Board is within the Department of Natural Resources. The Board is the State's primary water policy and planning agency within the executive branch. The primary activities of the Board include:

- Protecting the State's interests in interstate water issues.
- Evaluating and overseeing state-financed water projects.
- Working with federal agencies to develop water projects.

For further information on this report, contact the Auditor's Office at (303) 866-2051.

- Assisting local governments with floodplain mapping.
- Managing the State's program for protecting instream flows and natural lake levels.
- Encouraging water use efficiency and conservation.
- Providing a forum for the evaluation of water resource conflicts among Colorado communities.

The Board's policies are set by a governing body of 14 members. Nine Board members are appointed by the Governor with the consent of the Senate. These members are selected geographically to represent different water basins. There are five ex officio members of the Board: the executive director of the Department of Natural Resources, the Attorney General, the State Engineer, the director of the Division of Wildlife, and the staff director of the Board. The staff director is the chief administrative head of the Board and is under the direction and supervision of the Board's governing members.

Description of the Construction Fund

The Colorado Water Conservation Board Construction Fund was established in 1971. The General Assembly enacted legislation that authorized the Board to assist financially in the development and maintenance of water projects. The first priority of the Fund is to undertake projects which will increase the beneficial consumptive use of Colorado's undeveloped compact entitled waters. This is water that is under one of the compacts that allocates water between Colorado and other states and is not put to use in Colorado. The balance of the monies available to the Fund are for projects for the repair and rehabilitation of existing water storage and delivery systems and for investment in water management projects. Low-interest loans are granted for engineering and construction project costs. Loan amounts can vary from 50 to 100 percent of the project costs.

The Fund is a continuing cash fund and balances do not revert to the State's General Fund at the end of the fiscal year. The balance in the Construction Fund available for new projects and other activities was about \$8.3 million at the end of FY 1992. Interest earned from the balance of Construction Fund monies deposited with the State Treasurer are credited to the Fund. Up until last year, loan interest rates were usually set at a minimum of 5 percent. Currently, statutes authorize the Board to recommend interest rates of 0 to 7 percent on project loans.

The Construction Fund has enabled the Board to finance the development of water resources within the State. The Board has provided over \$83 million in financing for 124 water projects since the Fund was established in 1971.

Construction Fund Project Planning

The management of water resources is a long-range commitment. Many projects require substantial and lengthy planning as well as several years to construct. Therefore, planning efforts should consider water needs and concerns well into the future.

The Department of Natural Resources developed a four-year plan in early 1992. The Board's input was included in the plan. While the plan has some goals and objectives related to the Construction Fund, the Board has not developed its own long-term plan. The Board has not developed an implementation plan which prioritizes projects consistent with long-term goals, establishes milestones for monitoring, and provides performance measures to assess effectiveness.

The Board should develop a formal, systematic program or process which provides a long- and short-term framework for the use of the Construction Fund. This process should include developing broad policy statements, establishing goals and implementation plans, and developing performance measures.

Colorado Water Conservation Board Response:

Agree. The CWCB is in the process of developing and implementing both a short- and long-term program and procedure for the use of the Construction Fund consistent with today's more complex fiscal, environmental, and legislative requirements, statutory requirements, the departmental plan, and the CWCB mission.

Financial Management of the Construction Fund

The Board has not developed a method for projecting the long-term financial status of the Construction Fund. While the Board has identified some long-term project needs, it has not developed a comprehensive implementation plan that shows how it will meet those needs.

The Board recently reported to the Joint Budget Committee that disbursements from the Construction Fund could exceed \$120 million over the next 10 years. In addition, the Board may have to fund unrecoverable operating expenses and studies authorized by the General Assembly. Recently, it began an effort to better define these future requirements on an annual basis. However, a similar forecasting need exists relative to determining how much money will be available in the Fund on a long-term basis.

The Board should develop and implement an effective process for long-term financial planning for Construction Fund monies. This process should include establishing long-term funding needs, assessing current sources of funds, and projecting future funding requirements that may be needed to meet long-term goals.

Colorado Water Conservation Board Response:

Agree. The CWCB is in the process of developing and implementing a short- and long-term financial projection, as well as a managerial accounting system, consistent with fund statutory requirements, CWCB fund policy and procedure, and the CWCB long-term development plan.

Setting Subsidized Loan Interest Rates

In 1981, statutes authorized the Board to charge a minimum of 5 percent on loans from the Construction Fund. The Board could have charged higher rates, when appropriate. However, the Board charged the minimum interest rate on almost all of its loans. In 1992, legislation was passed authorizing the Board to set interest rates between 0 and 7 percent.

Loan interest rates have not reflected changing market conditions. We recognize it was the Legislature's intent to provide subsidized interest rates. However, the Board had the option to charge interest at a higher level and still provide a subsidized rate to project sponsors. Cash inflows to the Construction Fund were reduced. As a result, fewer funds were available for other projects.

For example, we developed an "alternative interest rate" based on tax-exempt municipal bond rates. This alternative rate reflected market conditions while still providing a subsidy. We estimated that Construction Fund inflows during Fiscal Year 1992 could have been \$500,000 more if this method were used to set rates on contracts executed between Fiscal Years 1982 and 1990.

The Board should establish guidelines for its loan rates to reflect market conditions. The guidelines should be reflected in the projects that will be authorized during the upcoming legislative session.

Colorado Water Conservation Board Response:

Partially agree. The CWCB is in the process of implementing procedures establishing loan interest rates and terms that reflect market conditions to be used as a standard against which all projects will be measured. Actual rates and terms for individual projects may vary depending on market conditions and other considerations.

Interest on Construction Cash Advances

A project sponsor, such as a municipality, water district, or irrigation company, is the entity building the project. During the construction phase of a project, a project sponsor is responsible for covering costs incurred in the first month. For the remainder of the construction period, the project sponsor may request monthly reimbursements from the Board.

The Board does not require the project sponsor to pay interest on funds advanced during the construction phase of a project. Interest charges begin after the project is completed. As a result, the Board is losing interest on these funds. This means there is less money available to fund other projects.

The Board should charge interest on cash disbursements made to project sponsors during the construction phase of projects. Interest charges could be added to the principal amount of the loan and financed over the term of the loan.

Colorado Water Conservation Board Response:

Agree. The CWCB is in the process of developing and implementing a policy of charging interest on cash disbursements made during the construction phase of authorized projects.

Monitoring Project Status

The Board annually recommends projects for funding to the General Assembly. If the General Assembly approves a project for funding, monies are authorized for the project from the Construction Fund. The Board's current practice is to review its list of contracts annually to determine if construction on a project was initiated. If construction has not started within five years, project sponsors are contacted to determine if the funds should be deauthorized.

Project sponsors do not always go ahead with an authorized project. An extended period can pass between the time of authorization and eventual deauthorization. For example, since 1980, 32 projects have been deauthorized. The average length of time that passed before deauthorization was five years. Construction has not started on 11 projects that were authorized for a total of \$22 million prior to the 1988 legislative session. This means that \$22 million has been committed to projects where construction lapsed for four or more years after authorization.

The Board should improve its monitoring of projects by contacting project sponsors at least annually to determine if project sponsors plan to go ahead with the projects. Responses should be documented and reported to the General Assembly on an annual basis.

Colorado Water Conservation Board Response:

Agree. The CWCB is in the process of developing and implementing procedures for monitoring authorized projects that have not initiated construction. A status summary evaluation for each project will be included in the CWCB annual report.

Recovery of Feasibility Study Costs

The Board determines if the project is viable before a project sponsor is loaned money. These decisions are made through feasibility studies. The Board usually pays 50 percent of the total feasibility study cost and the project sponsor pays the other 50 percent. The Board's cost of the feasibility study is added to the amount of the loan. The feasibility study costs, as well as project costs, are paid back over the period of the project loan. However, the Board does not seek recovery of its share of feasibility study costs when authorized projects are not constructed.

According to a Board analysis, the Board expended more than \$58,000 in feasibility study costs for five authorized projects that were eventually deauthorized over the past three years (1990-1992). These projects did not go ahead because of a decision by the project sponsors. The Board believes that requiring reimbursement could discourage applications for financing from the Construction Fund.

However, \$58,000 is lost money to the Construction Fund. As a result, there is less money available for projects that are viable and needed. In the current fiscal environment, the Board should identify all opportunities to recover its costs to demonstrate it is effectively managing the Construction Fund.

The Board should develop and implement procedures which would recover its share of feasibility study costs for projects that are not constructed. Alternatives should be evaluated, including payback over a period of time.

Colorado Water Conservation Board Response:

Agree. The CWCB is in the process of revising its policy for recovery of the CWCB's share of feasibility study costs. However, the CWCB wants to preserve the option of funding selected feasibility studies on a non-reimbursable basis when those studies are determined by the CWCB to be necessary to the mission of the Construction Fund.

RECOMMENDATION LOCATOR

| Rec. No. | Page No. | Recommendation Summary | Agency Addressed | Agency Response | Implementation Date |
|----------|----------|---|------------------|-----------------|---------------------|
| 1 | 18 | Develop a formal, systematic program or process which provides a long- and short-term framework for the use of the Construction Fund. This process should include developing broad policy statements, establishing goals and implementation plans, and developing performance measures. | Board | Agree | 12/93 |
| 2 | 21 | Develop and implement an effective process for long-term financial planning of Construction Fund monies. This process should include establishing long-term funding needs, assessing current sources of funds, and projecting future funding requirements that may be needed to meet long-term goals. | Board | Agree | 12/93 |
| 3 | 25 | Establish guidelines which include setting loan interest rates to reflect market interest rates. The guidelines should be reflected in the projects that will be authorized during the upcoming legislative session. | Board | Partially Agree | 7/93 |
| 4 | 26 | Charge interest on cash disbursements made to project sponsors during the construction phase of projects. Interest charges could be added to the principal amount of the loan and financed over the term of the loan. | Board | Agree | 12/93 |

RECOMMENDATION LOCATOR

| Rec. No. | Page No. | Recommendation Summary | Agency Addressed | Agency Response | Implementation Date |
|-------------|-------------|--|---------------------|--------------------|------------------------|
| 5 | 29 | Improve Board monitoring of projects by contacting project sponsors at least annually to determine if project sponsors plan to go ahead with the projects. Responses should be documented and reported to the General Assembly on an annual basis. | Board | Agree | 12/93 |
| 6 | 31 | Develop and implement procedures which would recover the Board's share of feasibility study costs for projects that are not constructed. Alternatives should be evaluated, including payback over a period of time. | Board | Agree | 10/93 |
| 7 | 34 | Develop methods to demonstrate Board compliance with procedures it has established, including documentation of all Board reviews and approvals. | Board | Agree | 7/93 |

DESCRIPTION AND PURPOSE OF THE COLORADO WATER CONSERVATION BOARD CONSTRUCTION FUND

Description of the Colorado Water Conservation Board

The Colorado Water Conservation Board is within the Department of Natural Resources. The Board is the State's primary water policy and planning agency. The activities of the Board include:

- Protecting the State's interests in interstate water issues.
- Evaluating and overseeing state-financed water projects.
- Working with federal agencies to develop water projects.
- Assisting local governments with floodplain mapping.
- Managing the State's program for protecting instream flows and natural lake levels.
- Encouraging water use efficiency and conservation.
- Providing a forum for the evaluation of water resource conflicts among Colorado communities.

Organization

Board members are selected geographically to represent different water basins.

The Board's policies are set by a governing body of 14 members. Nine Board members are appointed by the Governor with the consent of the Senate. Members are selected geographically to represent different water basins. There are five ex officio members of the Board: the executive director

of the Department of Natural Resources, the Attorney General, the State Engineer, the director of the Division of Wildlife, and the staff director of the Board.

The staff of the Board includes a director and 29.5 FTEs for FY 1993. The director is the chief administrative head of the Board and is under the direction and supervision of the Board's governing members.

Description of the Construction Fund

Low-interest loans are granted for 50 to 100 percent of the project costs.

The Colorado Water Conservation Board Construction Fund was established in 1971. The General Assembly enacted legislation that authorized the Board to assist financially in the development and maintenance of water projects. The first priority of the Fund is to undertake projects which will increase the beneficial consumptive use of Colorado's undeveloped compact entitled waters. This is water that is under one of the compacts that allocates water between Colorado and other states and is not put to use in Colorado. The second priority of the Fund is the repair and rehabilitation of existing water storage and delivery systems and for investment in water management projects. Low-interest loans are granted for engineering and construction project costs. Loan amounts can vary from 50 to 100 percent of the project costs. The term of loans may extend up to 40 years.

The fund is a continuing cash fund, and balances do not revert to the State's General Fund at the end of the fiscal year. The balance in the Construction Fund available for new projects and activities was about \$8.3 million at the end of FY 1992, as noted in the following chart.

Construction Fund
Fund Balance and FTE Information
Fiscal Years 1991 - 1993
(Dollars in Millions)

| | 6/30/91 | 6/30/92 | 6/30/93* |
|--|-----------------|-----------------|-----------------|
| Available cash balance for new projects and activities | \$ 10.0 | \$ 8.3 | \$ 5.4 |
| Authorized project funds not yet disbursed | 68.2 | 75.7 | 78.8 |
| Outstanding loans due from project sponsors | 53.3 | 53.7 | 54.0 |
| TOTAL ASSETS | \$ 131.5 | \$ 137.7 | \$ 138.2 |
| Less: Liabilities | .1 | .2 | .2 |
| FUND BALANCE | \$ 131.4 | \$ 137.5 | \$ 138.0 |
| FTE | 24.9 | 28.2 | 30.5 |

Note: *Board estimates

Source: Board Financial Reports and Budget Requests

The Board's statute specifically authorizes the transfer of \$48.6 million for water resource development from the General Fund over a three-year period beginning in July 1993. The transfers are scheduled to go to the Construction Fund (25 percent), the fish and wildlife resources account in the Fund (50 percent), and the Colorado Water Resources and Power Development Authority (25 percent).

Currently, interest charges on loans may range from 0 to 7 percent.

Interest earned from the balance of Construction Fund monies deposited with the State Treasurer are credited to the fund. Interest

charges on loans made by the Board for projects financed through the Construction Fund may range from 0 to 7 percent on the basis of the project sponsor's ability to pay and the significance of the project to the State.

Overview of the Project Application Process

Generally, an entity, such as a water district, requests assistance from the Board. The Board does not solicit the request. The application process includes the following steps:

- The applicant submits a loan application to the Board.
- The Board reviews and discusses the application and project with the project sponsor.
- A feasibility study is conducted. The cost of the study may be shared by the Board and the sponsor. The Board's share of the feasibility study is generally recovered if the project is approved and completed.
- The staff of the Board reviews the feasibility study.
- A formal request for funding is submitted to Board members after the staff's approval of the feasibility study.
- The Board members may approve or disapprove the project. Board members assign priorities to the projects and annually submit a report to the General Assembly.
- Authorization of project funding is accomplished by adoption of a statute by the General Assembly and approval by the Governor.

The General Assembly annually authorizes projects recommended by the Board.

CONSTRUCTION FUND PROJECT PLANNING

Chapter 1

Overview

The Colorado Water Conservation Board was created by the General Assembly in 1937. The Board was established to work with agencies such as the U.S. Bureau of Reclamation on federal water projects within the State. One of the early projects was the Colorado River-Big Thompson Project. This was the first large transmountain diversion of water from the western slope to the eastern plains. Since the 1960s, the Board has worked with the Bureau on the Colorado River Storage Project, which includes a series of reservoirs such as the McPhee, Ridgeway, and Blue Mesa.

The Legislature made a series of changes to the Board's statute related to state water resource studies beginning in 1953. Today, the Board's responsibilities in this area are broadly defined. The Board is authorized to conduct water resource studies in order to provide for the integrated development of the State's available water.

The Board's Construction Fund was established to make financial assistance available for water projects.

The Construction Fund was established by the General Assembly in 1971. The purpose of the fund was to make financial assistance available for the development and maintenance of water projects. The Board accomplishes this by providing low-interest, long-term loans from the Construction Fund to municipalities, water districts, irrigation companies, and other similar entities. The Board's statute allows it to recommend interest rates from 0 to 7 percent. Board practice has been to grant repayment periods for a maximum of 40 years. The Board annually submits a list of projects to the General Assembly for authorization.

The Board's policy at one time was to require the borrower to pay half the project cost. However, in 1992, the Board decided to fund up to 100 percent of the loan if the project was important to the State.

The General Assembly has periodically transferred General Fund monies to the Construction Fund to finance the loan program. The Board receives applications for loans and recommends projects to the Legislature. The Board provides financing for projects out of the Construction Fund after approval by the General Assembly. The borrower makes repayments to the Construction Fund after the project is completed. These repayments become funds available for other project loans. The Construction Fund is a continuous fund. As a result, any year-end balance in the Fund does not have to be returned to the State's General Fund.

The Fund has provided over \$83 million for 124 projects since 1971.

The Construction Fund has enabled the Board to finance the development of water resources within the State. The Board has provided over \$83

million in financing for 124 water projects since it was established in 1971.

Two Broadly Defined Priorities Were Established for the Construction Fund

Currently, the Board's statute sets two broad priorities for the use of construction funds:

- First priority goes to projects which will increase the beneficial consumptive use of Colorado's undeveloped compact entitled waters.

Board priorities include increasing the beneficial consumptive use of undeveloped compact waters.

This is water that falls under one of the interstate river compact agreements. These agreements allocate water between Colorado and other downstream states. Undeveloped compact entitled waters are those waters legally available to Colorado but not currently used within the State. Beneficial consumptive use means that the water has been used for some purpose with reasonable efficiency.

- The balance of the monies available in the fund are for the repair and rehabilitation of existing dams and water delivery systems and for investment in water management projects.

The Board was recently granted authority to use Construction Fund monies for two programs in addition to the loan program. The programs include using funds for:

- Grants promoting efficient management and operation of water systems.
- Studies related to particular issues, such as the effects of transferring water from one river basin to another.

These programs provide the Board with greater flexibility in using construction funds.

Board's operating expenses have come out of the Construction Fund for the past two years.

Also, the General Assembly has required the Board to fund its operating expenses out of the Construction Fund for the past two years. Previously, a portion of the Board's operating expenses were appropriated out of the State's General Fund.

Water Resource Management Is Important in the West

Historically, water resource development has been viewed as a key to economic development in the western states. Water projects have provided water for the irrigation of once arid lands and the growth of cities throughout the west. Colorado's situation is unique in that it contains the headwaters for a number of rivers, including the Colorado, South Platte, Arkansas, and Rio Grande. Downstream states, as well as Mexico, also depend on water from these rivers. Over the years Colorado has entered into compact agreements in an effort to allocate available waters.

There is a growing recognition that water issues require increased cooperation.

There has been a growing recognition of the need for cooperation among various interests in the State to address water-related concerns. There are important issues within the State that need to be dealt with in addition to increasing the beneficial use of water available to Colorado. For example, most of the State's population is located along the eastern slope resulting in a large demand for water. However, water resources are concentrated on the western slope. Also, recreational activities which require water are important to the western slope economy.

In general, the margin of reserves of supply over demand for water has diminished as the west has developed. This means that, in the future, not all water needs may be met at a reasonable cost. As a result, the need for planning in the area of water resources has become increasingly important.

Board's Planning Process Has Not Been Fully Developed

The management of water resources is a long-range effort. Many projects require substantial and lengthy planning as well as several years to construct. Therefore, planning efforts should consider water needs and concerns well into the future.

The Board does not have a long-term plan for achieving goals.

The Department of Natural Resources developed a four-year plan in early 1992. The Board's input was included in the plan. The plan has some goals and objectives related to the Board's Construction Fund. However, the Board has not developed its own long-term plan that recognizes Departmental goals and ensures the best use of monies available in the Construction Fund in achieving those goals. The Board has not developed an implementation plan which:

- Prioritizes projects consistent with long-term goals.
- Establishes milestones which monitor progress toward meeting goals.
- Provides performance measures to assess the effectiveness of activities.

Performance measures are particularly important because they should measure the effectiveness of a program as directly as possible. They need to be useful to managers for monitoring projects and to legislators and policy makers. For example, a performance measure might be the total cost of increasing the capacity of existing dams per additional acre-foot of water storage compared to the total cost of building a new dam.

Recently, the Board has begun to pursue a more active role. It has identified a number of projects that it would like to accomplish over a period of years. The Board has also requested authorization for a new program which will enable it to encourage the development of small dam sites. This may result in an increased need for Board funds.

The Board can help facilitate the resolution of water issues.

We recognize that water issues are varied and complex. The Board cannot realistically set water priorities for the State by itself. However, it can perform a valuable role in providing a forum for diverse interests and helping to form collaborative relationships in seeking solutions for state water issues.

Project Planning Needs To Consider the Prior Appropriation Doctrine

The Board has generally relied on project sponsors coming forward and requesting assistance. Also, sufficient funds were available for these projects. Some Board members and staff have reported that the prior appropriation doctrine provides a system that controls how water is developed in the State. For these reasons, planning activities were limited or not perceived as needed for the Construction Fund.

The prior appropriation doctrine, which is recognized in the State's constitution, is the system of water law under which (1) the right to water is acquired by diverting water and applying it to a beneficial use and (2) a right to water is superior to a right acquired later in time. Water rights are regarded as property rights and can be bought and sold separately from the land.

According to Board members, some holders of water rights perceive any attempt to plan for water development by a state agency as a potential interference with their ability to exercise use of those rights. This perception on the part of water rights holders is a major consideration for Board members.

However, the need to plan for the best use of monies in the Construction Fund is important. The Board has limited staff and financial resources. The sources of cash inflows to the fund are beginning to decline in part due to decreases in interest income on the fund balance. At the same time, more of the fund is being used to finance studies and operating expenses which do not replenish the fund like loan repayments do. Also, meeting long-term water needs is more complex due to federal environmental and public health regulations. Finally, water development issues understandably continue to be impacted by the values of diverse interests across the State.

Planning is a tool that needs to consider all relevant factors, including the prior appropriation doctrine. The Board needs to coordinate an effort that helps identify how monies in the Construction Fund should be used. Further, the Board can use this process to work with other interested parties to establish a framework for the development of water resources.

Construction Fund Monies May Not Be Used in the Most Effective Manner

All projects recommended by the Board to the General Assembly must meet Board requirements. These requirements include meeting priorities established by the Board's statute. These statutory priorities are broad. However, the Board

cannot demonstrate that Construction Fund monies are being used effectively without a comprehensive plan. The projects financed may or may not be the most important ones.

Currently, projects financed may or may not be the most important ones.

We recognize the Board's expertise in the area of water resources. Also, projects helped by the Board have benefited different areas of the State.

However, the Board needs to ensure that Construction Fund monies are directed to those projects that provide the greatest overall benefit.

Recommendation No. 1:

The Board should develop a formal, systematic program or process which provides a long- and short-term framework for the use of the Construction Fund consistent with the broader Departmental plan. This process should:

- a. Identify critical water issues and develop broad policy statements.
- b. Establish goals and implementation plans to meet those goals.
- c. Develop performance measures which monitor the effectiveness of the activities sponsored through the Construction Fund.

Colorado Water Conservation Board Response:

Agree. The CWCB has already begun the process of developing this program and procedure, which will include an opportunity for public comment, the establishment of Board policies for the use of construction fund monies, and the setting of goals and performance measures to assure that the goals are being achieved. While fiscal pressures on state government have increased, the complexity of developing Colorado's interstate entitlements to water resources and the competition for scarce water development funds have also increased. The CWCB agrees that more sophisticated management guidelines are needed to assure the Construction Fund resources continue to be directed to Colorado's most important water resources protection and development priorities.

FINANCIAL MANAGEMENT OF THE CONSTRUCTION FUND

Chapter 2

Introduction

The General Assembly established the Colorado Water Conservation Board Construction Fund to help finance "projects that will increase the beneficial consumptive use of Colorado's undeveloped compact entitled waters." The fund finances the development and maintenance of the State's water resources through loans, grants, and studies.

The financial demands on the Construction Fund have increased over the past few years. Before FY 1992, the Board received General Fund monies towards part of its operating and administrative expenses. For example, in FY 1991, the Board received almost \$700,000 from the General Fund. However, in FY 1992, the Legislature required that the Board fund all of these expenses out of the Construction Fund. These expenses were about \$1.6 million in FY 1991 and \$1.8 million in FY 1992. In addition, the Construction Fund is used for loans, grants, and studies. The Board reports that the complexity of future water projects and the restoration of the State's infrastructure will increase the demand on Construction Fund monies.

Financial planning is a critical part of long-term planning.

Financial planning is a critical component of long-term planning for the Construction Fund. Planning is a dynamic process. It involves the setting of priorities based on available resources and monitoring the financial position of the fund. Also, the allocation of financial resources may be changed based on shifts in priorities or financial conditions.

We reviewed how the Board monitors and manages the Construction Fund. We found that:

- A long-term financial plan for the Construction Fund has not been developed. As a consequence, the Board cannot ensure funds will be available when needed or used for the most important projects or activities in the future.

- Loan interest rates were generally set at the minimum of 5 percent permitted by statute. During the period 1981 to 1992, long-term tax-exempt interest rates ranged from 6 to 12 percent. The 5 percent interest rate resulted in reduced cash inflows to the fund and less money available for other projects.
- Interest is not charged on funds advanced to project sponsors during the construction phase of projects. As a result, less money is available for other projects.
- Project sponsors are not contacted annually to determine if they plan to go ahead and construct projects. Some projects are never constructed and eventually are deauthorized. This means that monies allocated to these projects from the Construction Fund are not effectively used during this period.
- Feasibility study costs of the Board are not recovered for projects that are not constructed. If a project is constructed, feasibility costs are recovered through loan repayments. The former practice results in an additional subsidy and less money available for other projects.

Long-Term Financial Plans Need To Be Developed

The Board has not developed a method for projecting the long-term financial status of the Construction Fund. While the Board has identified some long-term project needs, it has not developed a comprehensive implementation plan that shows how it will meet those needs.

Project disbursements could exceed \$120 million over the next 10 years.

The Board recently reported to the Joint Budget Committee that disbursements from the Construction Fund could exceed \$120 million over the next 10 years.

In addition, the Board may have to fund unrecoverable operating expenses and studies authorized by the General Assembly. Recently, it began an effort to better define these future requirements on an annual basis. However, a similar forecasting need exists relative to determining how much money will be available in the fund on a long-term basis.

For example, authorized projects may not begin immediately and may require several years to complete. Therefore, it is necessary to plan how the projects will be funded along with other Board projects and activities. The development of a financial plan is an integral part of project and activity planning for the Construction Fund.

Sufficient Construction Funds Were Available in the Past

Generally, there were sufficient monies in the Construction Fund to finance projects. Also, the Board did not actively seek out projects. As a result, on a short-term basis, financial planning may not have been critical.

However, water resource development is a long-term effort. In the future, it will be particularly important to focus resources on the most important projects and activities.

Need To Ensure That the Construction Fund Can Meet Future Demands

The Construction Fund represents a limited amount of monies for water development projects and activities. However, as noted above, water development financing needs over the next 10 years are considerable. Also, the Board has used Construction Fund monies to finance its operations and nonrecoverable studies. Therefore, it is important to ensure funds are available when needed.

Long-term financial projections could impact project selection and interest rates.

The Construction Fund has some continuing sources of funds, such as interest income, repayment of loans, and mineral royalty income. Many of the Board's loans will be repaid over a forty-year period, which makes projecting some cash inflows fairly easy. However, the Board has not developed long-term projections of cash inflows and outflows for the fund. These projections could influence which projects are funded, effect the level of interest rates on Board loans, or indicate the need for additional general fund transfers to the Construction Fund.

The Board plays a contributing role in the water resource management area. Also, the General Assembly continues to recognize the importance of this role by authorizing most Board-recommended projects each year. The Board needs to continue these efforts and help facilitate the development of water resources through the Construction Fund.

Recommendation No. 2:

The Board should develop and implement an effective process for long-term financial planning of Construction Fund monies. This process should include:

- a. Establishing long-term funding needs for Board projects and activities: a ten- to twenty-year plan that includes projected funding required to develop and maintain the State's water resources.
- b. Assessing current sources of funds and evaluating what can be done given the current sources: an assessment of funds currently available to the Board for accomplishing the long-term goals.
- c. Identifying future sources of funding, as needed: a projection of additional funding requirements that may be needed to meet long-term goals. The evaluation should also include projections of the various funding mechanisms available to the Board.

Colorado Water Conservation Board Response:

Agree. The CWCB has already adopted a schedule for the development of short- and long- term goals for the Construction Fund; short- and long-term funding needs, a projection of revenue available to the Fund; an evaluation and ranking of Construction Fund needs; determination of the funding required to meet the goals and needs; and a monitoring process to assure that these goals are being fulfilled.

Statutes Allow the Board Flexibility in Setting Loan Interest Rates

Prior to 1992, the Board could set loan interest rates at no less than 5 percent.

In 1981, statutes authorized the Board to charge interest on its loans. Section 37-60-119(2) C.R.S. provided: "Interest charges shall be assessed at no less than 5 percent." We believe that this means the Board could have charged higher rates, when appropriate. However, the Board charged the minimum interest rate on almost all of its loans.

In 1992, legislation was passed authorizing the Board to set interest rates between 0 and 7 percent. The Board believed that the minimum interest rate of 5 percent was too high for some borrowers. Also, it wanted more flexibility to establish the interest charges based on the project sponsor's ability to repay and the importance of the project to the State.

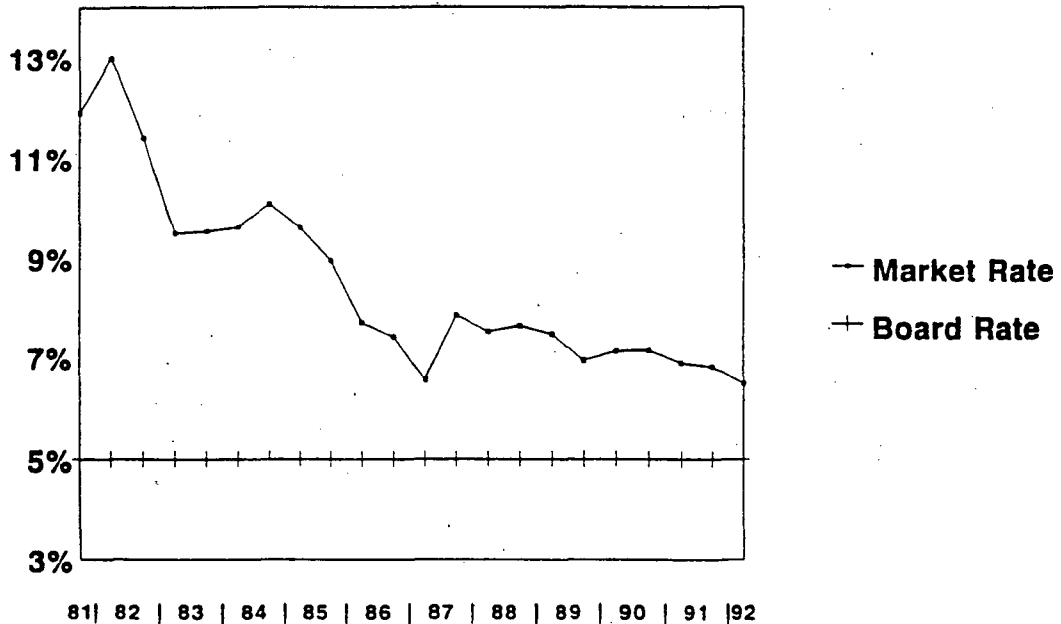
Loan Interest Rates Have Not Reflected Changing Market Conditions

Long-term tax-exempt interest rates have ranged from 6 to 12 percent during the past ten years.

Over the past ten years, long-term interest rates varied considerably. For example, interest rates on municipal bonds ranged from 6 to over 12 percent.

Since the Board set interest rates on loans at 5 percent, the Board's rates did not reflect changing market rates as shown in the following chart.

Board Interest Rate Compared to the Tax Exempt Municipal Bond Rate



Source: SAO analysis of data from Legislative Council.

A Board task force is now developing guidelines for determining interest rates on project loans under the new statutory requirements. These guidelines will probably include other factors that will be considered when setting interest rates.

We recognize it was the Legislature's intent to provide subsidized interest rates. Also, the Board had the latitude to set interest rates at no less than 5 percent. However, the Board had the option to charge interest at a higher level and still provide a subsidized rate to project sponsors. As a result, cash inflows to the Construction Fund were reduced resulting in fewer funds available for other projects.

Entities Involved in Similar Activities Set Loan Rates That Reflect Market Rates

The U.S. Bureau of Reclamation is empowered to construct a system that will store and develop water in the western United States. The Bureau operates a loan program to construct water projects. The Bureau has developed cost recovery guidelines, which include guidelines for charging interest on its loans. The interest rates charged by the Bureau reflect the current rates of long-term government obligations. The rates are reassessed at least annually. For example, the current interest rate is 7-3/8 percent on loans of 30 years or longer.

Additional Cash Inflows to the Fund Could Have Been Significant

Loan interest rates could be subsidized and still reflect market rates.

There are various ways the Board could have set loan interest rates to reflect market conditions. We prepared an analysis to determine the potential impact to the fund. We

developed a reduced or subsidized interest rate that was linked to both market rates and the minimum of 5 percent in the statute.

We obtained the average tax-exempt municipal bond rates for new issues with a maturity date of 20 or more years. We developed an "alternative rate" of interest using the tax-exempt municipal rates. The rate is 5 percent plus half of the difference between the market rate and the Board's 5 percent interest rate. This alternative rate reflects the market while still providing a subsidy. Thus, the alternative rates ranged from about 6 percent to less than 9 percent.

We applied the alternative rate and Board rate of 5 percent to loans for 70 projects with a contract date between Fiscal Years 1982 and 1990. Contracts executed in FY 1991 and 1992 were not included because loan repayments may not have started. We then determined the amount of repayments for these loans during Fiscal Year 1992 using the two different interest rates. Total repayments for our sample using the Board's rate were about \$2.1 million. However, loan repayments for the same contracts using the alternative interest rate were about \$2.6 million.

Cash inflows to the Construction Fund could have been \$500,000 higher in FY 1992.

Construction Fund inflows during Fiscal Year 1992 could have been \$500,000 more if the Board's rate had reflected market conditions using this method.

We recognize that this is only an example of one method to set interest rates. However, it shows how the Board could have improved the fund's cash flow and still provided loans with below market interest rates.

Recommendation No. 3

The Board should establish guidelines for its loan rates to reflect market conditions. The guidelines should be reflected in the projects that will be authorized during the upcoming legislative session.

Colorado Water Conservation Board Response:

Partially agree. The CWCB established a subcommittee several months ago to work out the details for developing interest rate guidelines. The CWCB utilized a preliminary draft of those guidelines in evaluating and establishing interest rates for the loans included in HB 93-1273, the 1993 Construction Fund authorization bill. Although this is a complicated task, the CWCB is committed to completing this process by July 1993.

No Interest Is Charged on Cash Funds Advanced During the Construction Period

A project sponsor, such as a municipality, water district, or irrigation company is the entity building the project. During the construction phase of a project, a project sponsor is responsible for covering costs incurred in the first month. For the remainder of the construction period, the project sponsor may request monthly reimbursements from the Board.

The Board does not require the project sponsor to pay interest on funds advanced during the construction phase of a project. Interest charges begin after the project is completed. However, usually interest is charged on funds when they are advanced to a borrower in similar situations, such as construction mortgages. As a result, the Board is losing interest on these funds.

We reviewed the files of some recently completed projects between 1982 and July 1992. The Board charged 5 percent interest on these loans. We applied the Board's interest rate of 5 percent to the cash advances, using a simple interest calculation. Therefore, the lost interest does not reflect the higher market rate of interest. If it did, the amount of interest lost would be greater. The following table shows the lost interest during the construction phase of three projects.

| LOAN # | CONTRACT DATE | AMOUNT OF LOAN | NUMBER OF DRAWS | CONSTRUCTION PERIOD IN MONTHS | LOST INTEREST |
|--------|---------------|----------------|---------------------|-------------------------------|---------------|
| 1 | 2/27/90 | \$330,666 | 10 | 18 | \$ 12,777 |
| 2 | 4/16/90 | \$214,537 | 2 | 13 | \$ 1,724 |
| 3 | 7/24/91 | \$310,000 | 1 | 4 | \$ 1,267 |
| Total | | \$855,203 | Total Lost Interest | | \$ 15,768 |

This practice results in an additional subsidy to the borrower.

As the table indicates, the Board lost over \$15,000 during the construction phase of the three projects. This practice results in an additional subsidy to the borrower. Also, this means there was less money available to fund other projects. Based on discussions with some Board members, we believe this practice may have been inadvertently overlooked.

Recommendation No. 4

The Board should charge interest on cash disbursements made to project sponsors during the construction phase of projects. Interest charges could be added to the principal amount of the loan and financed over the term of the loan.

Colorado Water Conservation Board Response:

Agree. The CWCB's contract guidelines will be revised during the upcoming months to require the payment of interest during construction on future projects recommended by the CWCB for assistance from the Construction Fund.

Projects Authorized by the Legislature May Not Be Constructed

Authorization represents an allocation of monies already in the Construction Fund.

The Board annually recommends projects for funding to the General Assembly. If the General Assembly approves a project for funding, monies are authorized for the project from the Construction Fund. This

authorization represents an allocation of monies already in the Construction Fund. After a project is authorized the following may occur:

- Project construction begins immediately.
- Project construction is deferred.
- Project sponsors request the authorized funds to be deauthorized.

Project sponsors may request funds to be deauthorized if they decide not to proceed with construction of the project for some reason, such as an inability to obtain the balance of funding from other sources. Deauthorized project funds stay in the Construction Fund and are available for other projects.

Project Sponsors Are Contacted If Construction Has Not Started Within Five Years

The Board's current practice is to review its list of contracts annually. However, if construction on a project is not initiated within five years, the Board contacts the project sponsor to determine if the project should be deauthorized. If the project sponsor does not agree to deauthorization, the Board takes no further action, except to continue to contact the project sponsor on an annual basis. The Board only recently began documenting these communications.

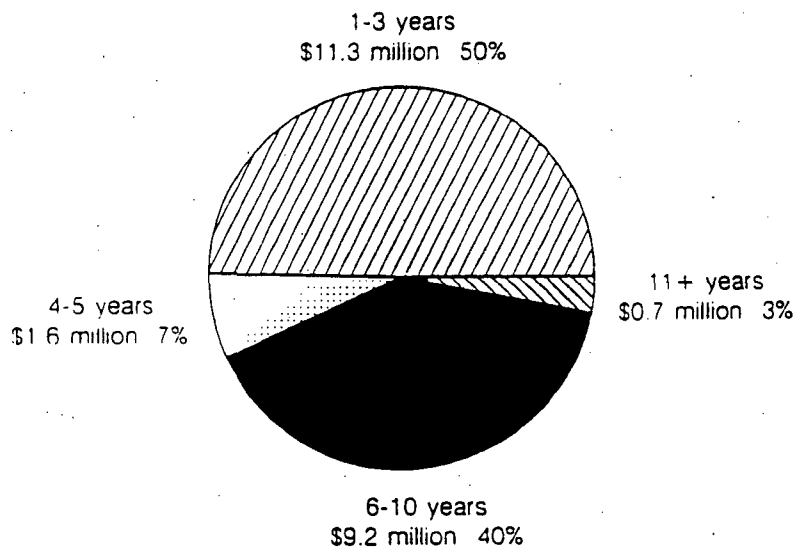
Thirty-Two Projects Have Been Deauthorized Since 1980

Project sponsors do not always go ahead with an authorized project. An extended period can pass between the time of authorization and eventual deauthorization. For example, since 1980, 32 projects have been deauthorized. The average length of time that passed before deauthorization was five years. During this period, these funds were not available to finance other projects.

**An average of five years passes
before projects are deauthorized.**

We reviewed Board records for all projects authorized since 1977 that were eventually deauthorized. We found that 13 of 32 projects totalling almost \$10 million were not deauthorized for more than six years. The following chart shows the dollar amount and the number of years funds were held before being deauthorized.

DEAUTHORIZED WATER PROJECTS Since 1980



Source: SAO analysis of Board Data.

Currently, construction has not started on 11 projects authorized for a total of \$22 million prior to 1988.

Construction has not started on 11 projects that were authorized for a total of \$22 million prior to the 1988 legislative session. This means that \$22 million has been unavailable for funding other projects for four or more years.

Construction Fund Monies Need To Be Monitored Better

Construction Fund monies may not always be available to benefit other or more important projects because projects are not deauthorized in a timely manner. For example, monies appropriated to agencies from the state capital construction fund which are not used or encumbered within a three-year period revert to the state capital construction fund. This allows the General Assembly to ensure that funds are used in the most efficient manner.

The General Assembly needs to be kept informed.

In the current fiscal environment, there may be less monies available. It is important for the Board to encourage the use of Construction Fund monies in the most efficient manner.

Also, the General Assembly needs to be kept informed about the status of projects it authorizes.

Recommendation No. 5:

The Board should improve its monitoring of project sponsors by:

- a. Contacting project sponsors at least annually after authorization of funds to determine if project sponsors plan to proceed with the projects.
- b. Documenting the responses from project sponsors, including requests to deauthorize projects.
- c. Reporting the results of the contacts to the General Assembly on an annual basis.

Colorado Water Conservation Board Response:

Agree. The CWCB has established a time table which will include notification to all proponents of authorized projects that a status report will be required. The CWCB will evaluate those status reports and include a summary in its annual report.

Feasibility Studies Are Conducted for All Projects

The Board determines if the project is viable before a project sponsor is loaned money. These decisions are made through feasibility studies. The statutes require feasibility studies to evaluate:

- Water rights and yield available for a proposed project.
- Engineering and economic feasibility of a proposed project.
- Projected economic, social, and environmental effects of a proposed project.

If the results of the feasibility study indicate that the project would be viable, the project may be authorized for construction.

Feasibility Study Costs for Projects That Are Not Constructed Are Not Recovered by the Board

The Board usually pays 50 percent of the total feasibility study cost and the project sponsor pays the other 50 percent. The Board's cost of the feasibility study is added to the amount of the loan. The feasibility study costs, as well as project costs, are paid back over the period of the project loan. However, the Board does not seek recovery of its share of feasibility study costs when authorized projects are not constructed.

According to Board staff, feasibility study costs are not recovered because:

- Project sponsors might be discouraged from applying for Construction Fund loans if they knew they were going to be responsible for repaying all of the feasibility study costs for a project that did not go ahead to construction.

- Feasibility studies allow the Board to understand what type of projects will and will not work under certain conditions. Even if a project does not get constructed, the Board has gained new information from the feasibility study.

Over \$58,000 in Feasibility Study Costs Were Not Recovered

According to a Board analysis, the Board expended more than \$58,000 in feasibility study costs for five authorized projects that were deauthorized over the past three years (1990-1992). These projects were not constructed because of a decision by the project sponsors.

Study costs which are not recovered represent another subsidy.

The \$58,000 is lost money to the Construction Fund. Also, it represents another subsidy provided to the sponsor of a project. The practice of not recovering feasibility study costs of projects that are not constructed results in less money available for projects that are viable and needed.

The Board's governing statutes provide that "the board's costs or its participation in any feasibility studies shall be repaid when construction on a project commences." The statutes do not contain specific criteria for recovering study costs of authorized projects that do not go ahead to construction. However, if a project sponsor requests deauthorization of a project, it seems reasonable to expect recovery of these costs.

In the current fiscal environment, this is another opportunity for the Board to demonstrate to the General Assembly it is effectively managing the Construction Fund.

Recommendation No. 6:

The Board should develop and implement procedures which would:

- a. Recover its share of feasibility study costs for projects that do not get constructed.
- b. Evaluate options for the recovery of feasibility costs, including payback over a period of time.
- c. Communicate the new policy and practice to project sponsors.

- d. Monitor the results of the new practice, including the cost recoveries.
- e. Report the results to the General Assembly on an annual basis.

Colorado Water Conservation Board Response:

Agree. The CWCB has historically recovered its share of feasibility study costs of projects which receive Construction Fund assistance by adding those costs into the loan repayment schedule. The CWCB agrees that those costs should also be recovered for projects which are not built even though the feasibility study shows the project is viable and Construction Fund assistance is authorized.

PROJECT APPROVAL PROCESS

Chapter 3

Introduction

During the course of our audit, we reviewed selected contract files for projects recommended by the Board and authorized by the General Assembly. We found that the Board has guidelines for reviewing and approving various documents required to evaluate a loan application and to support cash advances during construction. However, Board staff do not always document their reviews or approvals.

Guidelines Are Established for the Construction Fund

The Board has established guidelines that describe the loan program, the application process, and administrative procedures for construction of a project. Also, the Board incorporates Construction Fund program procedures into its contracts with project sponsors.

These guidelines require Board staff to review and approve specific check points and various documents in the process.

Board Does Not Consistently Document Its Compliance With Guidelines

Board staff did not consistently document their reviews or approvals as required by established guidelines. As a result, they could not demonstrate that reviews and approvals were made, as appropriate. We reviewed a sample of four project files and identified the following examples of incomplete documentation.

- Two files did not have documentation of the Board review and approval of project plans and specifications prepared by the consulting engineers.

- None of the files contained evidence that the Board attended the bid opening for construction and approved the award of the contract to the contractor.
- None of the files had documentation of the Board's periodic project construction observations.
- Three files included change orders. However, one of the files did not have documentation that the Board approved the change order.
- None of the files contained documentation that the Board staff attended the final inspection and accepted the finished project.

Board Procedural Requirements Are Important Controls

The Board maintains that the procedures are based on generally accepted practices for sound planning, design, and construction of water resource projects. Therefore, it is important for Board staff to document their reviews and approvals. The Board staff reported that the various activities were performed. However, they were not documented due to limited staff.

The Board established review and approval requirements partly to ensure that there were controls over the process. In order to facilitate the documentation process, the Board should consider other alternatives. For example, the Board can incorporate a contract checklist in the file where reviews and approvals are documented. This option would also indicate the status of an application at any point in time. In any event, good controls require complete documentation.

Recommendation No. 7:

The Board should develop methods to demonstrate its compliance with procedures it has established, including:

- a. Obtaining and filing documentation of all inspections, as appropriate.
- b. Documenting all Board reviews and approvals.

Colorado Water Conservation Board Response:

Agree. The CWCB is in the process of revising its checklist to assure and document compliance with all operating procedures established for the Construction Fund.

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