



**CITY AUDITOR'S OFFICE**

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# **Utility Franchise Agreement Compliance**

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**SEPTEMBER 6, 2012**

**AUDIT REPORT NO. 1206**

**CITY COUNCIL**

Mayor W.J. "Jim" Lane

Lisa Borowsky

Suzanne Klapp

Robert Littlefield

Ron McCullagh

Linda Milhaven

Vice Mayor Dennis Robbins





September 6, 2012

Honorable Mayor and Members of the City Council:

Enclosed is the audit report, *Utility Franchise Agreement Compliance*. A franchise is a privilege conferred by a municipal corporation to a public utility company for use of the municipality's public right-of-way. We selected the Arizona Public Service Company (APS) franchise agreement, which is the City's longest established and not previously reviewed, for the audit.

This audit determined that APS franchise payments appear to be based on appropriate customer revenue categories, calculated correctly and remitted timely. However, the City does not require APS to submit supporting information; therefore, oversight is limited to ensuring payments are received. Also, a contract administrator has not been designated to monitor compliance with contract terms.

We would like to thank City staff from the Public Works Division, the Finance & Accounting Division, and the Information Technology department for their cooperation and assistance throughout the course of this audit.

If you need additional information or have any questions, please contact me at (480) 312-7867.

Sincerely,

A handwritten signature in black ink that reads "Sharron Walker". The signature is written in a cursive, flowing style.

Sharron Walker, CPA, CFE  
City Auditor

**Audit Team:**

Lai Cluff – Senior Auditor  
Cathleen Davis, CIA – Senior Auditor  
Joanna Munar, CIA – Senior Auditor



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## EXECUTIVE SUMMARY

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This audit of *Utility Franchise Agreement Compliance* was included on the Council-approved Fiscal Year (FY) 2011/12 Audit Plan to review compliance with a selected franchise agreement. We selected the Arizona Public Service Company (APS) franchise agreement, which is the longest established and not previously reviewed, for the audit.

A franchise is a privilege conferred by a municipal corporation, such as a city or county, to a public utility company for the use of the municipality's public right-of-way. Most franchise agreements impose a small percentage of gross revenues as the franchise fee and cover an extended period of time, such as 25 years.

During the past three fiscal years, the City's light and power franchise revenue totaled approximately \$7.8 to \$8.1 million per year, while cable franchise revenue was between \$3.2 and \$3.4 million annually. In addition, the City's Water and Sewer Enterprise Funds paid an in-lieu franchise fee of approximately \$6.5 million per year.

Based on the audit, APS franchise payments appear to be based on appropriate customer revenue categories, calculated correctly and remitted timely. While the audit found errors in APS' Scottsdale customer file, the revenue impact is not significant. Of the approximately 103,000 Scottsdale site addresses provided by APS, we found 145 that were actually located outside Scottsdale boundaries. While this audit did not identify any apparent gaps in APS' Scottsdale customer data, it did not include testing all of APS' non-Scottsdale customers for proper coding. Test results indicate the potential for a small number of Scottsdale customers to be miscoded as other cities' customers.

The City does not require APS to submit supporting information with its franchise fee payments; therefore, City staff oversight is limited to ensuring payments are received. In addition, a contract administrator has not been designated to ensure that compliance with contract terms is monitored.



## **BACKGROUND**

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A franchise is a privilege conferred by a municipal corporation, such as a city or county, to a public utility company for the use of the municipality's public right-of-way. Arizona Revised Statute (ARS) requires that a public utility franchise be approved by a majority of the qualified voters and the term of a franchise agreement cannot exceed 25 years. Most franchise agreements impose a small percentage of gross revenues as a franchise fee for use of right-of-ways.

### **Types of Franchise Contracts**

Due to different provisions in state law, the City has different types of franchise contracts – voter-approved franchise agreements and franchise licenses, which are not subject to voter approval.

### **Voter-approved Franchise Agreements**

The City has franchise agreements with Arizona Public Service Company (APS) and Southwest Gas as described below.

- APS — In 1980, the City Council passed an ordinance granting APS a franchise for electric and gas delivery through March 2005. Subsequently, in 1983, APS assigned the gas portion to Southwest Gas. In January 2005, APS was awarded a new 25-year franchise based on voter approval in the November 2004 election. The 2% franchise fee is paid on revenues from the sale and delivery of electric services within Scottsdale and is in lieu of all fees or charges for construction and inspection permits or any similar fees.<sup>1</sup>
- Southwest Gas — Although the APS franchise agreement under which it was operating expired in March 2005, Southwest Gas continued paying those franchise fees until a new agreement was negotiated and received voter approval. In April 2012, the City Council awarded the new voter-approved 25-year franchise agreement, which provided for a 2% franchise fee is based on its gross revenues from the sale of natural or artificial gas within the City. As also established in the franchise agreement, Southwest Gas pays the City 0.5% of gross revenues to a special fund used to reimburse Southwest Gas for certain capital expenditures.<sup>2</sup>

Salt River Project (SRP), an electric utility provider operating within the City, does not have a franchise agreement due to its status as a political subdivision. SRP is comprised of the Salt River Valley Water Users' Association, a private water corporation, and the Salt River Project Agricultural Improvement and Power District, an agricultural improvement district and political subdivision of the state of Arizona.

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<sup>1</sup> According to APS Franchises & Technical Services, the company has franchise agreements with 52 Arizona municipalities using a model franchise agreement with the same franchise rate.

<sup>2</sup> This fund will be used to reimburse Southwest Gas for certain capital expenditures, such as city-driven utility relocations, permits and fees.

### **Nonvoter-approved Franchise Licenses**

Alternatively, a cable license was issued to Cox Communications (Cox) and Qwest (now CenturyLink). Franchise licenses are authorized by state statute and also regulated by federal guidelines.<sup>3</sup> Unlike the requirement for a franchise agreement, voter approval is not required for these public utility franchises.

- Cox — In June 2007, the City Council approved a cable license renewal for Cox Communications to provide services within the city through June 2018. The agreement requires a 5% fee on gross revenues subject to the cable license fee, plus continued payment of permit, plan review and inspection fees, which are capped at \$45,000 annually.
- Qwest/CenturyLink — In December 2003, the City Council approved a cable license for Qwest, which expires in September 2013. In return for changes to its September 1998 approved construction schedule, Qwest agreed to make in-kind contributions to support the City's intelligent traffic system, information systems and communications needs. Qwest also pays a 5% cable franchise fee.

Separate from their franchise licenses, Cox and Qwest (as well as other such companies operating within the City) pay a flat \$2,000 fee for a City telecommunications license.

### **Water and Sewer Fund In-Lieu Franchise Transfers**

In addition to the City's formal franchise agreements and licenses, its Water and Sewer Enterprise Funds also pay franchise fees. Because there is not a formal agreement or policy, these fees are referred to as in-lieu franchise payments. Calculated at 5% of actual operating revenue, the payments have totaled \$6.4 to \$6.6 million during the last three fiscal years. The Water Fund paid approximately 73% of these amounts, and the Sewer Fund about 27%.

### **Franchise Fee Revenues**

As shown in Table 1, light and power franchise fee revenue has totaled approximately \$7.8 to \$8.1 million per year, cable television revenue between \$3.2 and \$3.4 million annually and in-lieu fees totaled about \$6.5 million each year.

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<sup>3</sup> The state law provides that the license fee plus transaction privilege taxes together constitute the franchise, and the total may not exceed 5%. In addition, federal telecommunications law does not allow such fees to be assessed on interstate telecommunications service so these companies' telephone and internet services are not included.

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**Table 1: Franchise Fees**

	<b>FY 2009/10</b>	<b>FY 2010/11</b>	<b>FY 2011/12</b>
APS	\$ 6,657,724	\$ 6,770,503	\$ 6,989,163
Southwest Gas	1,175,920	1,071,279	1,125,508
<b>Total Light &amp; Power</b>	<b>7,833,644</b>	<b>7,841,782</b>	<b>8,114,671</b>
Cox	3,309,107	3,152,321	3,441,303
Qwest	7,814	10,218	3,219
<b>Total Cable Television</b>	<b>3,316,921</b>	<b>3,162,539</b>	<b>3,444,522</b>
<b>Total Agreements &amp; Licenses</b>	<b>\$11,150,565</b>	<b>\$11,004,321</b>	<b>\$11,559,153</b>
Water Fund	4,739,462	4,676,156	4,769,871
Sewer Fund	1,792,785	1,756,898	1,785,429
<b>Total Enterprise In-Lieu</b>	<b>6,532,247</b>	<b>6,433,054</b>	<b>6,555,300</b>
<b>Grand Total</b>	<b>\$17,682,812</b>	<b>\$17,437,375</b>	<b>\$18,114,493</b>

**SOURCE:** Auditor analysis of SmartStream general ledger detail reports.

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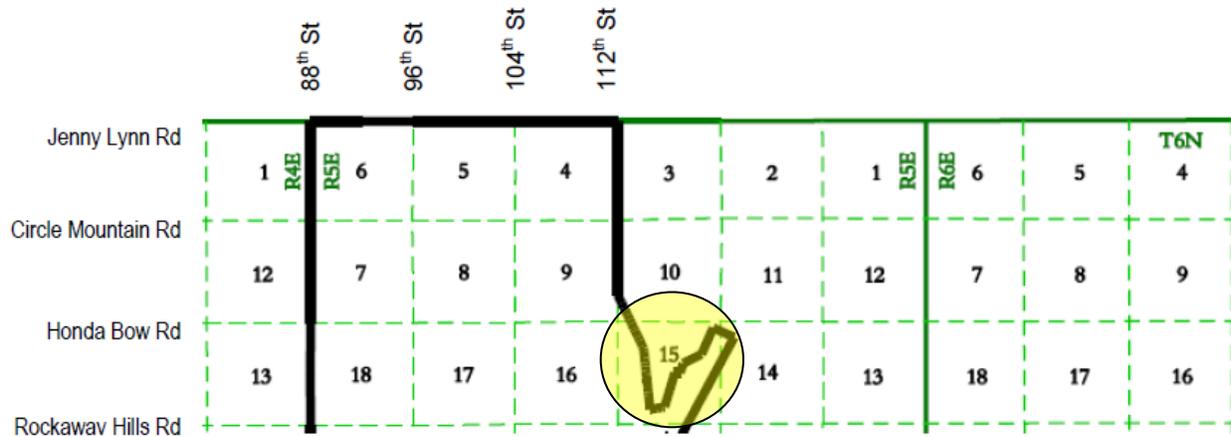
Franchise fees are generally paid to the City quarterly, with most accompanied by a payment advice or letter explaining the related revenue and fee calculation. Enterprise in-lieu fees are calculated and transferred monthly.

### **Selected Franchise Agreement: APS**

Selected for this audit, the APS agreement generates the most franchise revenue for the City, approximately \$6.8 million annually. Also, the APS franchise is the longest established agreement, beginning in 1980 and renewed in 2004, but it has not been previously audited.

Based on review of APS-provided revenue and customer reports, APS has approximately 103,000 service addresses in Scottsdale. Each APS service address (meter) has a unique site identifier (site ID) and is associated with customer information such as the physical address, a code that identifies the location's map quarter section, and a code that identifies the customer's revenue class (such as commercial or residential). APS staff stated they manually verify new site IDs annually to ensure they have been assigned the proper quarter section code based on boundary information provided by the cities. This is particularly important for a site ID in a location such as the one highlighted on Figure 1.

**Figure 1: Example Quarter Section**



Note: The yellow circle illustrates an area where proper city coding would be more challenging. “T” designates the township, “R” is range; “N” is north, “E” is east. These designations correspond to the Maricopa County Assessor’s maps.

**SOURCE:** City of Scottsdale’s Information Technology department, Geographic Information Systems (GIS) staff.

The APS site IDs are assigned one of 5 revenue classes: Residential, Commercial, Industrial, Irrigation, and Street Lighting. As shown in Table 2, within Scottsdale, approximately 85% of APS customer site IDs are residential and 15% are commercial. Less than 1% of the site IDs is in the other rate classes.

**Table 2: APS Customer Site Addresses for Scottsdale, by Rate Class**

Rate Class	Count	Percent
Residential	87,794	85.00%
Commercial	14,956	14.48%
Industrial	250	0.24%
Irrigation	25	0.02%
Street Lighting	272	0.26%
Total	103,297	100%

**SOURCE:** Auditor analysis of APS customer site address reports.

## Geographic Information System Data Comparison

The City's Geographic Information Systems (GIS) staff maintains City maps coded with many types of City data, such as city facilities, development cases, and water and sewer lines. Therefore, this extensive address mapping provides an opportunity for comparison to the APS site address data for its Scottsdale customers. To allow the comparison, GIS first "cleaned" the APS data, as shown in Figure 2, to improve formatting consistency as much as possible without manual corrections.

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**Figure 2: Data Cleaning Example**

Site Address Data as Provided by APS					
House	Prefix	Street	Suffix	Modifier 1	Modifier 2
12345	N	Adams	Ave	Unit	A

APS Site Address Formatted and Combined by GIS Staff
12345 N Adams Av Unit A

**SOURCE:** The City's GIS staff address analysis.

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The APS-provided site ID data included latitude and longitude coordinates. For the remaining inconsistent addresses, these coordinates facilitated plotting the APS site addresses onto a City map.



## OBJECTIVES, SCOPE, AND METHODOLOGY

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An audit of *Utility Franchise Agreement Compliance* was on the City Council-approved fiscal year (FY) 2011/12 Audit Plan. The audit objective was to review a selected franchise agreement for compliance with fee-related requirements, including whether franchise fees are calculated accurately and remitted timely. For this audit, we selected the Arizona Public Service Company franchise agreement and fee payments.

To gain an understanding of the City's franchise agreements and franchise licenses as well as the related laws and regulatory guidance, we reviewed the following items:

- City Franchise Agreement No. 2004-118-COS with Arizona Public Service (APS) Company effective December 1, 2004, City Ordinance 3581, and the related City Council Report (January 11, 2005, agenda item 19).
- City Franchise Agreement No. 2011-124-COS with Southwest Gas Corporation effective April 1, 2012, Resolution 8855, and the related City Council Report (November 10, 2011, agenda item 17).
- Cable license agreement with Cox Communications, effective January 5, 2007, Resolution 7110, and the related City Council Report (June 5, 2007, agenda item 10). Although not specifically reviewed, cable licenses have also been issued to Qwest, TCG Phoenix (subsequently owned by AT&T), TW Telecom (Time Warner), Zayo Group, and Integra Telecom.
- Arizona Revised Statutes, Title 9, Chapter 5, *Public Utilities*, which establishes a municipality's rights and limitations to grant a franchise for a public utility.
- City Charter, Article 12, *Franchise and Public Utilities*, specifying the City's power to prescribe classifications and rates to be used by all corporations rendering public utility service within the corporate limits.
- City Administrative Regulations (AR) 215, *Contract Administration*.

To help assess risks commonly associated with franchise fee agreements, we reviewed related audit work completed by other auditors. We also interviewed staff from the City Attorney's Office, the Finance & Accounting Division, and Geographic Information Systems in the Information Technology department regarding the City's related procedures.

To assess the data completeness and the company's compliance with fee-related contractual terms, we:

- Obtained from APS summary reports of its FY 2010/11 and 2011/2012 quarterly Scottsdale franchise revenues and fees, and its billing totals by customer site ID for June 2012.
- Recalculated APS's franchise fees to verify mathematical accuracy of its payments.
- Randomly selected a sample of 30 site IDs and obtained APS service billings to verify reliability of the site ID billings and reported franchise fee revenues.

- Compared the APS site addresses as of June 2011 to June 2012 to analyze completeness and identify any exceptions.
- Compared the selected APS service billings to the APS chart of accounts to determine completeness of the identified electric revenue sources.
- Obtained GIS staff assistance in matching APS customer site addresses to City address records and then plotting the APS addresses on a City map to identify any potential exceptions.
- Compared APS site addresses shown on GIS results as outside the City to the Maricopa County Assessor's web-based information, including GIS maps and tax area codes. A land parcel's tax area code identifies the taxing jurisdictions in which it is located. This comparison identified instances in which the APS address data was faulty and clarified which site IDs were within or outside the City.

Based on these audit procedures, APS franchise payments appear to be based on appropriate customer revenue categories, calculated correctly, and remitted timely. The City's external auditors confirm with APS the franchise revenue amounts recorded in the City's accounting records during the annual audit to ensure the amount is accurate and not misclassified. However, City staff should periodically match APS customer site addresses with City address data. In addition, the City does not require APS to submit any supporting documentation with its quarterly franchise fee payments; therefore, City oversight is limited to ensuring payments are made. In addition, a contract administrator has not been designated to ensure monitoring of contract compliance.

We conducted this audit in accordance with generally accepted government auditing standards as required by Article III, Scottsdale Revised Code, §2-117 et seq. 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 that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives. Audit work took place from June through August 2012, with Lai Cluff, Cathleen Davis and Joanna Munar conducting the work.

## FINDINGS AND ANALYSIS

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### 1. APS customer data used in the calculation of Scottsdale franchise fee payments may not be complete and accurate.

To test completeness of the Scottsdale electric revenues on which APS franchise fees are based, auditors requested Scottsdale customer addresses as of June 30, 2011, and June 30, 2012. Besides the address, each APS customer meter location is assigned a unique site identifier (site ID) and is also coded to identify the city in which it is located. APS uses this city code to calculate the 2% franchise fees owed to each city.

The City's Geographic Information Systems (GIS) staff assisted us by matching the APS site ID addresses to City GIS address records. The matched addresses can be plotted onto a city map using the City's geocoding, which helps identify potential exceptions, such as areas within the City that did not match APS customer site data or those customers appearing to fall outside the City's boundaries.

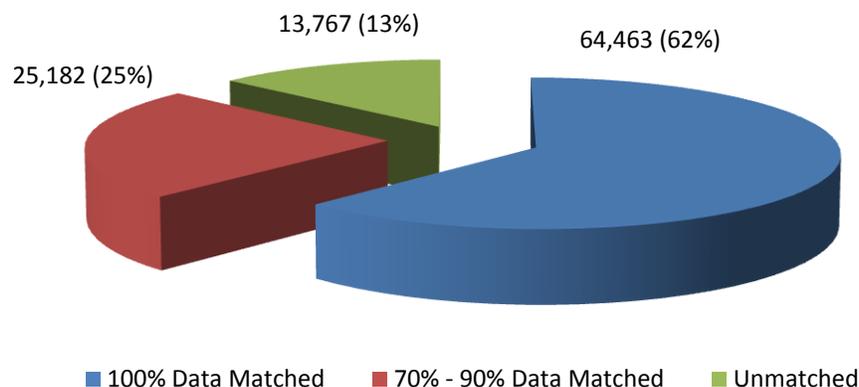
- A. Approximately 14,000 APS site addresses did not closely match to the City's GIS address records.

The GIS system scores the level of matching between two sets of data. If all elements of two addresses are exactly the same, it is scored as a 100% match. Address variations are assigned scores ranging from 90 to 70% depending on how closely they match. For example, if the address modifier differs (e.g., "Apt" versus "Unit"), it is scored 80%. Anything less than a 70% match is scored as zero and will not be plotted by the system.

As shown in Figure 3, of the 103,412 APS site addresses provided for June 2011, about 64,000 scored as 100% matches to City address records and another 25,000 matched with 70 to 90% accuracy. Almost 14,000 site addresses, or 13%, will have to be manually reviewed to determine if they can be matched to City addresses.

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**Figure 3: Matching Results for APS June 2011 Site Addresses to City GIS Data**



**SOURCE:** Analysis of APS Site Addresses by the City's Geographic Information Systems (GIS) staff.

Many of the unmatched APS addresses appear to be caused by variations in how an address was entered into APS’s system. As an example, Mountain View Road was also entered as “Mountainview,” “Mtn View” and “MtView” in the APS data. Also, when an APS site address cannot be matched to a City address, it may not be within the city-limits or may be improperly coded by APS. Such results reduce assurance that APS customer data for Scottsdale is complete and accurate. Additional work would be needed to continue matching and validating APS service addresses to the City’s records to gain a higher level of assurance of the franchise fee revenue completeness. As a result of the numerous variations, we did not conduct an address match using the June 2012 data.

- B. Based on the City’s GIS plotting results, 145 APS customer site addresses appear to fall outside Scottsdale city-limits, but were included in calculating its franchise fee payments to the City. These errors indicate that some Scottsdale customers may also be coded as being in other cities.

While the address formatting discrepancies prevented address matching analysis, the City’s GIS staff was able to plot the APS site addresses using the latitude and longitude coordinates provided for each site ID. GIS was able to plot 102,623 (or 99%) of the 103,297 site addresses on the June 2012 APS customer list. Of the plotted site addresses, 236 (or 0.2%) appeared to be located outside the Scottsdale city-limits. After further analysis using the Maricopa County Assessor’s web-based tax parcel information, auditors confirmed 145 site addresses were located outside Scottsdale boundaries, and an additional 23 site addresses could not be matched using the county or city maps. Table 3 summarizes the data plotting results and they are also illustrated on a City map on page 14.

**Table 3: Comparison of APS June 2012 Scottsdale Customer Addresses to Scottsdale Boundaries**

APS Site Address	Amount	% of Total
Site IDs Plotted	102,623	99.35%
Outside City Boundaries	145	0.14%
Address not Confirmed	23	0.02%
Site IDs Unable to Plot	674	0.65%
Total APS Customer Addresses as of June 30, 2012	103,297	100.00%

**SOURCE:** Auditor analysis of APS Site Addresses and results of the City’s Geographic Information Systems address plotting.

When APS miscodes a site address to the wrong city, two cities are affected with incorrect franchise payments: one is overpaid while the other is underpaid. In this case, testing identified 145 accounts included in APS’s Scottsdale revenue that are actually located in other cities. Based on GIS plotting results, there do not appear to be

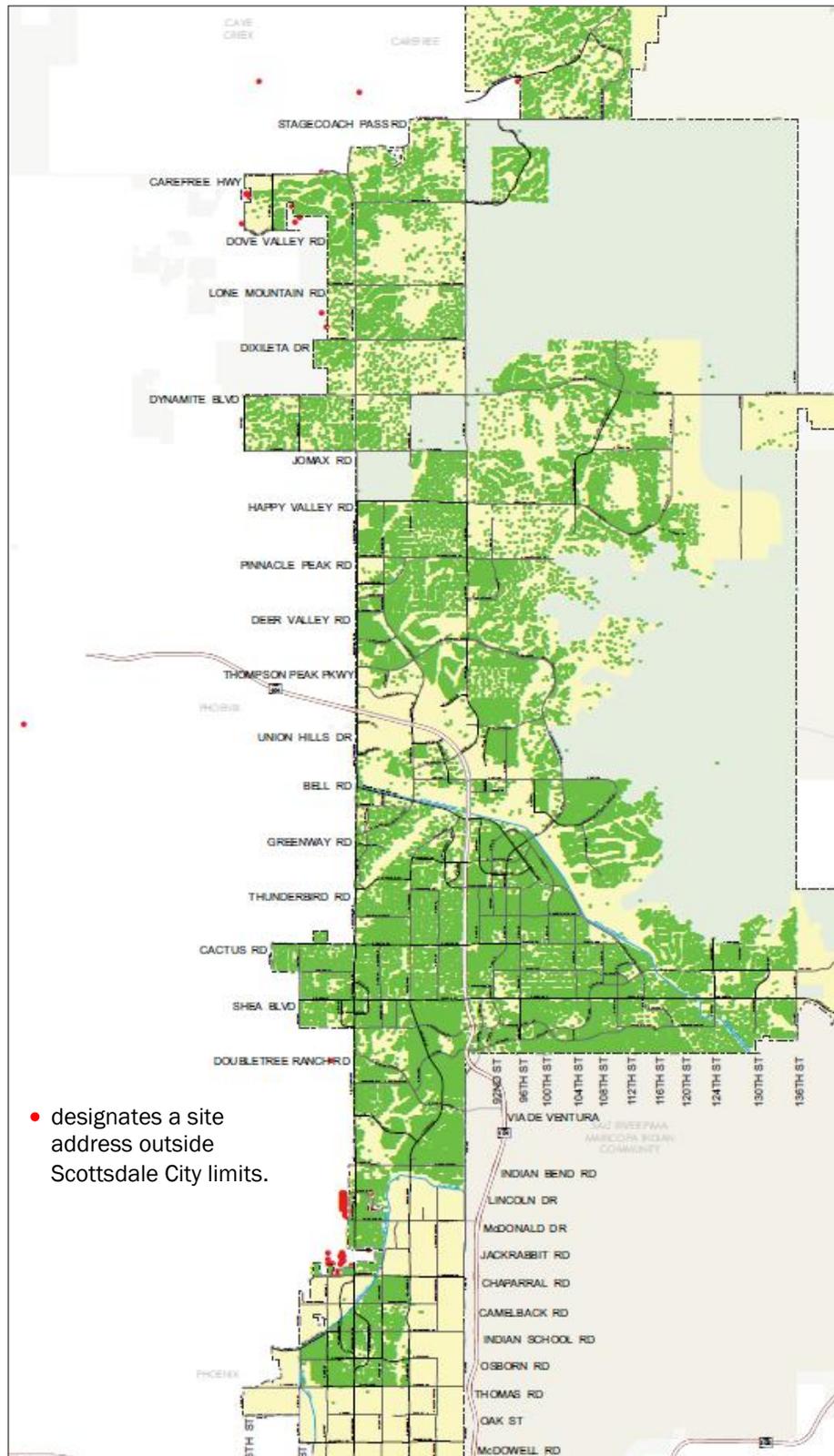
unexplained gaps in APS's Scottsdale customer sites. But further detailed address matching would be needed to determine whether any Scottsdale customers are miscoded to other cities.

We estimate the overpaid franchise revenue associated with the 145 accounts totaled approximately \$14,000 during FY 2011/12. Due to the limited nature of these errors, Scottsdale's franchise fee payments from APS appear to be materially complete.

**Recommendation:**

The City Manager and City Treasurer should direct their appropriate staff to work with APS to periodically match APS customer site addresses to the City's.

**Figure 4: APS June 2012 Scottsdale Site Addresses Outside City-Limits**



**2. Franchise fee payments are not reviewed periodically for accuracy or completeness.**

Totaling approximately \$7.8 to \$8.1 million annually, light and power franchise revenue is a significant revenue source to the City. Yet limited oversight is exercised for these revenues.

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**Table 4: Franchise Agreement and License Revenue (in millions)**

	FY 2009/10	FY 2010/11	FY 2011/12
APS	\$ 6.6	\$ 6.8	\$ 7.0
Southwest Gas	1.2	1.0	1.1
<b>Total Light &amp; Power</b>	<b>7.8</b>	<b>7.8</b>	<b>8.1</b>
Cox	3.3	3.2	3.4
Other	0.0	0.0	0.0
<b>Total Cable</b>	<b>3.3</b>	<b>3.2</b>	<b>3.4</b>
<b>Total</b>	<b>\$ 11.1</b>	<b>\$ 11.0</b>	<b>\$ 11.5</b>

**SOURCE:** Auditor analysis of SmartStream general ledger detail reports.

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Cable franchise payments to the City are accompanied by a cover letter or payment advice stating the related revenues, franchise rate and calculated franchise fees. In contrast, the APS and Southwest Gas franchise payments do not include any supporting information that would allow staff to validate the fee calculation or monitor revenue fluctuations. Instead, their accompanying document just states the payment amount. As a result, the oversight exercised for the City's electric and gas franchise fees is limited to verifying payments were received. Additional information, such as customer counts and revenue totals would allow additional monitoring.

While the Public Works Division currently negotiates terms of such agreements, the Finance & Accounting Division receives the franchise fee payments and related documentation. A contract administrator has not specifically been designated for the APS franchise agreement to ensure contract compliance is being monitored as required by Administrative Regulation 215.

**Recommendation:**

The City Manager and City Treasurer should designate a contract administrator to monitor compliance with the APS agreement, such as periodically comparing customer addresses to City records. In addition, APS should be required to submit more specific revenue and fee information with its payments.



## MANAGEMENT ACTION PLAN

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- 1. APS customer data used in the calculation of Scottsdale franchise fee payments may not be complete and accurate.**

**Recommendation(s):**

The City Manager and City Treasurer should direct their appropriate staff to work with APS to periodically match APS customer site addresses to the City's.

MANAGEMENT RESPONSE: Agree

PROPOSED RESOLUTION: The City Manager and City Treasurer will determine staff most appropriate to periodically review a sampling of APS customer site addresses to confirm location.

RESPONSIBLE PARTY: City Manager and City Treasurer

COMPLETED BY: 10/1/2012

- 2. Franchise fee payments are not reviewed periodically for accuracy or completeness.**

**Recommendation(s):**

The City Manager and City Treasurer should designate a contract administrator to monitor compliance with the APS agreement, such as periodically comparing customer addresses to City records. In addition, APS should be required to submit more specific revenue and fee information with its payments.

MANAGEMENT RESPONSE: Agree

PROPOSED RESOLUTION: The City Manager and City Treasurer will assign a contract administrator for the APS agreement. This individual will request that APS submit specific revenue and fee information with its quarterly franchise fee payment.

RESPONSIBLE PARTY: City Manager and City Treasurer

COMPLETED BY: 10/1/2012

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