



CITY AUDITOR'S OFFICE

Southwest Gas Franchise Agreement

September 14, 2018

AUDIT REPORT NO. 1909

CITY COUNCIL

Mayor W.J. "Jim" Lane
Suzanne Klapp
Virginia Korte
Kathy Littlefield
Linda Milhaven
Vice Mayor Guy Phillips
David N. Smith



September 14, 2018

Honorable Mayor and Members of the City Council:

Enclosed is the audit report for *Southwest Gas Franchise Agreement*, which was included on the Council-approved FY 2018/19 Audit Plan. This audit was conducted to evaluate the franchisee's compliance with the franchise agreement terms, focusing on primarily on the franchise-related fees.

The audit found that some revenue types were excluded from the franchise fee calculation. These included ancillary revenues, such as service change fees and late fees, and certain customer accounts. We also found a small percentage of inaccuracies in the jurisdiction coding for three selected zip codes. Our review of reimbursements to Southwest Gas from the Capital Expenditures Fund fees indicate that costs appear adequately supported and these fees reduce the expenses for the combined Arizona region's rate base, though direct benefits to jurisdictions vary.

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

Sincerely,

A handwritten signature in blue ink that reads "Sharron Walker".

Sharron E. Walker, CPA, CFE, CLEA
City Auditor

Audit Team:

Paul Christiansen, CIA, CPA – Sr. Auditor
Lai Cluff, CIA – Sr. Auditor

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AUDIT HIGHLIGHTS

Southwest Gas Franchise Agreement

September 14, 2018

Audit Report No. 1909

WHY WE DID THIS AUDIT

An audit of *Southwest Gas Franchise Agreement* was included on the City Council-approved fiscal year (FY) 2018/19 Audit Plan to evaluate the franchisee's compliance with the franchise agreement terms, focusing primarily on the franchise-related fees. This audit was requested by the Public Works Division Director.

BACKGROUND

In March 2012, Scottsdale voters approved a Southwest Gas Corporation franchise agreement, which allows Southwest Gas to construct, maintain and operate its natural gas system in the City-owned public rights-of-way. In exchange, the agreement requires Southwest Gas to pay the City a 2% franchise fee and a 0.5% Capital Expenditures Fund fee based on gross revenues derived from its sale and/or delivery of natural and artificial gas within the City.

Capital Expenditures Fund fees are held by the City and used to reimburse Southwest Gas annually for permit and inspection fees and costs related to relocating utilities for City projects. Any funds remaining belong to the City and are transferred to the General Fund.

Franchise-related fees totaled about \$7.8 million from April 2012 through March 2018.

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City Auditor 480 312-7867
Integrity Line 480 312-8348
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WHAT WE FOUND

Some revenue types were excluded from the franchise fee calculation.

- Franchise-related fees were not paid on ancillary revenue, such as service change fees and late fees. These represented about \$75,000 in franchise fees.
- Certain customers were not charged franchise fees and the cause is not clear. These totaled nearly \$15,100 in unpaid franchise fees.

A small percentage of Southwest Gas service addresses were incorrectly identified as being within or outside of Scottsdale boundaries.

We tested service addresses for three zip codes, with the assistance of the GIS department mapping the addresses against the City boundaries. We found that:

- About 3% of these service addresses within Scottsdale boundaries were coded to other jurisdictions.
- About 5% of these service addresses not within Scottsdale boundaries were coded to Scottsdale.

Reimbursements from Capital Expenditures Fund fees appeared appropriate and reduced expenses for the Arizona region's rate base.

Based on our sample of costs, the reimbursement requests appeared adequately supported. Direct benefits to each jurisdiction vary, however, because franchise agreement terms differ, and reimbursements are applied to the combined region's rate base.

WHAT WE RECOMMEND

We recommend the Public Works staff:

- Work with the City Attorney's Office to evaluate whether these revenues should be included under the franchise agreement terms and, if applicable, recover any unpaid fees and associated late charges. As well, require Southwest Gas to provide more detailed documentation to support the franchise fees.
- Work with Southwest Gas to periodically verify the jurisdiction coding of selected service address areas.

MANAGEMENT RESPONSE

The department agreed with the audit recommendations.

BACKGROUND

A utility 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 rights-of-way. Arizona state law and the City Charter require that a public utility franchise be approved by a majority of the City's qualified voters and the franchise agreement's term cannot exceed 25 years. In March 2012, Scottsdale voters approved a Southwest Gas Corporation franchise agreement, which the Public Works Division's Real Estate group administers.

The franchise agreement allows Southwest Gas to construct, maintain and operate its gas system in the City-owned public rights-of-way, which may include streets, alleys, bridges and other public places. In exchange for these rights, the agreement requires Southwest Gas to pay the City a franchise fee and a capital expenditures fund fee.

After any use, installation, or construction work, Southwest Gas is responsible for restoring the public right-of-way. Except where the utility has prior property rights, Southwest Gas is also responsible for relocating gas facilities when required for City purposes, such as capital improvements.

Franchise Fee

The franchise agreement requires Southwest Gas to pay the City a franchise fee of 2% of gross revenues derived from its sale and/or delivery of natural and artificial gas within the City. The utility charges this fee to its customers on each monthly utility bill, typically as part of a combined "applicable revenue taxes" charge.

After collection, the franchise fees are then remitted to the City quarterly. Figure 1 on page 4 shows the franchise fees received during this agreement's term. For the period of April 2012 to March 2018, Southwest Gas paid the City about \$6.26 million in franchise fees, averaging about \$1 million each year.

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Southwest Gas Franchise Agreement Contract 2011-124-COS

Voter approval: March 13, 2012

Contract term:
25 years, April 1, 2012 – March 31, 2037

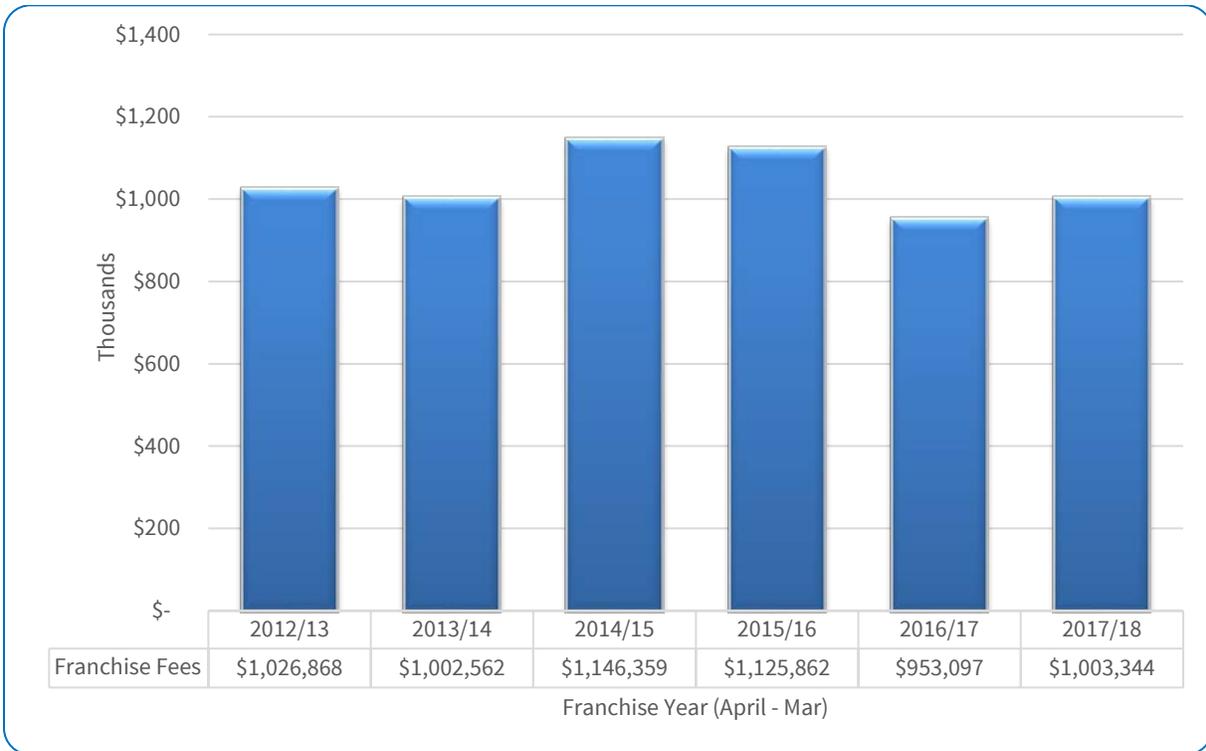
Southwest Gas Corporation (SWG) is a wholly owned subsidiary of Southwest Gas Holdings, Inc. SWG is in the business of purchasing, distributing, and transporting natural gas in Arizona, Nevada, and California.

Its natural gas operations consist of about 85% residential and small commercial, 12% transportation-only, and 3% other sales.

The Arizona market comprises 53% of SWG's customers.

Source: Southwest Gas Holdings 2017 Annual Report

Figure 1. Franchise Fees Received, April 1, 2012 – March 31, 2018



SOURCE: Auditor analysis of SmartStream accounting reports.

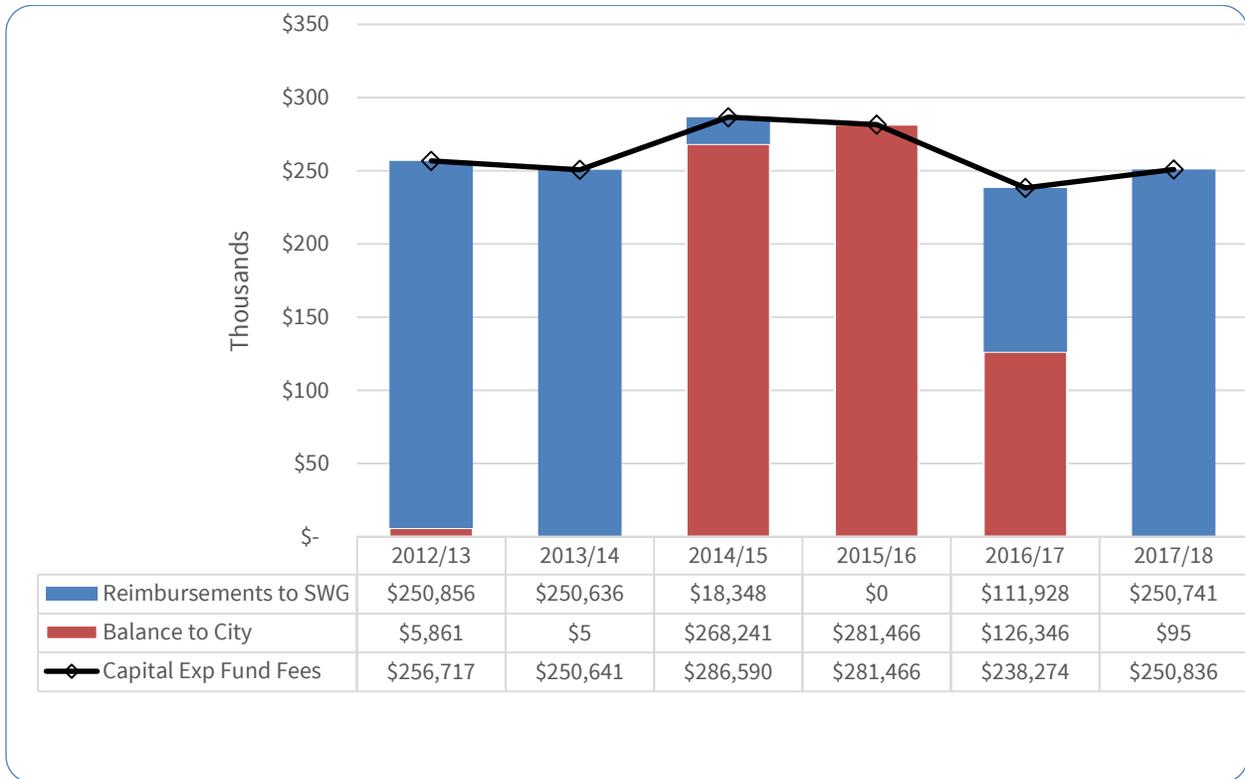
Capital Expenditures Fund Fee

The City’s franchise agreement also requires Southwest Gas to pay a 0.5% Capital Expenditures Fund Fee. Southwest Gas similarly charges this fee monthly to its utility customers and pays the City quarterly. The City maintains this fee in a separate fund to reimburse Southwest Gas for permit and inspection fees paid to the City and for costs of relocating utility lines for City projects. Annually, Southwest Gas submits an invoice with its eligible costs, up to the fund balance, to the Contract Administrator for review and reimbursement. Any amounts remaining in the fund after the annual reimbursement then belong to the City and are transferred to the General Fund.

Since April 2012 through March 2018, Southwest Gas customers paid approximately \$1.5 million into this fund. Of that amount, as shown in Figure 2 on page 5, about \$883,000 was reimbursed to Southwest Gas for eligible expenses.

(continued on next page)

Figure 2. Capital Expenditures Fund Fees, April 1, 2012 – March 31, 2018



SOURCE: Auditor analysis of SmartStream accounting reports.

Compliance with Franchise Fees

Southwest Gas Corporation has franchise agreements with the various municipalities in which it operates, and each jurisdiction’s franchise terms may vary. While the 2% franchise fee is common among the Valley cities, the gross revenues that it is based on are sometimes defined differently. As well, some agreements do not include a capital expenditures fund fee, while those that do range from Scottsdale’s 0.5% to as much as 2%.

To comply with the various agreement terms, Southwest Gas assigns a jurisdiction code to each of its service addresses in its billing system based on the municipal jurisdiction. To ensure that its jurisdiction codes are up-to-date, Southwest Gas uses a third-party application that compares service addresses and jurisdiction codes in the billing system to GIS data with tax jurisdictions and municipal boundaries. According to Southwest Gas representatives, this application updates the tax jurisdiction in the Southwest Gas billing systems when errors are found.

OBJECTIVES, SCOPE, AND METHODOLOGY

An audit of *Southwest Gas Franchise Agreement* was included on the City Council-approved fiscal year (FY) 2018/19 Audit Plan. The audit objective was to evaluate the franchisee's compliance with the franchise agreement terms, focusing primarily on the franchise-related fees. This audit was requested by the Public Works Division Director.

To obtain an understanding of the franchise agreement requirements, we reviewed the Southwest Gas Franchise Agreement (COS contract 2011-124-COS). We also interviewed the Real Estate Asset Manager and the Senior Real Estate Management Specialist responsible for administering the contract. We reviewed the contract administration files, including the Southwest Gas documentation submitted to support the franchise-related fees remitted.

We interviewed Southwest Gas Corporation representatives, including the Director and the Manager of the company's Tax department, to gain an understanding of the franchise fee-related billing and accounting process.

To verify revenues used to calculate franchise-related fees, we requested and reviewed the following documentation:

- General ledger reconciliations of franchise-related fees collected and remitted and
- Billing system reports for the Scottsdale jurisdiction.

We reviewed billing system reports provided by Southwest Gas to identify Scottsdale revenues that were included in the franchise fee calculations. We recalculated the franchise fee amount for comparison to the amount actually remitted to the City.

However, Southwest Gas general ledger data reflects combined Phoenix-region balances. Due to privacy concerns, Southwest Gas was not willing to share other jurisdictions' billing reports to allow us to reconcile City of Scottsdale activity to general ledger totals. While we were not able to directly reconcile the billing system reports of Scottsdale revenues to the company's general ledger, we gained more assurance of the reports' completeness by reviewing franchise fee reconciliation worksheets the company had prepared for the selected quarter ending March 31, 2018.

We interviewed the assigned Southwest Gas representative for Scottsdale's franchise agreement to gain an understanding of the Capital Expenditures Fund reimbursement process. To verify that the utility's capital expenditure reimbursements were adequately supported, we reviewed the documentation submitted and obtained the utility's supporting invoices for a sample of costs that constituted about 26% of the reimbursed amount. We also verified that the annual remaining balances, if any, were transferred to the City's General Fund.

To determine if Southwest Gas is accurately assigning customer accounts to Scottsdale, we requested service address data for three zip codes that encompass multiple jurisdictions: 85254, 85253, 85250. At our request, the City's GIS Manager plotted these addresses against the City's GIS addresses to identify any that did not match.

The audit found that some revenue types were excluded from the franchise fee calculation, a small percentage of Southwest Gas service addresses were incorrectly identified as being within or outside of Scottsdale boundaries, and reimbursements from Capital Expenditures Fund fees appeared appropriate and reduced expenses for the Arizona region's rate base.

We conducted this performance 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 2018.

FINDINGS AND ANALYSIS

1. Some revenue types were excluded from the franchise fee calculation.

The City received a total of \$7.8 million in franchise-related fees for the period between April 1, 2012 to March 31, 2018. However, Southwest Gas did not pay franchise-related fees on ancillary revenue types, and certain customers were not charged franchise-related fees. The Real Estate group has periodically requested more detail to support the franchise fee amounts submitted by Southwest Gas, but the company has not provided sufficient documentation.

- A. Southwest Gas has not been paying franchise-related fees on ancillary revenues from residential and commercial customers.

These ancillary revenues consisted primarily of service change fees, late charges, low-income ratepayer assistance assessments, and other maintenance fees. Of the \$317 million in Scottsdale natural gas revenues shown for the six years since the franchise agreement began, these ancillary revenues total about \$3 million. According to Southwest Gas representatives, the utility considers these ancillary revenues to not meet the contractual definition of revenues subject to franchise fees. However, Southwest Gas did pay franchise-related fees on about \$100,000 of ancillary revenues from its transportation-only customers.¹ These customers comprise only about 2.3% of the utility's Scottsdale revenue base.

The City's franchise agreement language, as shown in the textbox, broadly encompasses all gross revenues resulting from the sale or delivery of natural gas within the City of Scottsdale. In contrast, another Valley city's franchise agreement (approved by voters in August 2018) specifically refers to "gross revenues derived only from Grantee's Commodity Charge and Basic Service Charge", which effectively excludes these ancillary revenues.

As shown in Table 1, on page 10, these ancillary revenues for Southwest Gas customers within Scottsdale represented almost \$75,000 in unpaid franchise-related fees since the agreement's 2012 inception.

Southwest Gas (Grantee) is required to pay a combined 2.5 percent of "the gross revenues of Grantee, from the sale and/or delivery by it of natural and/or artificial gas for all purposes, within the corporate limits of City, as shown by Grantee's billing records."

Source: Southwest Gas Franchise Agreement, Contract 2011-124-COS

(continued on next page)

¹ Transportation-only service is for customers that secure their own gas supply. Southwest Gas provides transportation services to move the customer-purchased gas to the intended location.

Table 1. Revenue Types Excluded from Franchise-related Fees, April 1, 2012 through March 31, 2018

Excluded Revenues	Revenue Amount	Unpaid Franchise Fees ¹
Late Charges	\$319,554	\$7,989
Service Changes	\$2,036,244	\$50,906
Returned Item Fees	\$83,636	\$2,091
Other Revenues	\$20,570	\$514
Ratepayer Assistance Program	\$315,522	\$7,888
Maintenance of Services	\$224,264	\$5,607
Total	\$2,999,790	\$74,995

¹ These amounts include both the 2% franchise fee and the 0.5% Capital Expenditures Fund fee.

SOURCE: Auditor analysis of Southwest Gas residential and commercial gas revenue reports for the Scottsdale jurisdiction.

B. Southwest Gas did not collect or pay franchise-related fees for certain customer revenues and did not provide documented support for these exceptions.

- *Customer revenues designated as tax exempt.* From 2012 through 2014, Southwest Gas exempted approximately \$164,000 of its residential and commercial gas revenue from franchise-related fees. Southwest Gas could not identify the number of customers or the reason why they were designated as tax exempt. The utility’s representatives provided a general explanation that such exemptions are usually given to government facilities, Southwest Gas facilities, or businesses that have an agreement with the municipality. The revenue improperly designated as tax exempt represents about \$4,100 in unpaid franchise-related fees.
- *Other exclusions.* Southwest Gas also excluded one transportation-only customer from franchise-related fees and did not charge franchise fees to another customer for one month. These excluded revenues total \$440,000 and represent \$11,000 in franchise fees. Southwest Gas representatives could not identify the reason these revenues were excluded.

The City’s franchise agreement does not have a provision defining tax-exempt activity and requires franchise-related fee on all gross revenues from gas sales and delivery within City limits.

Further, the franchise agreement states that "reimbursements for underpayments as a result of audit findings shall be identified as late payments and are subject to late payment interest of 1.5%

per month." As shown in Table 2, we estimate late payment interest charges of nearly \$56,000 for these unpaid franchise-related fees.

Table 2. Estimated Late Payment Interest Charges for April 1, 2012 through September 1, 2018

Revenue Type	Unpaid Franchise Fees	Est'd Interest Charges
Excluded "ancillary" revenues	\$74,995	\$46,554
"Tax exempt" and other exclusions	\$15,095	\$9,356
Total	\$90,090	\$55,910

SOURCE: Auditor analysis of Southwest Gas residential, commercial, industrial and transportation-only revenue reports for Scottsdale.

Recommendations:

The Public Works staff should work with the City Attorney's Office to:

- A. Evaluate whether these revenues are included under the franchise agreement terms. As applicable, seek recovery from Southwest Gas for any unpaid franchise-related fees plus the associated late payment interest charges.
- B. Require Southwest Gas to provide accurate and complete supporting documentation, including support for any excluded customer revenues generated within Scottsdale boundaries.

2. A small percentage of Southwest Gas service addresses were incorrectly identified as being within or outside of Scottsdale boundaries.

For Southwest Gas to accurately comply with its City of Scottsdale franchise agreement, it must remit the agreed-to fees for all its revenues within the City's boundaries, relying on the jurisdiction coding. We found a small percentage of jurisdiction coding errors in the service addresses selected for testing. This indicates potential issues with its verification processes.

We selected three zip codes that overlap Scottsdale and one or more other municipalities and requested a listing of the service addresses and related jurisdiction codes.

As shown in Table 3, the City’s GIS department was able to map about 94% of the 16,567 Southwest Gas service addresses provided for these zip codes.² GIS was not able to accurately map the remaining 6% of service addresses, possibly because they contained invalid address information or represented an unknown address outside the City boundaries and not included in Maricopa County GIS data.

Of the 5,079 customer addresses that mapped to a Scottsdale address, Southwest Gas had coded 153, or 3%, as being within a different jurisdiction.

Some of these errors were locations with the same address or within the same development. For 21 service locations, properties at a single address had more than 1 jurisdiction code. For example, Southwest Gas coded a residential property’s guesthouse and the main house as being in different jurisdictions. Also, half of one Scottsdale residential development was coded to another jurisdiction although the other half was correctly coded as being within the City.

Conversely, about 5% of the service addresses not within Scottsdale boundaries were coded with the Scottsdale jurisdiction. This primarily occurred in the 85254 zip code, which largely encompasses City of Phoenix properties that have Scottsdale mailing addresses.

Zip code 85250 – This zip code is largely in the City of Scottsdale, but also includes small portions of Paradise Valley, the Salt River Pima Maricopa Indian Community, and a small unincorporated area. This area has a Scottsdale postal address.

Zip code 85253 – This zip code is largely in the Town of Paradise Valley, with Scottsdale portions along the eastern and southern borders. The area has a Paradise Valley postal address.

Zip code 85254 – This zip code is largely in City of Phoenix with small portions of Scottsdale along the eastern border but has a Scottsdale postal address.

Table 3: GIS Mapping Results for Sampled Service Addresses

Southwest Gas Service Address Count	
Total addresses provided by Southwest Gas	16,567
Addresses mapped with acceptable accuracy score	15,560
Addresses in Scottsdale coded as Scottsdale	4,926
Addresses in Scottsdale coded to other jurisdictions	153
Addresses not in Scottsdale, coded as Scottsdale	574

SOURCE: GIS department analysis of Southwest Gas service addresses for three selected zip codes.

² The City GIS department’s most accurate data is for Scottsdale addresses; it relies on Maricopa County GIS data for the surrounding areas.

Recommendation:

The Public Works staff should require Southwest Gas to periodically submit the service address jurisdiction coding of selected address areas for verification.

3. Reimbursements from Capital Expenditures Fund fees appeared appropriate and reduced expenses for the Arizona region's rate base.

The 0.5% Capital Expenditures Fund fee paid by Scottsdale natural gas customers is held by the City in a special revenue fund. Southwest Gas can submit for reimbursement certain eligible expenses, including permit and inspection fees paid to the City and costs of relocating utilities for City projects. Any balance remaining at the end of each franchise agreement year becomes the City's and is transferred to the General Fund.

For the selected sample of reimbursed costs, we found that the reimbursement requests were adequately supported. Also, the Capital Expenditures Fund reimbursement of these costs reduced Southwest Gas expenses for the Arizona region's rate base.

The Capital Expenditures Fund fee was initially proposed as 1% of gross revenues, with the option to increase it to 2%. However, City Council rejected the proposed fee and approved a reduced fee of 0.5% to decrease the burden to Scottsdale residents.

SOURCE: Council meeting minutes, November 1, 2011.

A. Southwest Gas' reimbursed costs were adequately supported by invoices and cost reports.

From documentation that Southwest Gas previously submitted with the Capital Expenditures Fund reimbursement requests, we selected a sample of two cost categories for verification of actual costs. These two cost categories totaled about \$65,000 and represented 26% of the reimbursed costs.

About 99% of the costs reviewed were supported by contractor invoices and reports. About 1% was incorrectly recorded as a Scottsdale project, but belonged to a different project. This error appeared to be an isolated instance and was not a significant dollar amount. Further, Southwest Gas records documented total eligible costs that exceeded the Capital Expenditures Fund balance for the contract year. In such instances, Southwest Gas reduced its reimbursement request to no more than the Fund balance.

B. Capital Expenditures Fund reimbursements for Scottsdale and other area municipalities reduce Southwest Gas' rate base for the Arizona region, but direct benefits may vary.

According to Southwest Gas representatives, the company applies the capital expenditure reimbursements from the combined Arizona region to reduce the region's infrastructure costs included in its rate base.

Direct benefits to each jurisdiction vary because franchise agreement terms relating to capital expenditures differ. For example, some Valley municipalities do not charge a Capital Expenditures Fund fee, while others charge as much as 2% of gross revenues.

As well, reimbursable capital costs incurred by Southwest Gas in the individual municipalities may vary depending on the fees charged and the relocation projects requested.

Table 4 illustrates how three cities with the same amount of reimbursable capital expenditures, number of customers and per-customer average revenue, but different Capital Expenditures Fund fee rates would realize different results. For example, City B, with Capital Expenditures Fund fees that cover the reimbursable project costs, would subsidize through the Arizona region customer rates the project costs of City A and City C, when fees do not cover those costs.

Table 4. Varying Impact of Capital Expenditures Fund Fees to Individual Jurisdictions

	City A	City B	City C	Region
Capital Expenditures Fund Fee	1%	2%	0%	1%
Reimbursable Project Costs	\$400,000	\$400,000	\$400,000	\$1,200,000
Customer Capital Expenditures Fund Fees ¹	\$200,000	\$400,000	\$0	\$600,000
Unreimbursed Regional Infrastructure Costs allocated through Increased Rates	\$200,000	\$200,000	\$200,000	\$600,000
Total Infrastructure Cost to Customers (through fees & rates)	\$400,000	\$600,000	\$200,000	\$1,200,000

¹ Customer fees charged through Southwest Gas billings. These examples assume the same customer billing revenues.

SOURCE: Auditor analysis of rate impact, assuming similarly sized jurisdictions, natural gas usage, and reimbursable project costs.

Recommendation:

None.

MANAGEMENT ACTION PLAN

1. Some revenue types were excluded from the franchise fee calculation.

Recommendations:

The Public Works staff should work with the City Attorney's Office to:

- A. Evaluate whether these revenues are included under the franchise agreement terms. As applicable, seek recovery from Southwest Gas for any unpaid franchise-related fees plus the associated late payment interest charges.
- B. Require Southwest Gas to provide accurate and complete supporting documentation, including support for any excluded customer revenues generated within Scottsdale boundaries.

MANAGEMENT RESPONSE: Agree

PROPOSED RESOLUTION: Contract Administrator will work with City Attorney to draft a communication to Southwest Gas requesting payment of unpaid franchise fees and late payment charges. Beginning with the next quarterly payment cycle Contract Administrator will ask Southwest Gas for complete supporting documentation for each quarterly payment.

RESPONSIBLE PARTY: Laurel Edgar, Contract Administrator & City Attorney's Office

COMPLETED BY: Recommendation A – complete by 10-12-2018; Recommendation B – complete with each quarterly payment.

2. A small percentage of Southwest Gas service addresses were incorrectly identified as being within or outside of Scottsdale boundaries.

Recommendation:

Public Works staff should require Southwest Gas to periodically submit the service address jurisdiction coding of selected address areas for verification.

MANAGEMENT RESPONSE: Agree.

PROPOSED RESOLUTION: Laurel Edgar, Contract Administrator, will require SWG to submit service address jurisdiction coding every two years for review with GIS staff. First review to be completed 8-31-2020.

RESPONSIBLE PARTY: Laurel Edgar, Contract Administrator

COMPLETED BY: 8-31-2020

3. Reimbursements from Capital Expenditures Fund fees appeared appropriate and reduced expenses for the Arizona region's rate base.

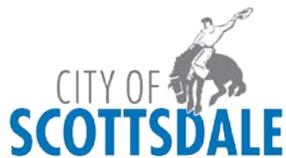
Recommendation: None.

City Auditor's Office

7447 E. Indian School Rd., Suite 205
Scottsdale, Arizona 85251

OFFICE (480) 312-7756
INTEGRITY LINE (480) 312-8348

www.ScottsdaleAZ.gov/auditor



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