INTERNAL AUDIT

Franchise Fee Audit Report

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Authorization

The City Auditor has conducted a Franchise Fee audit. This audit was conducted under the authority of Ordinance #2013-51 and in accordance with the Annual Audit Plan approved by the League City, City Council (Resolution #2014-27).

Objective

The objective of this audit was to determine if the City is receiving all the franchise fee revenue it is entitled to.

Scope and Methodology

The City Auditor conducted this audit in accordance with Generally Accepted Government Auditing Standards except this audit function has not had an external peer review. Those standards require planning and performing the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for the findings and conclusions based on the audit objectives. The City Auditor believes that the evidence obtained provides a reasonable basis for the findings and conclusions based on the audit objectives.

The sampling methodology is discussed in Exhibit A and the reliability and integrity of information is discussed in Exhibit B.

To adequately address the audit objectives and to describe the scope of work on internal controls, the City Auditor has:

- Pursued the relevant contact for each of the franchisees
- Requested the appropriate information be submitted to the City
- Analyzed the submitted information
- Read applicable laws and franchise agreements
- Contacted other cities to gain information for comparison purposes
- Contacted third parties and the State of Texas Comptroller’s office
- Coordinated with GIS on comparing our database to that of the franchisee
- Inquired with staff regarding process flow
- Conferred with the City Attorney where necessary
- Compared City database with our third party information

BACKGROUND

Electricity

The city's largest electrical provider is Texas-New Mexico Power (TNMP). The city has a franchise agreement that expires in October 2016. However, the law has changed since the franchise agreement's inception in 1991(Texas Utilities Code Section 33.008). Prior to the law change the franchise agreement provided for a franchise payment of 4%. Subsequent to the law change a kWh factor is multiplied by the total kWh used by League City customers. Payments are received quarterly. The law changed in 1999. Audit can go back two years.

TNMP Franchise Fees (Annual – Calendar Year)				
2011	2012	2013	2014(1/2 yr.)	Total
$2,902,177.73	$2,875,576.32	$2,870,495.74	$1,272,393.95	$9,920,643.74
Source: Franchisee's Checks and Customer Receipts in Accounting				

In determining if the city has been and is being paid all the revenue it should be, two items were verified.

First, total kWh hours which involves ensuring that all residents are included in the count are accounted for. We received a database from TNMP and GIS compared it to our existing address points. GIS indicated there seemed to be no apparent gaps in their service area.

Second, is the kWh factor truly representative of our right-of-way cost? The calculation goes back to 1998. At that time, TNMP took the 1998 total franchise revenue of $1,431,305.89 and divided it by the 1998 total kilowatt hours of 388,979,925 to get the kWh factor. That factor is still in use today as .0036796. In reviewing other cities electrical franchise agreements, many have changed that factor several times over by way of an annual adjustment factor.

Additionally, Contributions In Aid of Construction (A payment from Retail Customer, required prior to construction, for line extension projects whose project costs exceed the customer's Standard Allowance, if applicable.) and Discretionary Service Charges (e.g., Priority Move-In, Reconnections, Disconnections, Temporary Service) do not appear to have been included in revenue at the time of the initial calculation of the factor or are separate fees subject to the 4% rate.

Cable

The city's only cable provider is Comcast. The authoritative pronouncement that governs cable services is Chapter 66 – State-Issued Cable and Video Franchise, Subtitle C – Telecommunications Utilities, Title 2 – Public Utility Regulatory Act of the Utilities Code which became effective in 2005. The franchise fee according to this document is five percent. There is an additional one percent fee for In-Kind contributions. This is more commonly known as the PEG fee. PEG stands for Public, Educational and Governmental. Payments are received quarterly. The law allows the audit to go back four years.

Comcast Franchise Fees (Annual – Calendar Year)				
2011	2012	2013	2014(1/2 yr.)	Total
$1,150,520.93	$1,209,108.98	$1,211,904.72	$604,234.53	$4,175,769.16
Source: Transaction Detail Reports and Customer Receipts in Accounting				

Since Comcast is our only provider, GIS plotted coverages to visualize voids in coverage. Their analysis has shown 275 active video customers that should be in the city limits but are not.

The Auditor's office researched other audit offices audits on cable providers to find issues that League City might also have.

Centerpoint Energy

Centerpoint Energy (Centerpoint) is the city's gas provider. The authoritative pronouncement is a franchise agreement signed in 2003. It calls for a 2% of gross receipts franchise fee received quarterly. The term of the contract is five years and contains a five year evergreen clause. The audit period allowed is within two years. Franchise revenue for the past several years is as follows:

Centerpoint Franchise Fees (Annual – Calendar Year)				
2011	2012	2013	2014(3/4 yr.)	Total
$227,069.23	$199,486.19	$239,389.34	$225,621.39	$891,566.15
Source: Transaction Detail Reports and Customer Receipts in Accounting				

This audit's objective was to verify three items:

- Does Centerpoint include all League City resident addresses in its calculations?
- Does it include all revenue categories in its gross receipts calculation?
- Can the franchise agreement be strengthened?

Telephone

One of the largest Certified Telecommunication Providers (CTP) we have is Verizon.

Verizon Franchise Fees (Annual – Calendar Year)				
2011	2012	2013	2014(1/2 yr.)	Total
$206,212.87	$183,210.57	$165,513.39	$77,514.14	$632,450.97
Source: Check Copies and Customer Receipts in Accounting				

CTP's are governed by the Texas Administrative Code, Chapter 26, Section R. Previous to HB-1777, the city had a franchise agreement with Verizon. That agreement required GTE/Verizon to pay the city 2% of gross receipts as the franchise fee. According to a city memo, Verizon terminated its franchise agreement with the City of League City by notification in November 1999, as provided in HB-1777. According to the new legislation, franchise fees are based on three different categories of access lines; residential, commercial and point-to-point (private) (high-capacity data lines). Each category has a per line charge. CTP's are required to report the number of access lines in the city on a quarterly basis. Taking the number of access lines reported times the access line charges yields what each franchisee pays to the city. The city can gain access to the Public Utility Commission's (PUC) website to determine the number of access lines each CTP had in the city for the previous quarter. A comparison of the last 10 years for access lines is as follows:

	Category 1	**Category 2**	**Category 3**
June 2014	16,774	4,636	93
July 2004	21,423	4,459	122
Source: PUC Access Line Reports			

The law allows an audit to go back three years.

Requested Information

Verizon provided us with a range of addresses for the streets of League City. The analysis of address ranges focused on any obvious voids.

CTP's Using the City's ROW

During this audit it came to the auditor's attention by way of the PUC access line counts that numerous CTP's utilize the city's rights-of-way (ROW). Since first quarter 2011, 22-25 CTP's have been reporting to the PUC that are operating in League City. According to Chapter 26 of the Texas Administrative Code there are two types of CTP's.

> "An underlying CTP is a CTP that owns facilities or provides facilities or capacity to another CTP in the rights-of-way of municipalities. A reselling

> CTP is a CTP to whom an underlying CTP resold, leased or otherwise provided access lines that extend to the end-use customer's premises."

According to a reliable city source, the city has four underlying CTP's. They are AT&T, Comcast, Verizon and Phonoscope. The remaining CTP's would be reselling CTP's.

During the audit it was discovered that several entities are paying a ROW fee but are not registered with the PUC; additionally, several entities were on the PUC list but not paying access line charges. It should be noted that only voice service must register with the PUC.

Access Line Charges

When the law changed at the turn of the century, the PUC developed access line charges for each of the three categories. PUC rules indicate the average default ratio for access line categories 1, 2 and 3 is 1:2.3:3.5, respectively. The city's current access line rates are 1.32, 1.36, and 3.19 for access line categories 1, 2, and 3 respectively.

The city has two ways to change the access line charges. One is by reallocation of the category charges. A municipality may petition a modification of the default allocation or its own allocation by notifying the commission and all affected CTP's in the municipality. This is done no later than September 1 of each calendar year, and not more than once every 24 months.

Secondly, the PUC allows annual adjustments to the rates per access line by category by an amount equal to one-half the annual change, if any, in the most recent consumer price index (CPI).

Solid Waste

Republic Waste has an exclusive franchise agreement for service in League City. The authoritative pronouncement that governs garbage pick-up is a franchise agreement that took effect in February 2013 and expires on January 31, 2018 with one additional period of five years. The agreement reads as follows: "The City shall bill residential units, and shall pay the Contractor on a monthly basis; such remittance to be received by Contractor by the 15th of the month following the month service was rendered. Contractor shall bill commercial customers directly. 1. CONTRACTOR shall pay the City monthly, $5,000 for sales of recyclables. 2. CONTRACTOR shall remit to the city a monthly franchise fee of 7% within twenty (20) days of previous service month. This fee will be based on the gross Commercial revenues generated in the City. The franchise fee is subject to adjustment by the City during the term of this agreement. In addition, the CONTRACTOR shall supply a report showing the gross revenues billed and used for calculating the franchise fee. Report shall also include a listing of dumpsters, roll off containers, and any other commercial collections by size, frequency, company name, location address and any other pertinent information. CONTRACTOR shall not discontinue service to any commercial customer except for delinquent payment and then only after written delinquent notice has been given to customer." There is no stipulation of how far back we can audit these entities.

Prior to Republic Waste, Ameriwaste held the exclusive franchise for garbage service in the city. Its franchise agreement was very similar to Republic Waste's agreement.

Republic and Ameriwaste Franchise Fees (Annual – Calendar Year)				
2011	2012	2013	2014(2/3 yr.)	Total
$181,347.43	$178,958.58	$163,952.73	$107,988.83	$632,247.57
Source: Check Copies and Customer Receipts in Accounting				

GIS verified if there were any voids in coverage.

Additionally, the auditor needed to verify that the revenue database indicated that the revenue reported was accurately reported.

Republic Waste does make use of tax resale certificates. For example, some businesses in League City may have national contracts with other waste haulers such as Waste Management. That presents a problem in League City since we operate under an exclusive franchise agreement with Republic Services. Republic Services 10K annual report indicates over 500 affiliates. During this audit it was observed that O'Reilly's invoice presented to us did not include sales tax. Inquiry revealed that O'Reilly's is a customer of Waste Management not Republic Service. It was determined that Waste Management's subsidiary Oakleaf Waste Management was paying sales tax to the State of Texas Comptroller.

The arrangement for this to work is as follows: Waste Management subcontracts with RSNA, a subsidiary of Republic Services who in turn subcontracts to BFI of Texas who is the entity League City has the exclusive franchise agreement with.

Overall Conclusion

Solid Waste

The two main issues observed were contract terms and monitoring the contract.

The Opportunities for Improvement are as follows:

- Both Ameriwaste and Republic netted out sales tax and franchise fee from Commercial Gross Revenue
- The $5,000 recycling fee for January 2013 was not made by Ameriwaste
- The January 2013 payment of $8901.33 is trending low with an average of approximately $14,000 per month
- In some cases tax-exempt resale certificates are being used. It appears that Ameriwaste used them also. Verification of the sales tax payment needs to happen
- For a couple of months the supporting documentation that supported the monthly payment was not complete
- The contract needs to be strengthened as follows:
    - Interest must be applied to late payments since they are several days late every month and in several cases they were late by a month
    - Additionally assess a penalty on late payments
    - Expressly state the deficiency must be paid within a certain amount of days
    - A provision that states the company shall establish a reasonable accounting system, which enables ready identification of gross revenues and any other pertinent information the City may need. The City requires the contractor to keep adequate books and records for review. The City requests the ability to examine the financial system and that the City can request improvements to the system
    - Request Republic to provide an independent audit of gross receipts

- Not all customers of Republic were found on their revenue report

Electricity

The GIS study on voids did not show any specific voids to pursue.

Two items stood out:

1) It does not appear that the original kWh factor which is still in use was inclusive of all revenue such as Contributions in Aid of Construction (CIAC) and Discretionary Service Charges (DSC) or they do not take 4% (as stipulated in the franchise agreement) of this revenue.

2) The kWh factor has been fixed and does not account for increases in rights-of-way fees. Several cities (Exhibit C) have an Annual Adjustment Factor built into the calculation.

Gas

The GIS study on voids indicated seven addresses should have been included in League City's franchise payments and were not.

Additionally, there were Opportunities for Improvement regarding the contract itself.

Cable

The audit found several errors in their calculation of revenue. Additionally, not all customers were included in League City revenue.

Telephone

What was found in this phase of the audit was more from the CTP standpoint rather than the individual CTP Verizon. The city's monitoring should ensure that we are receiving all monies from the CTP's on the PUC report and if we find payment from what appears to be a CTP and is not on the PUC report then that should be reported to the PUC. The managing of the City's CTP's needs improvement. The city should reevaluate the access line charges and consider the opportunity to raise the rates annually.

Opportunities for Improvement

During the audit there was identified certain areas for improvement. The audit was not designed or intended to be a detailed study of every relevant system, procedure, and transaction. Accordingly, the Opportunities for Improvement section presented in this report may not be all-inclusive of areas where improvement might be needed.

One of Management's projects for this fiscal year is determining other sources of revenue. This audit does provide ways in which to improve the revenue flow. However, it must be understood that some of the Opportunities for Improvement in revenue may pass through to the ultimate consumer. The revenue then cycles back out to the citizen in the form of public services.

Management is in a unique position to best understand their operations and may be able to identify more efficient and effective approaches to the following recommendations:

Opportunity for Improvement #1
REPUBLIC
Condition (The way it is)
Ameriwaste (contract from 2/1/08 – 1/31/13) and Republic Waste (contract from 2/1/13 – 1/31/18) have previously and are currently netting out sales tax and franchise fees collected from the customer in their calculation of franchise fees paid.
Criteria (The way it should be)
Section 16 of the franchise agreement states the fee will be based on the gross Commercial revenues generated in the City. The term gross Commercial Revenues is defined as all revenues generated from this agreement, excluding those generated in residential. Gross means all intakes. The court case City of Dallas, TX v. Federal Communications Commission provides great insight into the definition of gross revenue and franchise fees. This court case is from the United States Court of Appeals Fifth Circuit. While it specifically deals with the cable industry its content and conclusion can be applied to other sectors of the economy. ➢ From the court case – "Black's Law Dictionary defines "gross" as "Before or without diminution or deduction" or "not adjusted or reduced by deductions or subtractions." "Gross Revenues" is defined by Black's as "receipts of a business before deduction for any purpose except those items specifically exempted." ➢ From the court case – "Industry accounting practices require that money collected from subscribers to pay franchise fees be included in gross revenue. The Financial Accounting Standard Board's Statement of Financial Accounting Standards No. 51 notes that "cable franchise fees are costs no

different than the general manager's salary, marketing costs, and programming costs." Therefore, under the standard accounting practices money collected to pay franchising fees are included in gross revenue."

- From the court case – "Franchise fees are not a tax, however, but essentially a form of rent: the price paid to rent use of public right-of-ways….Furthermore, even if franchise fees were treated as a tax, they would still be treated as a normal expense of doing business unless the tax was imposed directly upon the subscriber. Courts have held that gross revenue generally includes revenues collected for taxes."

- From the court case – "Webster's New International Dictionary, 1103 (2d Ed.1940) defines "gross' as "Whole; entire; total; without deduction… The gross earnings, receipts or the like are the entire earnings, receipts or the like, under consideration, without any deduction."

- From the court case – "The phrase "passed the tax on" is inaccurate….The purchaser does not pay the tax. He pays or may pay the seller more for the goods because of the seller's obligation, but that is all….The price is the total sum paid for the goods. The amount added because of the tax is paid to get the goods and for nothing else. Therefore, it is part of the price."

- In our City Attorney's view, the language in our franchise agreement would not accommodate netting out sales tax and franchise fees collected from end users.

- Other franchise agreements have the same provision for fee on fee.

Effect (So what?)

It appears the netting of gross revenues has been going on since the inception of the Ameriwaste contract. For calendar year 2011 when Ameriwaste had the contract the difference between netting and not netting was $23,109.58 and for 2012 the difference was $23,823.38. The city did not receive all the revenue it should have according to the contracts.

The time Republic has had the contract taxable and nontaxable revenue were not split out therefore the netting effect cannot be calculated.

Cause (Difference between condition & criteria)

A lack of monitoring for the payments received to see if they agree with what the contract dictates.

Recommendation

The following steps are recommended:

- Put into place a monitoring process to ensure that all payments (not just for solid waste) received by the city meet the requirements of our contracts.

- Confer with the City Attorney about the collection of past years franchise fee payments that were netted and handling this for future payments.

Management Response

In the 2012 RFP process that resulted in the current contract, the City took the position that sales tax and franchise fees were not to be included in the base cost, and thus they were considered "add on" fees. This position was consistent with the contract that was in place at the time. The intent of the contract with Republic was to mirror the practice under the Ameriwaste agreement.

Management agrees that there is ambiguity in the contract language; however, the franchise fee has been collected consistently, from both contractors, since 2008 based upon the mutual understanding of the contractor and the City as to the definition of gross revenue.

Action Plan

1. Finance will be responsible for ensuring that all payments received by the City meet the requirements of the contract. With Council's concurrence, we recommend that the City amend the contract to clearly define the intent and practice of collection of franchise fees and to clarify that for the purpose of this contract, the definition of gross revenue is to net out sales tax and franchise fees.
2. If there is a desire to increase the franchise fee revenue, staff recommends working with our vendor to amend the solid waste agreement to increase the franchise fee rate from the current 7%.

Implementation Date

Staff will work with the vendor to clear up language and bring back a revised agreement for Council consideration by September 30, 2015.

Auditor's Comment

Generally Accepted Government Auditing Standards Section 7.37 states: "If the auditors disagree with the comments, they should explain in the report their reasons for disagreement."

Auditor respectfully disagrees with points made in the Management Response.

In Exhibit "B" of the Ameriwaste agreement the commercial pricing stipulates that it includes the 7% Franchise Fee and the 8% Sales Tax. Additionally, those items are "revenues generated" from the Agreement. However, when Ameriwaste sent in their supporting documentation and check they took out the franchise fee and sales tax from their calculation of the city's franchise fee. It appears that we did not realize we received a franchise fee based on Net Revenue rather than Gross Revenue as the city allowed this to happen for the duration of that contract. The Ameriwaste contract stipulates, "This fee will be based on the gross Commercial revenues generated in the City. In addition, the CONTRACTOR shall supply a report showing the gross revenues billed and used for calculating the franchise fee." It should be noted that the contract called for a report showing gross revenues "billed." Billed means what was invoiced to their customers. Note also that the contract does not exclude sales tax or franchise fee from the category of gross Commercial revenues.

In 2012 an RFP process began to determine the city's next waste hauler.

Management states in their response that, "In the 2012 RFP process that resulted in the current contract, the City took the position that sales tax and franchise fees were not to be included in the base cost, and thus they were considered "add on" fees. This position was consistent with the contract that was in place at the time." Auditor contends that was not consistent with the contract that was in place at the time. Reference third paragraph of the Auditor's Comment.

Exhibit "B" of the Republic agreement excludes the sales tax and franchise fee in Commercial pricing. This is different from the Ameriwaste agreement which included sales tax and franchise fees in Commercial pricing. During the audit, auditor was given an excerpt from the question and answer phase of RFP 12-08 which stated the following, "Does the price on the Proposal Form include franchise fees? The answer was: No, do not add franchise fees, administrative fees or sales taxes." That is what in fact was found on Exhibit "B". However, that does not say that such sources of revenue are excluded from the term "Commercial Revenues;" it does indicate that they are not considered a component of the quoted fee for service. They are "revenues generated" from the Agreement. As in the Ameriwaste contract, the Republic contract states the following: "This fee will be based on the gross Commercial revenues generated in the City. In addition, the CONTRACTOR shall supply a report showing the gross revenues billed and used for calculating the franchise fee." Here again the contract called for a report showing gross revenue "billed." Billed means what was invoiced to their customers. A sampling of invoices from Republic clearly indicates that the billed or invoiced amount included sales tax and franchise fees. Again, as in the Ameriwaste contract, the city continued to receive franchise fee based on Net Revenue not Gross Revenue.

Section 35 of the Republic Agreement states, "This Agreement constitutes the entire agreement of the parties. There have been no representations made other than those contained in this Agreement." Therefore, the contract prevails.

Management Response states, "….the franchise fee has been collected consistently, from both contractors, since 2008 based upon the mutual understanding of the contractor and the City as to the definition of gross revenue." The definition of gross revenue is clear. It is defined in the dictionary; it is noted in a Financial Accounting Standard and interpreted in a court case. By way of example, Gross Revenue includes sales returns, sales allowances and sales discounts. Those are deducted to get Net Revenue. Gross is all intakes. The mutual understanding of the contractor and the City and what was in the contracts differ.

The effect is that the city did not receive all the revenue it should have.

Opportunity for Improvement #2
REPUBLIC
Condition (The way it is)
1) The city shows no record of the $5,000 recycling fee made for January 2013 2) The January 2013 payment of $8,901.33 does not trend properly as the average monthly payment is around $14,000. 3) For a couple of months the supporting documentation received was not complete. In June of 2014 only 12 of the usual 20 page monthly report was received and no front-loaders were found on the report. In July of 2014 the report title page showed over $202,000 in gross revenue but the backup only added to $91,000.
Criteria (The way it should be)
1) Section 16 of the franchise agreement states, "Contractor shall pay the City monthly, $5,000 for sale of recyclables." 2) A trend analysis of large receivables can quickly spot an irregularity and compels an inquiry. 3) For large payments the city should ensure proper monitoring over the payment received by reviewing supporting documentation.
Effect (So what?)
1) The city loses out on $5,000 of revenue 2) The city loses out on a potential $5,000 of revenue 3) Supporting documentation provides the evidence for the payment received to ensure the city is receiving what it deserves
Cause (Difference between condition & criteria)
1 and 2) This was the last month of the contract with Ameriwaste. Republic took over in February 2013. The monitoring over the transition from Ameriwaste to Republic was lacking. 3) A lack of monitoring over the large payments from our franchisees
Recommendation
1) Ensure that during any transition of contracts due diligence is performed with a final accounting and an observation over the first couple of months with the new franchisee. 2) Train the appropriate personnel to perform the monitoring process. Properly supervise the monitoring process.
Management Response
Management agrees.
Action Plan
1. Finance will be responsible for ensuring that all payments received by the City meet the requirements of the contract. 2. Finance will request a more detailed payment report from Republic as

discussed in Opportunity for Improvement #3. When the detailed report and payment are received each month, Finance will verify that the payment amount is in compliance with the contract.

3. Finance invoiced Ameriwaste on 02/11/2015 and again on 03/16/2015 for the past amount due for recycling fees and franchise fees from January 2013. If payment is not received, the issue will be turned over to the City Attorney.

Implementation Date
The City's request for more detailed reports from Republic is expected to occur by June 30, 2015.

Opportunity for Improvement #3
REPUBLIC
Condition (The way it is)
In some cases Republic was a party to tax-exempt resale certificates. The city does not monitor if the ultimate seller of the services is remitting sales tax to the state. In Ameriwaste's case, the supporting documentation showed big box retailers as nontaxable.
Criteria (The way it should be)
State of Texas Tax Code Chapter 151, Subchapter E, Resale and Exemption Certificate.
Effect (So what?)
It is unknown whether the city actually receives the funds from the use of tax-exempt resale certificates.
Cause (Difference between condition & criteria)
Republic Waste – The monthly reports are not broken out between taxable and nontaxable. Because of this management would not have found this unless they requested a customer invoice from Republic and questioned why no sales tax appeared on the invoice. Ameriwaste – The monthly reports were broken out between taxable and nontaxable. Management was not properly monitoring the supporting documentation that came with the payment.
Recommendation
Request Republic to break out their customers by tax classification and on a periodic basis review tax-exempt resale certificates to ensure the city is getting their sales tax dollars. Continue pursuing all tax-exempt resale certificates from Republic and determine if the form is properly filled out and qualifies to have a tax-exempt resale certificate.
Management Response
Management agrees.
Action Plan
1. Finance will request a report from Republic that breaks out the customers by tax classification to ensure the City is getting their sales tax dollars. 2. This report will be reviewed no less than annually in conjunction with tax exempt resale certificates to ensure sales tax is being remitted accurately to the State.
Implementation Date
The City's request for more detailed reports from Republic is expected to occur by June 30, 2015. Implementation is contingent upon receiving the detailed report from Republic.

Opportunity for Improvement #4
REPUBLIC
Condition (The way it is)
For FY12, 13, and 14 each monthly payment was made 2-7 days late and in eight cases the payment was several weeks late.
Criteria (The way it should be)
The franchise agreement states payment must be made by the 20^{th} of the following month
Effect (So what?)
Noncompliance with the agreement. The city can't spend the money until the city receives it.
Cause (Difference between condition & criteria)
Republic has no incentive to pay on time.
Recommendation
Revise contract to reflect the following: 1) Apply interest for each day the payment is late. 2) In addition to the interest, assess a penalty. 3) A provision that states the deficiency must be paid within a set number of days
Management Response
Management generally agrees. A late payment is a default under the terms of the contract. When put on notice, they have 60 days to cure.
Action Plan
Management will work with Republic to request an amendment to the current contract to address the recommended contract revisions.
Implementation Date
Working with Republic on an amendment to the contract is expected to be implemented by September 30, 2015.

Opportunity for Improvement #5
REPUBLIC
Condition (The way it is)
GIS analysis revealed locations that appeared they should have been on Republic's revenue report but were not. Analysis on these locations revealed 13 that should have been included in their revenue report but were not. An additional two locations are violating our Exclusive Franchise Agreement in that Waste Management is making the pick-ups.
Criteria (The way it should be)
The City must receive all franchise fee revenue it deserves.
Effect (So what?)
The City is not receiving all the revenue it deserves. The total dollar amount owed is approximately $10,000.
Cause (Difference between condition & criteria)
Republic's financial accounting system is suspect. See Opportunities for Improvement #2 Part 3. Because of this there is an inherent risk with the revenue reported by Republic. Closer monitoring was lacking.
Recommendation
1) Closer monitoring is required for this contract. Ensure accountability for this contract has been assigned. 2) A provision in the contact and future third-party contracts that states the company shall establish a reasonable accounting system, which enables ready identification of gross revenues and any other pertinent information the City may need. The City requires the contractor to keep adequate books and records for review. The City requests the ability to examine the financial system and that the City can request improvements to the system or request that Republic attain an independent audit of gross revenues to ensure the reliability and integrity of the calculation for franchise fees
Management Response
Management agrees.
Action Plan
1. Finance in conjunction with Public Works will be responsible for monitoring contract compliance. 2. Management will work with Republic to request an amendment to the current contract to address the recommended contract revisions. 3. A GIS address analysis will be performed on a periodic basis to ensure the City is receiving all the revenue it deserves. 4. Finance will send an invoice to Republic for the $10,000 due from the 13 miscoded addresses.
Implementation Date
Working with Republic on an amendment to the contract is expected to be implemented by September 30, 2015. An invoice to Republic for the miscoded addresses is expected to be sent by June 30, 2015.

Opportunity for Improvement #6

TNMP

Condition (The way it is)
The TNMP kWh factor may not have included all revenue (CIAC and DSC) in the initial calculation which is still used today or the City is not receiving 4% of that revenue. It is not clear how CIAC and DSC revenue should be accounted for.
Criteria (The way it should be)
All CIAC and DSC revenue should be accounted for.
Effect (So what?)
No matter how CIAC and DSC should be accounted for currently the city may not be receiving all revenue.
Cause (Difference between condition & criteria)
TNMP considers CIAC and DSC to be cost recovery charges and not revenue
Recommendation
Continue to work with the City Attorney to ensure the baseline kWh includes all revenue or ensure that CIAC and DSC revenue is remitted at 4%
Management Response
Management agrees.
Action Plan
1. Prior to the contract expiring in October 2016, management will begin working with the City Attorney to negotiate a new contract. During that process, management will work to establish a kWh factor that is inclusive of all costs.
Implementation Date
Contract negotiations are expected to be completed by October 31, 2016.

Opportunity for Improvement #7

TNMP

Condition (The way it is)
The kWh factor is probably not truly representative of what our right-of way fees should be. The factor was devised in 1998 using 1998 revenue and 1998 kilowatt hours.
Criteria (The way it should be)
Prudent practices would dictate that our largest franchise fee should be using a more current factor.
Effect (So what?)
The city may not be receiving all the revenue it deserves to receive.
Cause (Difference between condition & criteria)
Monitoring over our large payments was not observed during this audit.
Recommendation
Confer with the City Attorney to update the franchise agreement to: ➢ Take into consideration the new law and including an Annual Adjustment Factor. ➢ Include an Interest and Penalty provision for late payments. ➢ Provide for an annual audit report showing gross revenues received by the franchisee with respect to the City during the preceding fiscal year of the Franchisee. This provides a mechanism to determine where we stand in comparison to % of Gross Revenue.
Management Response
Management agrees
Action Plan
1. Prior to the contract expiring in October 2016, management will begin working with the City Attorney to negotiate a new contract. The new contract may include (1) an annual adjustment factor, (2) a penalty and interest provision for late payments, and (3) a provision for an annual audit showing gross revenues.
Implementation Date
Contract negotiations are expected to be completed by October 31, 2016.

Opportunity for Improvement #8
CENTERPOINT
Condition (The way it is)
1) The GIS analysis of Centerpoint revealed 7 addresses that League City should have received franchise fees but did not. 2) The contract has areas that are a hindrance to the city: ➢ The audit period of two years does not allow an adequate resolution of an audit issue ➢ The contract lacks incentives for prompt payment ➢ The contracts two percent franchise fee has potential for additional revenue ➢ The contract does not require sufficient and appropriate supporting documentation with the payment
Criteria (The way it should be)
1) The city needs to pursue all revenues that it rightly is entitled to. 2) ➢ A four year audit period should be in all contracts ➢ Incentivization should be in all contracts to encourage prompt payment ➢ Periodic reviews of our revenue contracts to determine if they are still in line with other cities and inflation ➢ All revenue contracts should require sufficient and appropriate supporting documentation to substantiate the payment made to the city
Effect (So what?)
The city has not optimized its revenue source for Centerpoint gas
Cause (Difference between condition & criteria)
Monitoring over our revenue contracts
Recommendation
Confer with the City Attorney on updating this evergreen contract regarding the four points mentioned above.
Management Response
Management agrees
Action Plan
1. Management will propose an amendment to the current contract which will include (1) a four year audit period, (2) an incentive to encourage prompt payment, and (3) a requirement of sufficient and appropriate supporting documentation with the payment. 2. Management will perform a periodic review of the 2% franchise fee rate to see if it is in line with other cities and inflation. 3. On January 6, 2015, the City received a payment of $126.78 for the revenue loss from the 7 miscoded addresses.

Implementation Date
Management will attempt to amend the current contract by March 2016. If that attempt is unsuccessful, management will propose the amendments during the contract renewal period in March 2018.

Opportunity for Improvement #9

CERTIFIED TELECOMMUNICATION PROVIDERS

Condition (The way it is)

1) Management over the city's rights-of-way and collection on the rights-of-way for Certified Telecommunication Providers (CTP's) needs improvement.

2) The 2013 1st and 2nd Quarter PUC Access Line Reports were examined to determine if League City is receiving all access line revenue that it should be and if all payments we are receiving are listed on the PUC Access Line Report. What this examination found was three entities on the PUC Report but not on our list of payments received. Also, six entities were listed as providing franchise fee payments to us but not on the PUC Report.

3) Auditor found no history on the access line rates for each category. It could not be determined if the current access line rates (1.32, 1.36 and 3.19 for categories 1, 2 and 3 respectively) have ever been evaluated or changed. "The commission's default allocation shall be a ratio of 1:2.3:3.5 for access line categories 1, 2, and 3 respectively. This default allocation represents an average of all allocation ratios filed by municipalities with the commission pursuant to Section 26.463 of this title." Our ratio is currently 1:1.03:2.42. Times have changed since the first access line calculation came into law in 1999. The following table provides estimated access line charges for our current ratio and other variations of our current ratio based on the default allocation for a one month period (December 2014).

Category 1	Category 2	Category 3	Access Line Fees
1.32	1.36	3.19	$30,000
.91	2.09	3.19	$27,000
1.32	3.04	4.62	$39,000
.59	1.36	2.07	$17,000
Source: Internal Audit Calculations			

The above is based on December 2014 access lines: 16,770 for Category 1, 5,290 for Category 2, and 111 for Category 3.

According to Section 26.467 of the Texas Administrative Code, Title 16, Part II, the original rate determination was calculated based on 1998 total revenue from all categories and then allocated by percentage to each of the three categories and then dividing by each categories access line count. No information can be found on determining the allocation percentage for each category.

The allocation must be just and reasonable, competitively neutral, and non-discriminatory.

To revise the allocation formula, Chapter 26 states, "No later than September 1 of each calendar year, and not more than once every 24 months, a municipality may petition a modification of the default allocation or its own allocation by notifying the commission and all affected CTP's, the municipality shall designate the allocation that it wishes to have the commission apply in the next calendar year."

4) Each March the PUC notifies the cities of any inflationary increase in the maximum access line rates. The city can choose whether they want to retain the default rate of the previous year or increase the access line rates due to inflation. In the past the city has not opted to increase the rates due to inflation.

Criteria (The way it should be)

1) The ability to use the city's rights-of-way should be predicated on the basis of a registration process. A coordinated approach to rights-of-way and payment must be present.

   Chapter 283 of the Local Government Code, Section 283.001 (b)(1) and (b)(2) states the following:

   "It is also the policy of this state that municipalities:

   (1) Retain the authority to manage a public right-of-way within the municipality to ensure the health, safety, and welfare of the public; and
   (2) Receive from certificated telecommunications providers fair and reasonable compensation for the use of a public right-of-way within the municipality."

   City Charter Article IX, Sections 1 through 7, Franchises and Public Utilities, Sections 1-7 governs the grant of and regulation of franchises.

   Sec. 98-156 of the city's code on unauthorized use of public rights-of-way states this. "Unless otherwise specifically provided by law, it shall be unlawful for any person to lay, construct, operate, maintain, offer for lease, or make available for any use whatsoever, any facilities across, along, over, above, or under any public right-of-way for any private or commercial purpose unless authorization has been granted by the city."

   Sec. 98-157 of the city's code on registration. "To protect the public health, safety and welfare, all users of the right-of-way must register with the city."

2) and 3) Proper operating revenue management would dictate periodic reviews of our large revenue streams and the allocation of access line charges which gives us our revenue.

4) Proper operating revenue management would dictate the awareness and consideration of all potential revenue sources. This would coincide with management's revenue study. Additionally, it would enhance our ability to go to a pay-as-you-go basis for capital items.

Effect (So what?)
The rights-of-way of the City are inalienable to the City. The City must ensure they are safe, efficient, and a continuous service to the public. Proper management facilitates this process. If one CTP pays the proper amount and another does not pay the proper amount or doesn't pay any amount *equity* becomes an issue. The City needs to ensure it is provided all the revenue it deserves. This past year League City could have assessed the following rates: 1.41, 1.45, and 3.35 for categories 1, 2, and 3, respectively. The difference between the current rates and the CPI adjusted rates for the month of September 2014 comes out to about $2,000 ($31,503.69 - $29,510.98 = $1,992.71)
Cause (Difference between condition & criteria)
Auditor found no city personnel using the PUC Access Line Count report. This report would give the city some idea of who exactly is using the City's rights-of-way and what revenue the City should be collecting each quarter.
Recommendation
1) Use the PUC Access Line Report 2) Recalculate the payments for the top three to five CTP's 3) Follow-up by contacting those not submitting payments. 4) Follow-up on those the city is receiving payments on but not included in the PUC report. If necessary, report those not registered on the PUC site. 5) Reevaluate the access line charges. 6) Request a remittance form for the number of lines being used 7) Consider the increase in access line rates due to inflation. 8) Evaluate what process to implement to better manage the CTP's that use the City's rights-of-way.
Management Response
Management agrees.
Action Plan
1. Finance will contact the PUC for online access to the PUC Report. The PUC report will be reviewed no less than annually to ensure the City is receiving payment from all CTP's that are required to submit payment. 2. Finance will recalculate the access line payments for the top three to five CTP's. 3. Finance will contact any CTP that is registered on the website but not remitting payment to the City. 4. Finance will notify the PUC of any CTP that is remitting payment but not registered on the PUC website. 5. Management may hire a third party vendor to reevaluate the access line charges to determine how the allocation ratio should be changed. 6. Finance will request a remittance form from the top three to five CTP's that do not submit the number of lines being used with their payment.

7. Rates will be submitted to City Council to consider an increase in the access line rates for determination of implementation of the CIP adjustment due to inflation.
8. Management will work on formalizing the relationship with the primary (Verizon) by developing a ROW agreement to replace the agreement terminated in November 1999. Management will monitor CTPs based upon the PUC listing to confirm that the CTPs that are not primary are just leasing capacity from the primary and not also utilizing the City's right of way.

Implementation Date

Action plan items 1-4 and 6 will be implemented by June 30, 2015. A reevaluation of the allocation ratio for the access line charges (item 5) will be implemented by September 30, 2016. Submittal to City Council of the possible inflationary rate increase (item 7) will be completed by April 30, 2015. Action Item 8 is expected to be implemented by September 30, 2016.

Opportunity for Improvement #10

COMCAST

Condition (The way it is)

1) Comcast is netting Advertising Commissions against Advertising Revenue.
2) Video install revenue was understated by a small amount for February and April of 2011
3) FCC Fee Revenue was understated 1/11 – 6/12 by $22,731.47.
4) February 2013 In-kind fee revenue did not include $16,815.23 in revenue
5) The address comparison revealed 275 active video customers that should be in the city limits but are not.

Criteria (The way it should be)

1) Chapter 66 of the Public Utility Regulatory Act states, "Advertising commissions paid to third parties shall not be netted against advertising revenue included in gross revenue."
2) Chapter 66 of the Public Utility Regulatory Act states, "Gross Revenues" means all consideration of any kind or nature ……….."
3) See #2
4) See #2
5) See #2

Effect (So what?)

1) Auditor recalculated one month, March of 2011, and found the additional franchise fee amounted to just over $2,000 for the month. $2,000 per month equates to $96,000 for a 48 month period.
2) Comcast owes $34.24 in unpaid franchise fees for Video Install Revenue.
3) FCC Fee Revenue created a shortfall of $1,363.89 in franchise fees.
4) In-kind franchise fee created a shortfall of $168.15.
5) Through December 2014, the additional franchise fee from the location study is approximately $42,018.

Cause (Difference between condition & criteria)

1) No previous monitoring over Comcast Franchise Fees has been done.
2) Same as #1
3) Same as #1
4) Same as #1
5) Same as #1

Recommendation

1) A determination needs to be made as to who best should periodically monitor franchisee's payments and adherence to the franchise agreement: City Management, City Auditor or a collaborative effort.
2) Same as #1
3) Same as #1
4) Same as #1
5) Same as #1

Management Response

Management agrees.

Action Plan
1. Management of this franchise agreement will be a collaborative effort between the management and the City Auditor. This includes a periodic review of the calculation of gross revenues and a GIS address analysis. 2. An invoice for the amount due will be sent to the vendor with a payment due date. If payment is not received by the due date, the matter will be turned over to the City Attorney.
Implementation Date
The invoice is expected to be sent by June 30, 2015.

Opportunity for Improvement #11

VERIZON

Condition (The way it is)

The GIS analysis of Verizon's street ranges revealed the following miscodings:

- 26 Single Line Residential
- 1 Residential with 2 Lines
- 1 Business with 2 Lines
- 1 Business with 3 Lines

These accounts were not correctly applied to League City.

Criteria (The way it should be)

The city needs to pursue all revenues that it rightly is entitled to.

Effect (So what?)

This equates to an additional $139 per quarter in TX Right-of-Way payments to League City. The effect of the misapplication of the past three years is approximately $1,300.

Cause (Difference between condition & criteria)

Monitoring over our revenue contracts

Recommendation

1) With the assistance of the City Attorney pursue collection of the misapplied past three years.
2) Monitor street ranges on a periodic basis.

Management Response

Management agrees.

Action Plan

1. On March 20, 2015, a letter was sent to Verizon requesting payment by April 30, 2015 in the amount of $1,290.24.
2. A GIS address analysis will be performed on a periodic basis to ensure the City is receiving all the revenue it deserves.

Implementation Date

Management expects to receive the requested payment from Verizon by the due date.

EXHIBIT A

Sampling Methodology

Republic Waste

Their entire database of League City customers was used for the GIS portion of the audit.

Their supporting documentation for each payment was used to determine if sales tax and franchise fees were netted out from gross revenues.

Five customer invoices for Republic were examined to determine if franchise fees and sales tax were charged to the customer.

TNMP

GIS used the entire database that the city was able to get through a Non-Disclosure Agreement.

Acquired two years of kWh's history in order to substantiate the calculation leading to the payment.

Centerpoint

GIS used the entire database that the city was provided by Centerpoint.

Acquired from Centerpoint two years of revenue history for examination purposes to substantiate the calculation leading to the payment.

Comcast

GIS used the entire database that the city was able to get through a Non-Disclosure Agreement.

Acquired from Comcast numerous gross revenue reports detailing revenue classifications for four years.

Verizon

GIS used subscriber addresses supplied by Verizon to determine if any voids existed in the data.

We attained PUC access line reports for the past four years and sampled two quarters of 2013. During the sampling we determined if the PUC report agreed with our monies received from franchisees.

EXHIBIT B

Reliability and Integrity of Information

Republic Waste

It took several tries to get accurate and comprehensive information to our GIS department. Even Republic admitted their system is old and has difficulty extracting information. Additionally, the response time to get information was slow. Some locations were not reflected on their revenue report. The city needs to consider their financial accounting system as an inherent risk with this contract.

TNMP

The auditor relied on computer-processed data in TNMP's information systems during this phase of the audit. Auditor directly tested the data rather than evaluate the systems' general and application controls. Auditor believes that the absence of testing general and application controls had no effect on the results of this phase of the audit.

It is the auditor's belief that there can be reliance on their information system.

Centerpoint

The auditor relied on computer-processed data in Centerpoint's information systems during this phase of the audit. Auditor directly tested the data rather than evaluate the systems' general and application controls. Auditor believes that the absence of testing general and application controls had no effect on the results of this phase of the audit.

It is the auditor's belief that there can be reliance on their information system.

Comcast

The auditor relied on computer-processed data in Comcast's information systems during this phase of the audit. Auditor directly tested the data rather than evaluate the systems' general and application controls. Auditor believes that the absence of testing general and application controls had no effect on the results of this phase of the audit.

The auditor found a few errors with their information systems. They are covered in Opportunity for Improvement #11.

Verizon

The auditor relied on computer-processed data in Comcast's information systems during this phase of the audit. Auditor directly tested the data rather than evaluate the systems' general and application controls. Auditor believes that the absence of testing general and application controls had no effect on the results of this phase of the audit.

The auditor found issues with the reliability and integrity of their street ranges assigned to League City. See Opportunities for Improvement #11.

EXHIBIT C

City Comparison of Franchise Fees						
City	**League City**	**Pasadena**	**Pearland**	**Baytown**	**Sugar Land**	**Texas City**
Telephone	Multiple	Multiple	Multiple	Multiple	Multiple	Multiple
Telephone Fee Related	Have not changed or reallocated fees	Have not changed or reallocated fees	Have not changed or reallocated fees	Have not changed or reallocated fees	Have not changed or reallocated fees	Have not changed or reallocated fees
Gas	Centerpoint	Centerpoint	Centerpoint	Centerpoint	Centerpoint	Centerpoint
Gas Fee Related	2% Qtr.	4% Qtr.	2% Yr.	3% Yr.	2% Qtr.	3% Qtr.
Cable	Comcast	Comcast	Comcast & SW Bell	Comcast & Suddenlink	Comcast & AT&T	Comcast
Cable Fee Related	State Law	State Law	State Law	State Law	State Law	State Law
Primary Electricity	TNMP & Centerpoint	Centerpoint	Centerpoint & TNMP	Centerpoint	Centerpoint	TNMP
Electricity Fee Related	Has Not Changed Their kWh Factor	Has Annual Adjustment Built Into Factor	Has Not Changed Their kWh Factor	Has Annual Adjustment Built Into Factor	Has Annual Adjustment Built Into Factor	Has Not Changed Their kWh Factor
Solid Waste	Republic Waste for Residential and Commercial	The Municipality Handles Residential and Waste Management for Commercial	Waste Mgt. Inc. for both Residential and Commercial	Multiple Firms – Republic, Waste Mgt. Inc., IESI, etc.	Republic Waste for Residential and Commercial	Republic Waste for Residential and Commercial
Solid Waste Fee Related	Commercial - $5,000/Mo. Recycling Fee and 7% of Gross Revenues	10% of Compensa-tion Received	Residential – 15% of Gross Revenue and Commercial – 18% of Gross Revenue	10% of Gross Receipts	5% of Gross Revenues	10% of Gross Receipts

Source of Information for Table: Internal Audit's Inquiry with Sampled Cities

City Comparison of Franchise Fees (Continued)						
City	**League City**	**Galveston**	**Webster**	**Deer Park**	**Friendswood**	
Telephone	Multiple	Multiple	Multiple	Multiple	Multiple	
Telephone Fee Related	Have not changed or reallocated fees	Have not changed or reallocated fees	Have not changed or reallocated fees	Have not changed or reallocated fees	Have not changed or reallocated fees	
Gas	Centerpoint	Centerpoint	Centerpoint	Centerpoint	Centerpoint	
Gas Fee Related	2% Qtr.	4% Qtr.	3% Qtr.	2% Qtr.	2% Yr.	
Cable	Comcast	Comcast	Comcast	Comcast and others	Comcast and others	
Cable Fee Related	State Law	State Law	State Law	State Law	State Law	
Primary Electricity	TNMP & Centerpoint	Centerpoint	Center-point	Centerpoint	Centerpoint in Harris County and TNMP in Galveston County	
Electricity Fee Related	Has Not Changed Their kWh Factor	Has Annual Adjustment Built Into Factor	Has Annual Adjustment Built Into Factor	Has Annual Adjustment Built Into Factor	Has Not Changed Their kWh Factor	
Solid Waste	Republic Waste for Residential and Commercial	Residential done by City and Commercial done by Republic, Progressive, TrashMasters and Waste Mgt. Inc.	Republic Waste	Residential done by City and Commer-cial done by Waste Mgt. Inc.	Progressive for Residential and Commercial	
Solid Waste Fee Related	$5,000/Mo. Recycling Fee and 7% of Gross Revenues	8% Monthly	No Franchise Fee – Residential is free	12% and additional 8% for Billing	10% of Gross Collected (less taxes)	