

September 20, 2010
LEG 2010-0395

Honorable Steve White
Presiding Judge
Sacramento Superior Court
720 9th Street, Department 47
Sacramento, CA 95814

**Re: Sacramento Municipal Utility District's Response to the 2009-2010
Grand Jury Report, Survey of Independent Special Districts.**

Dear Judge White:

Pursuant to Penal Code sections 933 and 933.05, I am providing the official response of the Board of Directors of the Sacramento Municipal Utility District (SMUD) to the 2009-2010 Sacramento County Grand Jury Report, entitled, "Survey of Independent Special Districts" (Grand Jury Report). The SMUD Board of Directors approved the SMUD response to the Grand Jury Report at its regularly scheduled meeting of September 16, 2010.

Finding 1.0. ISD directors perform valuable service at minimal cost. However, this survey reveals inconsistent behaviors regarding compliance with sound management practices.

Response to Finding 1.0. SMUD agrees that members of the SMUD Board provide a valuable service to the agency, the Sacramento community, and their respective constituents by providing policy direction and oversight for the organization and its activities. SMUD disagrees with the second sentence of the finding to the extent it implies that SMUD lacks sound management practices. As set forth in this and subsequent responses to the Grand Jury Report, SMUD has policies and practices in place to ensure sound management practices. The SMUD Board of Directors' oversight and policy functions are articulated in a series of governance policies divided into three categories: (i) Governance Process policies, which describe the duties of the Board, its members, and how the members conduct the Board's business; (ii) the Board-Staff Linkage policies, which set forth the duties of the General Manager and Chief Executive Officer, the General Counsel, Internal Auditor and Special Assistant to the Board and also establish clear delegations of authority from the Board to the General Manager and Chief Executive Office; and (iii) the Strategic Direction policies which articulate the Board's expectations and metrics around key operational areas, such as competitive

rates, access to credit markets, customer relations, reliability, safety, ethics and environmental leadership. The governance policies provide clear policy direction to the organization, and management actions are directly linked to the achievement of the governance policies. The governance policies can be found on the SMUD website at <http://www.smud.org/en/board/pages/strategic-direction.aspx>. SMUD takes no position on the practices of other independent special districts (ISDs).

Recommendation 1.1. Directors should review their by-laws every four years to assure compliance with applicable laws, ethical practices, and appropriate behavior.

Response to Recommendation 1.1. SMUD agrees that the Boards of ISDs should review their governance policies to assure compliance with applicable laws, ethical practices, and appropriate behavior. As described in *SMUD's Response to Finding 1.0*, the SMUD Board of Directors has adopted comprehensive governance policies. These governance policies are monitored and reviewed by the Board of Directors on an annual basis and changes are made as necessary. In addition to the annual review of the governance policies, the Strategic Direction policies require written annual monitoring reports to the Board regarding the policy requirements and metrics. The Board reviews and discusses the monitoring reports at a publicly noticed Board committee meeting and, if appropriate, accepts the monitoring report through an adopted Board resolution.

Recommendation 1.2. Directors should limit compensation to reasonable meeting stipends and necessary costs of professional activities. All ISD boards should ensure their compensation practices conform to the principles in Section 5.1 of the report.

Response to Recommendation 1.2. SMUD agrees that Directors should limit compensation to reasonable meeting stipends and necessary costs of professional activities. SMUD also agrees that compensation practices should conform to the compensation principles set forth in Section 5.1 of the Grand Jury Report. SMUD's practices are consistent with the principles in Section 5.1. Public Utilities Code section 11908.2 establishes the parameters of Board member compensation. In addition, the SMUD Board has adopted Governance Process Policy, GP-12, Board Compensation and Benefits. GP-12 provides in pertinent part that:

Each Board member shall receive for each attendance at the meetings of the full Board, Board committee meetings, ad hoc committees, publicly noticed SMUD workshops or meetings, other publicly noticed meetings where the Board member is representing the Board, state or federal legislative briefings where the Board member is representing the Board,

meetings with SMUD customers or staff relating to SMUD business, community meetings or events where the Board member is representing SMUD, events where SMUD is being recognized, conferences and organized educational activities, the sum of \$150.00 per day of service.

In the event of multiple compensable events in a single day, the Board member is limited to the per day compensation of \$150.00. Board members are also limited to compensation for a maximum of 10 days of service for any one calendar month. GP-12 also provides for reimbursement for expenses related to travel, meals, lodging, and other actual and necessary expenses incurred in the performance of the Board member's official duties. Reimbursement is limited to Board member expenses only.

The Board has adopted a specific policy addressing Board travel and training, Governance Process Policy, GP-15, Board Travel and Training Reimbursement, is directed at training and travel, "appropriate to their work as Directors and provide value to SMUD."

Board member compensation and reimbursement for travel and educational activities are budgeted on an annual basis. The budgeted training and travel funds expire at the end of each calendar year and do not carry-forward to future budgets. Individual Board member compensation and reimbursement of expenses are approved at the twice-a-month regularly scheduled meetings of the Board of Directors.

Recommendation 1.3. Directors should limit the use of consent calendars according to the principles in section 5.1 of the report.

Response to Recommendation 1.3. As described herein, SMUD agrees in part and disagrees in part with the Recommendation. Specifically, SMUD disagrees with limitation No. 4 in section 5.1 of report ("Consent items should be limited in dollar value"). While not clearly articulated in the Grand Jury Report, the report seems to imply that consent calendars may limit the opportunity for public review and participation in the decision making process of the independent special district. SMUD believes that it has a robust process for notifying the public of the matters before the Board and its committees, providing public access to documentation regarding items on the discussion and consent calendars, and providing opportunity for interested members of the public to be heard. All SMUD Board and committee meetings are publicly noticed at least 72 hours in advance of the meeting. The agendas clearly identify the matters under consideration. The agendas and all supporting documentation are placed on the SMUD website at least 72 hours prior to the meetings. Supporting documentation is also available for public inspection at the SMUD headquarters. The agendas are faxed to ten local news organizations and emailed to approximately fifteen members of the public who have requested notice of agendas on a regular basis. The SMUD committee

meetings are audio streamed on the SMUD website. SMUD Board meetings are cable cast and also video streamed on the SMUD website. SMUD Board and committee meetings are also archived on the SMUD website and available to the public for later viewing. In addition, at each Board meeting the respective Committee Chair reports on the items discussed at the committee meeting and any actions taken, including the decision to place an item on the consent or discussion calendars of the Board meeting.

The Board of Directors has established governance policies on agenda planning (Governance Process policy GP-4, Agenda Planning) and the role of Board committees (Governance Process policy GP-8, Board Committee Principles). Under the policies, items scheduled for action by the Board of Directors are first presented to a standing committee of the Board. While standing committees are comprised of three members of the Board, all members of the Board are encouraged to attend standing committee meetings and fully participate. As a general rule, Board members attend most committee meetings whether they are members of the committee or not. The policies provide that the committee determines whether items are placed on the consent calendar or moved to the discussion calendar. The policies further provide that any Board member may move any item from the consent calendar to the discussion calendar. In addition, certain items are always placed on the discussion calendar (e.g., approval of a CEQA document and approval of the related project, approval of the annual budget, rate hearings and adoption of rate changes, and approval to issue revenue bonds).

As described above, SMUD does not believe that limiting items on the consent calendar is necessary in SMUD's specific case for the following reasons: (i) SMUD has a robust process for public notification of Board and Committee agenda items, public access to documentation regarding agenda items, opportunities to be heard, and access to meetings through audio and video streaming; and (ii) the SMUD Board of Directors has adopted clear policies on agenda planning and the role and practice of Board Committees.

Finding 2.0. Some ISDs grant monetary awards for education and training; many have inadequate evaluation of employees and degrees.

Response to Finding 2.0. SMUD Does not grant monetary awards for education and training. SMUD disagrees with Finding 2.0 to the extent it can be read to imply that SMUD conducts inadequate evaluation of employees and degrees. SMUD takes no position as to the practices of other ISDs.

Recommendation 2.1. All ISDs should encourage education and training, but should not make direct monetary (cash) awards for educational achievement.

Response to Recommendation 2.1. SMUD agrees with Recommendation 2.1 and its business practices meet the intent of the recommendation. SMUD supports education and training for its employees, finding that education and training improve employee performance and readiness for promotional opportunities and overall organizational effectiveness. SMUD provides a number of internal and external education programs to enhance employee's professional and career development. SMUD encourages continuous learning and provides financial assistance for approved educational expenses to help employees pursue relevant knowledge and skills. SMUD does not provide monetary awards for educational achievements, but does have an educational reimbursement program for qualified educational programs.

Recommendation 2.2. All ISDs should recognize educational degrees and certificates only if they meet the criteria listed in Section 5.3.1.

Response to Recommendation 2.2. SMUD agrees with Recommendation 2.2 and its business practices meet the criteria listed in Section 5.3.1. SMUD's practice is to provide financial assistance for post-secondary degree programs only for completion of classes at an accredited college or university. Classes or courses taken toward completion of certification programs are offered through accredited colleges, universities or vocational schools and related to SMUD's business interests. SMUD regularly reviews tuition reimbursement applications to ensure the educational institution meets eligibility criteria. For purposes of hiring, SMUD performs a background check for those potential new employees where a specific degree is required for hiring purposes (e.g., engineer, attorney, and accountant) to verify the employee has the appropriate degree.

Finding 3.0. ISD pension awards and Other Post Employment Benefits (OPEB) have increased markedly in the last decade. Some of these awards are unfair and unsustainable.

Response to Finding 3.0. SMUD disagrees with Finding 3.0 to the extent it implies that SMUD has failed to prudently manage its pension and OPEB obligations. SMUD has no opinion with regard to the practice of other ISDs. As evidenced by the Grand Jury Report, SMUD's pension formula of 2.0% at age 55 based on the highest three years pensionable compensation is in the least generous category of pension benefits (see Grand Jury Report, p. 16). The Grand Jury Report expresses concerns regarding compensation spiking and pension boosting and appears to

attribute the phenomenon to ISD's changing their pension formula to base final compensation on the single highest year of compensation and increasing the percent component of the formula (e.g., increasing from 2.0% to 2.5% or greater) (see Grand Jury Report, pp. 15, 20-22). Neither of these factors are present with regard to SMUD's pension benefit which continues at the baseline formula (2.0% at 55 (36months)). While the Grand Jury Report does not engage in a meaningful discussion of the impacts of OPEB, SMUD agrees that OPEB liability has increased over the last decade. As a result, SMUD has taken prudent steps to reduce its OPEB liability. SMUD has a three-tier OPEB medical benefit program: (i) Tier 1 is comprised of employees hired before January 1, 1993 with at least five years of service receive coverage of 100% of their retiree medical premiums; (ii) Tier 2 is comprised of employees hired between January 1, 1993 and December 31, 2006 and retiring with ten years of service receive 50% of the retiree medical premiums covered, increasing up to 100% coverage with twenty years of service; and (iii) Tier 3 is comprised of employees hired after January 1, 2007 and retiring with ten years of service receive 25% of the retiree medical premiums covered, increasing to 75% coverage with twenty-five years of service. SMUD's proactive adjustment to the retiree medical benefit portion of the OPEB has resulted in a reduction in the annual required contribution to fund the OPEB (e.g., \$21.4 million in 2010 as compared to \$26.7 million in 2007). Unlike many ISDs, pension and OPEB costs represent a relatively small percentage of SMUD's annual budget with CalPERS pension costs accounting for 1.77% of the budget and OPEB funding accounting for 1.32% of the budget. Accordingly, SMUD believes its current OPEB and CalPERS pension obligations are sustainable into the future.

Recommendation 3.1. All ISDs should adopt pension and OPEB plans that are fair, affordable and sustainable.

Response to Recommendation 3.1. SMUD agrees with the recommendation. As described in SMUD's *Response to Finding 3.0*, SMUD declined to enhance its pension benefit formula above the baseline formula. SMUD has also taken proactive steps to reduce its OPEB costs by creating tiers for the medical benefit portion of its OPEB and reducing benefits for newer hires. Because of these prudent steps SMUD has pension and OPEB plans that are fair, affordable and sustainable.

Recommendation 3.2. To minimize unfair pension boosting, all ISDs should ensure that calculations of employees' base pension awards are on actual base salary earnings over their highest 36 months of earnings and urge CalPERS to promote this standard.

Response to Recommendation 3.2. SMUD agrees with the recommendation, and its pension practices are consistent with the recommendation.

Recommendation 3.3. All ISD pension/OPEB benefits should be made only after analysis and full disclosure to all parties of the fiscal ramifications.

Response to Recommendation 3.3. SMUD agrees that any changes to ISD pension/OPEB should be subject to thorough analysis and a transparent process. As described in SMUD's *Response to Finding 3.0*, SMUD has not enhanced and has no plans to enhance its pension benefit formula above the baseline formula. In addition, SMUD has taken proactive steps to reduce its OPEB costs.

Recommendation 3.3. All ISD pension/OPEB benefits should have an employee contribution component.

Response to Recommendation 3.3. SMUD disagrees with the recommendation. SMUD's current pension benefit practice is to pay the employee contribution component of the CalPERS pension contribution. This benefit was negotiated with SMUD's two unions and also implemented for non-represented employees. The practice was reached through negotiations in which there was a trade-off between higher wages and SMUD paying the employee contribution component. SMUD believes a more important inquiry is whether an ISD's pension costs are sustainable over time. As noted above, SMUD is in a very different situation from many ISDs, cities, and counties with regard to pension obligations and does not face the same challenges. Unlike many agencies, SMUD's current CalPERS obligation accounts for a small part of its annual budget (1.77% in 2010). As a result, SMUD believes its pension practices are sustainable and do not compromise its ability to fulfill its mission or provide electric service to its customers in a cost-effective, reliable manner. As described in *SMUD's Response to Finding 3.0*, SMUD has also taken proactive steps to reduce its OPEB costs by creating tiers for the medical benefit portion of its OPEB and reducing benefits for newer hires. SMUD's OPEB obligation also accounts for a small part of its annual budget (1.32% in 2010). As a result, SMUD believes its practices with regard to its OPEB obligation is sustainable and does not compromise its ability to fulfill its mission or provide electric service to its customers in a cost-effective, reliable manner.

Finding 4.0. The majority of the ISDs surveyed in this study are neglecting their fiduciary responsibility to taxpayers and ratepayers by excessive use of no-bid purchasing.

Response to Finding 4.0. SMUD disagrees with the finding to the extent the finding can be read to imply that SMUD is neglecting its fiduciary duty to its customer-owners through the excessive use of no-bid purchasing. SMUD agrees that excessive use of no-bid purchasing may operate to the detriment of the public. SMUD takes no position with regard to the contracting practices of other ISDs.

The SMUD Board of Directors has adopted a clearly defined policy regarding the procurement of goods and services, Board Staff-Linkage Policy BL-7, Delegation to the GM with Respect to Procurement, which sets forth principles to ensure that the procurement process is conducted, "in accordance with applicable legal requirements in a fair, competitive and inclusive manner to maximize the benefit to SMUD ratepayers and the economic development of the community." Among the principles articulated in the policy is that, "procurement activities be competitive whenever practical." From January 1, 2004 through August 31, 2010, SMUD has awarded contracts valued at approximately \$2 billion; of which 90.73% have been pursuant to a competitive process.

The non-competitive awards fall into two categories--either sole source awards or direct procurements; non-competitive contract awards are used in very limited instances. BL-7 provides that a, "sole source procurement shall be performed only in the case of emergency or when a competitive process would be an idle act." An "idle act" means there is only one supplier to provide the service or the good. All sole source procurements require written documentation substantiating that the procurement qualifies as a sole source contract. Since 2004, sole source procurements have accounted for 6.93% of all contracts awarded. Examples of sole source contracts include ongoing software maintenance and licensing agreements where the original software was procured through a competitive process and parts or equipment where there is only one supplier of the equipment or part.

Direct procurements are defined as, "procurements of goods and services made in SMUD's best interest without competition when multiple sources of supply are available." All direct procurements require written documentation establishing why it is in SMUD's best interest to move forward with a contract without engaging in the competitive process. Since 2004, direct procurements have accounted for 2.33% of all contracts awarded. Direct procurements are generally limited to instances where a contractor has special knowledge of a SMUD business process where the contract will result in a best value solution to SMUD or where the contractor is uniquely positioned to provide the service (e.g., The Sacramento Tree Foundation).

Recommendation 4.1. Every ISD in Sacramento County should establish and adhere to a goal of minimizing no-bid purchasing. Essentially all purchases except utilities and emergency construction should be by contracts awarded to the lowest responsive bidders.

Response to Recommendation 4.1. SMUD agrees that ISDs should establish and adhere to the goal of minimizing non-competitive purchasing. As described in the *Response to Finding 4.0*, SMUD has policies and procedures in place to ensure that procurement activities are competitive whenever practical. A written monitoring report on SMUD procurement activities is presented to the Board on a quarterly basis at Board committee meeting. Included in the procurement report is information on the number of competitive, sole source and direct procurement contracts.

While agreeing that the use of non-competitive contracting should be minimized, SMUD disagrees with the second sentence of the recommendation as too restrictive in terms of both the types of contracts limited to no-bid procurement and the competitive process used in procurements. The recommendation specifies that with the exception of utilities and emergency construction, all other contracts should be competitively bid. First, emergency conditions may warrant procurement of more than construction services, including, but not limited to, equipment, technology and other professional services. Second as described in the *Response to Finding 4.0*, non-competitive awards may be appropriate in limited circumstances (i.e., sole source and direct procurements). The SMUD Board of Directors has adopted policies to ensure that contracts are competitively awarded when ever practical and actively monitors SMUD's contracting practices.

SMUD also believes limiting the competitive process to, "contracts awarded to the lowest responsive responsible bidders" is inappropriate to the extent the language is intended to limit the competitive process to bid awards only. SMUD engages in the use of several competitive processes to ensure that its ratepayers and the community realize the best value from its procurement activities, including:

- (i) requests for bids with the contracts awarded to the lowest responsible bidder;
- (ii) requests for proposals with the contracts awarded to the highest evaluated proposer;
- (iii) best value competitive process with contracts awarded by the best value at the lowest cost methodology, where costs and other factors are used to obtain the maximum value; and (iv) multi-year, strategic alliance competitive process for goods or services where SMUD and the successful supplier collaborate over the life of the contract to improve quality, to reduce the cost of production, improve service delivery and lower the total cost of ownership for SMUD. SMUD's use of the processes described above serves to ensure that the vast majority of SMUD's contracts are awarded pursuant to a competitive process.

Finding 5.0. ISDs have not consistently conducted and reported required Independent Financial Audit Reports and management audits.

Response to Finding 5.0. SMUD disagrees with Finding 5.0 to the extent it can be read to imply that SMUD fails to conduct and report Independent Financial Audit Reports and Management Audits. SMUD takes no position with regard to the practices of other ISDs. The SMUD Board of Directors has adopted Governance Process (GP3), Board Job Description, which provides that the Board shall contract with, "an external auditor to audit SMUD's finances and procedures; such audits are to be performed on an annual basis." In addition, the SMUD Board of Directors has adopted Board-Staff Linkage policy (BL-3), Board Internal Auditor Relationship, which sets forth the duties for the Internal Auditor and provides the Internal Auditor with a direct reporting obligation to the Board of Directors. Under BL-3, the Internal Auditor prepares an annual audit plan and presents the plan to the Board of Directors' Finance Committee for comment. The Internal Auditor's plan and work is designed to achieve the following objectives: (i) adherence to plans, policies and procedures; (ii) compliance with laws and regulations; (iii) effectiveness and application of administrative and financial controls; (iv) effectiveness and efficiency of operations; (v) reliability of data; (vi) safeguarding assets; and (vii) ensuring the accuracy of staff prepared monitoring reports presented to the Board. Audit reports include recommendations for changes and management's response to the recommendations. All audit reports developed under the audit plan are provided to the Board and discussed at a publicly noticed Board committee meeting.

Recommendation 5.1. All ISDs must complete and file the required annual Independent Financial Audit.

Response to Recommendation 5.1. SMUD agrees with the recommendation, and fully complies with the recommendation. SMUD has an annual financial audit conducted by an independent accounting firm. The independent accounting firm presents its results at a publicly noticed Board committee meeting. The results of the independent financial audit are filed with the State Controller's Office and also made available to the public on SMUD's website.

Recommendation 5.2. All ISDs should commission a thorough periodic management audit. These audits should be completed by a multi-disciplinary team qualified to examine a district's management practices. This audit should be done in fiscal year 2011, and every four years thereafter.

Response to Recommendation 5.2. SMUD agrees that it is important for ISDs to conduct periodic management audits and believes it exceeds the recommendation through an ongoing and continuous audit program. With over 2,000 employees and annual revenues approaching \$1.3 billion, SMUD is the largest ISD in California. SMUD's business operations are complex and the consequences of failing

to operate reliably and efficiently are significant. Accordingly, SMUD actively engages in an ongoing and continuous program to audit SMUD's processes, operations and technology. As described in the *Response to Finding 5.0*, SMUD's Internal Auditor develops an annual audit plan identifying audits to be completed considering the policy objectives and risks associated with the process, function or technology (e.g., factors include potential financial impact, activity volume, external and internal visibility, reputational risk, regulatory risk, changes in people or processes and the length of time since the last audit). The Audit and Quality Services Department (AQS) has ten employees comprised of financial/operational auditors, information technology auditors and quality engineers. AQS conducts operational, compliance, internal control, informational technology, special investigations and financial audits of SMUD business processes and activities based on the audit plan and requests received from the Board of Directors, the General Manager and CEO and the General Counsel.

Thank you for opportunity to respond to the Grand Jury Report on behalf of the SMUD Board of Directors. If you have any questions about this letter, please contact me at aorchard@smud.org or at 916-732-5830.

Sincerely,

A handwritten signature in dark ink, appearing to read 'A. Orchard', written over a horizontal line.

Arlen Orchard
General Counsel

/dm

cc: Corporate Files