

Protecting Our Special Districts

Is There Any Oversight?

Summary

The absence of strong leadership to address the difficulties of a special water district in crisis exposes citizens to risk, and foreshadows potential problems for other special districts in the future. Using the Lompico County Water District's (LCWD) troubled history as a backdrop, the Grand Jury explored the boundaries and scope of oversight for independent special districts in Santa Cruz County. Good stewardship of water resources requires increasingly greater cooperation and transparency among multiple affected agencies. As a result, there is a growing need for clear procedures and proactive leadership for all agencies involved.

Santa Cruz County has special districts for water, fire, cemeteries, parks and recreation, as well as many other services. Initially, special districts were independent government agencies, subject only to state and local laws, until the California State Legislature created Local Agency Formation Commissions (LAFCOs) in 1963. Since then, new special districts and expanded spheres of influence are created through a LAFCO application process. The governing structure of most special districts, such as LCWD, actually predates the creation of LAFCO.

Independent special districts are governed by their own elected boards of directors. These boards annually report their financial statements to the California State Controller's Office, contract out for independent yearly audits and, in the case of an independent special water district, periodically send water samples to the California Department of Public Health. While such reports are routinely submitted to the appropriate agencies, the financial and governance information filed may be inadequate, not reviewed, or not acted upon. Even when followed by a succession of citizen complaints, in cases like LCWD, critical reports and financial documents seem to be ignored by all the agencies charged with oversight.

Whenever there is unsatisfactory governance or poor financial management, citizens of the district may use regular board elections to elect new directors, or may recall individual directors. If issues persist, however, the problem-solving process is ambiguous and unstructured, with no external agency taking responsibility. When county officials and LAFCO allow a special district to founder, the cost of the failure falls back on county taxpayers, who must eventually shoulder the burden of debt.

Background

The 2009-2010 Grand Jury conducted an extensive investigation of the Lompico County Water District, and recommended that LAFCO and San Lorenzo Valley Water District (SLVWD) intervene to prevent LCWD from bankruptcy and collapse.^[1] For well over six years, Santa Cruz County residents living in the Lompico area have complained about the LCWD's irresponsible management, poor adherence to sound governance practices, and degraded infrastructure. These complaints have largely been ignored by LAFCO and the Board of Supervisors.

The LCWD is now financially vulnerable, due to the lack of significant assistance or intervention. This inaction has resulted in a shortfall of an estimated \$2.5 to \$3 million needed for essential repairs to the deteriorating infrastructure.^[2] Recent, but insufficient, efforts to help the district include emergency technical assistance from the SLVWD and short-term cash flow assistance and payroll services from the County.

Scope

The Grand Jury's investigation sought to determine how the operation of LCWD could reach this point without triggering corrective action by the citizens, the water board, or the County. We also sought to discern where early intervention might have come from, and how it might have helped the LCWD and its residents. We asked ourselves the following questions to help guide our investigation:

- What jurisdictional boundaries and agreements exist to protect both county and district residents in the event of a special district failure?
- What evidence revealed in existing reports and procedures could have alerted someone early on that problems existed, and are these reports and procedures adequate?
- Is there a system in place to adequately respond to a special district under stress *before* it fails?

We explored what countywide protocols and shared responsibilities exist to prevent the failure of other independent special districts. Similarly, we tried to determine the limits to the autonomy of a special district, so that signs of trouble could be detected early, and assistance provided in a timely manner. We tried to determine what it would take to protect community residents and the County from a similar liability in the future.

Investigation

Our investigation started with a review of the 2009-2010 Grand Jury Report on the LCWD and the responses received. We examined state and county regulations specific to independent special districts, and jurisdictional agreements and understandings between Santa Cruz County, LAFCO, LCWD, and residents within the LCWD. We also examined documents regarding the fates of other troubled water districts, and reviewed the citizen guides about special districts published by the state.

Next, we met with individuals we believed could best understand and describe the situation in Santa Cruz County regarding current jurisdictional boundaries. We interviewed several county department heads and a County Supervisor, LAFCO staff and a Commissioner, water district supervisors and board members, a state water official, and numerous residents. During our investigation, we asked them to outline their understanding of pertinent ordinances, codes, and best practices, in the event of a special district's failure. We also asked them to contemplate LCWD's potential failure in light of the uncertain economic climate, and what could be done to prevent similar failures in the future.

Shared Governance

Residents of an independent special district have unique influence related to governance, because a district is an autonomous legal entity. Generally, elected or appointed board members are responsible for the health and proper functioning of the district. Their responsibilities include adopting and approving policies and procedures, providing budgetary oversight, and hiring and evaluating management. The board is charged with monitoring the overall performance and effectiveness of operations to ensure the future health and sustainability of the district's water supply.^[3]

LCWD's board members have admitted that they failed to do these things properly in the past.^[1] Citizens have the option of electing new board members, recalling individual board members, or, as a last resort, taking legal action. Lompico residents eventually chose to elect new board members, but as of April 2012, there was no consensus within the Lompico community on how to move forward.

The requirements for efficient operation of a water district are stringent, demanding a level of expertise the ordinary citizen may not possess. However, citizens can become educated to their roles and responsibilities, and training programs are available for this purpose. Part of that education includes understanding the roles of other agencies in shared governance.

Water Resource Issues

Water system management requires cooperation and transparency amongst multiple agencies. This calls for clear procedures and effective leadership. External agencies should be available to assist special districts when help is needed.

The Grand Jury interviewed an official of the California Department of Public Health (CDPH),^[4] who explained the Department's duties to oversee water quality and distribution of water in systems of LCWD's size (499 connections). The State delegates oversight of the small and medium-sized systems (5 to 199 connections) to the Environmental Health Services Division of the County Health Services Agency. We interviewed representatives of this division as well.

The CDPH conducts inspections of physical plant and equipment, samples water for pathogens, and tests for contaminants, at specified intervals. There is no single trigger

point for CDPH to take action. Only if a water district falls out of compliance with state and federal laws, is CDPH required and empowered to do anything.^[4] As of March 2012, no water district in the county, including Lompico, was found to be out of compliance.

However, water resource issues are not restricted only to those found by CDPH inspections. Historically, there have been several other problems with water management in Lompico. For example, a landslide took out a portion of the main water line loop on Lake Boulevard in 2006.^[5] The Lompico landslide and maintenance problems of 2006 should have been resolved by the LCWD Board of Directors, but they disagreed over how to finance the repairs.^[5]

The aftermath of the 2006 landslide was a clear signal the district was in trouble.

Financial Oversight

Water district revenues come from customer water bill payments, as well as a percentage of property taxes refunded to the water district by the State. Even before the landslide occurred, LCWD was struggling to pay operating costs, and had no capital improvement plan or reserve fund.^[1] The water district's financial situation was made worse by an ever-increasing need to repair or replace worn-out equipment and facilities.^[1] The 2009-2010 Grand Jury report stated that LCWD's financial structure was in worse shape than its physical water system. Five years of deficit spending put LCWD on the verge of bankruptcy.^[1]

The County Auditor-Controller's office offered assistance when they were alerted to LCWD's financial difficulties. Other Auditor-Controllers in California also assist smaller special districts.^[6] Special districts are required to file an audited annual financial statement to the State Controller's office, with copies to the County Auditor-Controller's office, for purposes of verifying that district finances have been independently audited and reviewed for problems. LCWD failed to submit their audited financials for the year 2008.^[1] They were not completed until July 1, 2009. At that time, at the request of the LCWD Board of Directors, the County Auditor-Controller's office took over paying the district bills and payroll.^[7]

In addition to the independent audit, special districts are required to submit an "Annual Report of Financial Transactions"^[8] in electronic form to the State Controller within 90 days after the end of each fiscal year. This information becomes part of a larger database available to consultants, other agencies, and the public. LCWD missed the deadline in October 2009, and was fined \$5,000 by the State Controller.^[1] Again, the County Auditor-Controller's office stated they provided assistance and were able to help get the report filed and the fine rescinded.

The County extended "dry period financing" to LCWD when district funds became inadequate to cover expenses for a limited period during fiscal year 2010. The process requires the district's board to pass a resolution to apply for dry period financing. The request is passed to the County Auditor-Controller's office and then submitted to the

County Board of Supervisors for approval. Although this financing method is frequently used by school districts, it is seldom done for special districts.^[9]

The request for “dry period financing” for a special district should have alerted the County Board of Supervisors that the district was in trouble.

LAFCO’s Role in Shared Governance

One of LAFCO’s primary responsibilities is to review ways to organize, evaluate, and streamline the boundaries of cities and special districts.^[10] This led us to believe that LAFCO also might be able to assist special districts in trouble. We therefore interviewed members of LAFCO staff and a Commissioner, plus a member of the County Board of Supervisors, to discuss their oversight of new and existing water districts.

The Cortese-Knox-Hertzberg Local Government Reorganization Act of 2000 (Hertzberg Act) requires that district services and spheres of influence be reviewed every five years, beginning on or before January 1, 2008.^[10] The Hertzberg Act further requires LAFCOs to conduct reviews of municipal and district services, and make written determinations regarding such factors as:^[10]

- Adequacy of public services, including infrastructure needs or deficiencies
- Financial ability of agencies to provide services
- Opportunities for sharing facilities
- Accountability for community service needs, including government structure and operational efficiencies

Santa Cruz County LAFCO staff informed the Grand Jury that LAFCO is a boundary-setting agency, and defines its responsibilities very narrowly. However, by law, LAFCO has the power to examine operational efficiencies, and the authority to initiate proposals for changes, when deemed necessary. LAFCO jurisdiction includes consolidations, dissolutions, mergers, establishment of subsidiary districts, formation of new districts, and reorganizations, such as annexations of special districts.^[11]

LAFCO stated that it does have the power to examine the operational efficiencies of districts, independent of the larger five-year review cycle. However, we found disagreement between a LAFCO commissioner and LAFCO staff on this point. One source asserts such reviews may be “proactive” and at the discretion of LAFCO, meaning LAFCO can initiate a review of a single special district and its operations. Another source asserts that reviews are only “reactive,” meaning a district must request a review. The question remains why a special district near failure, such as LCWD, would seek out a service review at significant cost to itself, especially if the review would expose possible neglect or incompetence.

Santa Cruz County LAFCO conducted its last service review of LCWD in 2005. The LCWD section was a brief portion of a larger consolidated review of countywide services (including nine water districts) under LAFCO jurisdiction. This review was

largely descriptive rather than evaluative, more similar to a job description than to a performance review.^[12]

Although this review could have been a useful opportunity to assess LCWD's needs, there was no exploration of LCWD's problems.

Santa Cruz County LAFCO has not always utilized the consolidated "Countywide Service Review" approach. This type of review was formally adopted by LAFCO in December 2007.^[13] Interviewees characterized the service reviews as sometimes perfunctory and lacking in prescriptive remedies for problems. One district manager wasn't certain if he had ever seen a review for his district. Another interviewee told the Grand Jury that service reviews were being done with self-reported information supplied by the districts, without vetting for accuracy by LAFCO. A third official stated that service reviews were a "kind of checklist."

LAFCO's Budget and Fees

According to a staff memo to the LAFCO Commissioners (February 29, 2012),^[14] "LAFCO is now expecting local agencies with sphere adoption or amendment proposals to prepare, or fund LAFCO to prepare, the needed service reviews." It is not clear if this is a formal policy or an informally adopted work procedure. Either way, LAFCO is not independently pursuing service reviews of special districts, but instead is simply waiting for the districts to come to them.

It appears an action can be initiated by voters or property owners, but only if they can afford to pay the costs of performing the review. While LAFCO budgets have historically maintained a litigation reserve, there is only a small budget item for hiring outside consultants to conduct service reviews. In spite of repeated attempts, the Grand Jury was unable to determine how much an adequate review of LCWD or any single special district would cost.^[15]

The State does not provide any funding for LAFCOs. However, Santa Cruz County LAFCO does receive budget approval and funding from the Santa Cruz County Board of Supervisors, and dues from each city and special district, as well as revenue from application and proposal fees. LAFCO has an extensive schedule of fees for applications and services.^[16] For example, the initial deposit fee for a boundary change application is \$5,150. The estimated application cost for LCWD to merge with another water district is about \$15,000.^[17] It is important to note that the schedule of fees is simply an initial deposit for the applicant expenses. There is no schedule of fees that estimates total costs beyond the initial deposit for the services provided by LAFCO.

LAFCO's Work Program and Priorities

The Work Program proposed by LAFCO for 2012-2013 (Attachment D, LAFCO budget) includes activities of high, medium, and low priority. Highest priority tasks include: (1) public assistance with questions about boundary change procedures; (2) processing applications and conducting public hearings on applications; and (3) updating city and

district spheres of influence. In our county, sphere of influence study applications are submitted before municipal service reviews are conducted. Other LAFCOs in the State of California rank service reviews as a higher priority than boundary changes.^[19] Santa Cruz County LAFCO has a backlog of required special district reviews, but has no plans to study them this coming fiscal year (Attachment C of budget).

During the course of this investigation, we learned that LAFCO has the authority to exert considerable influence over service districts by using political leverage and the “soft power” of persuasion when reviewing sphere of influence proposals. One agency representative stated that LAFCO could conduct service reviews “as narrowly or as broadly as it preferred.” After public hearings LAFCO can approve or deny any application. If LAFCO approves, it can impose terms and conditions. The only ways to challenge a LAFCO decision are to appeal the decision to LAFCO itself, or file suit in court.^[20]

One example of LAFCO influence is its response to the Bonny Doon Fire District proposal. In 2008 Bonny Doon residents petitioned LAFCO to establish a Sphere of Influence for the Bonny Doon Fire Protection District, and remove Bonny Doon from the Sphere of Influence of County Service Area 48 (Cal Fire). After hearings and litigation, LAFCO denied the Bonny Doon petition, stating that the financial loss to Cal Fire would negatively impact the level of services being provided in other communities. Nonetheless, LAFCO staff did offer suggestions to relevant parties that could possibly improve fire protection and response times.^[21]

More recently, LAFCO has specified conditions for approvals of the City of Santa Cruz and University of California, Santa Cruz, petitions to expand water and sewer services beyond the city limits. LAFCO added conditions to the petition requiring the City and the University to indemnify LAFCO against any future litigation, to pay all LAFCO costs of processing the applications, and to apply to annex the lands within the proposed 240-acre expanded campus area.^[22]

Who is Responsible for a Failing District and When Should Action Be Taken?

So who is ultimately responsible when a special district shows signs of trouble, and when should action be taken? If a special district needs help, someone should be paying attention and feeling compelled to act sooner rather than later. The Grand Jury believes a thorough review and possible reorganization of the district is required.

The process for reorganization of a special district may begin in one of three ways: by citizen petition whereby registered voters or landowners request a boundary change; by resolution of the County Board of Supervisors; or by LAFCO.^[20] ^[10] According to the state guide, *It's Time to Draw the Line*, a citizen's guide to LAFCO, page 19, the Board of Supervisors can also start the process:

A county is always an affected agency because its boundaries include all of the cities and special districts in that county. Therefore, the county board of supervisors can initiate any boundary change in its county.^[20]

The third way to initiate change is for LAFCO to act of its own accord. Drawing on its knowledge from routine service reviews, LAFCO is in the best position to offer guidance when action becomes necessary.^[20]

Discussion

At the close of our investigation, we realized that almost every interview seemed to bring us to the same conclusion: everyone said, “Not my job.” LAFCO can and does indeed exert pressure that initiates change in some circumstances. However, LAFCO continues to fall back on citing that it is a “boundary-setting agency” and not an oversight agency. In the instance of water districts, CDPH stated in an interview that they look only at water quality and are not involved with other managerial or financial decisions. Other special water districts have interests and problems of their own.

Consequently, citizens are the ones who lose when government officials adhere to narrow constructions of their own roles and responsibilities. Under the guise of deferring to local control, some agencies may assume a hands-off position regarding independent special districts, to the detriment of county taxpayers and citizens as a whole.

Inaction has resulted in a shortfall of an estimated \$2.5 to \$3 million for the essential repairs of the deteriorating infrastructure in the case of LCWD. The Grand Jury questions whether ignoring immediate problems, in favor of an unspecified longer-term solution, is a sound way to do business. Ultimately, everyone pays when a special district fails.

The net result is that LAFCO is not completely fulfilling its statutory obligations as defined by the Hertzberg Act.

Findings

F1. When a special district fails due to neglect or poor practice, the financial burden falls upon the county taxpayers.

F2. When problems in special districts occur, there is no clear cooperative path of response for addressing those problems.

F3. LAFCO underutilizes reviews that would allow for early problem detection and evaluation of independent special districts.

F4. LAFCO has the ability and the responsibility (per Government Code Section 56430) to do service reviews at least every five (5) years; however, they are not being completed in a timely or effective manner.

F5. LAFCO asserts that a general lack of funding prevents the performance of proactive and comprehensive service reviews, yet they selectively pursue funding for other purposes.

F6. LAFCO, external agencies, and citizens have conflicting interpretations of the scope and frequency of service reviews for special districts.

Recommendations

R1. Once a problem is identified within a special district, LAFCO should proactively conduct a thorough service review of that district, with the aid of state and county agencies.

R2. To protect the public interest, the Board of Supervisors should work with LAFCO to initiate special reviews that adequately examine the effectiveness of service delivery, especially when unaddressed chronic problems are discovered.

R3. LAFCO should adopt policies to ensure proactive service reviews are completed, to safeguard the proper functioning of a district. These reviews should be in addition to, and independent of, sphere of influence studies.

R4. LAFCO should budget adequately for professional services to conduct proactive service reviews, and maintain sufficient reserves for unanticipated service reviews of special districts.

R5. Service reviews should be designed as diagnostic assessments with recommendations to the special district, County Board of Supervisors, and LAFCO Commissioners, in order to pinpoint, make transparent, and preemptively resolve special district problems.

Commendations

C1. The Santa Cruz County Auditor-Controller's Office should be commended for providing assistance and professional services to Lompico County Water District.

Responses Required

| Respondents | Findings | Recommendations | Respond Within/ Respond By |
|---|------------------|------------------------|---------------------------------------|
| LAFCO Commissioners | F1-F6 | R1, R3-R5 | 90 days October 1, 2012 |
| LAFCO Executive Officer | F1-F6 | R1, R3-R5 | 60 days September 1, 2012 |
| Santa Cruz County Board of Supervisors | F1-F3, F5, F6 | R1, R2, R4, R5 | 90 days October 1, 2012 |
| Santa Cruz County Auditor- Controller | F5 | | 60 days September 1, 2012 |

Definitions

- **CDPH:** *California Department of Public Health.*
- **CSA:** *County Service Area* - A CSA is a special taxing district, similar to a special district, in that it is empowered by state law to provide specific services within a specified boundary; however, a CSA stays under the governance of the County Board of Supervisors. Road maintenance and sewer districts can fall into this category. Water and fire districts are generally set up as independent special districts.
- **Dry Period Financing:** A method of paying bills used by public agencies during the months prior to receiving monies from the distribution of property tax payments. The County Auditor-Controller “loans” the money to the agency and then later deducts that amount from the property tax money assigned to that agency.
- **Hertzberg Act:** Cortese-Knox-Hertzberg Local Government Reorganization Act of 2000 redefined LAFCO’s jurisdiction by combining and adding to several prior laws. Gives LAFCO authority to: approve boundaries; form, merge and dissolve districts and annex territories.
- **LAFCO:** *Local Agency Formation Commissions* - The independent commissions created by the California Legislature to control the boundaries of cities and most special districts.
- **LCWD:** *Lompico County Water District.*
- **Lompico Board of Directors:** Five citizens residing within the geographical boundaries of the LCWD, elected by the community to govern the water district.
- **Service Review (Municipal Service Review or MSR):** A comprehensive study designed to better inform LAFCO, local agencies, and the community about the

performance of municipal services. Service Reviews capture and analyze information about the governance and operations of service providers, and identify opportunities for greater coordination and cooperation between providers.

- **Shared Governance:** Governance based on cooperation and interaction between multiple stakeholders.
- **SLVWD:** *San Lorenzo Valley Water District.*
- **Special District:** A separate local government entity, unique to California, that delivers a limited number of public services to a geographically limited area.
- **Sphere of Influence:** The physical land boundaries defining a service area, or potential future area, to which a local agency will or may provide services.
- **SVWD:** *Scotts Valley Water District.*

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Meetings

Santa Cruz LAFCO monthly meetings, March 2012 and April 2012.

The Power and Privilege of Transparency

Access to information is the cornerstone to good governance, meaningful participation, and increasing transparency, and is recognized as a fundamental human right.

Democracy depends on a knowledgeable citizenry whose access to a range of information enables them to participate more fully in public life, help determine priorities for public spending, receive equal access to justice, and hold their public officials accountable. Inadequate access to public information allows corruption to flourish, and back-room deals to determine spending in the interests of the few rather than many.^[1]

–The Carter Center

Summary

The 2010-2011 Santa Cruz County Grand Jury Report found that,

...the City of Watsonville had not been conducting its business in a professional way; one that is transparent in all its dealings, and one that gives all relevant information needed by elected officials to be able to make informed decisions.^[2]

After reviewing that report, the 2011-2012 Grand Jury decided to investigate issues that are “illustrative of a laxity of process and controls”^[2] in the Watsonville City Government, both those identified by the prior Grand Jury and new relevant concerns:

- Issuance of a \$225,000 check in April 2008 for a fire truck, more than three years prior to its delivery. Nearly a year after its delivery, its operational status remains unclear.
- Continuing concerns about the process by which Community Development Block Grant (CDBG) funds were used to purchase the fire truck
- Cash handling procedures for the Strawberry Festival
- Citywide cash handling policy and procedures
- Difficulties obtaining complete, accurate, and timely information, which suggests a lack of transparency

The citizens of Watsonville deserve a clear understanding of where, why, and how their tax dollars are being spent.