Franchise Tax

As of September 30, 2013

City of Tulsa Internal Auditing

June 2014

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Introduction / Background

Franchise taxes/fees are assessed on utility and cable/video providers by municipalities for use of public right of way (ROW). These fees also function as compensation for the right and privilege to provide service within the City. Natural gas and power franchises are governed by formal franchise agreements codified in City ordinances. Thermal, cable and telephone franchise-type payments are paid based on ROW occupancy ordinances. **2013 actual City Franchise Fees were $21.8 million per the June 30, 2013 Comprehensive Annual Financial Report (CAFR). Franchise revenue is roughly 6% of General Fund revenue.** Main utility types and payor companies are:

- Cable/video services – primarily Cox Communications and AT&T Uverse
- Natural Gas – primarily Oklahoma Natural Gas
- Power/Electricity – primarily AEP/PSO
- Thermal – Veolia Energy
- Telephone – primarily AT&T/SW Bell

The major telecommunications franchise fee payor (AT&T/Southwestern Bell) pays franchise fees using an optional right of way linear footage basis. Assessment of these fees occurs through a different method, process and personnel. Accordingly, a separate report titled **Right of Way Telecommunication Occupancy Fees** will be issued on these fees.

Scope and Objectives

The scope of our audit encompassed review and testing of the related processes, internal controls, ordinances and rate levels in place for the major payors of City of Tulsa franchise tax.

The objectives of the audit were:

- To document and evaluate adequacy of internal controls and processes in place to calculate, collect, record and monitor franchise fees and major telephone utility ROW occupancy fees
- To assess compliance with ordinances governing franchise fees and major payor ROW occupancy fees
- To assess franchise and ROW occupancy revenue methods/rates/practices vs. other similar municipalities.

Audit Methodology

A sample of franchisee and major telecommunication ROW occupant payment returns was reviewed to determine franchise fees were correctly calculated, billed/collected and recorded. Franchise payment activity from July 2011 through August 2013 was reviewed to determine consistent payments were occurring. Roles, responsibilities and tasks related to franchise revenue were reviewed to determine they were established and appropriately segregated. Methods used for monitoring, forecasting and budgeting franchise revenue were assessed for completeness and validity. Franchise fee related ordinances were assessed for compliance, and implementation of ordinance changes was reviewed. Franchise revenue levels and rates were reviewed vs. other comparable municipalities to ensure collected fees were reasonable, and the City is not imposing a fee burden on taxpayers beyond that of other cities.

Summary and Conclusions

Power, natural gas, thermal and cable/video service franchise revenue calculations, collections, and recordkeeping are materially accurate. Lack of well-defined responsibilities, roles and authority for monitoring ordinance compliance has caused some accounting and compliance errors.

The City's power franchise fees are significantly below comparable peer cities. Eligible rate revisions to the power franchise agreement have not been evaluated. Omission of this evaluation was caused by a lack of knowledge regarding power rate agreement terms as well as a lack of defined responsibility for conducting such evaluations. As a comparative metric, **a 1% increase for the City of Tulsa would be the same as Oklahoma City and Denver's 3% fee levels and could result in approximately $19.3 million in franchise revenue over a 5 year period. The maximum allowable 2% increase in power franchise rates for Tulsa would result in rates closer to Minneapolis and Wichita rate levels, and could result in approximately $38.6 million in franchise revenue over a 5 year period.**

To address these areas**, improvements to roles and responsibilities for ordinance requirements and ordinance change evaluation need to be considered** by management for a number of City-wide functions and departments. For full detail of these summarized findings, **please refer to the following *Audit Finding and Management Responses*** section of this report.

The Office of the City Auditor would like to extend its appreciation to the personnel and management of the Streets and Stormwater, Finance, Engineering Services, and City Clerk departments for their assistance in conducting this audit.

Audit Findings and Management Responses

1. Roles and responsibilities for monitoring and evaluating franchise ordinance provisions and potential agreement changes have not been fully established.

The City's current power franchise agreement with Public Service Company of Oklahoma (PSO) is at a rate of 2% of gross revenue. PSO's 25-year franchise agreement states in Section 411. A. that fees are set "as consideration of the granting of the franchise, for use of the public ways, and as a compensation for the rights and privileges enjoyed" through the franchise.

Contemplating that right of way fees may need to change over time, the agreement contains provisions to present an option for fee rate revisions to the voters every 5 years for the term of the agreement. Based on discussion with various City department managers, there was no awareness the agreement provided for a potential increase, and there is not clear consensus regarding who has responsibility or authority to evaluate and/or lead rate evaluation efforts.

To evaluate Tulsa franchise rates vs. other municipalities, the Office of the City Auditor initially compared **all** COT franchise fee types to Oklahoma City. **Based on fiscal 2014 budget data, Oklahoma City franchise fee revenue comprises 10.1% of its general fund. Tulsa franchise fees comprise 6% of municipal general fund revenues. The only revenue type noted to have a substantial rate difference was the power franchise rate**. A further evaluation of power franchise rates was conducted using three additional municipalities noted as comparison peer cities in the annual Tulsa City *Quality of Life Report* – Denver, Minneapolis and Wichita. The applicable power franchise rates noted for each city evaluated are shown in the table below.

SELECTED CITIES' POWER UTILITY
FRANCHISE FEE RATES CURRENTLY IN EFFECT

<table>
<tr><th>TULSA</th><th>OKC</th><th>DENVER</th><th>MINNEAPOLIS</th><th>WICHITA</th></tr>
<tr><td rowspan="3">2%</td><td rowspan="3">3%</td><td rowspan="3">3%</td><td>4.5% residential</td><td rowspan="3">5%</td></tr>
<tr><td>3% large commercial</td></tr>
<tr><td>5% small commercial</td></tr>
</table>

Power franchise rates varied 1-3% below other comparable cities reviewed. Beyond franchise rates, flexibility has been exercised by other Oklahoma municipalities (Dewey, Vinita and Weatherford) to assess 1% economic development rider fees within their PSO franchise agreements. Tulsa has negotiated a fractional rate revision of the City's 3% natural gas franchise rate with ONG in 2011. **Tulsa is next eligible to consider revising power franchise rates in 2017.**

The estimated effect on the City's power franchise revenue assuming either a 1 or 2% rate increase allowed by ordinance is shown below. The total revenue for the 5 year rate window period is calculated.

5 YEAR ESTIMATED ADDITIONAL POWER FRANCHISE REVENUE USING COMPARABLE CITIES' ALLOWABLE RATES

(in thousands)

2013 CAFR Power franchise revenue, assessed at 2% gross revenue	$7,725
Divided by 2% rate – Total power franchisee gross revenue	$386,250
Tulsa franchisee gross revenue multiplied **by > 1%** (OKC & Denver) x 5 years	$19,312
Tulsa franchisee gross revenue multiplied by **> 2% allowable*** (Minneapolis & Wichita rate) x 5 years ***Tulsa max allowable rate is 4%**	$ 38,625

As estimated above using 2013 power gross revenue, the potential impact is significant. **Allowable peer cities' rates would result in a range of $19.3 and $38.6 million additional revenue in the general fund over a 5 year period.** (Equivalent estimated revenue stated on an annual basis would range between $3.86 million and $7.72 million).

Multiple factors caused the power franchise adjustment provisions to remain unevaluated. As noted in an April 2012 report of the City Council Fee Review Task Force, "There is not a single 'steward' of all of the fees assessed by the City and its trusts. Department and agency staff are often too occupied with day-to-day operations to review the appropriateness of fee schedules relative to the costs of service." Additionally, responsibilities and roles in this area shifted with the 2011 elimination of the unified Public Works department. Based on discussion with various City department managers, there was no awareness that ordinance provisions allowed for revision of these fees, and there is not clear consensus regarding who has responsibility or authority to evaluate and/or lead an effort to evaluate franchise rate change.

RECOMMENDATION:

Due to the significant general fund revenue and multiple stakeholders connected with potential power franchise rate revision, and to ensure that franchise rates are evaluated for reasonable levels consistent with other municipalities' practices, we recommend the following:

- establishment/definition of roles and responsibilities for periodic assessment of franchise fee levels;
- the defined responsible parties then pursue evaluation/assessment of potential feasibility of power franchise fee adjustment per ordinance provisions;
- if adjustment is deemed appropriate, steps to pursue rate adjustment, including negotiation, stakeholder input, and franchisee notification be completed *before* the latest next eligible franchise notification date of June 1, 2017
- additionally, it is relevant to note that any corresponding ballot proposal and election would need to be conducted no more than 6 months after notification date.

RESPONSE:

Management has not provided a response to these findings at this time.

2. <u>The City has not consistently complied with cable/open video service ordinances</u>.

Incorrectly recorded cable/video franchise general fund revenue was detected and corrected by Finance management. Monies from a new ordinance requiring payment of a capital contribution fee of ½ of 1% of cable gross revenues were incorrectly recorded in the general fund from the April 2010 effective date through December 2011. General fund revenues were overstated and capital fund revenues were understated by $901,000 at December 31, 2011. The error was corrected in February 2012.

Cable/open video provisions specified in Title 11, Chapter 12, Section 1220 A. 1. require cable/video service occupants to file an annual statement of gross operating revenues verified by an external CPA. No such filings were located, and the provision was unknown to applicable City personnel. As a result, the City is not in compliance with this ordinance. Non-compliance does not carry any specific penalty; however, the intended additional assurance of cable/video taxable revenue is not occurring.

Both situations were caused by a lack of resources to monitor ordinance provisions and changes. Formal roles and responsibilities for monitoring implementation of ordinance changes are not fully developed and specified across City functions/departments.

<u>RECOMMENDATION:</u>

We recommend revenue ordinance monitoring and implementation responsibilities be evaluated and more formally documented. This will require a collaborative effort across several departments, including Finance, Streets and Stormwater, the City Clerk's Office, and the Mayor's Office.

We also recommend consideration be given to requiring other major payors of franchise and/or occupancy revenue to file verified revenue statements. This would require the other payors to assume certification compliance with ordinance reporting provisions.

RESPONSE:

Management has not provided a response to these findings at this time.

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