REPORT TO THE

UTAH LEGISLATURE

Number 2004-09

A Performance Audit of Davis and Weber Counties Canal Company

December 2004

Audit Performed by:

Audit Manager	Rick Coleman
Auditor Supervisor	Wayne Kidd
Audit Staff	Brian Dean

Table of Contents

Table of Contents (Cont.)

Digest of
A Performance Audit of Davis and Weber Counties Canal Company

Davis and Weber Counties Canal Company (D & W) is a private non-profit entity that owns and operates a canal that delivers water from Echo and East Canyon Reservoirs via the Weber River for agricultural and residential lawn and garden purposes to users in Davis and Weber Counties.

Concerns have been raised about D & W's financial position and operations by some shareholders and cities involved in the secondary water operations. Due to questions about the company, a performance audit was requested by several legislators. We were asked to address the concerns of the cities and some of the shareholders, and conduct a review of the financial management practices of the company. Following the introduction in Chapter I, Chapters II through V review the following areas:

- Financial management practices,
- General canal operations,
- Secondary operations, and
- Water supply.

This audit was completed to determine what steps D & W should take in order to help improve operations and the financial viability of the company in the future.

Chapter II: D & W needs better financial information.

D & W Should Rely on Accrual Basis Accounting. In the past D & W has used cash basis accounting. Accrual accounting provides a better indication of earnings and the financial position of the company. When D & W was an agricultural irrigation business with little debt, cash accounting may have been adequate for its needs. However, in recent years D & W has engaged in many transactions with long-term financial consequences that are not adequately recognized under cash basis accounting. For example, the fact that D & W currently has over $41 million in debt is not reflected in their cash basis statements.

D & W Should Keep Funds Separate. Separate revenue and expense records should be kept for each line of business. D & W is involved with two distinct lines of business: general canal operations and secondary water operations. D & W should also keep a separate fund for purchasing water for the secondary operations, or ask the cities to require new users to purchase or make water available for the secondary systems. Principal funding sources include: shareholder assessments for the general canal operations fund, annual user fees for the secondary operations fund, and secondary hook-up fees for a purchasing water fund, less one time costs associated with new hook-ups. By keeping funds separate, D & W will be able to have a clearer and more accurate financial picture of their operations.

As part of managing finances effectively, D & W should budget for their fiscal year and build a reserve fund to cover unforeseen expenses.

Chapter II Recommendations

1. We recommend that D & W use accrual accounting and include statements of financial position, activities, and cash flows in their annual report.

2. We recommend that D & W keep funds separate for the general canal operations, secondary operations, and water purchases.

3. We recommend that D & W's budget year coincide with their fiscal year.

4. We recommend that D & W continue their plan to develop a reserve fund in order to meet unexpected expenses.

Chapter III: Shareholder assessments provide revenue for general canal operations.

Shareholder Assessments Were Set too Low to Cover the Canal Rehabilitation Projects and General Canal Operating Expenses. In order to be a financially viable company, D & W needs to ensure that shareholder assessments accurately reflect their obligations and expenses each year. A financial review of general operations for FY 2003 showed that assessments were too low to cover expenses for the general canal operations. Assessments need to not only meet loan obligations, but also pay for general canal operating expenses— both direct and indirect expenses, and the establishment of a reserve fund for the canal.

D & W currently owes over $14 million in loans for canal related expenses. D & W has developed a capital improvement plan for 9.1 miles of the canal, which covers over half of the length of the canal. The Utah

Board of Water Resources has authorized D & W to borrow an additional $15.9 million to make more improvements to the canal in the future.

Water Should Be Fairly Allocated to All Users. In addition to financial equity, water should be allocated to all shareholders fairly. Water meters or other water measuring devices should be considered to fairly allocate water to all users. Of the 67 gates along the canal, 22 gates have meters that can adequately measure water flow. Effective water measuring at the gates will allow D & W to monitor and report water distribution activity through each gate along the canal.

Chapter III Recommendations

1. We recommend that D & W assign direct expenses and use a formula to allocate indirect expenses to the company's general canal operations.
2. We recommend that D & W set shareholder assessments to cover their expenses for the general canal operations.
3. We recommend that D & W continue to develop and complete capital improvement plans as needed to keep the canal in good condition.
4. We recommend that D & W consider using additional water meters or other water measuring devices to help ensure water is fairly allocated to all users.

Chapter IV: Secondary systems need more revenue.

User Fees Cover the Loans for the Secondary Systems and Secondary Operating Expenses. The secondary water systems were built with $23.5 million in loans from the Utah Board of Water Resources. When the user fees were originally determined, they were set to cover the loan payments, direct operations and maintenance expenses, and an assessment to use D & W's water.

Because the cities have been concerned about the secondary systems subsidizing more than their proportionate share of the company expenses, the auditors and D & W staff developed a methodology to allocate direct and indirect expenses to the secondary operations. For FY 2003 user fees did not cover all of the expenses for the secondary operations. D & W will need to project future expenses and adjust user fees to cover those expenses.

Chapter IV Recommendations

1. We recommend that D & W assign direct expenses and use a formula to allocate indirect expenses to the secondary operations.

2. We recommend that D & W, with the cities, set user fees to cover expenses for the secondary operations.

3. We recommend that D & W develop and complete capital improvement plans for the secondary systems as needed.

Chapter V: Future Water Supply Is a Valid Concern.

Hook-up Fees Buy Water for the Secondary Operations. D & W collects a hook-up fee from the secondary water users from the cities that D & W serve. This fee has been dedicated to buy water stock to provide water for the secondary systems, less the one-time costs associated with new hook-ups.

Since the beginning of the secondary operations, D & W has collected $2.9 million in hook-up fees for purchasing water. When the canal breach occurred in 1999, D & W used a significant portion of the revenue from hook-up fees to repair the damage to the hillside in Riverdale. D & W has spent $1.1 million to buy water stock for the secondary systems.

The secondary operations have had adequate water in the past due to the fact that the secondary systems have been using 4,742 acre feet of water committed from the shareholders; however, there is a concern about the adequacy of the water supply in the future. D & W will need to secure about 18,000 acre feet of water to meet the needs of the cities that D & W serves at build-out. D & W also has a contract with Summit Water Distribution Company (SWDC), which may require D & W to perpetually lease up to 5,000 acre feet of water to SWDC. D & W is working on a plan to secure the needed water for the secondary systems.

Chapter V Recommendations

1. We recommend that D & W keep hook-up fees, less one time costs associated with hook-ups, in a separate fund to purchase water stock.

2. We recommend that D & W make an effort to renegotiate their contracts with the cities to require new users of the secondary systems to provide the water.

3. We recommend that D & W determine how much water they have to deliver to SWDC, and develop a strategy to make the water available under the terms of the contract.

Chapter I
Introduction

Davis and Weber Counties Canal Company (D & W) is a non-profit entity that provides water not only to private shareholders, but also to several public entities within Davis and Weber Counties. Due to the public interest in the future viability of the company, our office was asked to conduct a performance audit of the company's operations.

D & W Has Evolved into A Dual Purpose Entity

D & W owns and operates a canal that delivers water for agricultural and residential lawn and garden use.

The Davis and Weber Counties Canal Company (D & W) owns and operates a canal that delivers water from Echo and East Canyon Reservoirs via the Weber River for agricultural and residential lawn and garden purposes to users in Davis and Weber Counties. The canal was originally built to serve agricultural needs, but as residential subdivisions continued to be developed within their service area, D & W saw another use for the water—residential secondary watering systems. D & W expanded their scope of operations in 1988, so that they now provide water for residential, as well as agricultural, purposes.

D & W was established in 1884 as a non-profit entity with the purpose of supplying water to the agricultural community in it's service area. D & W's decreed water right was determined in the 1930's and was based on the irrigation of 40,790.7 acres. While the boundaries of the service area has not changed, the agricultural irrigated acreage has decreased or changed over the years.

Water is distributed to users in D & W's service area based on the number of water shares owned. Shareholders pay an annual assessment on each share owned, which in turn covers the costs to manage D & W and the costs related to operations and maintenance of the canal system.

The transition from agricultural land to residential subdivisions has continued over the years. So, D & W sought ways to ensure utilization of their water supplies. In 1985, D & W's Board of Directors began to investigate alternative uses of irrigation water in their service area, to keep the company's water within the service area; as well as, to look for additional sources of revenue to make needed canal repairs.

In an attempt to plan for the future development of the land within the service area of D & W and to develop a new source of revenue, the board of directors saw the secondary water project as a logical step. The secondary water project was seen by the board of directors as a prudent course of action for the company for the following reasons:

- To keep the water in the service area to prevent D & W from losing their water rights,
- To provide income from the secondary water systems to help keep D & W solvent,
- To provide revenue from the secondary systems to offset rising assessments, and
- To provide a service to the communities in D & W's service area by helping to curtail additional demand upon the cities culinary water sources.

Providing secondary water and rehabilitation projects on the canal has been a costly venture for D & W.

Providing secondary water to residents in their service area and completing rehabilitation projects on the canal has been a costly venture for D & W. Many of these projects have been funded through the assistance of loans from the Utah Division of Water Resources, assessments collected from shareholders and fees collected from secondary water users. Appendix A shows a brief history of significant events and decisions that helped shaped the company over the last 20 years. While D & W has completed numerous projects on the canal and the secondary water systems, questions have been raised about D & W's operations and financial viability.

Concerns Have Been Raised About D & W

In the 1980's, the company wanted to expand their operations to provide secondary water to the cities within their service area. In February 1988, the shareholders voted to commit one-half acre foot of water per share to the secondary systems so that D & W could enter the secondary water business. It depends on the year, but on average each share is worth 6 acre feet of water. However, some shareholders were and are concerned about D & W's ability to effectively operate the secondary water systems. Also, the committed one-half acre foot of water per share was expected to be temporary, and over the years some of the shareholders have questioned if the committed water will ever be returned.

D & W provides secondary water services to Clinton, West Point, parts of Kaysville, and parts of Layton.

The canal breach that occurred in July 1999, damaged property and created a large drain on D & W's financial resources.

With the one-half acre foot per share, D & W was able to acquire the necessary loans from the Utah Division of Water Resources. The loans were necessary for D & W to finance the construction of the up-front infrastructure required to begin providing secondary water supply services to local municipalities. The Board of Water Resources originally authorized $38 million for development of secondary water systems in D & W's service area. D & W incurred $23.5 million of debt to install the secondary water systems. Today D & W provides secondary water services to Clinton, West Point, parts of Kaysville, and parts of Layton.

Before D & W entered into the secondary water business, some of the D & W shareholders were worried about the condition of the canal. The canal was old and in need of additional repair in critical areas. One reason D & W wanted to expand their operations was to obtain additional revenue to repair the canal. The canal breach of 1999 created concerns about D & W's ability to repair the breach and pay for the damages.

Canal Breach Significantly Impacted D & W. The canal breach that occurred in July 1999, damaged homes, lawns, and gardens in Riverdale. The breach was very costly for D & W and weakened their financial viability. The Board of Water Resources deferred D & W's loan payments for one year. Due to the breach, D & W:

- Spent $2 million from their funds to repair the hillside where the breach occurred,
- Paid $492,000 in pumping charges to Weber Basin Water Conservancy District to deliver the water needed for the rest of the 1999 irrigation season, and
- Settled a lawsuit with Riverdale homeowners that were flooded by the breach for $8.3 million. The company's insurance coverage totaled $3 million, so the company had to borrow $5.3 million to cover the remaining amount of the settlement.

In addition, the company obtained loans for $4 million from the State of Utah Board of Water Resources, which was used to:

- Install 6,600 feet of pipe to enclose the section of the canal near the area where the breach occurred, and
- Relocate and install 1,200 feet of box culvert, and replace 2,300 feet of reinforced concrete liner to improve a section of the canal where the breach occurred.

The costs and additional debt resulting from the canal breach created a large drain of D & W's financial resources.

Some shareholders question how leasing up to 5,000 acre feet of water will affect their shares in the future.

Business Agreement Made by D & W May Create a Difficult Situation in the Future. In addition to issues raised about the finances and whether the committed one-half acre foot of water for the secondary systems will be returned to the shareholders, some shareholders have been concerned about another business agreement that D & W has made. D & W entered into an agreement in 1999 to permanently lease up to 5,000 acre feet of water to Summit Water Distribution Company (SWDC) to provide a perpetual revenue stream to rehabilitate the canal. Shareholders are concerned if D & W delivers water to SWDC, that it may reduce the acre feet of water per share of D & W stock.

Cities Involved in the Secondary Water Operations Also Have Questions. Over time as D & W's secondary water operations continued to grow, the cities involved in the secondary water operations—Clinton, Kaysville, Layton, and West Point—developed concerns about how effectively D & W is managing the secondary operations. The three main issues questioned by the cities are:

- Does D & W have the ability to pay back the $41 million for all of the loans that they have acquired for the canal rehabilitation project, to build the secondary water systems, and the lawsuit settlement?
- How has the revenue (user fees and hook-up fees) that D & W has collected from the secondary systems been spent?
- Has D & W secured adequate water for the secondary systems?

Some of the cities that D & W serve question whether D & W will be able to continue to provide services as the population in their service area continues to grow.

Some cities to which D & W provides secondary water have been concerned that D & W may not be able to continue to provide services as the population in their service area continue to grow.

Audit Scope and Objectives

Due to the questions about the financial position of the company, a performance audit of D & W's operations was requested by several legislators. We were asked to address the issues that the cities and some of the shareholders mentioned above.

We were specifically asked to review the financial management practices of D & W. We reviewed the company's:

- Accounting policies and practices,
- Budgeting process,
- Long-term debt – loans from the Board of Water Resources,
- Financial review of the Secondary Water Operations
- Use of assessments and fees,
- Capital Improvement Plan, and
- Existing contracts.

The audit scope also included a review of the adequacy of the water supply for the shareholders and secondary users. We also looked at the water needs for the secondary water operations at build-out. Build-out occurs when land within a city's limits is fully developed.

The objectives of this audit were to address questions raised about D & W's financial viability and operations. In order to accomplish this we evaluated D & W's:

- Current financial position,
- General canal operations,
- Secondary operations, and
- Water supply.

This evaluation was completed to determine what steps D & W should take in order to help improve operations and the financial viability of the company in the future. This audit report covers the following material.

Chapter II reviews the company's accounting practices and financial management practices.

Chapter III addresses the general canal operations of the company including: current financial position, the loans for the canal rehabilitation projects, and D & W's capital improvement plan.

Chapter IV reviews the secondary water operations including: the current financial position of the secondary water operations, loans for the secondary systems, and how D & W has spent revenue collected from the secondary water operations.

Chapter V looks at the hook-up fees D & W charged secondary water users to purchase water, the overall water used by the secondary systems and projected needs for the future.

This Page Left Blank Intentionally

Chapter II
D & W Needs Better Financial Information

This audit was initiated partly because of concerns raised by legislators and some cities about the financial practices of D & W. Among other concerns, the cities that have contracts with D & W to supply secondary water are concerned about the long-term financial viability of the company and three of the cities are concerned whether payments from city residents were properly accounted for and expended.

We believe that D & W can be financially viable, but it largely depends on the decisions of D & W administrators. Some of the financial practices of D & W made it difficult to respond to the cities' concerns. In particular, D & W's use of cash basis rather than accrual basis financial statements has made it difficult to assess the company's financial viability. Additionally, the commingling of funds received from different sources made it difficult to assess how payments by city residents were spent. We also believe that D & W's budget year should coincide with their fiscal year. By combining a strong budgeting process and planning for the future by building a reserve fund, D & W will be better able to keep their business well-managed.

D & W Should Rely on Accrual Basis Accounting

D & W should use accrual basis accounting rather than cash basis accounting to provide a better indication of the earnings and financial position of the company. Accrual accounting reflects all revenue and obligations whether or not they have been realized in cash. According to the Financial Accounting Standards Board (FASB),

Accrual accounting generally provides a better indication of a company's financial position.

> Information about enterprise earnings based on accrual accounting generally provides a better indication of an enterprise's present and continuing ability to generate favorable cash flows than information limited to the financial effects of cash receipts and payments.

Thus, by using accrual basis accounting, D & W will be able to provide better information about its long-term financial viability for its customers and shareholders.

During the audit we looked at financial statements of several water districts and those entities use accrual accounting. D & W has historically used cash basis accounting which may be appropriate for a simple business, but is not acceptable under generally accepted accounting principles. The cash basis of accounting has the advantage of being easy to understand, but does not provide a good measure for the performance of a complex business because it focuses on short-term cash flows.

Accrual Accounting Provides Better Information than Cash Accounting

D & W has long-term financial obligations that are not adequately recognized under cash basis accounting.

Accrual accounting includes information about a company's net income and financial position that is not available with cash accounting. When D & W was a less complex business with little debt, cash accounting may have been adequate for its needs. However, in recent years D & W has engaged in many transactions with long-term financial consequences that are not adequately recognized under cash basis accounting.

Cash basis accounting doesn't show the company's future obligations. For example, under cash basis accounting, a business can be going broke and still generate a positive cash basis income. A business, like D & W can generate a positive cash basis income annually, but not recognize the liabilities incurred such as accrued interest and accounts payable until they are actually paid. Although D & W has significant debt, it has not been shown on the cash basis statements provided to the shareholders each year. The figure below shows that as of October 31, 2003, D & W had $38 million in loans and it has been determined that D & W's debt has increased to $41 million by October 31, 2004.

Figure 1. D & W's Long-term Debt. It is essential that D & W's financial planning include long-term debt.

Purpose of Loan	Loan Balance as of October 31, 2003	Loan Balance as of October 31, 2004
Secondary Systems	$ 26,459,900	$ 26,967,700
Canal Improvements	6,296,800	8,843,800
Canal Breach Lawsuit Settlement	5,260,000	5,195,000
Total	**$ 38,016,700**	**$ 41,006,500**

Because it provides better information, accrual accounting is required by generally accepted accounting principles (GAAP). According to the Financial Accounting Standards Board (FASB),

> A basic premise of generally accepted accounting principles [is] that accrual accounting provides more relevant and useful information than cash basis accounting. . . . It provides information about an entity's assets and liabilities and changes in those amounts that cannot be obtained from information produced by accounting only for cash receipts and outlays.

Accrual accounting provides better information than cash accounting because it matches revenues with associated expenses. Transactions are recorded when they occur, even if cash is not received or disbursed at the time. Since D & W has incurred a lot of long-term debt including some with deferred interest payments, it is better to adopt the accrual method to obtain a better financial picture of the company.

D & W Is Starting to Provide Accrual Accounting Information

D & W made a first attempt to prepare accrual based financial statements for FY 2003.

D & W had their consulting accountant prepare accrual based financial statements for FY 2003, which was the first attempt to prepare those statements. All financial information included in those financial statements were provided by D & W to their consulting accountant. The consulting accountant did not audit the financial information provided by D & W.

Financial information provided to the accountant needs to be consistently applied to D & W's different lines of business and be accurate.

The FY 2003 annual shareholders report contained the cash basis financial statement—which is basically a cash flows statement. Also, the FY 2003 shareholders report contained a balance sheet—a statement of financial position; however, it did not include an income statement—a statement of activities.

A complete set of financial statements of a not-for-profit organization should include a statement of financial position, a statement of activities, and a statement of cash flows for the reporting period, and accompanying notes to financial statements.

The primary purpose of financial statements is to provide relevant information to meet the common interests of the board of directors, management, shareholders, municipalities, creditors, and other interested parties. The financial statements provide a tool in assessing the services an organization provides and its ability to continue to provide those services. Financial statements also assess the organization's liquidity, financial flexibility, ability to meet obligations, and needs for external financing.

Financial Statements Were Adjusted During the Audit

D & W's long-term debt has been understated in the past.

During the audit we went through the process of developing financial statements for D & W. Even though D & W had their consulting accountant prepare the unaudited financial statements, based on our audit work, some adjustments needed to be made. Some of the financial data we gathered was inconsistent with the data in the prepared financial statements. For example, long-term debt was understated because two loans for the secondary systems have accumulated deferred interest which was not included in the statement of financial position or statement of activities. Hook-up fees paid by secondary users should not be commingled with D & W's other revenue. In the past, the main purpose of the hook-up fee was to buy water shares for the secondary systems. The hook-up fees, less the one-time costs associated with new hook-ups —such as an inspection, should be kept in a separate restricted fund.

A Statement of Financial Position Helps Assess D & W's Ability to Continue to Provide Services. Below is the statement of financial position. This statement shows what we believe are the correct amounts. This statement of financial position focuses on the company as a whole.

Figure 2. Simplified Statement of Financial Position. D & W's long-term debt as of October 31, 2003 was $38 million.

As of October 31, 2003	Amount
ASSETS	
Current Assets	$ 2,997,400
Property and Equipment (net)	35,047,500
D & W Water stock (395 shares)	1,202,200
Other Water stock investments	1,350,300
Total Assets	**$ 40,597,400**
LIABILITIES AND NET ASSETS	
Current liabilities	$ 1,545,200
Long-term debt, less current maturities	37,582,600
Restricted net assets (purchasing water)	1,886,300
Unrestricted net assets	(416,700)
Total Liabilities and Net Assets	**$ 40,597,400**

When the restricted funds for water stock purchases are separated from net assets, a deficit in unrestricted net assets is revealed. This is the amount the company needs to make up in profitable operations in the future.

The Statement of Activities Show How D & W's Resources Are Used. The statement of activities is shown for the company as a whole for the year ending October 31, 2003. We also made other adjustments to the statement of activities. Revenue was less than what D & W determined because hook-up fees, less one time costs associated with new hook-ups, should be restricted to the purchase of water stock and placed in a separate fund. Plus two adjustments were made to other revenue accounts—rental income, and other income.

For the operating expenses, we capitalized engineering expenses and some salary expenses that went directly toward the Layton secondary water project. We adjusted interest expense to reflect the total interest incurred that fiscal year, which included the deferred interest amount on two loans for the secondary systems. We also recalculated depreciation expense. D & W agreed with our recalculations. Our statement of activities shows that expenses exceeded revenue by $700,000 for FY 2003. Assessments and fees should have been adjusted accordingly, to match revenue with expenses.

The statement of activities shows that expenses exceeded revenue by $700,000 for FY 2003.

Figure 3. Simplified Statement of Activities. For 2003, D & W's expenses for general canal and secondary operations exceeded revenue according to the adjustments that we made to the statement of activities.

For Year Ending October 31, 2003	Amount
Revenue	
Water Assessments	$ 1,000,000
Secondary Systems Revenue	2,065,700
Other Revenue	221,700
Total Revenue	**$ 3,287,400**
Expenses	
Operating Expenses	$ 1,315,500
Interest Expense	1,846,700
Depreciation	847,200
Total Expenses	**$ 4,009,400**
Over/(Under)	**$ (722,000)**

Note: Amount related to water purchases are excluded.

The statement of activities shown above, shows the importance of matching revenue and expenses. As noted, expenses exceeded revenue by $700,000 for FY 2003. We provided a separate statement of activities for the general canal operations, and another statement for the secondary operations. Those statements are shown in Chapter 3 and 4 of the report, where the secondary operations and the general canal operations are discussed separately.

The Purpose of a Cash Flows Statement Is to Provide Information about the Cash Receipts and Cash Payments of D & W During a Period. The Statement of Cash Flows for D & W for year ending 2003 is shown below.

Figure 4. Statement of Cash Flows for D & W. The statement of cash flows shows the short-term financial position of D & W.

For Year Ending October 31, 2003	Amount
Beginning Cash	**$ 1,412,600**
Cash Receipts	
Stockholder Assessments	$ 905,200
Secondary User Fees	1,976,700
Secondary Hook-up Fees	546,000
Loan Proceeds	415,600
Other Receipts	147,600
Total Receipts	**$ 3,991,100**
Cash Disbursements	
Loan Payments	$ 1,638,800
Other Disbursements	1,854,500
Total Disbursements	**$ 3,493,300**
Total Receipts Over Disbursements	**$ 497,800**
Ending Cash	**$ 1,910,400**

A statement of cash flows alone would be incomplete financial information and perhaps misleading. The figure above shows D & W had an ending cash balance of over $1.9 million, but when the statement of activities (Figure 3) is reviewed, we can see that expenses exceeded revenues by $700,000.

D & W should prepare complete accrual basis financial statements.

D & W should include complete accrual basis financial statements in their annual shareholders report. Without the statements of financial position and activities, the cash flow statement only shows the short-term financial position of D & W.

In the past, D & W has not known their financial position well enough. Also, it would be better if D & W kept the general canal operations and secondary operations separate for each statement rather than commingling the finances.

D & W Should Keep Funds Separate

Separate accounting records should be kept for each line of business. D & W is involved with two distinct lines of business: general canal operations, and secondary water operations. D & W should also keep a separate fund for hook-up fees which are intended for purchasing water for the secondary operations. D & W is currently pursuing another option to secure water by asking the cities to require new users to make available or purchase the water for their secondary water needs, which is discussed in Chapter V. By keeping funds separate, D & W will be able to have a clearer and more accurate financial picture of their operations, and provide better accountability to the shareholders and cities.

The general canal operations of the company include maintaining the canal and providing water to their shareholders.

The first line of business is general canal operations. The general canal operations of the company include maintaining the canal and providing water to the shareholders within D & W's service area. Shareholder assessments are the main source of revenue for general canal operations. Shareholders are assessed annually for each share of water stock they own. Shareholder assessments cover general operating expenses, including salary and benefits, utilities, vehicle expenses, and other expenses. Shareholder assessments cover the loans from the Board of Water Resources to complete sections of the canal rehabilitation projects, and the lawsuit settlement agreement to cover the damage caused by the canal breach that occurred in 1999.

The second line of business is the secondary water operations.

The second line of business is secondary water operations. For this line of business, the main responsibility of D & W is to provide secondary water to residential and city users. The revenue source for secondary water operations is the annual user fees. The revenue from secondary users should cover the direct and indirect secondary operating expenses, and the loans from the Board of Water Resources for the secondary water systems infrastructure. The secondary operations should also be assessed for the shares of water that they use, just as shareholders are assessed to cover their share of the canal operating expenses. It is not equitable for shareholders to pay for the committed water that the secondary systems are using.

Within the secondary operation's line of business, a separate fund should also be kept for purchasing water for the secondary systems. As new users are added to the systems, the water supply to serve them must be secured. In the past, developers have either purchased the water shares for new housing developments, or paid a hook-up fee for each new user. Hook-up fee revenue, less one time costs associated with new hook-ups, should be kept in a separate fund for the sole purpose of securing water. Each of these lines of business will be addressed in more detail in Chapters III, IV, and V of this report.

D & W has kept the revenue separate for the secondary water operations and the general canal operations coming into the company, but those funds have been commingled when the company's expenses have been paid. During the audit it was difficult to determine how the revenue received from the three sources had been spent. One of the complaints from three of the cities that use the secondary water is that D & W had not been able to provide them with a report detailing how the revenue from the secondary operations has been spent. Figure 5 shows the individual funds for D & W's different operations.

Figure 5. Simplified Statement of Activities by Fund for Year Ending October 31, 2003. Separate funds show a clearer financial picture for D & W.

	General Operations	Secondary Operations	Water Purchases	Total
Revenue	$ 1,221,700	$ 2,065,700	$ 853,300	$ 4,140,700
Expenses	1,564,900	2,444,500	164,600	4,174,000
Difference	**$ (343,200)**	**$ (378,800)**	**$ 688,700**	**$ (33,300)**

D & W should make a reasonable effort to allot expenses that cover more than one of the company's operations.

We realize that some of the indirect expenses are difficult to separate between the general canal operations and secondary operations, such as liability insurance expense that covers both operations. But, D & W should make a reasonable effort to allot expenses that cover more than one of the company's operations. We allocated indirect expenses to the general canal operations and secondary operations based on water usage and staff's time that was spent for each operation. We worked with D & W staff to allocate indirect expenses, and the staff agreed that the allocations were reasonable.

Special Service District Would Have Helped Avoid Commingling

Before D & W entered into the secondary water business, it was told to the shareholders and the Board of Water Resources that D & W planned on creating a special service district for the secondary water operations. However, D & W did not follow through on this proposal. Some shareholders believed that they were misled by D & W. Some shareholders may not have voted in favor of committing one-half acre foot of water per share for the secondary systems, if D & W had not proposed creating a special service district.

A special service district may be one approach that D & W could have implemented to keep secondary water operations separate from the general canal operations.

At the 1990 shareholder meeting, D & W reported to the shareholders that as they proceeded with the first phase of the secondary system in Kaysville, they were not going to form a special service district at that time because Kaysville City was already a public entity and Kaysville was going to manage their own secondary system—which they did until 1993. In 1990, D & W said that they would study each phase of the project and determine if a special service district may be warranted some time in the future. As of 2004, D & W has not formed a special service district. D & W reported that the company entered into an agreement with each of the four cities it serves under the privatization act.

A special service district is one approach that D & W could have implemented, or could still implement, to keep the financial operations of the secondary water systems separate from the general canal operations of the company. If D & W doesn't establish a service district, then D & W needs to keep financial operations of the secondary water systems separate from the general canal operations.

Budgeting and Reserves Are Essential for Financial Stability

To enhance their financial stability and improve their financial planning, D & W's budget year should coincide with their fiscal year. By combining a strong budget and planning for the future by building a reserve fund, D & W will be better able to manage their operations and be more attuned to potential signs of financial trouble.

D & W's Budget Planning Should Coincide with their Fiscal Year

Planning for the future centers around developing a good budget. Creating a fiscal year budget plan is a standard operating procedure. D & W's fiscal year is from November 1 to October 31. However, they plan their budget for September 1 to August 31 in order to send out assessment notices to shareholders in September to collect revenue for some loan payments that are due in the fall. We believe that D & W should budget for their fiscal year to manage the operations of the company more efficiently and effectively. Otherwise it is more difficult for D & W administrators to assess how efficiently the company is operating within their fiscal year. The purpose of a budget is to help administrators work within the constraints of managing an entity within a fiscal year.

D & W Plans to Build Up Cash Reserves

A cash reserve will help D & W address unforeseen expenses.

As part of the planning process, D & W is beginning to develop a reserve fund for the main canal and secondary water systems. A cash reserve will help D & W address unforeseen expenses that may arise throughout the year, expenses that would otherwise need loan assistance. The D & W Board of Directors will need to determine an appropriate cash reserve level.

Other water entities have established reserves to meet unexpected expenses throughout the year, and we view the establishment of a reserve fund as a prudent business practice. A reserve fund would help alleviate financial strains on D & W if and when an unexpected expense arose. As of this audit, D & W does not have excess funds. D & W will need to increase assessments and fees to build a reserve fund. This will be a potential hardship on shareholders.

In conclusion, when it comes to the details involved in budgeting, accounting data is an invaluable source of information. It is essential that D & W follow generally accepted accounting principles, maintain separate accounting data for each line of business, and use accrual basis accounting that can accurately and clearly describes the financial position of the company.

Recommendations

1. We recommend that D & W use accrual accounting and include statements of financial position, activities, and cash flows in their annual report.

2. We recommend that D & W keep funds separate for the general canal operations, secondary operations, and water purchases.

3. We recommend that D & W's budget year coincide with their fiscal year.

4. We recommend that D & W continue their plan to develop a reserve fund in order to meet unexpected expenses.

Chapter III
Shareholder Assessments Provide Revenue for General Canal Operations

General operations and canal rehabilitation projects are largely funded through shareholder assessments collected annually by D & W. In order to be a financially viable company, D & W needs to ensure that shareholder assessments accurately reflect their obligations and expenses each year.

D & W needs to ensure that shareholder assessments accurately reflect their obligations each year.

In order to meet financial obligations in the future, D & W will need to increase their assessments. Over the last fifteen years, D & W has borrowed about $15 million for capital projects to rehabilitate sections of the canal. Under accrual accounting, the operating expenses, interest expense, and depreciation combined exceeded revenues collected from assessments for FY 2003. Based on future projects listed in their capital improvement plan, shareholders should not expect assessments to decrease. Capital projects will continue to drive shareholder assessments.

D & W has made significant improvements in their planning of capital projects over the last five years. The development and implementation of a capital improvement plan for over half the length of the canal has helped D & W plan for projects. In addition, over the last 15 years D & W has completed capital improvement projects on sections of the lower canal's 7.6 miles making improvements to 9,925 feet of the canal. D & W should continue to improve their capital planning processes in order to enhance their economic viability in the future.

D & W should continue to improve their capital planning processes in order to enhance their economic viability in the future.

Because of concerns of shareholders over a possible future water shortage, water meters or other measuring devices may be needed to fairly allocate water to all users. Effective water measuring at the gates would allow D & W to control and properly distribute water to the shareholders and monitor and report water distribution activity. In addition to fairly allocating water, additional meters or other measuring devices would also help D & W maintain better records on water usage.

Shareholder Assessments Are too Low

Revenue raised from shareholder assessments is used to help finance the canal rehabilitation projects.

Revenue raised from shareholder assessments is used to help finance the canal rehabilitation projects. D & W currently owes over $14 million in loans for rehabilitation projects on the canal. Our financial review of the general canal operations for FY 2003 showed that assessments were too low to cover current expenses. Listed below are the loans that D & W has already received in order to address canal related projects and cover damages associated with the 1999 canal breach.

Figure 6. D & W debt incurred for canal related expenses. D & W has incurred about $15 million in debt from canal related expenses and from the lawsuit settlement.

Loan Purpose & Year Loan Secured	Original Loan Amount	Loan Balance for Oct. 31, 2003	Loan Balance for Oct. 31, 2004
Canal - 1993	$ 180,000	$ 90,100	$ 80,700
Canal - 1994	37,400	10,200	6,700
Canal - 1996	240,000	27,500	0
Canal - 2001	2,425,000	2,279,800	2,340,100
Canal - 2001	3,000,000	2,882,700	2,816,500
Canal - 2002	1,020,000	1,006,500	986,200
Canal - 2004	2,735,000	0	2,613,600
Lawsuit - 1999	5,310,000	5,260,000	5,195,000
Totals	**$ 14,947,400**	**$ 11,556,800**	**$ 14,038,800**

Most of these loans were used to replace sections of the old canal liner with reinforced concrete liner, concrete box culverts, or piping. D & W has already addressed a lot of the critical sections of the canal, and are planning on addressing other sections of the canal in the near future. Appendix B summarizes D & W's past and planned capital projects for the canal. The lawsuit loan, which was originally for just over $5.3 million, is for the lawsuit settlement that D & W entered into as a result of the canal breach of 1999.

General Operation Expenses Exceeded Revenue in 2003

Assessments need to be raised to meet operating expenses, interest expense, and to establish a reserve fund for the canal.

D & W's Board of Directors sets assessments annually. In FY 1999, before the canal breach occurred, shareholder assessments were $34 per share. Assessments increased to $68 per share from FY 2000 through 2002, then in FY 2003 assessments increased 47 percent to $100 per share. For FY 2004 assessments were increased 10 percent to $110 per share.

Looking back at FY 2003, we allocated income and expenses between the two main areas of the company, general canal operations and secondary operations. The figure below shows that general canal operations had a loss of $343,200.

Shareholder assessments should have been $135 for FY 2003 to cover expenses.

Figure 7. Statement of Activities for D & W's General Canal Operations. Shareholder assessments were set at $100 for FY 2003, but they should have been $135 to cover expenses.

General canal operations: For Year Ending October 31, 2003	Amount
Revenue:	
Shareholder Assessments	$ 1,000,000
Other Revenue	221,700
Total	**$ 1,221,700**
Expenses:	
Operating Expenses	$ 602,200
Depreciation	378,800
Interest Expense	583,900
Total	**$ 1,564,900**
Over/(Under)	**$ (343,200)**

We also reviewed general canal operations revenue and expenses for FY 2004. Assessments for FY 2004 should have been $139, instead of $110 per share, to cover direct and indirect operating expenses, interest expense and depreciation. The needed increase in shareholder assessments of $29 for FY 2004 is sufficient to cover expenses for this fiscal year.

Capital Improvement Plan Shows Increases in Loan Payments

Water share assessments and other revenue will need to cover existing loans for the canal and loans that are scheduled to be borrowed in the future. For the current loans, loan payments for the canal will continue to increase until 2005. From 2005 to 2017 annual loan payments remain constant, just over $1 million annually. If no changes were made, current loan payments would remain static for several years. However, according to D & W's capital improvement plan, D & W will need to spend an additional $21.7 million to complete projects scheduled to begin between 2005 to 2011. The Board of Water Resources has already authorized D & W to borrow $15.9 million to complete a majority of these projects.

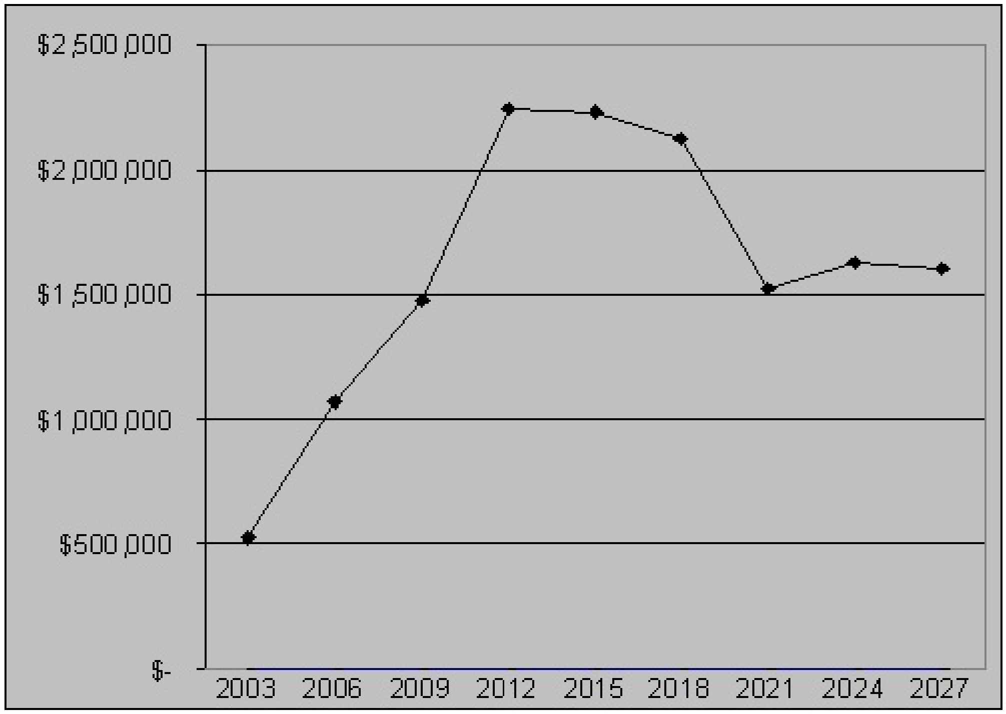
D & W's capital improvement plan shows an additional $21.7 million in capital improvements to be completed on the canal.

As stated above, the current capital improvement plan shows an additional $21.7 million in capital improvements that have not been addressed. Each of these projects are listed in Appendix B. Replacing the canal liner with reinforced concrete, box culverts, or piping are of the biggest concerns for D & W and account for most of the capital improvements still to be done.

Listed below in Figure 8, is a chart representing D & W's current annual loan payments for the canal with estimated loan payments for future projects, totaling $21.7 million, factored in.

Figure 8. D & W's Annual Loan Payments for the Canal with Projected Loans Factored In. D & W's annual loan payments for the canal will continue to increase until 2011, and then remain somewhat constant until 2017, with the first noticeable decrease in annual payments scheduled for 2019.

D & W can expect to see annual loan payments continue to increase until 2011.



D & W can expect to see annual loan payments continue to increase until 2011, when estimated future loans are factored in with current loans for the canal. We estimated a loan payment schedule for each of these projects, based on the structure of the current loans from the Board of Water Resources. According to past agreements with the Board of Water Resources, D & W can borrow 85 percent of the total projects' costs. We estimated future loan payment schedules on 85 percent of the total future projects' costs according to the time line in D & W's capital improvement plan. The estimated future loan payments were added to the current loan payment schedule to create the graph above.

As a result, from 2011 to 2017 annual loan payments will remain somewhat static being about $2.2 million per year. About 2018, D & W should start to see a decrease in loan payments if no other projects are added. By that time, additional projects may be needed. Shareholder assessments and other revenue will have to cover these expenses.

We also forecasted expected assessments for the next five years. Using the accrual basis of accounting, and D & W's capital improvement plan for the canal, we believe that assessments will need to continue to be increased to cover expenses. For FY 2005 assessments should be similar to FY 2004 at $139. By 2008, the assessments could be as high as $200 per share depending on when future capital projects are completed. After reviewing D & W's capital improvement plan for the canal, detailing future projects and needed O & M (operations and maintenance), shareholders should not expect assessments to decrease in the future.

Capital Improvement Planning Enhances D & W's Economic Viability

In 1999 and 2000, D & W developed a capital improvement plan for 48,000 feet or 9.1 miles of the canal from the point of water diversion to Riverdale. This plan covers the most critical areas of the canal and where the canal breach of July 1999 occurred.

The capital improvement plan that D & W currently has addresses over half the length of the canal.

The capital improvement plan that D & W currently has addresses over half the length of the canal. The canal is 16.7 miles long. D & W does not currently have a capital improvement plan for 7.6 miles of the lower canal. But we recognize that the 7.6 miles of canal that is not addressed in the current capital improvement plan is not in sloped areas, and is in fair operating condition. Over the last 15 years, D & W has completed 9,925 feet of capital improvement projects for the lower canal, and D & W told us that they are in the process of developing a capital improvement plan for the entire length of the canal in order to better plan financially for future projects.

D & W can further enhance their financial viability by continuing to plan for the future.

D & W can further enhance their financial viability by continuing to plan for the future. The development and implementation of a capital improvement plan for the canal has provided direction for the company. This project has included the following:

- Repairing the existing canal liner to minimize seepage.
- Replacing the existing non-reinforced concrete canal liner with new reinforced concrete liner and water-stop joints.
- Adding large sections of concrete box culverts.
- Piping portions of the canal.
- Working with Hill Air Force Base, who provided the funding, to reroute storm water facilities and eliminate retention ponds that allow water to percolate into the ground in the vicinity of the canal.
- Working with adjacent property owners to eliminate ponds and depressions that concentrate water near the hillside.
- Monitoring the hillside, adjacent to property owners, that may create risk to the existing slope.

D & W should continue to take steps as needed to plan for future capital projects for the canal and secondary water systems. This will help D & W prepare for future expenses and consider revenue sources to help stabilize the company's future financial viability.

Water Should Be Fairly Allocated to All Users

Water allocations have become a concern for shareholders because of increasing use of their water by non-shareholders. With the growth of the secondary water systems, more and more users have access to D & W's water supply. In addition, the business agreement between D & W and Summit Water Distribution Company (discussed in Chapter V) also may reduce the water available to shareholders. To ensure equity in the allocation of water to all users, D & W should take additional steps to measure and report water distributions.

Additional Water Meters or Other Measuring Options May Be Needed

Effective water measuring at the gates allows D & W to monitor and report water distribution activity.

Because of concerns of shareholders over water allocation, additional water meters or other measuring options may be needed to fairly allocate water to all users. Effective water metering or measuring at the gates allows D & W to monitor and report water distribution activity through each gate. Distribution records show that D & W has restricted water flow because of dry years in 1994, 1999, 2000 and 2003. Except for the four years when water flow was restricted, water distribution per share was constant at 0.028 cubic feet per second (cfs) since 1988. Although only some gates are measured, the equity of restrictions imposed on shareholders can be maintained by setting head gates equally based on available supply of water.

There are 67 gates along the canal and 22 of the gates can adequately read and measure water flow. Figure 9 shows the status of the gates distributing water from the D & W canal.

Figure 9. Water Metering Capability of Gates on the D & W Canal. Of the 67 gates along the D & W canal, 22 gates have meters that can adequately measure water flow.

Metering Capabilities of Gates On the D & W Canal	Total Number of Gates
No Measuring Device	39
Measuring Device	22
Measuring Device – Does Not Work	1
Installing a Measuring Device	5
Total	**67**

D & W needs to consider if placing meters or other measuring devices on each gate off of the canal would be beneficial to the company. Meters are expensive to purchase; it would cost approximately $450,000 to meter all the gates. If meters are determined to be too costly, D & W should explore other options to ensure water is fairly allocated to all users.

Additional measuring of the available water would help D & W maintain better records on water usage.

In addition to considering meters or other measuring options at all gates off of the canal, D & W needs to put forth more effort in reading the meters that they currently have. In the past, D & W records indicate that they have read and recorded one meter regularly. D & W administrators need to be diligent in regularly recording water flow from every meter.

In addition to fairly allocating water, additional meters or other measuring devices would also help D & W maintain better records on water usage. D & W should also provide an annual report that details water distributed to users; this would help assure shareholders and users that water is being distributed equitably.

Recommendations

1. We recommend that D & W assign direct expenses and use a formula to allocate indirect expenses to the company's general canal operations.

2. We recommend that D & W set shareholders assessments to cover their expenses for the general canal operations.

3. We recommend that D & W continue to develop and complete capital improvement plans as needed to keep the canal in good condition.

4. We recommend that D & W consider using additional water meters or other water measuring devices to help ensure water is fairly allocated to all users.

This Page Left Blank Intentionally

Chapter IV
Secondary Systems Need More Revenue

User fees cover secondary systems' expenses.

One of the questions that we addressed is how did D & W spend the user fees that have been collected from users of the secondary systems. Most of the user fees have been directly spent on the secondary systems. In the course of our audit we did not identify any inappropriate use of user fees collected by D & W from the secondary water users. However, expenses for the secondary systems and the general canal operations were not kept separate, so we had to estimate them. Based on our estimates there is $588,000 of unidentified expenses that may have been spent for canal breach repairs.

D & W borrowed money from the Board of Water Resources to build the secondary systems. The annual loan payments drive the user fee rate. The scheduled loan payments will continue to increase until the year 2026, but for the last fiscal year, 2003, the revenue from the user fees did not cover the expenses for the secondary operations. Since expenses will be increasing faster than projected revenue (from user fees at the current rate) for the next several years, D & W may need to increase user fees to cover expenses.

Most User Fees Were Spent on Secondary Systems

Most of the user fees have been directly spent on the secondary water systems.

One of the reasons D & W went into the secondary water business was to provide the company with an additional source of revenue. D & W has stated this objective from the beginning of the secondary water projects. However, the cities believe that D & W should only use the revenue generated from the secondary water users for the secondary systems and related expenses, but not subsidize the canal expenses. Two fees are collected from secondary systems' users: the user fees and hook-up fees. The user fees will be discussed here and the hook-up fees will be discussed in Chapter V. Most of the revenue collected from the user fees has been used directly for the secondary systems' obligations and expenses.

User fees need to cover all of the costs associated with the secondary systems. In the past no formula has been used to assess the indirect expenses. D & W should also have assessed the secondary users the proper amount for the secondary systems' share of the canal expenses by assessing the users for all water used by the secondary systems, including the committed water that the secondary systems use from the shareholders.

Since D & W has not kept all expenses for the general canal operations and secondary operations separate, we had to determine whether some expenses or a portion of an expense went to the general canal operations or secondary operations.

As part of the secondary operating expenses, D & W should have been assessing the secondary systems for the water committed from the shareholders that they have been using for several years, as discussed above. The total cost for the committed water used is estimated at about $256,000, and was added to secondary operating expenses in the figure below.

The figure below shows user fees collected since D & W went into the secondary water business. D & W has collected over $12 million in user fees, and has spent over $10 million towards the secondary operations, with $1.6 million in reserve.

Figure 10. A Review of Total Secondary User Fees. D & W has spent secondary user fees to cover loan payments and operation and maintenance expenses.

Use of Secondary User Fees Fees Collected and Spent from 1992 - 2003	Amount
User Fees Collected	$ 12,080,700
Interest Earned	426,000
Total Revenue	**$ 12,506,700**
Secondary Operating Expenses	4,300,000
Secondary Loan Payments	6,025,900
Secondary Bank Accounts Balance - Ending Oct. 2003	1,592,800
Unidentified Expenses (Estimated)	**$ 588,000**

Since we had to estimate some of the secondary operating expenses, the $588,000 in expenses that is unidentified could have been used for either the secondary operations or the general canal operations. D & W reports that some user fees went toward the canal breach repairs. Because expenses were not kept separate we were unable to verify how these funds were specifically spent.

User Fees May Need to Be Increased

User fees have not changed since they were originally determined.

The secondary water systems were built with loans from the Utah Board of Water Resources. A large portion of the user fees goes toward loan payments. In addition to loan payments, user fees must cover secondary operations. Total expenses for the secondary systems exceeded revenue by $378,800 for fiscal year ending 2003. Since secondary systems' expenses will continue to increase, user fees may need to be increased to cover expenses for the secondary systems.

Residents in Clinton, Kaysville, Layton, and West Point pay a $200 annual user fee for unmetered water. When the user fees were originally determined, they were based on the estimated population growth in the cities that use secondary water. The user fee was set at $156 per user to cover the loan payments. Then an additional $44 was added to the user fee to cover operating and maintenance expenses for the secondary systems, and an assessment to use D & W's water. The user fees have not changed since they were originally determined.

Significant Loan Balances Were Incurred to Build Secondary Systems

The secondary water systems were built using loans from the Board of Water Resources. For FY 2004, debt is $26.9 million for the secondary systems in Clinton, West Point, parts of Kaysville and parts of Layton. Listed below are the loans that D & W has received in order to complete the secondary systems in these cities.

Figure 11. D & W debt incurred for secondary systems. D & W has incurred over $23.5 million in debt to install secondary water systems to serve residents in Clinton, West Point, parts of Kaysville and parts of Layton.

Cities Loan(s) Service	Original Loan Amount	Loan Balance for October 31, 2003	Loan Balance for October 31, 2004
Clinton[1]	$ 3,400,000	$ 3,400,000	$ 3,400,000
Clinton & Layton[2]	6,375,000	6,421,100	6,523,700
Kaysville[3]	8,300,000	10,811,900	10,956,700
Layton[4]	545,000	299,600	543,400
West Point[5]	4,884,000	5,527,300	5,543,900
Total	**$ 23,504,000**	**$ 26,459,900**	**$ 26,967,700**

The Clinton (1) loan has 0 percent interest with the first payment scheduled for 2009; the Clinton & Layton (2) and Layton (4) loans increased from 2003 to 2004 because the loans were not fully dispersed; the Kaysville (3) and West Point (5) loans increased from 2003 to 2004 because interest has been greater than actual payments.

The Kaysville loan and West Point loan have created an additional expense because interest owed exceeded actual payments.

The outstanding loan balances, when originally secured for the secondary systems, were just over $23.5 million, but the loan balances at the end of FY 2004 is over $26.9 million. This increase in D & W's debt is a result of interest being greater than actual payments for two loans. D & W currently owes about $2.7 million more than they borrowed for the Kaysville loan and about $660,000 more than they borrowed for the West Point loan.

These two loans were designed so that for the first several years D & W's annual loan payments only covered a portion of the annual interest. The deferred amount was built into the loan schedule several years in the future. D & W is required to pay the deferred amount plus interest on the deferred amount. The structure of these two loans adds significant expense to the secondary water operations. For FY 2003 the deferred balance was $2.6 million.

Cost Sharing Enforcement on Board of Water Resources Loans Raise Concerns. Another concern with the secondary systems' loans is that it seems they were not implemented as approved by the Board of Water Resources. The Board agreed to loan D & W eighty-five percent of the secondary systems' costs if D & W paid the remaining fifteen percent out of their own funds. Actually, D & W spent much less than the required amount. According to records at the Division of Water Resources, D & W had water purchases of $3.9 million to meet its cost sharing requirement when D & W had actually spent only $1.1million.

According to Division of Water Resources staff, there was an unwritten agreement that D & W could satisfy its cost sharing obligation by purchasing water for the secondary systems. Under this agreement, D & W could use the loan proceeds to cover the full cost of designing and constructing the secondary water delivery infrastructure. In practice, as D & W built the secondary systems it submitted invoices for costs incurred to the Division of Water Resources. Based on those invoices, state staff calculated how much D & W needed to spend on water purchases to meet its 15 percent cost sharing obligation. Water Resources then disbursed the loan amounts required to pay for all the invoices submitted without requiring evidence that the required water purchases were actually made.

The Utah Division of Water Resources statements showed that D & W had spent $3.9 million to purchase water, when actually D & W had spent $1.1 million.

We found that D & W spent much less on water purchases than reported in Division of Water Resources records. State records show that D & W spent almost $3.9 million on water purchases to meet the cost sharing obligation for over $23 million in Board of Water Resources loans. Since D & W actually spent only about $1.1 million to buy water, the Board actually paid more than 85 percent of the cost of the projects.

Division of Water Resources staff states that the market value of the water committed to the secondary systems by shareholders likely exceeds 15 percent of the systems' cost. While we agree with that, some shareholders thought that the committed water would be returned to them because D & W was expected to purchase water for the secondary systems. As discussed in Chapter V, securing an adequate water supply for the secondary system remains a major concern.

Secondary Operations' Expenses Exceeded Revenue in 2003

Total user fees collected last year were about $2 million, but expenses exceeded revenue by $378,800 for fiscal year ending 2003. User fees may need to be increased to cover expenses for the secondary systems.

Because the cities have been concerned about secondary systems subsidizing more than their proportionate share of the canal expenses, the audit team and D & W staff developed a formula to allocate indirect expenses to the secondary operations. We believe that D & W should assign direct expenses to the secondary operations—including an assessment on the amount of shareholder water that the secondary operations use, and D & W should also use a formula to allocate indirect secondary operation expenses—those costs that are shared among all shareholders and water users, including general overhead. Users fees should also cover the interest expense for the loans obtained from the Board of Water Resources and depreciation. The figure below shows the accrual basis statement of activities for FY 2003 showing the revenue and expenses for the secondary water operations.

Figure 12. Statement of Activities for the Secondary Systems. Secondary systems' expenses exceeded revenue by $378,800.

Secondary Systems Operations For Fiscal Year Ending October 31, 2003	Amount
Revenue:	
User Fees	$ 2,045,100
Other Revenue	20,600
Total	**$ 2,065,700**
Expenses:	
Operating Expenses	$ 713,300
Depreciation	468,400
Interest Expense	1,262,800
Total	**$ 2,444,500**
Over/(Under)	**$ (378,800)**

The statement of activities above shows the expenses that the secondary operations should have paid in FY 2003. While actual population growth has exceeded the estimated population growth and user fees collected have been more than originally expected, the user fees did not cover all of the expenses for FY 2003.

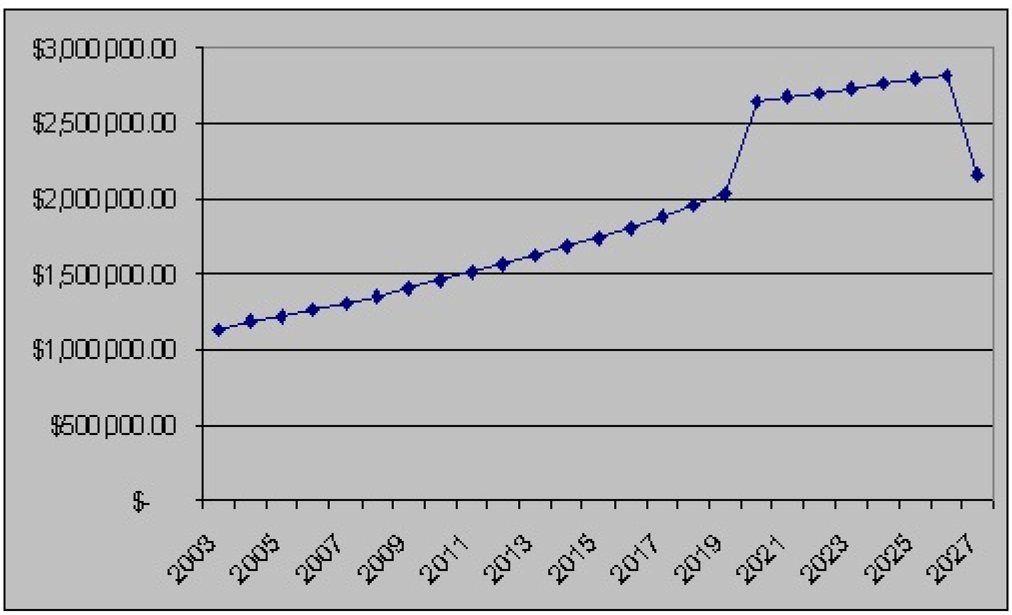
It appears that most of the shortfall is caused by operating expenses exceeding the amount of user fees available to cover them. The user fee was originally set at $200 to provide $156 for loan repayment and $44 for operations. Thus, 22 percent of the user fee, or about $450,000 in FY 2003 is available to pay for operating expenses. However, as shown in Figure 12, operating expenses were about $713,000 last year. Therefore, operating expenses exceeded the amount of user fees available to pay for them by about 58 percent, or $263,000.

Secondary Expenses Will Continue to Increase

D & W is on the front-end of paying back the loans to Water Resources. The current loans will not be retired until 2038. The figure shown below is a chart representing D & W's annual loan payments for the secondary systems loans.

Total loan payments for the secondary water systems are scheduled to continually increase through 2026.

Figure 13. Loan Payments for the Secondary Water Systems. User fee rates need to be set to cover loan payments.



Annual loan payments are scheduled to continually increase through 2026. Payments will increase in 2026 to $2.8 million from $1.1 million in 2003, which represents a 150 percent increase in that time period. Loan payments for the secondary systems were designed to increase over the life of the loan to coincide with population growth which will add new users to the system. The annual loan payment for the Kaysville loan will increase by $600,000 in 2020, this is shown by the sudden change of the slope in the line graph above. This figure is based on the assumption that no additional debt for the secondary systems is acquired by D & W.

We projected future expenses and user fees for the secondary operations for the next several years. At the current fee structure, we believe that D & W will incur a loss of almost $1 million total for the next five years. While revenue will increase as new users connect to the secondary systems, we project that expenses will continue to out-pace the revenue growth from the user fees until at least the year 2008. The D & W Board, with the cities, should consider raising the cities' user fees to adequately cover projected expenses. For the secondary operations to break-even in FY 2003, D & W would have had to raise their user fees by 20 percent.

D & W May Incur More Debt for Future Infrastructure Needs. In discussions with city officials, they expressed concerns with the current infrastructure of D & W's secondary systems. They are concerned that the existing infrastructure may not be able to accommodate expected growth and development. According to D & W, in 2004 operational changes to secondary systems allowed for more efficient operations. D & W reports that there should not be a need for more infrastructure until 2009.

The population growth in West Point and Clinton has been more than what was anticipated when the secondary systems were designed. D & W's engineering firm used the Governor's Office of Planning and Budget population growth estimations in designing the secondary systems, but actual growth in 2003 has exceeded estimated growth for 2010 for these two cities.

City officials expressed concerns that under current conditions D & W will not be able to provide water to accommodate the expected growth.

To keep up with growth, West Point and Clinton need additional infrastructure such as transmission lines and a reservoir site for water storage. City officials expressed concerns that under current conditions D & W would not be able to provide water to accommodate the expected growth in the cities that D & W serves. D & W already has millions of dollars invested in the secondary systems and it would be to their benefit to develop a capital improvement plan for all of their secondary systems as the company moves forward. Depending on how much additional infrastructure is needed in the future, D & W may need to obtain additional loans, which would further increase user fees.

Recommendations

1. We recommend that D & W assign direct expenses and use a formula to allocate indirect expenses to the secondary operations.

2. We recommend that D & W, with the cities, set user fees to cover expenses for the secondary operations.

3. We recommend that D & W develop and complete capital improvements plans for the secondary systems as needed.

This Page Left Blank Intentionally

Chapter V
Future Water Supply Is a Concern

Cities have expressed concern that the water supply will not be able to keep up with the population growth in coming years.

While the water supply has been adequate to meet past and current needs for the secondary systems, there is justification for concern by users regarding D & W's ability to meet future demands for water. The cities have expressed concern that the water supply will not be able to keep up with the population growth in coming years. We believe this concern may be validated by the following three issues:

- D & W has spent a significant amount of hook-up fees, that should have been used to purchase water, on canal breach repairs.
- D & W will need to secure a significant amount of water to meet water commitments for the secondary systems at build-out; but the cost to purchase water has increased significantly.
- A 1999 lease agreement with Summit Water Distribution Company could limit D & W's water supply from East Canyon Reservoir.

As the population continues to increase in the D & W service area, D & W needs to continue to work with the cities and Weber Basin Water Conservancy District to revise existing agreements to provide adequate water for the secondary systems in the future. We believe that D & W has developed a reasonable approach by asking the cities to require water shares to be purchased or made available by new users for areas being developed within the respective cities. Otherwise, D & W may need to increase hook-up fees to buy the water shares, or obtain water from other sources.

Hook-up Fees Were Spent on Canal Repair

A majority of hook-up fees collected were spent on the canal breach and other canal maintenance. D & W collects an initial hook-up fee from the secondary water users. This fee, less one time costs associated with new hook-ups, has been intended to buy water shares for the secondary water systems. This revenue source should be put in a separate fund and used only to acquire water. However, D & W has spent a significant portion of these fees on canal projects.

D & W Has Spent About One-third of the Hook-up Fees to Purchase Water

Figure 14 shows a summary of the hook-up fees collected and the amount spent to purchase water. Through 2003, D & W had collected $3.2 million in hook-up fees. One time costs associated with the hook-ups were $259,400, leaving almost $3 million for water purchases. However, D & W only spent about $1.1 million of the hook-up fees collected to buy water.

Figure 14. Use of Secondary Hook-up Fees. D & W has spent hook-up fees to buy water shares and pay for the canal rehabilitation.

Use of Secondary Hook-up Fees Fees Collected and Spent from 1992 - 2003	Amount
Hook-up Fees Collected For Water Purchases	**$ 2,970,900**
D & W Water Shares Purchased (364 shares)	1,020,500
Kaysville Irrigation Shares Purchased (47.5 shares) (water is used in Kaysville City)	64,100
Difference	$ 1,886,300

Note: In addition, $235,900 worth of water shares was secured by D & W in lieu of cash for use in the secondary systems.

D & W reports that they used hook-up fees to help repair damage caused by the 1999 canal breach. D & W paid $2.5 million for that project, so they could deliver water to the shareholders and users of the secondary systems. But they were not able to obtain a loan from the Board of Water Resources for the hillside restoration where the breach had occurred. Therefore, D & W used a significant portion of the $1.9 million difference, shown in Figure 14, on the hillside restoration project. The remainder of the $1.9 million in hook-up fees received since the canal breach repairs have apparently been spent on other canal improvement projects.

If the breach had not occurred, D & W could have purchased more shares for the secondary systems.

If the breach had not occurred, D & W could have purchased the water shares needed for the secondary systems. We estimated, at that point in time, that the $1.9 million would have bought enough shares to meet most or all of the water needs through 2003—assuming the purchases didn't push the price of the water shares up. This includes buying enough shares to return the committed acre feet of water to the shareholders that will be discussed in the next section of the report.

However, we looked at the number of shares D & W purchased from 1988 to 1999 before the breach occurred, and we believe that D & W did not purchase as many shares as they could have for the secondary water systems during that time. D & W reported that in some instances the cities did not cooperate in fulfilling their agreement with D & W. According to the agreements, the cities are required to give D & W the first opportunity to purchase water shares when land was sold within the cities' boundaries. This would have helped D & W secure shares for the secondary systems.

D & W Will Need to Secure a Significant Amount of Water for the Secondary Systems

D & W is responsible to provide adequate water to the secondary systems.

D & W needs to carefully plan for its future water needs because according to the contracts with the cities, D & W is responsible to provide adequate water for their needs. The secondary water systems are currently using all the shares of water that have been allocated to the secondary systems including D & W treasury shares, the committed shares from the shareholders, and shares in the Kaysville Irrigation Company. Since the secondary systems are growing, D & W must secure additional water to meet future water needs. Otherwise, the acre feet of water per share will be reduced in the future.

D & W is continuing to consider alternatives to secure additional water for the secondary systems. In the past, new users could buy water shares for their property or pay a hook-up fee in lieu of buying water shares. In the future, D & W wants the cities to require that developers acquire the water needed to serve new users. Then D & W would charge a hook-up fee to pay for one time connection costs.

Committed Water Has Helped D & W Meet Past Water Needs

In February 1988, a shareholder meeting was held to approve D & W's entry into the secondary water business. In that meeting the shareholders voted to commit one-half acre foot of water per share for use in the secondary water systems. In a letter sent to the shareholders before the meeting, D & W stated that it was the goal of the company to secure shares for the secondary water systems as funds became available and return the committed acre feet to the shareholders. However, no deadline was ever set for when the committed acre feet of water would be returned.

D & W has not been able to return the committed shares of water to the shareholders as was originally intended.

According to D & W's management, D & W needed the committed half-acre foot of water from each shareholder so the secondary systems would have sufficient water in the initial phases. However, D & W has not been able to return the committed acre feet of water to the shareholders as was originally intended.

With the use of the committed water, D & W has had sufficient water to meet secondary systems needs in the past. The company consists of 10,000 shares of D & W stock. D & W has 395 treasury shares and Kaysville City owns 121.5 shares, that totals 516.5 shares of D & W stock that are fully dedicated to the secondary systems. In addition to the D & W shares, D & W and Kaysville City also own water shares in the Kaysville Irrigation Company that are used in the D & W secondary water systems. Also, the secondary systems have water committed from D & W shareholders, as mentioned above. The shares available to borrow one-half acre foot from is currently 9,483.5, which amounts to 4,742 acre feet of water. The figure below summarizes the water available for use in the secondary water systems, including the committed water from the shareholders.

Figure 15. Water Available for Use in the Secondary Systems. Between D & W and Kaysville Irrigation Company there is currently 9,727 acre feet of water available for the secondary systems.

Water Available for Use in Secondary Systems	Acre Feet
D & W Water	
owned by D & W (395 shares)	2,370
owned by Kaysville City (121.5 shares)	729
Kaysville Irrigation Company Water	
owned by D & W (211 shares)	633
owned by Kaysville City (487.5 shares)	1,463
Total Permanently Dedicated Water	**5,195**
Committed Water from 9483.5 shares of D&W stock owned by shareholders other than Kaysville and D&W	4,742
Total Available Water	**9,937**

Note: D & W shares are equal to an average of 6 acre feet of water per share. Kaysville Irrigation shares are equal to 3.0 acre feet of water per share.

Since not all of the water that serves the secondary water systems is metered, D & W had their engineer calculate the amount of water that the secondary water systems used for the 2003 watering season. As shown in Figure 16, about 10,000 acre feet of water was used in the secondary water systems in 2003. In addition, the engineer estimated that D & W will need to have available an additional 18,000 acre feet of water over the next 30 plus years as the cities grow towards build-out.

Figure 16. Water Used and Needed By Secondary Water Systems. As the number of hook-ups increases for the secondary water systems, water must be purchased or D & W shares of stock will be reduced.

Water Used by the Secondary Systems in 2003	Acre Feet
Estimated Number of Acre Feet Used in 2003	10,000
Total Water Available	9,937
Estimated Deficit for 2003	**63**
Water Needed to Be Secured for Secondary Systems When Cities Reach Build-out	
Estimated Water Needed at Build-out	28,000
Total Water Available	9,937
Estimated Water Needed to Secure for Build-out	**18,063**

The secondary water systems are likely using more water than is dedicated to the systems.

The figure above shows that the secondary water systems likely used only slightly more water than was dedicated to the systems in 2003. Thus, it appears that there has been sufficient water, (with the use of the 4,742 acre feet of water committed by shareholders) every year to provide adequate water for the secondary systems in the past. However, for future growth, more water will need to be secured.

D & W Is Working to Obtain Needed Water

The secondary systems will need to secure about 18,000 acre feet of water to serve the secondary water systems at build-out.

D & W's engineer estimated that a total of 28,000 acre feet of water for the secondary systems will be needed when the four cities involved in the secondary systems reach build-out in 30 to 40 years. Since D & W currently has only 9,727 acre feet of water committed to the secondary systems, D & W will need to secure at least 18,000 more acre feet of water to serve the secondary systems at build-out. If D & W were going to return the water committed by shareholders, an additional 4,742 acre feet of water would be needed.

As mentioned earlier in the chapter, new users can either buy water shares or pay a one-time hook-up fee. This hook-up fee was designed to provide funds for D & W to buy water shares in order to provide water to the secondary systems. D & W is obligated, under the current agreements with the cities, to provide the water. However, the average price per share has increased dramatically, and the hook-up fee rate has not changed since the rate was originally set. Agreements with the cities reflect the need for periodic changes in rate structures, so the hook-up fee can be adjusted to reflect the current market rate to buy water. In 2002 the average price per share was $3,500, and, according to D & W, water is currently selling for about $18,000 to $20,000 per share. The hook-up fee rate is too low to buy shares of stock at the current rate to provide water for the secondary systems.

D & W Is Working on a Plan to Secure Water for the Secondary Systems. D & W is working to procure four trilateral agreements with each of the four cities that they serve, and with Weber Basin Water Conservancy District. With these agreements D & W is identifying water sources to provide water for the cities, such as Weber Basin Water Conservancy District, Kaysville Irrigation Company, Hooper Irrigation Company, and others.

D & W is asking the cities to require new users to purchase or make available water for the secondary systems.

As part of these trilateral agreements D & W is asking the cities to require new users to purchase or make available water rather than paying a hook-up fee, since the price of water has increased dramatically over the last two years. We believe this is a reasonable approach. If these agreements become effective, D & W will no longer be purchasing water for the secondary systems. However, if the cities do not agree that developers should purchase the water for future developments, D & W will still have the responsibility to provide water for the secondary systems.

D & W needs to carefully plan for the future in order to secure adequate water.

If D & W cannot procure the trilateral agreements, they may have to pursue an increase in the hook-up fee in order to purchase the water needed to support the secondary systems. D & W shares now cost far more than they did when the hook-up fee amount was set. Therefore, the fee will not provide enough revenue to buy the water needed unless the cost of D & W shares decreases or a less expensive source of water is found. For example, if water is selling at $20,000 per share, it would cost D & W about $60 million to buy the needed water for the secondary systems at build-out. Since hook-up fees, at their current level, would provide D & W only about $10 million, there would be a shortfall of about $50 million. Thus, if the trilateral agreements are not finalized, D & W would need to work with the cities to increase the hook-up fee.

D & W May Never Return the Committed Acre Feet to the Shareholders. Although D & W's goal has been to return the water committed by shareholders to them, it may never do so. At the current price of D & W shares, it would cost over $15 million to buy enough shares to return the committed water to shareholders.

Future Water Shortages Are a Concern for All Users

Some of the cities and shareholders are concerned that the water supply will not be able to keep up with the population growth in coming years. Shareholders are not only concerned about if and when the committed acre feet of water for the secondary systems will be returned to them, but they are also concerned about D & W's agreement with Summit Water Distribution Company.

1999 Lease Agreement Could Limit Water Availability

In 1999, D & W entered into an agreement with Summit Water Distribution Company (SWDC) to make available up to 5,000 acre feet of water from East Canyon Reservoir per year for a fee. The water deliveries called for by this agreement is contingent on SWDC having a water pipeline connecting the East Canyon Reservoir to the Summit County distribution system by 2009. If D & W delivers the water to the SWDC, up to 5,000 acre feet per year will be permanently transferred out of D & W's service area. The shareholders voted to lease 5,000 acre feet of water to SWDC to provide revenue to repair the canal.

At the time, this agreement was viewed by the D & W Board of Directors as a good move for the company because it would provide another source of revenue. Even though up to 5,000 acre feet of water could be permanently allocated SWDC, the D & W Board felt that because of conservation efforts on the canal about that much water would be saved each year. The conservation efforts on the canal included relining the canal with concrete and installing box culverts which would limit seepage and evaporation. While it is acknowledged that water will be saved through these conservation efforts, the actual amount of water saved is uncertain.

If SWDC completes the pipeline by 2009, we believe the D & W board should carefully review the contract terms and explore its options. The reason for caution is that, as discussed earlier in this chapter, water supply has become a significant concern for D & W. Because the pipeline has not been completed, and no water has been delivered, some questions remain about how the contract would be implemented. If the pipeline is not completed by 2009, the contract will expire without affecting D & W's water supply.

One question we have involves how much water D & W would be required to provide to SWDC. According to the contract, "to the extent possible, D & W will make available 5,000 acre feet of water per year to SWDC." However, "in the event that D & W cannot provide all or any portion of the 5,000 acre feet," then SWDC shall dedicate sufficient shares of D & W stock to cover the amount of water being diverted. Since D & W is currently in a difficult position trying to locate water sources to provide sufficient water for the secondary systems, we believe that the board should explore whether the company has to provide water to SWDC. Certainly, to the extent that SWDC owns D & W shares, it doesn't harm D & W's water supply.

A second question involves whether D & W shares must back all water deliveries to SWDC. In approving the change application to deliver the water to the SWDC pipeline, the State Engineer required that "A total of 714.3 shares of stock in D & W are to be dedicated to this project" from East Canyon Reservoir. Those shares are enough to provide 5,000 acre feet of D & W water based on 7 acre feet per share. As discussed earlier, D & W owns 395 shares of treasury stock, but they are dedicated to the secondary system needs. Further, buying more treasury stock seems prohibitively expensive for D & W. According to D & W's attorney, the company would probably seek a modification in the State Engineer's ruling if SWDC completed the pipeline. We believe that D & W should develop a strategy on how it would deliver the water to SWDC. Even if this water provided is not tied to specific stock, it could reduce the water available to the company by one-half acre foot per share from East Canyon Reservoir.

Recommendations

1. We recommend that D & W keep hook-up fees, less one time costs associated with hook-ups, in a separate fund to purchase water stock.

2. We recommend that D & W make an effort to renegotiate their contracts with the cities to require new users of the secondary systems to provide the water.

3. We recommend that D & W determine how much water they have to deliver to SWDC, and develop a strategy to make the water available under the terms of the contract.

Appendices

APPENDIX A

Timeline of Significant Events That Helped Shape D & W From 1984 to Present. Significant events and decisions that helped shape D & W, from 1984 to present. Information obtained from minutes of D & W Board and Stockholder meetings.

DATE	**EVENT**
1984	Canal is in need of repair and upgrading.
1985	Company is set-up for agricultural irrigation, but area is changing. D & W needs to prepare for the future.
1986	Directors trying to keep assessments down, but company needs additional revenue.
1987	Water Decree based on 40,000 acres, but only irrigating approximately 32,000 acres. Secondary systems presented as an option to keep water in area and protect stockholders from rising assessments.
1988	Secondary systems proposal given to shareholders as a means to keep the company sound and to not loose their water rights.
1988	Proposal to create a special service district to manage secondary systems. Secondary systems is approved by a majority of the shareholders.
1988	5,000 acre feet of water committed to the secondary systems and approval given to obtain loans from the State. First phase of project will be in Kaysville.
1988	D & W obtains approval of funding in the amount of $38 million to install secondary water systems in D & W's service area.
1989	Kaysville secondary systems installed.
1990	D & W presented to the shareholders that D & W may need to create a special service district, but currently not needed. Letter sent to all stockholders stating that the company will purchase shares of stock as funds become available in order to revert the 5,000 acre feet of water borrowed for the secondary systems back to the shareholders.
1991	At the shareholders meeting, goals for secondary systems stated: Keep the water in the area, stabilize the assessments, add another source of income for the company. Roy Subdistrict states that there is a need for a plan to maintain and improve the canal. Argument presented that forming a special service district for the secondary systems would make D & W a public company.
1992	Shareholders voted to turn Bambrough Irrigation Company shares over to D & W.
1992	West Point secondary systems installed.
1995	D & W needs to come up with a new source of revenue to cover operation and maintenance for the canal.
1995	Clinton secondary system installed.
1996	Proposal for a perpetual lease of 5,000 acre feet of water per year to Summit Water Distribution contingent on a study to see if D & W has enough water.
1997	D & W manager states that the company has allocated funds to purchase available water stock.
1999	D & W canal breached, causes damage to land and homes.
1999	D & W shareholders seek avenues to fund needed repairs to the canal, including loans from the State. Agreement in place with Summit Water Distribution for $160 per acre foot per year.
2000	Layton secondary systems installed.
2001	Company now in debt $5.3 million from lawsuit relating to the canal breach, company needs to find ways to repay the debt.
2002	D & W takes over the West Layton Irrigation Company and lays 2.5 miles of HDPE pipe to serve West Layton.
2003	Vote to approve amended and restated Articles of Incorporation and Bylaws.

This Page Left Blank Intentionally

Agency Response

Davis and Weber Counties Canal Company
138 West 1300 North, Sunset, UT 84015-2918   (801)774-6373

December 15, 2004

John Schaff
Auditor General
West 315 State Capitol Complex
Salt Lake City, Utah 84114-0151

Dear Mr. Schaff:

This letter is written in behalf of the Davis and Weber Counties Canal Company, a private non profit shareholder company, engaged in the distribution of agricultural and non-treated water in the Davis and Weber Counties area, with water sources from the Weber River, Echo and East Canyon Reservoirs.

DAVIS AND WEBER COUNTIES CANAL COMPANY
RESPONSE TO RECOMMENDATIONS IN THE REPORT

The Legislative Audit Supervisors Mr. Rick Coleman and Mr. Wayne Kidd have made fourteen observations in this report regarding Davis and Weber Counties Canal Company (DWCCC) to which we are hereby responding as follows:

I. ACCRUAL ACCOUNTING. It is recommended that DWCCC use accrual accounting and include statements of financial position, activities, and cash flows in their annual report.

DWCCC beginning the 2004 budget year will have the accounting system on the accrual method and will provide the stockholders with complete reviewed financial statements at their annual meetings.

II. FUND ACCOUNTING. It is recommended that DWCCC separate funds for the general canal operations, secondary operations, and water purchases.

DWCCC with accrual accounting funding has now separated general canal operations funding and expenses from the secondary operation funding and expenses. Funds used to purchase water in the past are clearly identified and assigned to the systems. The future water acquisitions will require those developing the property or changing the use from agriculture to residential lawn and garden to bring and/or purchase the necessary water. The development of the TRILATERAL AGREEMENTS between DWCCC, Weber Basin Water Conservancy District and the four cities in the service area will ensure that the necessary water is available and the capital component to be borne by the development taking place on the land.

Through already adopted ordinances two of these cities along with DWCCC and Weber Basin Water Conservancy District have signed the newly developed Trilateral Agreements that ensure water to be provided within these service areas. Three cities have also adopted and passed ordinances that will require water to be provided by the developments in an exaction process.

III. BUDGET YEAR VS. FISCAL YEAR. It is recommended that DWCCC's budget year coincide with their fiscal year.

DWCCC beginning this year will include the budget year with the fiscal year. However due to the loan payments that are due to the State Board of Water Resources and also by request from some of the share holders, we will conduct a pre budget analysis during the month of July each year.

IV. RESERVE FUND. It is recommended that DWCCC continue to develop a reserve fund in order to meet unexpected expenses.

DWCCC this year has identified separate reserve funds for the main canal general operations and the secondary system. The reserve will be calculated based upon engineering estimates of projected replacement costs. The approved budget for 2005 includes $50,000 for the main canal reserves, and $180,000 for the secondary system reserves. This analysis includes the completion of the capital facilities plan for the secondary system that is now underway.

V. EXPENSES AND PROPER ALLOCATION. It is recommended that DWCCC assign direct expenses and use a formula to allocate indirect expenses to the company's general canal operations.

Total canal expenses are allocated to the main canal and to the secondary water system based on the amount of water delivered to each, currently 17.2% to secondary system and 82.8% to general canal operations. Administration and general office expense are based on actual time spent, currently 75% of total to secondary and 25% to canal operations. Other general expenses are divided equally or 50% to Secondary and 50% to canal operations. Equipment use is expensed to the secondary system based on their usage.

VI. ASSESSMENTS NEED TO COVER EXPENSES. It is recommended that DWCCC set shareholder assessments to cover their expenses for the general canal operations.

DWCCC has set up a budget to cover expenses and set up a reserve account for the general canal operations starting in the year 2005. The shareholder assessment is set at $145.00 per share on 10,000 shares. The secondary annual fees will be recommended to the cities within the service areas and will need to be approximately between $245.00 and $256.00. It will also reflect a reserve component for amortization and emergencies. The agreements with the cities are being amended to include the ability to have these fees reviewed jointly on an annual basis.

VII. CAPITAL IMPROVEMENT PLANS. It is recommended that DWCCC continue to develop and complete capital improvement plans as needed to keep the canal in good condition.

DWCCC in 2004 updated the canal general operations capital facilities plan and is in the process of completing a new secondary operations capital facilities plan that will be reviewed yearly and updated periodically. These plans are budgeted for 2005 and will be implemented.

VIII. WATER MEASURING DEVICES. It is recommended that DWCCC consider using additional water meters or other water measuring devices to help ensure water is fairly allocated to all users.

DWCCC as part of the long term plan will install meters, weirs, staff gauges, and orifice plates to better measure and control the fair distribution of water. There were many of these devices installed in 2004. A large number will be installed and constructed in 2005, including large ultrasonic meters on the discharge structures of the 3 main reservoirs which will also include a monitoring system. All information will be read and recorded regularly as is presently being done. All shareholders utilizing the canal will be allocated the same allotment in cubic feet per second per share.

IX. DIRECT EXPENSES AND INDIRECT EXPENSES FORMULATION. It is recommended that DWCCC assign direct expenses and use a formula to allocate indirect expenses to the secondary operations.

Direct expenses are allocated to each city based on their actual expenses, i.e., salaries, engineering, attorney, equipment use, payroll expense, billing, etc. Direct expenses charged to the overall secondary system, i.e., blue stakes, loan interest, tools and small equipment purchases are expensed to each city based on their current percentage of total hook-ups. Indirect expenses are based on the following: Administration and general office expense are based on actual time spent, currently 75% of total. Canal expense is based on the amount of water delivered to the secondary system (currently 17.2%) and will change each year based on the amount of water delivered to the secondary system. Other general expenses are divided equally between the secondary and canal operations. The total amount of indirect expenses is then expensed to the cities based on their percent of the total current hook-ups.

X. USER FEES SHOULD COVER SECONDARY EXPENSES. It is recommended that DWCCC with the cities set user fees to cover expenses for the secondary operations.

DWCCC is revising the fees for each service area and respective cities within the service area as a part of the amended contracts. They will reflect appropriate rate structures to satisfy expenses. These agreements will build in an opportunity for the DWCCC and CITIES to review the rate structure at least annually. The capital facilities plan will be tied to this and will include a reserve account for amortization purposes. All fees will be identified and kept in appropriate city accounts for accounting purposes to cover direct and indirect expenses. Separate bank accounts are maintained for each city at the present time.

XI. CAPITAL FACILITIES PLANS FOR SECONDARY. It is recommended that DWCCC develop and complete capital improvement plan for the secondary systems as needed.

DWCCC's Board of Directors approved the development of a Secondary Capital Facilities Improvement Plan in 2004. It is under way and should be completed by early 2005. It is the goal of management to review this plan yearly and make appropriate updates and changes periodically. It will be separated into service areas. It will be designed to be flexible, accountable, and manageable. The components will include city build outs, water quantification, fees, financing, reserves, accounting and other pertinent information.

XII. HOOK UP FEES AND WATER STOCK. It is recommended that DWCCC keep hook-up fees, less one time costs associated with hook-ups, in a separate fund to purchase water stock.

DWCCC has separated these funds and also the water voted by the shareholders to be assigned for secondary water service. These will be accounted to each service area. If there are funds available after payment of expenses and debt service, separate reserve funds will be set aside respectively. Two cities by ordinance have adopted the new Trilateral Agreements between DWCCC, the cities and Weber Basin Water Conservancy District. These agreements require water to be provided by the developments in the various service areas. Three cities have passed and adopted ordinances requiring by exaction that developments provide adequate water for their projects. As a result of this change DWCCC will no longer be purchasing water.

XIII. CITY CONTRACTS. It is recommended that DWCCC make an effort to renegotiate their contracts with the cities to require new users of the secondary systems to provide the water.

As a result of the new Trilateral Agreements and amended city contracts, the process for water acquisition will lie solely with the development entities. Accordingly DWCCC will not accept service to any new user until the development has satisfied and provided the necessary water supply.

XIV. SUMMIT WATER DISTRIBUTION CONTRACT. It is recommended that DWCCC determine how much water they have to deliver to SWDC, and develop a strategy to make the water available under the terms of the contract.

DWCCC will review the contract that expires in 2009 and make every effort amenable to satisfy the terms of the agreement. Current experience has confirmed that there has been sufficient water for the contract delivery and the full water supply to be provided to the share holders, even during drought periods. It will be important through this agreement to satisfy the requirements of the State Engineer.

Respectfully Submitted,

Ivan J. Ray, General Manager
Davis and Weber Counties Canal Company