



OFFICE OF
INSPECTOR GENERAL
U.S. DEPARTMENT OF THE INTERIOR

CENTRAL VALLEY PROJECT, CALIFORNIA: REPAYMENT STATUS AND PAYOFF



OFFICE OF
INSPECTOR GENERAL
U.S. DEPARTMENT OF THE INTERIOR

MAR 26 2013

Memorandum

To: Michael L. Connor
Commissioner, Bureau of Reclamation

From: *Stephen A. Henderson for*
Mary L. Kendall
Deputy Inspector General

Subject: Final Evaluation Report – Central Valley Project, California: Repayment Status
and Payoff
Report No. WR-EV-BOR-0003-2012

This memorandum transmits our evaluation report of the Bureau of Reclamation's (USBR) ability to recover Federal investments in the Central Valley Project (CVP) by 2030.

Because USBR's ratesetting policies do not ensure that an appropriate share of capital costs and funding deficits are repaid annually, it is not making steady progress toward recovering Federal investments in the CVP. With 18 years left to fulfill Congress' repayment mandate by 2030, USBR has an opportunity to address the repayment uncertainty inherent in its current ratesetting policies. We include two recommendations in our report that, if implemented, will help to improve USBR's ability to recover the CVP investments.

Based on the February 28, 2013 response from USBR to the draft report, we consider both recommendations resolved but not implemented. We will refer these recommendations to the Assistant Secretary for Policy, Management and Budget to track implementation.

The legislation creating the Office of Inspector General requires that we report to Congress semiannually on all audit reports issued, actions taken to implement our recommendations, and recommendations that have not been implemented.

A response to this report is not required. If you have any questions regarding this memorandum or the subject report, please do not hesitate to contact me at 202-208-5745.

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Results in Brief

In 1937, the Bureau of Reclamation (USBR) began construction of the largest water supply project in the United States: the Central Valley Project (CVP) in the State of California. To recover Federal investments in the CVP facilities, USBR established contracts that guaranteed contractors a fixed annual repayment rate for 40 years. The fixed water rates specified in these contracts, however, were insufficient to recover the Federal investment in the CVP. As a result, in the first 40 years of the CVP operation, little progress was made toward repayment of the Federal investments. In 1986, Congress passed legislation addressing operational repayment deficits and required repayment of the Federal investment in the CVP by 2030. We conducted this evaluation to determine whether the Federal Government is making steady repayment progress and is on track to recoup its investments in the CVP by the legally established deadline of 2030.

We found that USBR's water ratesetting policies do not ensure that an appropriate share of capital costs and prior-year funding deficits are repaid annually. Water deliveries to the CVP contractors have been highly variable from year to year. When actual water deliveries are less than projected deliveries, revenues are insufficient to recover the Federal investment in the project. When actual water deliveries exceed projected deliveries, however, existing contract provisions stipulate that excess revenues collected by USBR must be refunded to the contractors. As a result, USBR has not demonstrated steady progress toward recovery of Federal investments in the CVP. With 18 years left to fulfill Congress' repayment mandate of 2030, USBR has an opportunity to address its current ratesetting policies that are dependent on annual water deliveries.

Because of the uncertainty of annual water deliveries and the potential instability of repayment revenues, repayment shortfalls could become significant enough to require political intervention. If this repayment deadline is not met, USBR will not have met its legal mandate and once again will have to put this issue before Congress.

Introduction

Objective

Our objective was to determine whether the Federal Government is making steady repayment progress and is on track to recoup its investments in the Bureau of Reclamation's (USBR) Central Valley Project (CVP) by the legally established deadline of 2030.

Background

USBR began construction of the CVP in California in October 1937. It is currently the largest water supply project in the United States, providing water to more than 3 million acres of farmland, which produce crops worth \$3 billion a year. In addition, the CVP supplies water to nearly 1 million households each year. Power generation facilities constructed as a part of the CVP provide power equivalent to the annual energy needs of 650,000 Californians. As of 2011, the total reimbursable Federal investment in CVP facilities providing water for irrigation and municipal and industrial (M&I) purposes was \$1.3 billion.

Reclamation Law¹ requires that contractors, who benefit from the project, repay the Federal investment in irrigation and M&I facilities. To secure repayment of the Federal investment, USBR entered into water service contracts that guaranteed contractors fixed water rates for 40-year terms. The intent of the contracts was for these rates to repay construction costs over the 40-year period. Reclamation Law requires USBR to establish water rates that produce revenue at least sufficient to cover annual operations and maintenance (O&M) costs and the appropriate share of fixed (capital) costs of the project. As time went on, however, annual O&M costs increased to the point where they exceeded revenues generated by the fixed water rates established in the water service contracts. By the 1970s, contractors had repaid little of the original costs to construct the CVP and owed additional O&M costs financed by the Federal Government.

In 1986, Congress enacted the Coordinated Operations Act of 1986 to address the CVP repayment issues.² The law established 2030 as a firm repayment deadline for contractors to repay all construction costs and O&M deficits existing as of 1986.³ In addition, it required contracts to include provisions for adjusting rates if it is found that the rate in effect may not be adequate to recover Federal investments. USBR revised its water ratesetting policies⁴ to address previous repayment deficiencies and the requirements of the Act.⁵ Under its current

¹ Reclamation Law is the term used to refer to the total body of public law governing the reclamation program, beginning with the Reclamation Act of 1902 and including all laws amending and supplementing the Act.

² Coordinated Operations Act of 1986, Pub. L. No. 99-546, 100 Stat. 3050-56 (1986).

³ *Id.*

⁴ "The CVP Irrigation Ratesetting Document" was approved in 1988 and the CVP "Interim Ratesetting Policy, Municipal, and Industrial Water" was approved in 1995.

⁵ Coordinated Operations Act of 1986, Pub. L. No. 99-546, 100 Stat. 3050-56 (1986).

ratesetting policy, USBR calculates a new water rate each year for each contractor. Each contractor's annual water rate includes three primary component rates to—

- recover the estimated annual CVP O&M cost allocated to the contractor;
- recover the unpaid balance of the contractor's O&M deficit over the remaining repayment period; and
- repay the capital costs incurred by the contractor over the remaining repayment period.

USBR calculates these component rates by dividing the estimated annual O&M cost or the proportional share of Federal investment owed by the amount of water that USBR anticipates delivering in the upcoming year. USBR calculates some of the rates based on actual cost data from 2 years earlier because the CVP water-rate development process takes an entire year. For example, USBR calculated the 2013 CVP capital water rates based on the 2011 CVP financial data.

USBR's ratesetting policy also dictates how it will use annual water revenues. Revenues are used to pay O&M costs first, interest expenses second, and interest-bearing O&M deficits incurred since 1986 third. Non-interest-bearing O&M deficits accumulated prior to 1986 and the capital investment component are repaid last.

In August 2004, we issued a report on the CVP contract renewal process (see Appendix 2).⁶ In the report, we discussed concerns that contractors might not repay Federal investments in the CVP by 2030 due to understated water rates and uncertain water availability. We noted that these factors could result in expanding repayment relief to irrigation contractors and significant, unplanned increases in the CVP power rates. The report suggested that USBR—

- formally revise water ratesetting bases;
- annually estimate total aid to irrigation requirements; and
- provide the estimate to the Federal agency responsible for setting power rates.

In response to the report, USBR made some changes to its basis for computing water rates. Our evaluation concluded, however, that USBR's rate calculation changes were not sufficient to eliminate understated water rates and continued uncertainty about CVP repayment.

⁶ Office of Inspector General, U.S. Department of the Interior, No. W-IN-BOR-0016-2004, "Central Valley Project Contract Renewal Process," (August 2004).

Findings

USBR is not making steady progress toward recovery of Federal investments in the CVP. The current CVP ratesetting policies and water projection methods do not ensure that sufficient revenue is available each year to recover annual O&M costs and to repay an appropriate share of the remaining Federal investment in the project. In addition, current CVP water service contracts include a provision that prevents USBR from using excess annual revenues to repay the Federal investment.

Current Ratesetting Process Contributes to Repayment Uncertainty

Estimating Future Water Deliveries

USBR calculates the CVP contractors' water rates using estimates of the amount of water it expects to deliver during the coming year. The water that is actually available for delivery to contractors, however, depends on the amount of rain and snow that falls after water rates are set and can be highly variable from year to year. When the actual amount of water delivered is less than the estimated amount that USBR used to calculate the annual water rates, revenue shortfalls occur, which cause shortages in repaying capital costs and O&M deficits.

In addition, USBR compounds the uncertainty of the water ratesetting process by using more than one method to estimate the coming year's water deliveries.

USBR calculates O&M component rates using either the average of the previous 5 years of water deliveries or the contract maximum deliveries, whichever amount is lesser. Capital repayment and O&M deficit component rates, on the other hand, are calculated based on the average of water deliveries since 1995. The differences in these estimates are significant. For example, in developing the 2012 rate for irrigation water delivered to the Westlands Water District via the San Luis Canal, USBR used estimated water deliveries of 594,233 acre-feet to calculate the O&M component and 776,389 acre-feet to calculate the capital repayment component. Had USBR used the 5-year average to calculate Westlands' capital component, that rate would have been \$7.44 per acre-foot higher (30 percent) than the rate actually charged, which was \$24.25.

Priorities for Using Annual Water Revenues

USBR's ratesetting policy puts the least priority on capital repayment for irrigation revenue and O&M deficit repayment for M&I revenues. When water deliveries do not meet projections for the year, revenues are used to pay other expenses first. If there are any revenues remaining, then USBR applies them toward capital repayment and O&M deficit repayment. Thus, in water-short years, USBR does not generate sufficient revenues to pay for capital repayment and O&M deficits. Those revenues generated are used to pay other expenses first, which creates a larger than anticipated shortfall.

No Fixed Repayment Amount

USBR's current ratesetting policies for the CVP water service contracts do not include a fixed repayment amount to ensure that a portion of capital costs and O&M deficits are paid each year. Unlike fixed water rates, which resulted in insufficient repayment revenues and subsequent congressional action in 1986, a fixed repayment amount, much like a conventional mortgage, establishes a repayment schedule that assures repayment within a prescribed time. While the use of a fixed payment component is not typical in USBR water service contracts, fixed repayment amounts can stabilize water revenues and ensure steady CVP repayment even when annual water deliveries fluctuate wildly.⁷

USBR already uses a fixed repayment amount to ensure timely repayment of one part of the CVP. The San Felipe out-of-basin facilities supply water to two contractors serving the Santa Clara Valley and San Benito County in California. USBR incorporated fixed repayment schedules in the San Felipe out-of-basin water service contracts to ensure that all costs associated with these facilities are repaid by the established deadline.

Contract Provisions Limit Repayment

The language of current CVP water service contracts also limits and adversely impacts the repayment of CVP capital costs and O&M deficits. In reviewing USBR's water service contract with the Del Puerto Water District, we noted that Article 10 of the contract states:

The amount of any overpayment by the Contractor of the Contractor's O&M, capital, and deficit (if any) obligations for the year shall be applied first to any current liabilities of the Contractor arising out of this Contract then due and payable. Overpayments of more than \$1,000 shall be refunded at the Contractor's request.

According to USBR, this negotiated contract language was included in all of the long-term CVP renewal contracts that USBR executed in 2005, as well as interim contracts that were negotiated with Westlands Water District and a number of other contractors. USBR officials told us that reopening negotiations on CVP water service contracts would be very difficult unless required by law, policy, or some other compelling reason.

USBR officials believe that, absent the contract language in Article 10, the CVP ratesetting methodology would be sufficient to recover CVP construction costs because overpayments in high water years would offset underpayments in low water years. These officials acknowledged that the refund language of Article 10

⁷ For example, during the 10-year period ending with water year 2010, irrigation water delivered to the Westlands Water District via the San Luis Canal varied from a high of 1,066,037 acre-feet in 2006 to a low of 229,137 acre-feet in 2009.

defeats the design of the CVP ratesetting methodology and adversely impacts repayment of CVP construction costs.

Impact of Ratesetting Weaknesses

Repayment of Irrigation Investment

We determined that if recent CVP water delivery trends continue, repayment of the capital investment in the CVP irrigation facilities could be short by between \$330 and \$390 million by 2030, as illustrated in Figure 1.

To identify why repayment progress was not satisfactory, we reviewed water rate calculations and payment information for four irrigation contractors. We determined that for the 3-year period from 2008 to 2010, actual water delivered to these contractors was only 41 percent of estimated water deliveries used to calculate their contract water rate. The variance in water deliveries resulted in a \$45 million shortfall in the contractors' repayment of capital costs that USBR must recover in future years through rate increases. In the case of one contractor, we estimated that by 2030, their CVP water rate could more than double if current trends continue.

Projection of Unpaid Capital Investment in Irrigation Facilities

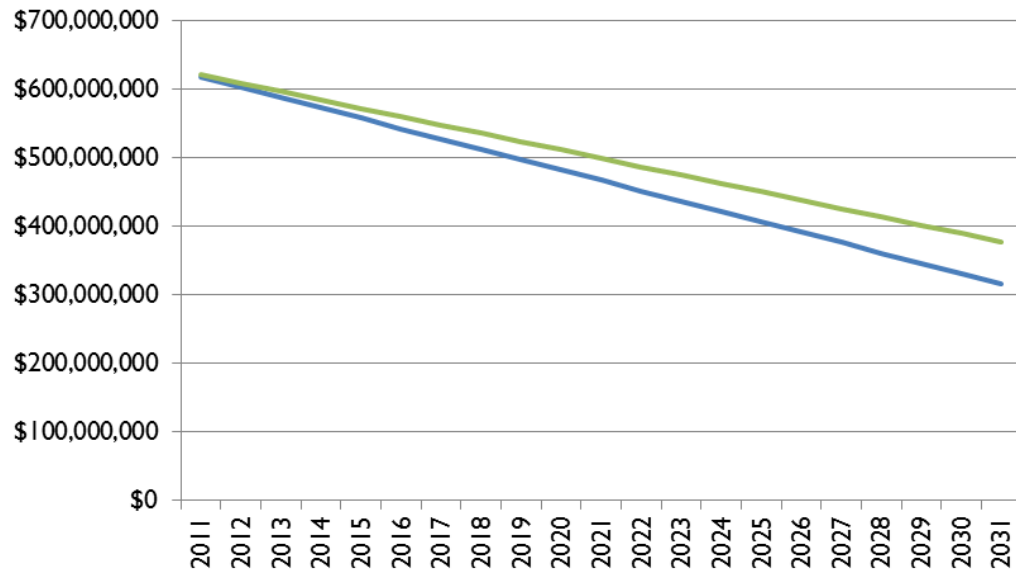


Figure 1. This figure projects the amount of Federal investments that will be left unpaid by 2030. The total amount unpaid with additional capital relief is projected to be approximately \$330 million. Without capital relief, the amount left unpaid is projected to be nearly \$390 million.

- The total unpaid with additional capital relief.
- The total unpaid with no additional capital relief.

Continued deferral of capital cost repayment by irrigation contractors could cause future water rates to exceed contractors' ability to pay. Provisions of Reclamation Law permit irrigation contractors to apply for relief from their capital repayment obligation based upon an economic analysis showing that they cannot meet that obligation. In this case, an irrigation contractor is charged the lesser of the cost of service or the irrigation contractor's payment capacity. At a minimum, the water rate must cover O&M costs. The difference between the cost-of-service rate and the irrigation contractor's ability to pay is shifted to the CVP power users for repayment through the U.S. Department of Energy. Thus, power users will pay any costs above the irrigation contractor's ability to pay.

Repayment of M&I O&M Deficit

We also determined that if the recent CVP water delivery trends continue, repayment of the O&M deficits accumulated by M&I contractors could be short by approximately \$55 million by 2030, as illustrated in Figure 2.

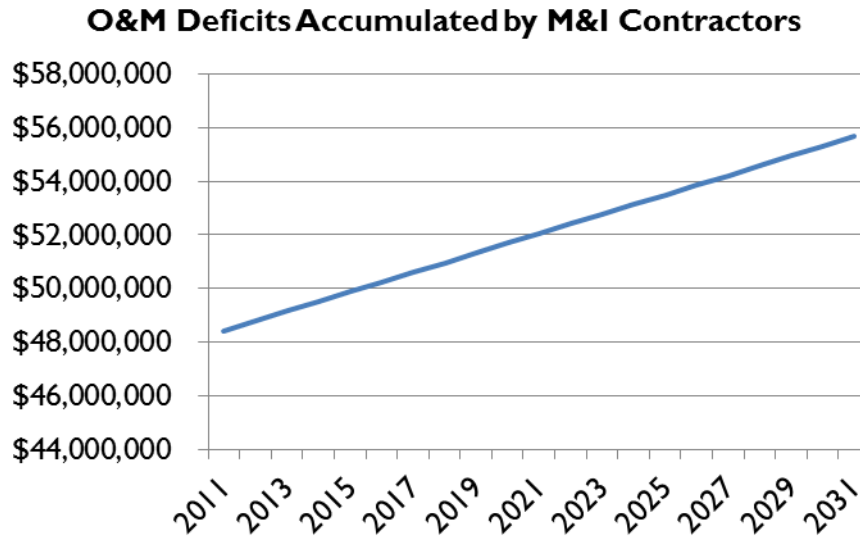


Figure 2. This figure shows the potential deficit growing over the next 18 years, as M&I contractors continue to accrue O&M costs and fall short of payments. This chart does not include repayment for San Felipe's facilities, as it is on track to repay the Federal investment.

Our review of water rate calculations and payment information for M&I contractors determined that for the 3-year period from 2008 to 2010, actual water deliveries to these contractors were only 63 percent of estimate. The variance in water deliveries resulted in a \$7 million shortfall in the contractors' repayment of accumulated O&M deficits. As with the CVP irrigation facilities, USBR must now recover this shortfall in the remaining 18 years through water rate increases. Unlike with irrigation repayment shortfalls, however, M&I contractors are not eligible for repayment assistance from power revenues. O&M deficits and all rate increases are the responsibility of the M&I contractors. Much like irrigation capital costs, if these trends continue, M&I water rates will continue to rise along with the possibility that not all costs will be repaid by 2030.

Conclusion and Recommendations

Conclusion

USBR has 18 years remaining to ensure that the repayment requirement for the CVP is met. The longer USBR waits, the more significant the impact will become as the 2030 deadline approaches. This could cause significant, if not unsustainable, rate increases to water contractors. Rate increases create the potential for rates to exceed irrigation contractors' ability to pay and shift the repayment requirement to power users. Rate increases could also lead to water contractors asking Congress to extend the repayment deadline beyond 2030 or provide additional repayment relief. As the 2030 repayment deadline approaches, USBR has an opportunity to act before the impacts become even more significant.

USBR has revised the CVP ratesetting policies to deal with repayment shortfalls. Its revised policies are not entirely effective, however, because they do not ensure that an appropriate share of capital costs and accumulated O&M deficits are repaid each year. In addition, the terms of existing CVP water service contracts exacerbate the problem by requiring that USBR refund any excess revenues to contractors rather than applying these revenues to reduce the unpaid capital costs and O&M deficits. We believe that the most responsible approach would be to deal with the issue now. Allowing continued repayment uncertainty—or worse, missing the repayment deadline set by Congress—would mean that USBR has failed to effectively implement the Coordinated Operations Act of 1986⁸ and fulfill its responsibility to obtain required, complete project repayment by 2030.

Recommendations

We recommend that USBR:

1. Evaluate additional changes in the CVP ratesetting policies and implement actions that will ensure stable and predictable repayment of the entire Federal investment in the CVP between now and 2030.

Agency Response:

Reclamation concurs that repayment contracts provide a more reliable means of repayment of capital costs. The update of the Central Valley Project (CVP) cost allocation, scheduled for completion in 2016, will provide an opportunity to convert to repayment contracts at the request of the contractor. However, because Reclamation cannot unilaterally amend a contract, each contractor must affirmatively request that its 9(e) or 9(c)(2) water service contract be converted to a 9(d) or 9(c)(1) repayment

⁸ Coordinated Operations Act of 1986, Pub. L. No. 99-546, 100 Stat. 3050-56 (1986).

contract pursuant to the Reclamation Project Act of 1939. The option to convert is contained in the current water service contracts. In addition, the Region will further analyze the rate of repayment and consider various factors that have impacted repayment. These factors include current operations criteria, hydrology impacts, and the repayment of Friant construction costs. If the rates appear to be too low then the rate methodology will be adjusted to promote recovery by 2030.

Responsible Official: David G. Murillo, Mid-Pacific Regional Director.

Target Implementation Date: The estimated completion for the analysis is December 31, 2013.

OIG Reply: We consider this recommendation resolved but not implemented (Appendix 4). The recommendation will be referred to the Assistant Secretary for Policy, Management and Budget.

2. Renegotiate the terms of irrigation water service contracts to eliminate the refund language of Article 10 at the earliest opportunity.

Agency Response:

Reclamation agrees the CVP contract Article 10 has impacted repayment. Renegotiation of this provision would be required and Reclamation will explore this option with our contractors. Reclamation will further analyze the costs and benefits associated with renegotiating the refund provision and determine whether to pursue this option.

Responsible Official: David G. Murillo, Mid-Pacific Regional Director.

Target Implementation Date: The estimated completion for the analysis is December 31, 2013.

OIG Reply: We consider this recommendation resolved but not implemented (Appendix 4). The recommendation will be referred to the Assistant Secretary for Policy, Management and Budget.

Appendix I: Scope and Methodology

Scope

Our scope included the Bureau of Reclamation (USBR), Central Valley Project (CVP) water ratesetting process, associated ratesetting documents and information.

We conducted our evaluation in accordance with the Quality Standards for Inspections as put forth by the Council of Inspectors General on Integrity and Efficiency. We believe that the work performed provides a reasonable basis for our conclusions and recommendations.

Methodology

To accomplish our evaluation, we—

- reviewed applicable laws, rules and regulations, and USBR policies related to CVP repayment;
- interviewed USBR officials regarding CVP repayment policies and practices;
- analyzed recent trends in CVP water deliveries, revenues, and repayment;
- selected a small judgmental sample of CVP contractors for more detailed review, emphasizing contractors that received substantial annual water deliveries from the CVP and that had significant unpaid balances of both capital cost and operation and maintenance deficits; and
- reviewed the contracts, water rates, revenues, and repayment data for the Westlands Water District, the Del Puerto Water District, the East Bay Municipal Utility District, Colusa Water District, Kanawha Water District, and the Sacramento County Water Agency.

Appendix 2: Prior Audit Coverage

The Office of Inspector General issued an audit report in August 2004, titled “Central Valley Project Contract Renewal Process, Bureau of Reclamation” (No. W-IN-BOR-0016-2004), that addressed the ratesetting policies and repayment status of USBR’s CVP. We discussed concerns that contractors might not repay the Federal investments in the CVP by 2030 due to understated water rates and uncertain water availability. We noted that these factors could result in expanding repayment relief to irrigation contractors and significant, unplanned increases in the CVP power rates. The report recommended that USBR—

- formally revise water ratesetting bases;
- annually estimate total aid to irrigation requirements; and
- provide the estimate to the Federal agency responsible for setting power rates to recover any unpaid capital investment in the CVP irrigation facilities.

To address the issue of understated water rates, USBR stated that it was planning to change its basis for computing water rates beginning in 2005. Under that plan, USBR would use the average of actual water deliveries for the last 5 years rather than contract entitlements as the base for calculating annual water rates. USBR was not planning to formally revise its ratesetting base or to alert the Federal agency marketing CVP power about ballooning irrigation assistance needs. USBR’s audit liaison coordinator told us that because the report contained suggestions rather than recommendations, the report was not referred to the Office of Financial Management for tracking of implementation.

During the course of this evaluation, we confirmed that USBR no longer uses contract entitlements as the basis for calculating water rates. We found, however, that USBR did not begin using the 5-year water delivery average to calculate all components of annual CVP water rates as it had planned. Instead, USBR calculates the capital repayment and O&M deficit components of CVP water rates based on the average annual water delivered to contractors since 1995. We found that USBR’s use of the longer-term average provides CVP contractors with lower water rates and contributes to continued uncertainty about CVP repayment.

Appendix 3: USBR Response

USBR's response to the draft follows on page 14.



United States Department of the Interior

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Washington, DC 20240

IN REPLY REFER TO:

84-27400

ADM-8.00

MEMORANDUM

To: Office of Inspector General
Attn: Assistant Inspector General for Audits, Inspections, and Evaluations

Through: Anne J. Castle *Anne J. Castle* MAR 8 2013
Assistant Secretary – Water and Science

From: ~~Michael L. Connor~~ *Michael L. Connor* FEB 28 2013
Acting For Commissioner

Subject: The Bureau of Reclamation's Response to the Office of Inspector General's (OIG)
Draft Evaluation Report, *Central Valley Repayment Status and Payoff*, Report No.
WR-EV-BOR-0003-2012

The OIG in its January 7, 2013, draft evaluation report, *Central Valley Repayment Status and Payoff*, requested that Reclamation inform the OIG of actions taken or planned to address the recommendations, as well as target dates and titles of the officials responsible for implementation. The requested information is attached.

If you have any questions or require additional information, please contact Elizabeth Cordova-Harrison, Director, Management Services Office, at 303-445-2783.

Attachment

The Bureau of Reclamation's Response to the
Office of Inspector General (OIG) Draft Evaluation Report
Central Valley Repayment Status and Payoff
Report No. WR-EV-BOR-0003-2012

February 2013

Response to OIG Recommendations

Recommendation 1: Evaluate additional changes in the CVP ratesetting policies and implement actions that will ensure stable and predictable repayment of the entire Federal investment in the CVP between now and 2030.

Reclamation's Response: Reclamation concurs that repayment contracts provide a more reliable means of repayment of capital costs. The update of the Central Valley Project (CVP) cost allocation, scheduled for completion in 2016, will provide an opportunity to convert to repayment contracts at the request of the contractor. However, because Reclamation cannot unilaterally amend a contract, each contractor must affirmatively request that its 9(e) or 9(c)(2) water service contract be converted to a 9(d) or 9(c)(1) repayment contract pursuant to the Reclamation Project Act of 1939. The option to convert is contained in the current water service contracts. In addition, the Region will further analyze the rate of repayment and consider various factors that have impacted repayment. These factors include current operations criteria, hydrology impacts, and the repayment of Friant construction costs. If the rates appear to be too low then the rate methodology will be adjusted to promote recovery by 2030.

Responsible Official: David G. Murillo, Mid-Pacific Regional Director.

Target Implementation Date: The estimated completion for the analysis is December 31, 2013.

Recommendation 2: Renegotiate the terms of irrigation water service contracts to eliminate the refund language of Article 10 at the earliest opportunity.

Reclamation's Response: Reclamation agrees the CVP contract Article 10 has impacted repayment. Renegotiation of this provision would be required and Reclamation will explore this option with our contractors. Reclamation will further analyze the costs and benefits associated with renegotiating the refund provision and determine whether to pursue this option.

Responsible Official: David G. Murillo, Mid-Pacific Regional Director.

Target Implementation Date: The estimated completion for the analysis is December 31, 2013.

Appendix 4: Status of Recommendations

Recommendations	Status	Required Action
I and 2	Resolved but not implemented.	No further response to OIG is required. The recommendations will be referred to the Assistant Secretary for Policy, Management and Budget for tracking of implementation.

Report Fraud, Waste, and Mismanagement



Fraud, waste, and mismanagement in Government concern everyone: Office of Inspector General staff, departmental employees, and the general public. We actively solicit allegations of any inefficient and wasteful practices, fraud, and mismanagement related to departmental or Insular Area programs and operations. You can report allegations to us in several ways.



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