RON GALPERIN
CONTROLLER

September 23, 2016

Honorable Eric Garcetti, Mayor
Honorable Michael Feuer, City Attorney
Honorable Members of the Los Angeles City Council
All Angelenos

Re: Audit of the City's Oversight and Management of its Natural Gas Utility Franchise Agreement

Recent events and concerns over safety and public health prompted the need to review the City of Los Angeles' oversight, regulation and revenues related to the distribution and delivery of natural gas. Accordingly, the Office of the Controller undertook an audit to examine the City's crucial utility Franchise Agreement with Southern California Gas Company (SoCalGas).

The SoCalGas Franchise Agreement details the utility's right to distribute and sell natural gas within City limits. Originally entered into in 1992 for a 21-year term ending in 2013, the Franchise Agreement has since been extended on a year-by-year basis -- and is now set to expire June 30, 2017.

Among the concerns we identified:

1. **Franchise Fees** -- The utility pays franchise fees quarterly to the City based on 2% of the utility's reported natural gas sales within the City. Over the life of the agreement, SoCalGas has paid the City an average of $17.6 million per year, but those payments have fluctuated by as much as $6 million from one year to the next -- depending largely on natural gas usage and on the price thereof. The City received its highest annual fee of $26.8 million in FY 2008-09. Our audit highlights that other cities are charging higher franchise fees than the City of Los Angeles. The City of San Diego collects a combined 4% fee and surcharge; Fresno receives 3% and San Jose, 2.3%. Disturbingly, our audit also found that the City has merely relied on numbers reported by the utility -- and has yet to undertake an independent review of the numbers reported by SoCalGas. My office recommends that the Office of Finance partner with the newly established Office of Petroleum and Natural Gas Administration and Safety to undertake such a review.

2. **Street Damage Restoration Fees** -- Our audit also highlights the fact that SoCalGas is the only utility operating in the City of Los Angeles that does not pay Street Damage Restoration Fees (SDRF) for the cuts it makes into our City streets. All other utilities, including the Department of Water and Power, pay such fees--which were established by the City after the franchise agreement was originally executed. According to my office's calculation, the City could realize up to $1.3 million--and possibly more--in additional annual revenue if SDRF were to be included in the new Franchise Agreement.

3. **Oversight** -- State Law grants regulatory authority over natural gas transmission and distribution to the California Public Utilities Commission (CPUC). This limits the City's ability to oversee natural gas operations. Notwithstanding, recent failures of natural gas systems within California (such as the Aliso Canyon gas leak, which caused significant environmental damage and health concerns throughout the Porter Ranch area, resulting in evacuation of more than 11,000 residents) have drawn significant criticism about the quality of regulation and oversight provided by regulatory agencies such as the CPUC.

   The newly created Office of Petroleum and Natural Gas Administration and Safety within the Board of Public Works will be responsible for monitoring the Franchise Agreement. (Previously, the Department of Transportation oversaw the agreement.) My office recommends that the new Petroleum Administrator work to develop measures and practices to allow for proper oversight and controls.

4. **Franchise Renewal; Terms and Conditions** -- With the SoCalGas Franchise Agreement set to expire on June 30, 2017, we believe the City has an opportunity to negotiate a contract that better ensures accountability, effective monitoring and the establishment of appropriate franchise fees. In addition to updating these fees, the City now has an opportunity to include additional language to increase revenue and further protect the interests of the communities of Los Angeles, particularly as it pertains to charging for street repairs and clarifying indemnity provisions. It would be advisable that the City take the opportunity to clarify SoCalGas' indemnification of the City for financial losses stemming not only from pipeline problems within the City, but also from problems in supplementary facilities on which the City depends but which are located outside its borders. This would include SoCalGas facilities such as the Aliso Canyon storage field, where the massive gas leak occurred that forced City residents to evacuate.

5. **Legal Considerations** -- Our audit notes that negotiating a new agreement has been delayed pending resolution of a case now before the California Supreme Court, *Rolland Jacks et. al. vs. City of Santa Barbara*. The case involves the legitimacy of a fee hike imposed, as the result of an agreement between the City of Santa Barbara and Southern California Edison, on utility customers rather than on the utility. A Court

of Appeal described this surcharge as an "illegal tax masquerading as a franchise fee." No matter how that case is resolved, however, the City has a real opportunity to include contract provisions that target safety, operational compliance and full cost recovery related to franchise operations.

RECOMMENDATIONS:

1. Direct the Office of Finance, in partnership with the newly established Office of Petroleum and Natural Gas Administration and Safety, to assist in establishing and implementing appropriate procedures related to receiving all of the fees to which the City is entitled;

2. Negotiate a new Franchise Agreement to increase City franchise revenues consistent with the outcome of the *Rolland Jacks et. al. v. City of Santa Barbara* case;

3. Include in the new Franchise Agreement requirements that SoCalGas be responsible for paying Street Damage Restoration Fees;

4. Direct the new Petroleum Administrator to develop measures and practices to allow for proper oversight and controls and a compliance program to evaluate safety and security of franchise-related assets and operations; and

5. Strengthen indemnity and liability provisions of the Franchise Agreement.

Respectfully submitted,

Ron Galperin
CITY CONTROLLER

RON GALPERIN
CONTROLLER

September 23, 2016

Miguel Santana, City Administrative Officer
Office of the City Administrative Officer (CAO)
200 N. Main Street, Room 1500, CHE, MS 130
Los Angeles, CA 90012-4190

Dear Mr. Santana:

Enclosed is the report entitled, "Audit of the City's Oversight and Management of its Natural Gas Utility Franchise Agreement." A draft of this audit report was provided to your office on July 6, 2016, and we considered your staff's comments while finalizing the report.

If you have any questions or comments, please contact me at siri.khalsa@lacity.org or (213) 978-7391.

Sincerely,

SIRI KHALSA, CPA
Interim Director of Auditing

Enclosure

cc: Patty Huber, Assistant City Administrative Officer, CAO
Victor Parker, City Risk Manager, CAO
David Hirano, Chief Management Analyst, CAO

City of Los Angeles

RON GALPERIN
CONTROLLER

September 23, 2016

Claire Bartels, Director of Finance / City Treasurer
Office of Finance
200 North Spring Street, Room 220, MS 766
Los Angeles, CA 90012

Dear Ms. Bartels:

Enclosed is the report entitled, "Audit of the City's Oversight and Management of its Natural Gas Utility Franchise Agreement." A draft of this audit report was provided to your office on July 6, 2016, and we considered your comments while finalizing the report.

If you have any questions or comments, please contact me at siri.khalsa@lacity.org or (213) 978-7391.

Sincerely,

Siri Khalsa

SIRI KHALSA, CPA
Interim Director of Auditing

Enclosure

RON GALPERIN
CONTROLLER

September 23, 2016

Gary Lee Moore, PE, ENV SP City Engineer
Department of Public Works - Bureau of Engineering (BOE)
1149 S. Broadway, Suite 700, MS 490
Los Angeles, CA 90015-2213

Dear Mr. Moore:

Enclosed is the report entitled, "Audit of the City's Oversight and Management of its Natural Gas Utility Franchise Agreement." A draft of this audit report was provided to your office on July 6, 2016, and we considered your staff's comments while finalizing the report.

If you have any questions or comments, please contact me at siri.khalsa@lacity.org or (213) 978-7391.

Sincerely,

Siri Khalsa

SIRI KHALSA, CPA
Interim Director of Auditing

Enclosure

cc: Kevin James, President, Board of Public Works
James Zabala, Sr. Management Analyst, BOE
Julie Sauter, PE, Principal Civil Engineer, BOE

City of Los Angeles

RON GALPERIN
CONTROLLER

September 23, 2016

Seleta Reynolds, General Manager
Los Angeles Department of Transportation (LADOT)
100 S. Main Street, 10th Floor
Los Angeles, CA 90012

Dear Ms. Reynolds:

Enclosed is the report entitled, "Audit of the City's Oversight and Management of its Natural Gas Utility Franchise Agreement." A draft of this audit report was provided to your office on July 6, 2016, and we considered your department's comments while finalizing the report.

If you have any questions or comments, please contact me at siri.khalsa@lacity.org or (213) 978-7391.

Sincerely,

Siri Khalsa

SIRI KHALSA, CPA
Interim Director of Auditing

Enclosure

cc: Glenda Y. Silv, Board of Transportation, LADOT
Robert Andalon, Chief Management Analyst, Pipeline Franchise, LADOT

A U D I T

City of Los Angeles

Audit of the City's Oversight and Management of its Natural Gas Utility Franchise Agreement

September 23, 2016

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Los Angeles City Controller
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CONTENTS

<u>EXHIBITS</u>

SUMMARY

In the City of Los Angeles (the City), the Southern California Gas Company (SoCalGas) holds the franchise rights to store, distribute and sell natural gas. As part of a nearly 25 year-old franchise agreement, SoCalGas agreed to pay an initial sum of $6 million, and a quarterly franchise fee based on 2% of its gross receipts from selling and distributing natural gas within the City. This has averaged $17.6 million annually. The agreement was in accordance with California's framework for regulating the gas utility industry, and similar agreements are common throughout the United States.

The Los Angeles Department of Transportation is in charge of overseeing the City's franchise, but relies on State and Federal entities to regulate and monitor the natural gas industry. For instance, the California Public Utilities Commission (CPUC) monitors safety and regulates the operations of private utility companies in the state; the United States Department of Transportation also requires utility companies to report on natural gas transmission and distribution systems.

However, recent natural gas catastrophes have raised concern over whether the gas utility industry is properly monitored. In 2010 a natural gas pipeline owned by Pacific Gas & Electric exploded, killing eight people and destroying 35 homes. From October 23, 2015 to February 18, 2016, a massive leak at The Southern California Gas Company's Aliso Canyon storage facility spewed approximately 97,100 metric tons of methane and 7,300 metric tons of ethane into the air. The leak caused significant environmental damage, and raised health concerns for the 11,000 residents living in nearby Porter Ranch.

Originally a 21-year agreement, entered into in 1992, the City's current gas utility franchise agreement has been extended multiple times and is now set to expire in June 2017. Ongoing litigation over cities' rights to incorporate surcharges into utility franchises has delayed the City in renegotiating its franchise agreement. Once resolved at the California Supreme Court, the City should take the opportunity to negotiate a new agreement with the most favorable terms.

Given these factors, we conducted this audit to evaluate:

- The terms of the City's current franchise agreement with SoCalGas,
- The City's role in:
  - Monitoring franchise operations; and
  - Ensuring the collection of franchise revenue; and
  - Protecting against liability and implementing risk management practices.

We found that the City's role in administering the franchise agreement is fragmented–split between multiple departments–and that the City lacks the appropriate expertise. Currently the Los Angeles Department of Transportation (LADOT) is in charge of managing the franchise agreement because natural gas pipelines are generally under City streets. However, LADOT's expertise is not in managing the safety and security of natural gas pipelines, but in controlling the traffic and safety of the City's right of way.

Further, we found the City needs to improve how it collects and monitors the money it is entitled to receive. There have been no audits or analysis of the franchise fees remitted by SoCalGas. Significant fluctuations in the amounts should be better analyzed to assess their reasonableness.

To address these findings, we recommend the City:

- Establish and implement procedures to ensure the City receives all revenue it is entitled to under the franchise agreement;

- Revise the City's franchise agreement during negotiations to increase City revenue and facilitate stronger operational oversight and better monitoring;

- Require SoCalGas, like other utility companies, to pay Street Damage Restoration Fees (SDRF) when cutting into City streets to access natural gas pipelines. We estimate that this could yield additional revenue between $470,000 to $1.3 million annually;

- Re-assign the safety and security oversight of natural gas operations from LADOT to the Department of Public Works, which is better equipped to provide the necessary expertise;
- Hire a Petroleum Administrator at the Department of Public Works who can lead monitoring and negotiations in conjunction with the City Administrative Officer (CAO); and
- Clarify and strengthen provisions related to indemnification and inspection within the franchise agreement, to ensure the City is adequately protected against all potential failures related to franchise operations and assets, including those involving appurtenant facilities.

Review of the Report & Subsequent Events

On June 6, 2016, a draft of this report was provided to LADOT, Public Works' Bureau Engineering (BOE) and Bureau of Contract Administration (BCA), CAO, and City Attorney staff. We considered their comments and the additional information they provided as we finalized this report. These departments generally agreed with our findings and recommendations.

On June 8, 2016, the City Council requested the City Attorney to draft an ordinance transferring the Petroleum Administrator function and franchise duties from the CAO and LADOT to the Board of Public Works (BPW). The City Council further requested that the BPW expedite the hiring of a Petroleum Administrator, and that the BPW and LADOT, in consultation with the Chief Legislative Analyst (CLA), CAO, Department of City Planning (DCP), and BOE, report within 90 days on the formation of a newly created Petroleum and Natural Gas Administration and Safety Office within the BPW. We therefore consider Audit Recommendations 1.1, 1.2, 1.3, 3.1, 3.2, 3.3, 3.4, and 3.5 as "In Progress," while the remaining recommendations are subject to additional policy consideration and/or full implementation of the Office of Petroleum and Natural Gas Administration and Safety.

On September 19, 2016, the Mayor announced his appointment of a Petroleum Administrator who will oversee a newly-created Office of Petroleum and Natural Gas Administration and Safety within the Department of Public Works.

BACKGROUND

The ability to safely gather, store, and deliver natural gas is critical to protect public safety and the local environment

Operating a natural gas distribution system is risky. Operators must gather, store, and deliver natural gas in a way that protects public safety and the local environment. Natural gas can be hazardous due to its potentially explosive and toxic chemistry. As such, significant capital and regulatory oversight are required to ensure safe and effective distribution. Without adequate safeguards over operations, public safety and the local environment are at risk.

Regulatory Authority and Operational Framework

Recent failures of natural gas systems within California have drawn significant public criticism over the quality of regulation and oversight

The Southern California Gas Company (SoCalGas) operates a natural gas distribution system with more than 50,000 miles of steel and plastic pipeline connected to over 4.3 million service locations throughout most of Southern California. By State law, the California Public Utilities Commission (CPUC) regulates investor-owned utility companies that operate in California. While various State and federal agencies have regulatory authority over natural gas transmission and distribution (see http://www.socalgas.com/regulatory/links.shtml), CPUC has the primary oversight responsibility for SoCalGas' operations within and surrounding the City. In addition to regulating utility rates, the CPUC performs mandatory monitoring and inspection of natural gas utility companies. However, recent failures of natural gas systems within California have drawn significant public criticism over the quality of regulation and oversight provided by regulatory agencies such as the CPUC.

Without legal authority over natural gas distribution, the City is limited in its ability to oversee natural gas operations and enforce applicable regulations. For example, the Los Angeles Fire Department (LAFD) is responsible for enforcing the City's Building Fire Code and is a Certified Unified Program Agency (CUPA) for the State's Hazardous Waste Generator (HW), Hazardous Materials and Business Emergency Plan (HMBEP), Above Ground Petroleum Storage Tank (APST) and Underground Storage Tank (UST) programs. As the designated CUPA within the City, LAFD regulates certain safety-related aspects of SoCalGas as they apply to CUPA programs. However, LAFD does not perform inspections of natural gas pipeline construction since this function falls under the legal authority of the State Fire Marshall and CPUC. As required by State law, LAFD-CUPA staff perform triennial inspections for the HMBEP and annual inspections for the APST and UST programs, while annual inspections are performed by the Los Angeles County Health Department for the HW program.

Recent Natural Gas Catastrophes

The San Bruno natural gas explosion led to death of eight people, significant regulatory action, and subsequent increases in gas utility rates

In September 2010, a 30-inch steel natural gas pipeline owned by Pacific Gas & Electric (PG&E) exploded in the San Bruno suburb of San Francisco, killing eight people and destroying at least 35 homes. After the San Bruno pipeline failure, PG&E was required to re-evaluate how it determines the maximum operating pressure for 1,800 miles of pipeline throughout its system. Specifically, the CPUC asked PG&E officials to prove the pipelines could withstand the current maximum operating pressure. However, by the March 15, 2011 deadline, PG&E was unable to provide details of some of its gas transmission pipelines. In response to the disaster and a subsequent decision by the CPUC (D.11-06-017), in August 2011, PG&E submitted a long-term plan to modernize and enhance the safety of its gas transmission operations. Over several years it would automate over 200 valves, strength-test over 700 miles (1,100 km) of pipe, replace 185 miles (298 km), and upgrade another 200 miles (320 km) to allow in-line inspection.

Within citywide emergency response plans for earthquakes and other natural disasters, the City's Emergency Management Department (EMD) has broadly considered the risk of natural gas leaks and explosions. As required by State law, SoCalGas prepares and maintains written plans that address emergency or disaster situations, including earthquake response. As part of these plans, employees are trained and equipped to respond promptly; direct their actions toward protecting people first and then property; maintain gas service to customers where possible; and, restore the affected pipeline system and company operations to normal status following an emergency or disaster. The plans address continuity planning to ensure organizational stability in the event of a major business disruption so that critical functions can continue during and after a disaster with minimal disruption.

The Aliso Canyon gas leak was the worst natural gas leak in U.S. history in terms of environmental impact

On October 23, 2015, a massive natural gas leak was reported by the Southern California Gas Company (SoCalGas) at its Aliso Canyon underground storage facility located in the Santa Susana Mountains of Los Angeles County. This facility borders the Porter Ranch community of Los Angeles, and an estimated 97,100 metric tons of methane and 7,300 metric tons of ethane was released into the atmosphere, making it the worst natural gas leak in U.S. history in terms of its environmental impact. This leak caused significant environmental damage and health concerns throughout the Porter Ranch area; over 11,000 residents (approximately 3,000 households) were temporarily relocated by SoCalGas. On February 18, 2016, State officials announced that the leak was permanently sealed, yet several civil and criminal lawsuits against SoCalGas remain outstanding.

Franchise Authority and Revenue

The City's 1992 franchise agreement with the Southern California Gas Company has been repeatedly extended without changes

State law grants the City of Los Angeles (City) authority to award franchises to utility companies to provide utility service to residents and businesses within the City. In 1992, the City executed a franchise agreement with SoCalGas to provide natural gas service to residents and businesses throughout the City. Originally for a 21-year term, the franchise agreement has been extended six times over the past five years. The City has no other franchise agreements for natural gas utility service, and officials have approved an additional extension through June 2017 because of a legal case pending at the California Supreme Court. The case deals with a city's right to incorporate a surcharge within a utility franchise agreement without a popular vote.

Under the current franchise agreement, the City collects fees averaging $17.6 million annually

Along with a one-time initial payment of $6 million, the current franchise agreement allows the City to collect quarterly franchise fees equal to two percent of gross receipts from the sale of gas to residential, commercial, industrial, electrical generating, and natural gas vehicle customers within the City (gross receipt franchise fee). In addition, the City collects 2% of other revenue paid by a separate small subset of customers, known as transportation service customers, who use SoCalGas' assets to transport gas from elsewhere. Under the current franchise agreement, the City has collected an average of $17.6 million annually from SoCalGas.

In exchange for paying the City quarterly franchise fees, SoCalGas is authorized to engage in the business of gas service within the City, and to construct, operate and maintain its gas system within the public right-of-way (i.e., under City streets). The City itself is a large customer of SoCalGas and its parent company Sempra Energy. According to ControlPanelLA data, from July 2013 through December 2015 the City spent $18.5 million on natural gas utility service, and the Los Angeles Department of Water & Power (LADWP) spent $46.5 million on natural gas provided by SoCalGas or Sempra Energy for power generating purposes.

FINDINGS & RECOMMENDATIONS

Section I: Monitoring Franchise Operations & Safety of Assets

Finding No. 1: The City performs limited monitoring of franchise operations.

- **The City relies on external oversight for regulatory assurance and SoCalGas' self-monitoring and inspection reports.**
- **The City lacks qualified expertise in natural gas operations and regulation.**

The City Relies on State and Federal Authorities to Regulate Operations of Natural Gas Companies

The State agency with primary responsibility over utility company oversight is the California Public Utilities Commission (CPUC). The regulatory framework established by the CPUC applies broadly to all natural gas utility companies that operate within California, and municipalities must receive approval from CPUC to award or modify utility franchise agreements.

The City's current franchise agreement requires SoCalGas to obey all local, State, and Federal laws relating to pipeline safety. The CPUC is the primary authority responsible for overseeing safety.

The City's reliance on external oversight may not sufficiently mitigate the risks particular to franchise operations in the City and surrounding area. These risks include, but are not limited to assuring the:

- Condition, safety, and security of natural gas storage facilities (i.e. Aliso Canyon, Honor Rancho, La Goleta, and Playa del Rey)

- Condition, age, safety, and security of pipelines and other distribution infrastructure (e.g. pipeline maintenance and overall safety monitoring)
- Reliability on natural gas service and supply to satisfy energy demands (i.e. cold weather demand and electrical generation demand during peak summer months)

The Los Angeles Administrative Code (LAAC) grants broad authority over public utility franchise oversight to the City's Board of Transportation Commissioners (BTC)[1]. In addition, the LAAC grants authority to the Los Angeles Department of Transportation (LADOT)[2] for the regulation and administration of City franchises. The current franchise agreement allows the BTC to examine franchise property, and what it calls "appurtenant," (i.e. associated) franchise property, that is situated in or outside of the City.

Despite this authority, neither the BTC nor LADOT staff have requested information on natural gas franchise assets or supporting financial records. While LADOT has authority over franchise agreements because gas pipelines run under city streets, the department does not have the staff expertise to effectively oversee these operations. LADOT has general authority over ground transportation and related activities within the City, and also administers multiple pipeline-related franchises (i.e. oil and gas). While a majority of franchise pipelines are located under City streets, natural gas operations have unique safety, security, and monitoring requirements that are distinct from ground transportation issues. For example, our audit found that administrative functions performed by LADOT with respect to the City's natural gas franchise are limited to the collection of quarterly franchise fee revenue. However, these accounting functions do not provide assurance that franchise operations conform to applicable safety laws and regulations, and LADOT management attributed the limited oversight to a lack specialized staff expertise in natural gas operations.

Without detailed information on franchise assets and appurtenant facilities, the City cannot effectively verify that safety, security, and operational

[1] LAAC Sec. 22.484 (g) (2) B. 2.
[2] LAAC Sec 22.481 (a) (4)

requirements are being met. SoCalGas is required to report information regarding its entire transmission and distribution systems on a quarterly and yearly basis to the United States Department of Transportation (USDOT) and CPUC. However, the reports do not break down the information by franchise territory. Even so, City staff rely on SoCalGas' self-monitoring and submission of those regional inspection reports.

At a minimum, City staff should proactively analyze inspection and monitoring reports related to SoCalGas. This analysis should determine whether franchise operations are at risk of non-conformance to franchise terms. If the information within existing reports is not detailed enough, City staff should request the information from SoCalGas to ensure they are conforming to franchise terms and applicable safety requirements.

We also noted that LADOT has no formal database of franchise-related assets within, and appurtenant to, SoCalGas' franchise operations. This lack of information and the limitations of available reports restrict the City's ability to assure that SoCalGas conforms to safety compliance and self-monitoring efforts related to franchise operations.

Due to complexity of regulations, elevated environmental risks, and threats to public safety, it is critical for the City to have the necessary expertise to evaluate franchise performance and gas/energy related initiatives. Without this expertise, the City is at a significant disadvantage in assessing franchisee performance and negotiating future franchise agreements.

To provide this expertise within the City, the Administrative Code assigns specific duties regarding petroleum administration and leases to the City Administrative Office (CAO)[3]. While a Petroleum Administrator position was established within the CAO, the position has not been filled with a qualified expert in oil and gas operations since the mid-1980s. To address this need, the City's 2016-17 Approved Budget transfers the Petroleum Administrator position from the CAO to the Board of Public Works for the purpose of coordinating City efforts to regulate oil and gas operations within the City.

[3] LAAC Sec 19.48-19.71

In our opinion, once filled by a qualified individual within the Department of Public Works, the Petroleum Administrator could provide the necessary skill-set within the City to advise and administer natural gas franchises from an operational safety and security perspective. In addition, due to the engineering and compliance competencies currently contained and organized within the Department of Public Works, franchise oversight could be improved by transferring responsibility for natural gas franchise administration from LADOT to the Board of Public Works.

Recommendations

City policymakers should support and approve:

1.1 Executing a new franchise agreement that transfers the administrative responsibility for natural gas utility franchise operations from the Department of Transportation to the Department of Public Works.

The Board of Public Works should:

1.2 Recruit a Petroleum Administrator with sufficient expertise to administer the franchise agreement and advise the Board and policymakers on natural gas issues.

1.3 Direct the Petroleum Administrator to establish a monitoring program to evaluate safety and security compliance of franchise-related assets and operations.

1.4 Ensure the Petroleum Administrator gathers and compiles franchise asset information that includes asset type, location, and maintenance information for all franchise-related assets and appurtenant facilities. This information should be securely stored and periodically updated.

City Permits, Approvals, and Related Inspections Provide Limited Assurance of Gas Utility Franchise Operations

The City does not actively ensure franchise conformance with all Federal, State, and local laws broadly referred to as the "Pipeline Code," though conformance is critical to ensure operational safety. The current franchise agreement requires SoCalGas to construct and operate franchise assets in conformance with the Pipeline Code; however, our audit found that the City relies upon SoCalGas itself, or upon external regulators to provide this assurance. The City's permitting and inspection of work performed by SoCalGas are focused on the maintenance and safety of the public right-of-way (i.e. City streets), but do not ensure the safety and security of franchise pipelines, assets or operations.

The Los Angeles Municipal Code (LAMC) requires all utility companies to apply for a permit to work in or under the public right-of-way. The Department of Public Works' Bureau of Engineering (BOE) issues construction permits for utility companies that wish to construct or maintain private facilities within the public right-of-way (gas pipelines under City streets). During our 30-month audit period, BOE reports that SoCalGas applied for 14,308 Utility Construction Permits (U-Permits), with 13,567 granted to SoCalGas.

As part of the U-Permit application process, BOE collects fees and checks submitted work plans for completeness, right-of-way and traffic safety requirements, and potential conflicts with other permitted construction in the area. However, it is not within BOE's jurisdiction to ensure that planned work will meet applicable CPUC safety requirements prior to issuing a U-permit, and it does not verify that the design and materials used within construction plans conform to the Pipeline Code. According to BOE management, State law grants exclusive authority of utility-related construction and safety to the CPUC, and plan checks performed by BOE are limited to right-of-way construction issues.

Therefore, at a minimum, BOE should require SoCalGas to assert within its U-Permit applications that all planned work will conform to applicable Pipeline Code requirements. BOE staff could then check for this assertion, and if missing, deny U-permits.

The Department of Public Work's Bureau of Contract Administration (BCA), under authority of the Board of Public Works and Superintendent of Streets, inspects permitted work performed by SoCalGas. Per Los Angeles Municipal Code, the purpose of these inspections is to:

- Monitor the excavation of the public right-of-way,
- Enforce all traffic regulations and controls germane to the work,
- Enforce compliance with plans and specifications related to the work location,
- Verify depth and placement of materials,
- Enforce California Office of Safety and Health Administration (Cal OSHA) Safety Orders for Confined Space and Trench Excavation where indicated,
- Oversee adequate and proper re-consolidation of the excavation, and
- Ensure that the permanent resurfacing of the public right-of-way is performed with the effort and materials required.

Without quality control supervision of franchise assets by City inspectors during construction, BCA cannot verify that franchise assets are constructed in conformance with the applicable requirements of the Pipeline Code. The Chief Public Works Inspector stated that the equipment, devices, materials, method of assembly, and installation of franchise assets are proprietary in nature, and that BCA inspectors do not perform any kind of quality control supervision on the work performed on franchise assets. In practice, the CPUC does not actively inspect all franchise work, leaving SoCalGas to monitor its own work.

Without ongoing assurance that SoCalGas operations conform to State and federal regulations, including the Pipeline Code, the City cannot effectively monitor, nor assess, the level of safety and effectiveness of franchisee operations. Designating clear roles in oversight responsibility to a citywide Petroleum Administrator would improve assurance that requirements are being met, by administering programs that target the safety and operational compliance of franchise assets and related operations. In addition, BOE can strengthen its U-Permit plan check process by requiring SoCalGas to proactively affirm on plans submitted for approval that permitted construction on franchise assets will conform to the Pipeline Code.

Recommendations

The Board of Public Works should:

1.5 Establish a program under the Petroleum Administrator to monitor and report on the performance of the franchisee under the terms and conditions of the City's gas utility franchise agreement. This program should include, but not be limited to the following functions:

- **Creating and maintaining a system to inventory franchise pipelines and appurtenant facilities.**

- **Using existing resources, assessing franchisee conformance with applicable Pipeline Code requirements pertaining to franchise assets and pertinent facilities within the Los Angeles area.**

- **Reporting to the Board of Public Works and City Council on franchise performance and regulatory issues that impact gas utility franchise operations.**

1.6 As part of the U-Permit plan check process, direct BOE to add a self-assertion requirement confirming that SoCalGas' construction plans fully comply with the Pipeline Code. This assertion should be verified as part of the U-Permit plan check application process and periodically reviewed by the Petroleum Administrator.

Section II: Monitoring Franchise Revenue & Collections

Finding No. 2: The City lacks assurance that it has received appropriate franchise fees.

- **There is no monitoring or periodic audits of the franchise revenue remitted by SoCalGas.**
- **LADOT lacks expertise to determine if variations in franchise revenue are reasonable or appropriate.**

Franchise Fee Collections Are Not Sufficiently Monitored

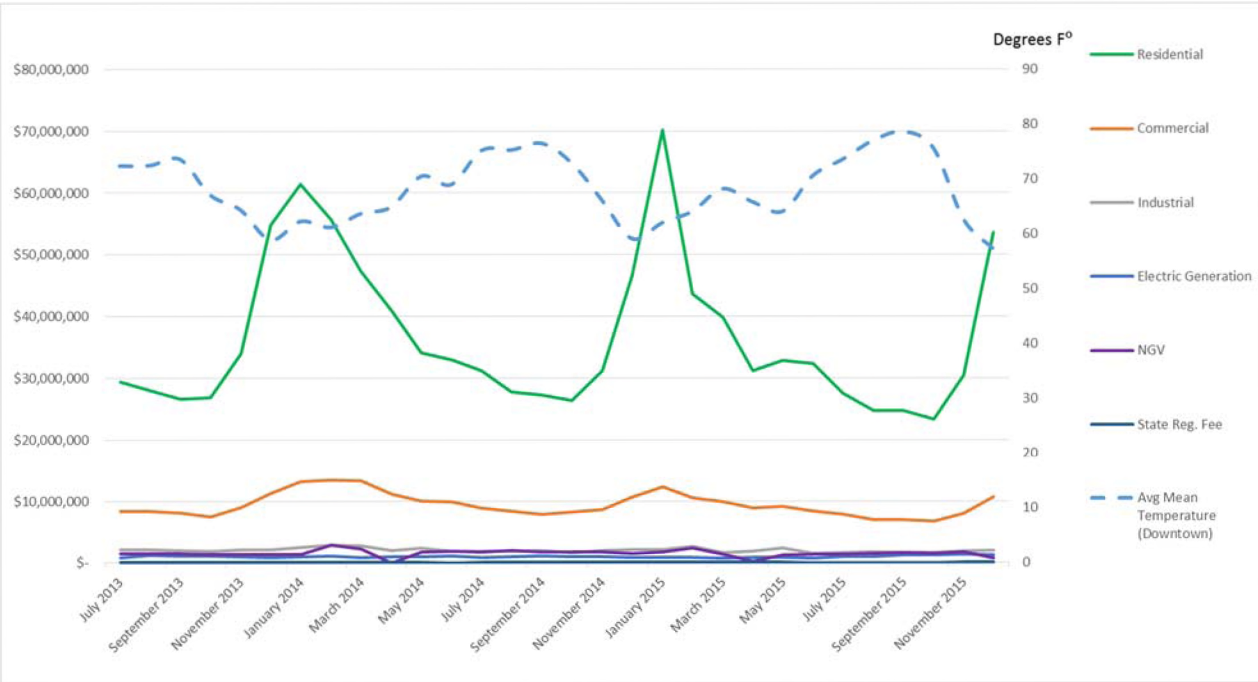
The City's current franchise agreement allows the City to collect franchise fees from SoCalGas, which have averaged approximately $17.6 million annually since 1992. As administrator of the franchise agreement, the Los Angeles Department of Transportation (LADOT) collects these franchise fees on behalf of the City, but LADOT is unable to verify that the City receives accurate and reasonable amounts from SoCalGas. LADOT's functions are limited to confirming that the total amount of franchise fees paid electronically by SoCalGas match the remittance documents provided.

Adequate financial oversight should include verifying the mathematical accuracy and reasonableness of the amounts reported in remittance documents, reconciling these amounts to the payments remitted by SoCalGas, and reviewing the fee payments for conformity with the terms of the franchise agreement. Further, the review should be sufficiently documented so that it can demonstrate the thoroughness of its examination to the City's auditors. The current procedures do not verify the remittance amounts and related calculations used by SoCalGas through any type of analytical review or audit of SoCalGas' financial records.

Quarterly, SoCalGas remits franchise fees that it says are equal to two percent of gross receipts from the sale of gas to residential, commercial, industrial, electrical generating, and natural gas vehicle customers within the City (gross receipt franchise fee). For a separate subset of customers, known as transportation service customers, SoCalGas collects and remits a surcharge based on 2% of the value of gas consumed within the franchise area (transportation surcharge).

Exhibit 1 shows a breakdown of franchise-related gross receipts revenue components that SoCalGas reported during our audit period, from July 2013 through December 2015[4]. Five of the six components relate to customer type, while the sixth relates to State Regulatory Fees that are also charged to customers. Exhibit 2, on the following page, shows the value of natural gas transported to transportation service customers.

Exhibit 1: Natural Gas Franchise (Gross Receipts) Revenue Components



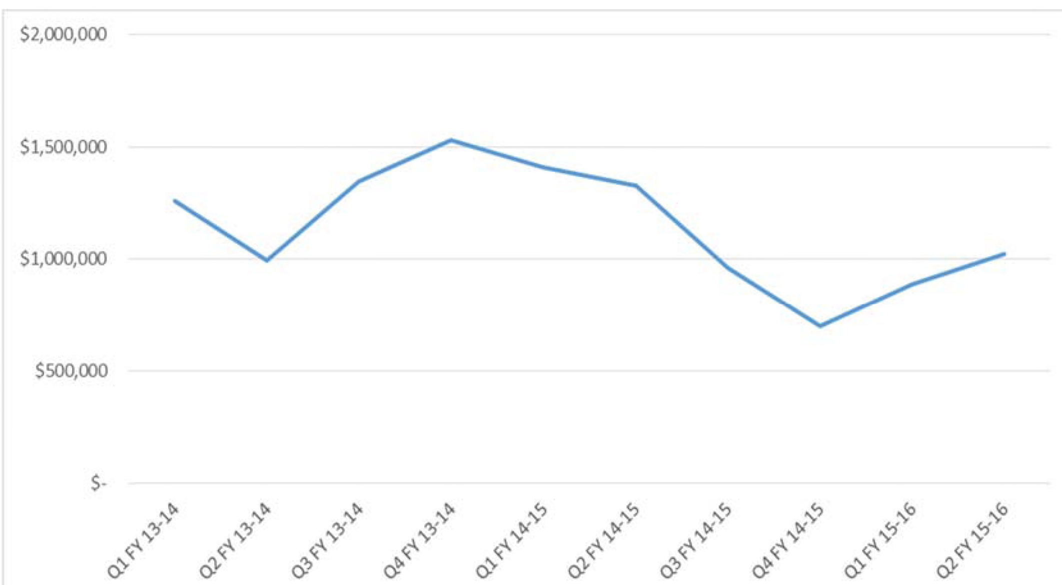
Note: Municipal surcharges for transportation customers are direct-billed by SoCalGas and included in quarterly amounts on remittance documents. Since monthly gross amounts for transported gas are not available within summary remittance documents, these amounts are excluded from this chart.

[4]According the ControlPanel LA, the Department of Water and Power spent $46.5 million over our 30-month audit period on natural gas provided by SoCalGas or an affiliated company. These payments were described as being for power generation, much of which occurs outside the City of Los Angeles.

This analysis shows that the largest revenues come from residential customers, and those receipts are highly sensitive to demand, which spikes during the colder winter months. Monthly residential revenues range from approximately $30 million in the summer up to $70 million at the peak of winter. Since most residential customers use natural gas for heating, this significant increase is expected. Exhibit 1 also indicates the average mean temperature during those months, demonstrating the inverse relationship between temperature and residential billings. Due to the fee structure established within the franchise agreement, the City can expect to receive varying quarterly franchise fees throughout the year.

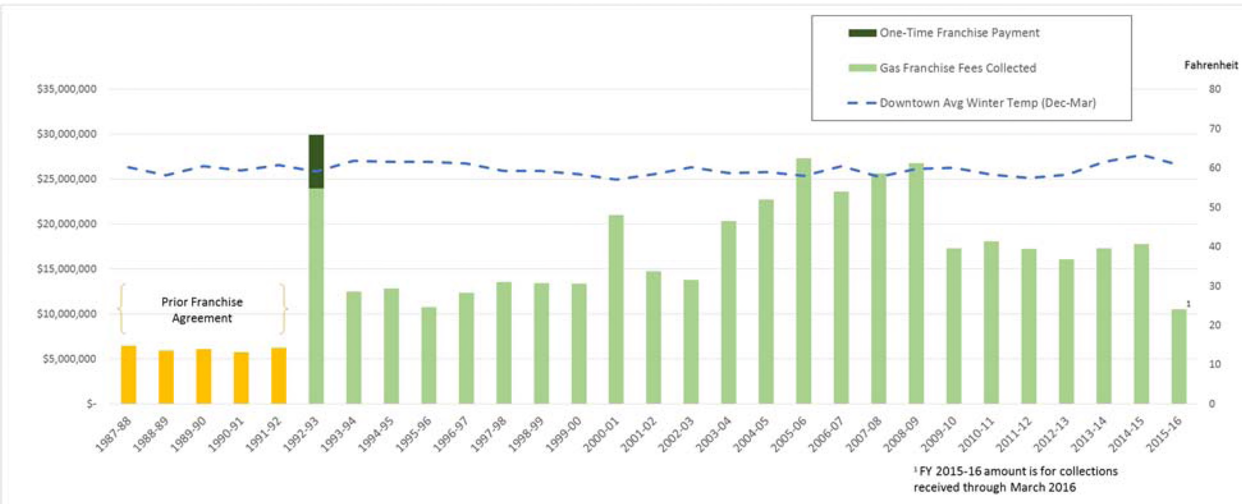
Transportation surcharges collected by SoCalGas are calculated separately from the gross receipts franchise fees, and are directly-billed to transportation service customers based on the value of gas transported to each customer. Exhibit 2 shows the quarterly amounts of municipal surcharges included in franchise fees over the audit period. (Q1 FY 2013-14 through Q2 FY 2015-16)

Exhibit 2: Franchise Surcharges Billed to Transportation Service Customers



As shown in Exhibits 1 and 2, six of the seven franchise-related revenue components remain fairly consistent throughout the year, while there is high seasonal variation in residential revenues. Since franchise fees are largely based on gross revenues received by SoCalGas, an evaluation of franchise fee collections over longer periods normalizes seasonal factors, and could provide additional insight on whether franchise fee collections are reasonable and accurate. Exhibit 3 illustrates the franchise fee revenue that the City has collected from SoCalGas since Fiscal Year 1987-88.

Exhibit 3: Gas Utility Franchise Fees Collected by Fiscal Year (Gross Receipts & Transportation Surcharges Combined)



There has been a significant decline in annual franchise fee revenue, but LADOT staff could not explain the reasons for this decline. The City collected gas utility franchise fees of $45.6 million during our audit period (July 2013 through December 2015). While the annual amount appears fairly consistent over the last six years (fiscal year 2010-11 through 2015-16), it was significantly lower than the prior six-year period (fiscal year 2003-04 through 2008-09) for reasons that are unclear. LADOT has not performed any analysis of industry conditions or utility rates to determine if the decline was reasonable.

As a leading practice, other California municipalities have performed periodic gas utility revenue and compliance audits that assess the accuracy of franchise payments made by their utility franchisees. These audits did not find significant underreporting of revenues. The City of Los Angeles has not conducted such an audit. Without ongoing monitoring, or performance audits to assess the accuracy and reasonableness of franchise fee payments, the City cannot effectively ensure that franchise fees have been calculated and remitted appropriately.

Due to the lack of available expertise and the level of administrative effort at LADOT, it is our opinion that the City's Office of Finance (Finance) is better suited to provide necessary fiscal oversight relative to franchise fee collection activities. The City Charter grants Finance with authority to develop and implement the City's revenue policy and it is responsible for the collection of revenue from various sources including taxes, licenses, fees, and permits. Finance administers a citywide revenue billing and collection program that aims to maximize City revenue and evaluate revenue policy.

Subsequent to our audit fieldwork, the City created an Office of Petroleum and Natural Gas Administration and Safety within the Board of Public Works that will have responsibility for overseeing the natural gas franchise agreement. Necessary revisions to City code and hiring a qualified Petroleum Administrator were still in process at the time of report issuance. We acknowledge that the Petroleum Administrator function will be primarily focused on safety and operational issues, and believe that the Office of Finance can and should provide direction and attention relative to the collection, monitoring and periodic auditing of franchise revenue.

Management of the Office of Finance indicated they are willing to assist with guidance on collection practices to the Board of Public Works as needed, though they believe that the department most familiar with the terms and conditions of the agreement is the most appropriate entity to actually collect the revenue. Further, they believe that separating the revenue collection aspects from other contract administration responsibilities would create an added layer of administration and potential inefficiencies.

Recommendations:

2.1 Finance should establish and implement appropriate procedures related to oversight and monitoring of franchise fee revenues. Alternatively, at a minimum, Finance should assist the Office of Petroleum and Natural Gas Administration and

Safety to implement procedures relative to franchise revenue oversight. These should include:

a) **Working with the Petroleum Administrator, or other industry experts, to develop a method to determine anticipated franchise fee collection amounts that accounts for expected fluctuations in revenue;**

b) **Requiring SoCalGas to include actual gas sales ledgers from the company's billing system that reflect revenues by customer classification, the volume of gas delivered to transportation customers, and provide the applicable rate schedule as filed with the California Public Utility Commission.**

c) **Engaging an expert to perform periodic revenue and contract compliance audits.**

Section III: Strengthening the Terms of the Franchise Agreement

The City has a Unique Opportunity to Enhance Its Natural Gas Utility Franchise Agreement

Finding No. 3: The City's gas utility franchise agreement could be enhanced in favor of the City.

- **Legal challenges have inhibited the City from negotiating higher franchise fee terms included in other municipal franchise agreements.**
- **The current franchise agreement prevents the City from collecting Street Damage Restoration Fees for excavations caused by franchise operations.**
- **Insurance and risk management sections of the franchise agreement could be enhanced and clarified to better protect City interests.**

Long-term municipal franchise agreements with private utility companies are commonplace throughout the United States. In general, franchise agreements provide utility companies with significant competitive advantages by controlling industrial competition within municipal territories. By awarding long-term franchises to utility companies, municipalities stabilize competition, and protect City interests by limiting right-of-way construction within the local community.

In May 2016, the City Council approved an additional extension of the current franchise agreement with SoCalGas through June of 2017. Subsequent to this extension, the City Council adopted a motion to instruct the CAO and Petroleum Administrator to work with the City Attorney and City Risk Manager to ensure that the franchise agreement has the strongest possible legal protections for the City and its residents. Further, the City Council instructed the City Attorney to structure the new franchise agreement with a total 20-year term that is divided into four, five-year periods with continuation of the same terms beyond each five-year period dependent upon full compliance with all provisions of the franchise agreement. The motion also instructed the CAO and Petroleum Administrator to ensure that the terms of the new franchise agreement require SoCalGas to provide the Board of Public Works with copies of all regulatory reports, and to include a provision that requires SoCalGas to notify the City concurrently of any event that results in the notification to regulatory entities. (i.e. leaks, equipment failures, execution of other franchise agreements)

With the expiration of the City's current gas utility franchise agreement in June 2017, the City has a unique opportunity to negotiate a new franchise agreement for natural gas utility service. The City Administrative Officer (CAO) was requested to assist LADOT by taking lead responsibility in negotiating the terms of a new franchise agreement with SoCalGas, however, this effort has been protracted over several years in anticipation of a legal decision by the California Supreme Court.

Legal Considerations Have Inhibited the City from Increasing Franchise Fees

State Law imposes no cap on the franchise fees that Charter cities such as Los Angeles can charge their natural gas suppliers[5]. The City of Los Angeles negotiated a fee equal to 2% of the gross revenue that SoCalGas collects as a result of its franchise. That fee is as high as State law allows for general law cities and counties to go in charging utilities. However, some of California's other Charter cities—notably San Diego, San Jose, and Fresno—have exceeded this rate. San Diego's negotiations with its natural gas supplier resulted in an agreement in which the supplier pays 3% of gross revenues and an additional 1.03% of gross revenues as a "surcharge." Fresno charges a 2% rate and a 1% "city recovery portion." San Jose charges its natural gas supplier a fee of 2.3%.[6]

[5] California Public Utilities Code Sections 6001.5, 6006, and 6231(c)

[6] These and other comparisons can be found in Appendix IV.

During franchise negotiations, the CAO has sought a utility surcharge. However, according to CAO and City Attorney staff, negotiations have been stymied pending the resolution of a lawsuit brought by utility customers and taxpayer advocates who argue that a surcharge may not be imposed without a popular vote. The California Supreme Court is currently considering the case, which involves the City of Santa Barbara and peripherally involves the role of the CPUC, which, as a matter of policy, considers only average franchise fees for jurisdictions served by the utility when approving a utility's application for a rate increase. The difference is that a utility surcharge is directly passed to ratepayers, and has no impact on the operational costs of a utility. If the California Supreme Court rules that such a surcharge is an illegal tax, and the CPUC does not reconsider its policy of only allowing average franchise fees for jurisdictions served by the utility when approving utility rate increases, it could strengthen utility company resistance to accept higher franchise fees that Charter cities may wish to impose.

In 2005, Southern California Edison (SCE) began collecting a 1% utility surcharge on behalf of the City of Santa Barbara in addition to a 1% franchise fee. The 1% franchise fee resembles a traditional franchise fee, as its purpose is to compensate the City for allowing SCE a right of way to deliver electricity. Taxpayer advocates challenged the legality of the additional surcharge, claiming it was imposed as an unjust tax.

According to the trial court that heard the case brought against the City of Santa Barbara, the 1% surcharge is entirely separate from the franchise fee, as its purpose was "to raise franchise fee revenues for use by the City Council for general City governmental purposes." The court noted that when this franchise agreement became effective, SCE had the privilege of using the City's property, regardless of whether or not the CPUC authorized SCE to impose the 1% surcharge. The court further noted that the only benefit to SCE from acting as the City's agent in collecting the 1% surcharge was to know with certainty how long the franchise would last.

Subsequently, in February 2015 the California Court of Appeals concluded that the 1% surcharge negotiated by the City of Santa Barbara "is an illegal tax masquerading as a franchise fee," and determined that the surcharge was unallowable because the California Constitution, as amended by Proposition

218[7], prohibits local governments from imposing new or increased taxes without first obtaining voter consent.

The Appellate Court decision is currently under review by the California Supreme Court, and this decision is expected to have significant ramifications for the negotiation of municipal utility franchise agreements throughout California. The League of California Cities argued that such fees now account for 5.8 percent of the general revenues accruing in State cities, and to require voter approval would pose a significant hardship on cities. At issue is not only the money to be refunded by cities that have collected similar surcharges, but the precedent it could set. California cities could be hampered in their ability to negotiate higher franchise related revenue from utility companies if the Santa Barbara ruling—the first of its kind in California—stands.

The pending California Supreme Court case might also complicate the City's intention to rely on a leading practice used by other municipalities—to include a "most favored nation (MFN)" clause within utility franchise agreements. An MFN clause allows a municipality to consider increasing franchise fees if the franchise utility company agrees to pay another municipality higher fees. The CAO has informed SoCalGas that a MFN clause will be required by the City within a new franchise agreement, and when applied, would enable the City to consider raising franchise fees, and any related surcharges, in line with those negotiated by comparable municipalities. Such a clause would ensure that the City can collect maximum franchise fees and surcharges throughout the agreement term, including any term extensions.

The City Does Not Collect Street Damage Restoration Fees for Natural Gas Utility Franchise Related Activity

The Los Angeles Municipal Code allows the Department of Public Works to collect Street Damage Restoration Fees (SDRF) from entities such as utility companies who excavate City Streets to install, access, or repair their assets. However, SoCalGas is currently exempt from paying SDRF. According to a City Attorney opinion, SDRF requirements were enacted by the City after the current franchise agreement was executed, and that charging SDRF to

[7]Cal. Const., art. XIII C, Sec. 2)

SoCalGas would violate the agreed-upon terms of the 1992 agreement. Therefore, the City's SDRF is not charged to SoCalGas.

By repeatedly extending the franchise agreement, the City is forgoing an opportunity to release the SDRF exemption currently enjoyed by SoCalGas. SoCalGas was granted 13,567 U-Permits from July 2013 through December 2015; averaging 5,427 annually. Had SDRF been applied to SoCalGas excavation work, the City could have collected additional revenue related to franchise operations. Estimating SDRF or Slurry Seal Damage Restoration Fee (SSDRF) revenue is uncertain, as fee amounts are dependent on street age and maintenance history (i.e. timing of latest slurry seal), as well as the size of excavation. The current SDRF ranges from $5.18 to $21.26 per square foot depending on the age and type of street; while the minimum fee for cuts into recently slurry-sealed streets (SSDRF) is $276 per excavation. The City Engineer estimated that the City would receive incremental revenue of $470,000 to $570,000 annually if SoCalGas were not exempt from paying SDRF based on averages paid by other utility companies. Auditors estimated an amount by using the minimum SSDRF of $276 per excavation applied to 90% of permits issued to SoCalGas, which equates to $3.4 million over our 30-month audit period ($1.36 million annually).

To address SoCalGas' current exemption, CAO staff have asserted that any new franchise agreement will specifically state that paying SDRF is required by the franchisee, along with any other required construction permit fees due to the City.

Risk Management Language of the Franchise Agreement Should Be Clarified

Indemnification and insurance requirements are standard in municipal franchise agreements. These requirements limit the City's exposure to legal risks associated with performance of the franchise, and help protect the City from significant financial losses. During our assessment of the franchise agreement, we observed that requirements established for indemnification (indemnity clause) and insurance differ in scope to those of inspection of property and records (inspection clause); the indemnity clause narrowly defines its scope to the "*performance of the franchise,*" while the inspection clause more broadly defines the City's authority to inspect "*all franchise property, together with any appurtenant property of the Grantee [SoCalGas] in or outside of the City*."

By aligning the language of the indemnification clause with that of the inspection clause, the agreement would clarify the full and comprehensive indemnification protection to the City. Furthermore, these enhanced terms would provide consistency to ensure that City-related interests are adequately protected from both franchise operations and related regional operations of SoCalGas (i.e. surrounding pipelines and storage facilities).

In addition to an indemnification requirement, the franchise agreement requires SoCalGas to maintain two additional insurance requirements. The first is a $500,000 corporate surety bond (performance bond) to insure the City against the risk of franchise non-compliance. CAO Risk Management staff stated they intend to double the performance bond limit requirement to $1 million in the next franchise agreement. Performance bonds are commonly required within municipal utility franchise agreements, but have been negotiated at varying limits[8]. Even though a $500,000 performance bond is the highest amount required by other municipal franchise agreements, CAO staff indicated that $500,000 may not be adequate for the City's current franchise operations.

The second requirement is a $10 million combined single limit general liability insurance policy. According to the City's Risk Manager, the current franchise agreement requires SoCalGas to show proof of insurance to protect the City should the indemnification come into play. The City Risk Manager further stated that SoCalGas must defend and pay any amount of legal judgments or other expenses which arise from their negligence. SoCalGas and its own insurance must therefore cover the appropriate exposure to loss and have sufficient limits to pay reasonably foreseeable claims. The City's Risk Manager and involved City Attorney indicated that the indemnification within the current franchise agreement provides the City unlimited liability protection; the liability insurance policy specifically referenced simply allows the City to file directly to

[8] Appendix IV provides examples of performance bond requirements for other comparable franchise agreements.

SoCalGas' insurance company as an additional insured, thereby affording the City coverage for defense and related costs immediately. The City's Risk Manager further noted that Sempra Energy (the parent company of SoCalGas) disclosed within a recent regulatory filing with the United States Securities and Exchange Commission (SEC), that the company has in excess of $1 billion in insurance coverage. According to a subsequent SEC filing, Sempra Energy reported collections of $34 million in insurance claims related to the Aliso Canyon gas leak for its fiscal quarter ending on June 30, 2016. Within the same filing, Sempra Energy reported estimated costs related to the leak of $717 million with $679 million as an insurance receivable on its consolidated balance sheet. However, Sempra disclosed that those costs do not include any potential damage awards, restitution, civil or criminal fines, or other penalties that may be imposed.

In light of recent operational failures such as the natural gas leak at the Aliso Canyon Storage Facility, the City's Risk Manager is considering to double the single liability limit requirement within a new franchise agreement to $20 million, as well as adding an additional environmental pollution policy to specifically address risks associated with environmental pollution caused by the franchise company. It should be noted that while these additional insurance requirements are intended to protect City interests, all additional franchise requirements must be approved by the CPUC prior to executing a new franchise agreement.

<u>Recommendations</u>

While negotiating a new franchise agreement for natural gas service, the CAO and/or Petroleum Administrator should:

3.1 Structure the franchise revenue terms to contain the maximum legally allowable amount including funding to cover the cost of franchise auditing and monitoring.

3.2 Incorporate a "most favored nation clause" that ensures any additional franchise revenue collection terms negotiated by other municipalities with SoCalGas are automatically available to the City.

3.3 Clarify language that specifies the franchisee must pay Street Damage Restoration Fees for utility-related excavations performed within the Public right-of-way.

3.4 Include terms that require additional reporting to facilitate the City's monitoring of franchise operations, including:

a. A requirement for SoCalGas to proactively provide reports regarding monitoring and inspection activities specific to franchise assets and facilities located within the City and surrounding geographical areas (e.g. storage facilities and arterial pipelines located within Los Angeles County and neighboring jurisdictions).

b. A requirement to provide additional reporting that will facilitate the City's monitoring of related franchise fee revenue.

3.5 Use consistent language to clarify that the indemnification and inspection provisions both apply to franchise operations and assets, including those involving any appurtenant facilities.

Respectfully submitted,

Paul E. Alberga

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Internal Auditor III

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APPENDIX I: AUDIT ACTION PLAN

Finding		Page	Recommendation		Page	Entity Responsible for Implementation	Priority
Section I: Monitoring Franchise Operations & Safety of Assets							
1	The City performs limited monitoring of franchise operations.	6	1.1	Support and approve the execution of a new franchise agreement that transfers the administrative responsibility for natural gas utility franchise operations from the Department of Transportation to the Department of Public Works.	9	Mayor/City Council/City Attorney	B
			1.2	Recruit a Petroleum Administrator with sufficient expertise to administer the franchise agreement and advise the Board and policymakers on natural gas issues	9	Board of Public Works	A
			1.3	Direct the Petroleum Administrator to establish a monitoring program to evaluate safety and security compliance of franchise-related assets and operations.	9	Board of Public Works	B
			1.4	Ensure the Petroleum Administrator gathers and compiles franchise asset information that includes asset type, location, and maintenance information for	9	Board of Public Works	B

Finding	Page		Recommendation	Page	Entity Responsible for Implementation	Priority
			all franchise-related assets and appurtenant facilities. This information should be securely stored and periodically updated.			
		1.5	Establish a program under the Petroleum Administrator to monitor and report on the performance of the franchisee under the terms and conditions of the City's gas utility franchise agreement. This program should include, but not be limited to the following functions: ▪ Creating and maintaining a system to inventory franchise pipelines and appurtenant facilities. ▪ Using existing resources assessing franchisee conformance with applicable Pipeline Code requirements pertaining to franchise assets and pertinent facilities within the Los Angeles area.	12	Board of Public Works	B

Finding	Page	Recommendation	Page	Entity Responsible for Implementation	Priority
		• Reporting to the Board of Public Works and City Council on franchise performance and regulatory issues that impact gas utility franchise operations.			
		1.6 As part of the U-Permit plan check process, direct BOE to add a self-assertion requirement confirming that SoCalGas' construction plans fully comply with the Pipeline Code. This assertion should be verified as part of the U-Permit plan check application process and periodically reviewed by the Petroleum Administrator.	12	Board of Public Works	C
Section II: Monitoring Franchise Revenue & Collections					
2 The City lacks assurance that it has received appropriate franchise fees.	13	2.1 Finance should establish and implement appropriate procedures related to oversight and monitoring of franchise fee revenues. Alternatively, at a minimum, Finance should assist the Office of Petroleum and Natural Gas Administration and Safety to implement procedures	17	Finance	B

Finding	Page	Recommendation	Page	Entity Responsible for Implementation	Priority
		relative to franchise revenue oversight. These should include: a) Working with the Petroleum Administrator, or other industry experts, to develop a method to determine anticipated franchise fee collection amounts that accounts for expected fluctuations in revenue; b) Requiring SoCalGas to include actual gas sales ledgers from the company's billing system that reflect revenues by customer classification, the volume of gas delivered to transportation customers, and provide the applicable rate schedule as filed with the California Public Utility Commission. c) Engaging an expert to perform periodic revenue and contract compliance audits.			

Finding		Page	Recommendation		Page	Entity Responsible for Implementation	Priority
Section III: Strengthening the Terms of the Franchise Agreement							
3	The City's gas utility franchise agreement could be enhanced in favor of the City.	19	3.1	While negotiating a new franchise agreement for natural gas service, the CAO and/or Petroleum Administrator should: Structure the franchise revenue terms to contain the maximum legally allowable amount including funding to cover the cost of franchise auditing and monitoring.	25	CAO / Petroleum Administrator	B
			3.2	Incorporate a "most favored nation clause" that ensures any additional franchise revenue collection terms negotiated by other municipalities with SoCalGas are automatically available to the City.	25	CAO / Petroleum Administrator	B
			3.3	Clarify language that specifies the franchisee must pay Street Damage Restoration Fees for utility-related excavations performed within the Public right-of-way.	25	CAO / Petroleum Administrator	A

Finding	Page	Recommendation		Page	Entity Responsible for Implementation	Priority
		3.4	Include terms that require additional reporting to facilitate the City's monitoring of franchise operations, including: a. A requirement for SoCalGas to proactively provide reports regarding monitoring and inspection activities specific to franchise assets and facilities located within the City and surrounding geographical areas (e.g. storage facilities and arterial pipelines located within Los Angeles County and neighboring jurisdictions). b. A requirement to provide additional reporting that will facilitate the City's monitoring of related franchise fee revenue.	26	CAO / Petroleum Administrator	B
		3.5	Use consistent language to clarify that the indemnification and inspection provisions both apply to franchise operations and assets, including those involving any appurtenant facilities.	26	CAO / Petroleum Administrator	C

A –High Priority *- The recommendation pertains to a serious or materially significant audit finding or control weakness. Due to the seriousness or significance of the matter, immediate management attention and appropriate corrective action is warranted.*

B –Medium Priority *- The recommendation pertains to a moderately significant or potentially serious audit finding or control weakness. Reasonably prompt corrective action should be taken by management to address the matter. Recommendation should be implemented no later than six months.*

C –Low Priority *- The recommendation pertains to an audit finding or control weakness of relatively minor significance or concern. The timing of any corrective action is left to management's discretion.*

N/A *- Not Applicable*

APPENDIX II: FINANCIAL SCORECARD

Finding/Recommendation		Page	Category	Financial Impacts
3.3	While negotiating a new franchise agreement for natural gas service, the CAO and/or Petroleum Administrator should clarify language that specifies the franchisee must pay Street Damage Restoration Fees for utility-related excavations performed within the Public right-of-way.	24	Increased Revenue	Ongoing estimated revenue of $470,000 to $1.36 million annually

APPENDIX III – OBJECTIVE, SCOPE & METHODOLOGY

OBJECTIVE

The overall objective of this audit was to evaluate the extent of which the City's franchise oversight of the Southern California Gas Company (SoCalGas) is adequate in protecting the City, and its residents, from financial, safety, and environmental risks. The audit evaluated the general terms and conditions of the City's franchise agreement with SoCalGas and assessed the inspection and oversight functions performed by the City. In addition, we evaluated how the City assures that franchise fees are received by the City in accordance with the franchise agreement.

SCOPE

The scope of this audit included the gas utility franchise revenues and related activities from July 1, 2013 through December 31, 2015. The audit also evaluated compliance with the terms of the franchise agreement, specifically with risk management, operational oversight, and safety requirements.

METHODOLOGY

This audit was performed in accordance with Generally Accepted Government Auditing Standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe the evidence obtained provides reasonable basis for our findings and conclusions based on our audit objectives.

In accordance with these standards, we performed the following key tasks:

- Reviewed relevant laws and regulations related to natural gas utility franchises.
- Reviewed and evaluated the terms of the City's gas utility franchise agreement
- Evaluated natural gas franchise oversight functions performed by City Departments that have administrative or operational oversight of franchise-related operations.

- Evaluated franchise fee collection processes.
- Compared the City's franchise agreement and administrative structure to comparable municipalities with similar franchise agreements.
- Reviewed audit reports of franchise fee collections performed by other comparable municipalities.

We interviewed various City staff responsible for administrative and operational oversight of the franchise agreement; including

- LADOT Management and Accounting staff
- Department of Public Works Bureau of Engineering
- Department of Public Works Bureau of Contract Administration
- Chief Administrative Officer and Citywide Risk Management
- City Attorney

We also interviewed financial management staff from other municipalities to gather comparative information and franchise-related documents.

We also obtained and reviewed data from the City's financial systems (FMS / FMIS Revenue), and U-Permit Data from the Public Works' Construction Permit and Inspection Tracking System.

We compared the City's franchise agreement and related administrative responsibilities to those of other major California municipalities. A summary of these effort can be found in Appendix IV.

APPENDIX IV – BENCHMARKING

Municipality / Franchisee	Franchise Term	Franchise Fee Amount	Franchise Administration & Audits	Insurance Requirements
City of Los Angeles	21 Years (1992-2017*) *Extended by City Council Ordinances	2% of gross receipts and 2% surcharge for transportation customers	Department of Transportation No recent franchise fee or contract compliance audits performed	$10,000,000 combined single limit general liability $500,000 performance bond
City of San Diego	50 years (1970-2020)	3% of gross receipts and 1.03% Franchise Fee Surcharge	No citywide administrator Cyclical Revenue Audits performed by City Treasurer (Approx. every three years)	$500,000 performance bond
City of Fresno	50 years (2010-2060)	2% of gross receipts plus 1% additional "City Recovery Portion" [3% total]	No citywide administrator No recent franchise fee or contract compliance audits performed	$100,000 performance bond
City of Long Beach	25 Years (1993-2018)	2% of gross receipts and 2% of the imputed value of non-proprietary delivered natural gas	Long Beach Gas & Oil Contract compliance audit performed in 2010.	$5,000,000 single limit or $5,000,000 aggregate $500,000 automobile liability Mandatory Workers' Comp. requirement
City of San Jose	Perpetual (1971-Present)	2.3% of gross receipts	No citywide administrator. City Auditor and Finance Dept. required to receive fee payment documents. City Auditor audit clause in franchise agreement	None
City and County of San Francisco	Perpetual (1939-Present)	1% of sales	San Francisco Public Utilities Commission (County Controller has recently performed franchise contract audits every 2-3 years)	None