

## City of Vernon

Although Reform Is Ongoing, Past Poor Decision Making Threatens Its Financial Stability

June 2012 Report 2011-131



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June 28, 2012

2011-131

The Governor of California  
President pro Tempore of the Senate  
Speaker of the Assembly  
State Capitol  
Sacramento, California 95814

Dear Governor and Legislative Leaders:

As requested by the Joint Legislative Audit Committee, the California State Auditor presents this audit report concerning the management and finances of the City of Vernon (city) and its Light & Power Department (power department). This report concludes that although the city is enacting reforms, it has not yet developed policies necessary to implement some reforms and for others it will take years to achieve the full benefits. The city also has not properly managed its executive positions by failing to establish minimum qualifications for several key leaders, including the city administrator. Further, the city may not have chosen positions in the most comparable cities for its May 2011 survey of executive salaries, potentially skewing salaries upward. The city may have also provided legally questionable retirement benefits to certain past and current executives.

The city has weak internal controls over contracting and our analysis revealed problems in 21 of the 25 service and consultant contracts we reviewed. Further, the city did not always ensure compliance with its conflict-of-interest code, which requires it to determine whether consultants it hires perform duties that require disclosure of economic interests.

For more than 20 years the city's general fund has operated at a structural deficit because the current revenue structure does not fully pay for the general fund's services. The city has funded past general fund deficits through reserves, transfers and loans from other funds, and one-time revenues. Although such practices may be common among cities, the city's continued reliance on other funds to cover its general fund deficit is now problematic because the funds available from these sources have decreased. As of March 2012 the city had \$571 million in outstanding bonds, mostly for its power department. However, the power department has struggled to manage its debt burden while maintaining competitive electric rates. The power department is forecasting a \$24 million deficit in fiscal year 2013–14, creating a need for electric rate increases.

Our finance and energy expert found that the city could not demonstrate that it performed the expected analyses for past energy decisions, such as purchasing a 15-year supply of natural gas for the city's power plant, which it then sold nearly two years later. Because the city used tax-exempt bonds to purchase the gas, selling the power plant created the need for the city to also sell this prepaid natural gas supply to an eligible buyer or risk losing the bond's tax-exempt status; as a result, it sold the gas at a significant discount. Finally, the city has used interest rate swaps to hedge risks associated with issuing bonds, which is a practice consistent with other cities. However, our finance and energy expert found that the city's use of swaps has proved costly—it terminated all but two of its swaps at a cost of \$33.4 million, and as of February 2012, it would have needed to pay \$47 million to terminate the remaining two swaps.

Respectfully submitted,



ELAINE M. HOWLE, CPA  
State Auditor

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## Summary

### Results in Brief

The City of Vernon (city) is an industrial city located southeast of the downtown district of the City of Los Angeles. The city operates under a city charter initially adopted in 1988 by the city's electorate. Covering approximately 5 square miles, the city is home to more than 1,800 businesses providing 55,000 jobs within the city boundary, though its population consists of only 112 residents. Under its charter, the city is governed by a five-member city council, elected to five-year staggered terms. The city's 275 employees are overseen by a city administrator, and the city provides various public services, including fire, police, health, community services, electricity, water, and gas. For fiscal year 2011–12, the city had general fund budgeted expenditures of \$61.6 million, and total city expenditures were budgeted at \$325.7 million.

In response to past scandals involving three former city executives, allegations of improper elections, and excessive salaries, in December 2010, the Legislature introduced Assembly Bill 46 to disincorporate cities with populations of fewer than 150 people—which would have applied only to the city. The legislation was not enacted, and as we discuss throughout this report, as part of its efforts to avoid disincorporation, the city adopted a governance reform package with the goal of promoting transparency and accountability, including various reforms involving housing, contracting, and internal policies and procedures.

The city is making progress in enacting the reform measures but has not yet developed the policies and procedures necessary to implement some of them, and for others, it will take years to achieve the full benefits of the intended reforms. For example, although the city amended its charter to address the voter-approved change to remove the requirement that city employees serve at the will of the city council, the city has not yet developed an alternative employment structure, such as a civil service system, which would promote hiring on the basis of qualifications and fitness. In addition, although the city has made some progress in implementing a number of reform measures related to a state senator's direction to double its electorate, full reform of the city's housing practices will take years to achieve.

The city also has not properly managed its executive positions. For example, it has failed to establish minimum qualifications for several key leaders, including the city administrator, city treasurer, and city clerk. Without minimum qualifications the city cannot ensure that it hires individuals with the proper qualifications and experience to succeed in their roles. The city has been without a

### Audit Highlights . . .

*Our review of the City of Vernon (city) highlighted the following:*

- » *It has not yet developed the policies and procedures necessary to implement some of the reform measures, and for others, it will take years to achieve the full benefits of the intended reforms.*
- » *It has not properly managed its executive positions.*
  - *It failed to establish minimum qualifications for several of the city's key leaders, including the city administrator, city treasurer, and city clerk.*
  - *The city's salary survey did not consider some important factors in comparing its executive salaries to those in other cities.*
  - *It may have provided legally questionable retirement benefits to certain current and past executives, entitling them to more generous retirement benefits.*
- » *It has inadequate contracting policies and weak internal controls resulting in poor practices for developing, awarding, and making payments on contracts—we found problems with 21 of the 25 contracts we reviewed.*
- » *The city did not ensure compliance with the disclosure requirements of its conflict code.*
- » *The current revenue structure for its general fund does not provide sufficient revenue to pay for the services that the general fund provides—in fiscal year 2010–11 the structural deficit was \$28 million.*
- » *Past general fund deficits were funded through reserves, interfund transfers and loans, and one-time revenues such as the sale of property.*

*continued on next page . . .*

- » *It does not have a policy to guide decisions to issue debt and ensure that they are consistent with the city's goals and principles of sound financial management—the city's total estimated debt service will be more than \$60 million annually for the next 10 years.*
- » *The Light & Power Department is forecasting a \$24 million deficit in the light and power fund under its current electric rates.*
- » *The city lacks a clear energy strategy—it sold its electrical power plant shortly after construction was complete and less than two years after it purchased a 15-year prepaid supply of natural gas for the power plant.*
- » *The city has used interest rate swaps to hedge risks associated with issuing bonds but lacked an effective process to evaluate risks and benefits of such swaps.*
  - *Contrary to best practices, some of the swaps entered into were for speculative purposes.*
  - *The city has terminated all but two of the swaps at a cost of \$33.4 million and, as of February 2012, would have needed to pay \$47 million to terminate the remaining two.*

director of human resources since July 2009, but it is in the process of hiring an individual who will be responsible for addressing these personnel concerns. Further, the salary survey the city completed in May 2011 did not consider some important factors when it compared its executive salaries to those in other cities. For example, the city did not consider the organizational size and structure of the other cities, the scope of responsibilities and duties of the positions being compared, or the qualifications associated with those positions. As a result, the city may not have chosen positions in the most comparable cities for its salary survey. Further, the city may have provided legally questionable retirement benefits to certain current and past executives, entitling them to more generous retirement benefits.

The city's inadequate contracting policies and weak internal controls have resulted in poor practices for developing, awarding, monitoring, and making payments on service and consultant contracts. Our analysis of selected contracts active between 2007 and 2011 revealed problems with 21 of the 25 contracts we reviewed. Specifically, we noted problems such as contracts awarded without a competitive bidding process, contracts that had no ending dates for the period of service, a lack of expenditure limits, poorly defined scopes of work or deliverables, and inadequate monitoring of payments to contractors. Because of these poor contracting practices, the city cannot ensure that it receives the best value for the money spent on services.

Further, we noted that the city did not always ensure compliance with aspects of its conflict-of-interest code, which requires it to determine and document in writing whether each consultant it hires performs duties that require disclosure of economic interests. Such duties include ones that involve making, participating in, or influencing governmental decisions. The city uses a number of consultants to provide it with advice on significant financial transactions, such as bond issues, city financing, and the purchase of assets, and we believe the city should have considered whether these consultants needed to file statements of disclosure. Without financial disclosures by consultants that perform duties requiring disclosure, the public may be unaware if consultants are acting in their own interests rather than in the best interest of the city.

The city's current revenue structure for its general fund does not provide sufficient revenue to pay for the services that the general fund provides. In fiscal year 2010–11 the general fund had revenues of only \$27.9 million to cover expenditures of \$55.9 million, leaving a structural deficit of \$28 million. For more than 20 years the city has operated its general fund at a deficit, and during the five fiscal years encompassing 2006–07 through 2010–11 significant increases in general government and public safety expenditures, its two largest cost categories, caused this deficit to increase to the

highest levels of the 20-year period. Over these five fiscal years, the city's public safety expenditures increased by nearly 29 percent for salaries and benefits, even though police staffing decreased over this same period.

The city has funded past general fund deficits through reserves, interfund transfers and loans, and one-time revenues such as the sale of property. Although such practices may be common among California cities, the city's continued and increasing reliance on other funds to cover its general fund deficits is now problematic because the funds available from these sources have decreased. As a result, to address a projected general fund budget shortfall for fiscal year 2012-13, the city has proposed a parcel tax on businesses to generate new revenues.

The city's budget process lacks transparency that would improve the public's understanding of the city's financial challenges. The city displays its budget to the public in an aggregate fashion, making it difficult to clearly see the general fund deficit. The city's budget document also does not discuss the city's efforts to address its challenges, such as the general fund deficit. Unlike other cities, the city lacks documented financial policies for use in developing and managing its budget. Implementing recommended best practices would be a positive step toward formulating the city's financial policies.

The city has not developed a policy to guide its decisions to issue debt and ensure that they are consistent with the city's goals and principles of sound financial management. The city considers the bond covenants in the bond official statements a sufficient debt policy. Although these documents provide some restrictions for debt, they are mainly designed to protect bondholders and not the city. Once the city redeems the bonds, any restrictions and other guiding controls contained in the bond covenants are no longer in effect. Additionally, for significant debt decisions we reviewed between 2004 and 2012, the city council's agenda documents show it was provided with little to no information that summarized and explained the fiscal impact and potential risks associated with those decisions.

Between 2004 and 2012, the city issued more than \$1.3 billion in bonds, primarily from its Light & Power Department (power department). As of March 2012 there were \$571 million in bonds still outstanding. In addition to these bonds, the city has two outstanding interest rate swaps<sup>1</sup> for which it is obligated to

<sup>1</sup> An interest rate swap is a contractual agreement between two parties, known as counterparties, who agree to exchange interest rate-based cash flows over a certain period.

make fixed rate interest payments in return for variable rate interest payments. The city's total estimated debt service for the bonds and swaps will be more than \$60 million annually for the next 10 years. Of the outstanding debt, \$504 million is for three separate bond issues to fund activities of the power department. The largest of these issues, of which \$388 million is still outstanding, is debt owed for the city's fixed-rate purchase of a 15-year supply of natural gas that it can no longer use to fuel a power plant the city sold less than two years after the gas purchase.

To satisfy the debt service on these three outstanding obligations, the city pledged revenues from power department operations, primarily from the sale of electricity to the city's businesses. The power department has struggled to manage this debt burden while maintaining the competitive electric rates necessary to attract new ratepayers into the city. At the city's current electric rates, the power department is forecasting a \$24 million deficit in the light and power fund beginning in fiscal year 2013-14, which pays for the cost of electricity in addition to paying the debt service on the bonds, creating a need for electric rate increases.

The city also lacks a clear energy strategy. Our finance and energy expert's review of various energy-related transactions over the past several years indicated a lack of documented analyses to support the city's decisions to enter into these transactions, which raise concerns about the city's vision going forward. For example, the city sold its electrical power plant shortly after construction was complete and less than two years after it purchased a 15-year prepaid supply of natural gas for the power plant. Because the city issued tax-exempt bonds to purchase the supply of gas, selling the power plant created the need for the city to also sell this prepaid natural gas supply or risk losing the bonds' tax-exempt status; as a result, it had to sell the gas at a significant discount. Additionally, our finance and energy expert concluded that the city's decision to purchase a prepaid supply of natural gas, with 75 percent of the purchase at a fixed price, was unreasonable.

The city has used interest rate swaps to hedge risks associated with issuing bonds, which is a practice consistent with other municipalities. However, the city lacked an effective process for appropriately evaluating the risks and benefits of swaps before entering into them. Further, contrary to best practices, some of the swaps that the city entered into were for speculative purposes, in which the city essentially took a bet that interest rates would move in its favor. Other swaps exposed the city to financial risks that proved to be costly. The city has terminated all but two of the swaps it entered into since 2003 at a cost of \$33.4 million, but lacks a clear process for deciding when to terminate these two remaining swaps. As of February 2012 termination would have cost the city \$47 million.



## Recommendations

To increase accountability and transparency in its governance, the city should ensure that specific reforms are appropriately implemented.

To ensure that it develops complete and appropriate personnel policies and procedures, the city should continue its efforts to hire an experienced human resources director and have this individual address the weaknesses we identified in the city's management of executive positions.

To ensure accurate reporting and payment of retirement benefits, the city should work with the California Public Employees' Retirement System to resolve the reported findings and observation noted in its April 2012 report within a reasonable period of time.

To better control contract expenditures and ensure that it receives the best value for the services it purchases, the city should develop a comprehensive contracting policy to address the contracting weaknesses we observed and apply this policy to current and future contracts.

To comply with its conflict-of-interest policy, the city should ensure that all city executives file statements of economic interests as required and should review existing and future consultant agreements to determine which consultants should file statements of economic interest.

To address the structural deficit in its general fund, the city should seek long-term solutions to balance the general fund's expenditures and revenues. It should also ensure that city budgets clearly present the general fund structural deficit, and provide narrative explanations to help the city council and the public understand the city's priorities and challenges.

To better guide its budget preparation and improve transparency, the city should develop financial policies and ensure that its budgets include the information required in the Vernon City Code and follow best practices, and also establish a centralized process to regularly monitor and report on the status of the budget.

The city should establish a comprehensive debt policy to better guide its decisions to issue debt that is consistent with the city's goals and principles of sound financial management. To ensure that the city council and public are well informed regarding proposed debt decisions, the city should provide summary information that clearly explains the costs, risks, and benefits related to the proposed decisions in its agenda packets and should provide these in advance on its Web site.

To ensure that it can demonstrate sufficient analyses and provide justifications for its decisions on significant energy-related transactions, the city should develop an integrated energy strategy that examines all elements of its energy needs, sources, and objectives.

The city should develop a strategy to terminate the two outstanding swaps based on the cost and future risk to the city. It should also develop a policy to ensure that it appropriately analyzes and documents the risks and benefits of any future swap transactions.

### **Agency Comments**

Although Latham & Watkins LLP, on behalf of the city, disagreed with our findings and conclusions, it acknowledges agreement with many of our recommendations and notes that the city is taking steps to implement them.

## Introduction

### Background

The City of Vernon (city) is an industrial city located southeast of the downtown district of the City of Los Angeles. The city was founded and incorporated in 1905 by two families who intended to create jobs. The city currently operates under a city charter initially adopted in 1988 by the city's electorate. Covering 5.2 square miles, the city has a population of 112 people according to the 2010 U.S. Census. The city is also home to more than 1,800 businesses within its boundaries that provide approximately 55,000 jobs, which the city estimates provide more than \$4.4 billion annually in salaries and wages to workers in Los Angeles County. Industries operating in the city include food and agriculture, apparel, steel, plastics, logistics, and home furnishings. To meet the needs of its business community, the city offers an array of services tailored to industry. For example, the city maintains a fire department with the highest rating of fire-suppression capability,<sup>2</sup> resulting in insurance savings for businesses located in the city. In addition, it operates a health and environmental control department (health department) that specializes in industrial issues. The city notes that businesses also pay low rates for water, electricity, gas, and fiber optics as a result of the city's independent utilities.

### Disincorporation Efforts

In response to past scandals involving three former city executives, and allegations of corruption, misspending, and mismanagement, the Legislature considered legislation to disincorporate the city. Specifically, in December 2010, the Legislature introduced Assembly Bill 46 (AB 46) to disincorporate cities with populations of fewer than 150 people—which would have applied only to the city. Supporters of disincorporation expressed concerns with the city's history of uncontested elections and the city council's control of its electorate because the city owns almost all of the housing located within its boundaries, as well as its history of instituting zoning rules and approving projects with little to no consideration of how those decisions affect the neighboring communities.

The city's response to the proposed legislation was a costly lobbying effort to defend its cityhood and promote the city's benefits. Lobbying reports filed with the Secretary of State's Office indicate

<sup>2</sup> Insurance Services Office, Inc. an advisory organization that evaluates municipal fire-protection efforts in communities and is a source of information that insurance companies may use to help establish fair premiums for fire insurance. Generally, communities with better protection pay lower premiums.

that for the 2011–12 Legislative Session, the city spent more than \$3.5 million to lobby members of the Legislature regarding proposed legislation, including AB 46. Ultimately, AB 46 was not enacted, but the city agreed to implement a significant number of governance reforms as well as invest \$60 million into a fund to provide air-quality mitigation and recreational opportunities for neighboring cities. As we discuss in this report, the city has begun its reform efforts, including receiving approval by the city’s voters for several amendments to the city’s charter in November 2011.

Besides the disincorporation efforts, several former city officials have been convicted of crimes, and the city has been subjected to a number of external reviews over the past several years. In December 2009 a former city mayor was convicted of eight charges of, among other things, voter fraud and conspiracy for falsely claiming to have established residency in the city and was ordered to pay more than \$500,000 in fines. Additionally, in May 2011 a former city administrator pleaded guilty to misappropriating \$60,000 in public funds and using the money for political contributions and various personal expenses. He was ordered to reimburse the city that amount in addition to paying \$10,000 in fines.

Another former city administrator, who also served as the director of the Light & Power Department (power department), pleaded guilty in July 2011 to conflict-of-interest charges related to the hiring of his wife as a clerical contractor. In September 2010 the State’s Office of the Attorney General began an investigation of the compensation paid by the city to various individuals, including those who may have acted in the capacity of officials, officers, or employees of the city. However, no final report has been released, and the city stated that it has not been advised of any action to be taken in connection with this investigation.

In August 2011 the Internal Revenue Service (IRS) selected the city’s \$419.4 million bond sale during 2009 for examination to determine whether the city complied with federal tax requirements. In December 2011 the IRS notified the city that it had completed the examination and had no issues to report. Finally, the California Public Employees’ Retirement System (CalPERS) conducted a compliance review of the city’s contract with CalPERS to provide retirement benefits to the city’s employees. In April 2012 CalPERS issued its report, which detailed 10 findings and an observation on the payroll reporting and enrollment of city employees as CalPERS members. We discuss the CalPERS report further in Chapter 1.

### Status as a Charter Law City

Although the city was originally incorporated in 1905, the Vernon city electorate exercised its right to change Vernon from a general law city to a charter law city in 1988. The California Constitution (Constitution) gives cities the right, based on the approval of a majority of the city's electorate, to operate as a charter law city. These so-called "home-rule" provisions of the Constitution are based on the principle that a city, rather than the State, is in the best position to govern matters of local concern. Unlike general law cities, which are subject to various general state laws that regulate municipal affairs, a charter law city has the authority, through the adoption of a charter, to define its own system of governance and to establish specific rules for conducting municipal affairs. The Constitution expressly defines regulation of the city's police force; election, removal, and compensation of municipal officers and employees; conduct of city elections; and regulation of subgovernmental units of the city as four primary areas of municipal concern over which charter law cities have absolute control, subject only to state and federal constitutions. In addition, the courts have recognized specific issues that are considered to be matters of municipal concern and over which a charter law city has control. Of the 481 cities in the State, according to the League of California Cities, 120 are chartered, including the city.

One illustration of the difference between a charter law city and a general law city pertains to the compensation of city council members. A general law city must follow the general requirements set out in state law, which require that a city establish a council member's salary based on the population of the city. So, for example, the salary of a city council member in a city with a population of up to 35,000 must be \$300 per month in any general law city in the State. In contrast, a charter law city is not subject to these general state laws and has complete discretion in setting the salaries of its city council members. Consequently, the salaries of city council members who serve charter law cities can vary considerably.

Despite the fact that a charter law city has considerable discretion over municipal affairs, it remains subject to the various state laws that do not pertain to municipal affairs and that are considered to be of statewide concern. For example, courts that have considered these issues have found that conducting city business at open public meetings, rather than in closed meetings, is a matter of statewide concern. This means that the city must comply with the Ralph M. Brown Act when it conducts business and that it must also comply with the various general laws relating to conflicts of interest, such as the Political Reform Act of 1974 and the California Government Code, Section 1090.

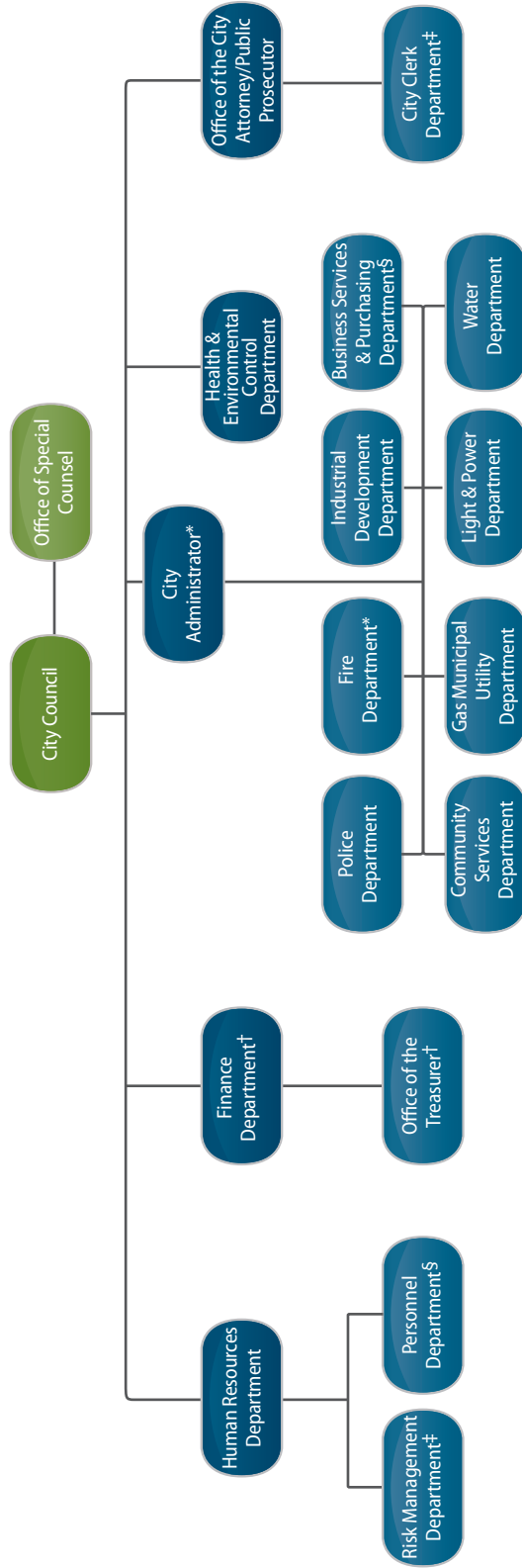
### City Structure

Under its charter, the city is governed by a five-member city council. The city council members are elected to five-year staggered terms, with one council seat up for election each April. The city council elects one of its members as mayor—the presiding officer of the city council—and designates one of its members as the mayor pro tempore—the officer responsible for performing the duties of the mayor during the mayor’s absence or disability. In October 2011 the mayor resigned, and his council seat will remain vacant until the results of a special election held in June 2012 are certified. A new council member was elected in April 2012, and the remaining three members of the city council have served in their roles for approximately three, 32, and 38 years, respectively. The city council is responsible for adopting and making policies in the form of ordinances and resolutions, as well as for holding council meetings at least once a month.

The city council appoints a city administrator—the city’s highest executive—who is responsible to the city council for managing all the affairs of the city. The city council may also appoint a city clerk, city attorney, and city treasurer, as well as other executives as it deems appropriate. Currently, the city has four individuals who each fill multiple executive positions within the city but receive the pay for only one position, except for one individual who receives half the pay for each of the two positions that she fills. Specifically, as of April 2012, the city administrator is also the fire chief, the city clerk is also the risk manager, the finance director is also the city treasurer, and the director of business services also serves as the director of personnel.

As shown in Figure 1, the city has various departments that perform typical city functions, including some specialized services unique to the industrial nature of the city. For example, the fire department has a hazardous materials emergency response team. The health department tailors its operations to regulate and meet the needs of the businesses in the city. The city’s power department offers electric, gas, and fiber optic services. As of October 2011 the city had 275 employees. Of these, the city organization charts indicated that there were 80 employees in the fire department and 62 in the police department. Except for certain employees in the fire and police departments who have collective bargaining agreements, the city employees serve at the will of the city council. The city contracts with CalPERS to provide retirement benefits to its employees.

**Figure 1**  
City of Vernon's Organization Chart



Source: City of Vernon Ordinance No. 1156, adopted by the city council in June 2009.

\* The fire chief also serves as the city administrator.

† The finance director also serves as the city treasurer.

‡ The risk manager also serves as the city clerk.

§ The personnel director also serves as the director of business services & purchasing.

## Financial Position

The city's general fund is its primary operating fund, used to account for all revenues and expenditures necessary to carry out the basic governmental activities of the city that are not accounted for through other funds. As Figure 2 shows, its general fund revenues were \$27.9 million during fiscal year 2010–11, and its general fund expenditures were \$55.9 million for the same year. The city's general fund pays for a majority of the departments shown in Figure 1, with the most significant exception being the power department. The general fund receives much of its revenue from taxes, but a significant portion of the general fund expenditures are funded through one-time revenues, transfers from other city funds, and other smaller revenue sources. The city's budget for fiscal year 2011–12 projected general fund expenditures of \$61.6 million and total expenditures for all funds of \$325.7 million.

**Figure 2**  
Revenues and Expenditures for the City of Vernon's General Fund and Light and Power Fund  
Fiscal Year 2010–11 (In Thousands)

General Fund		Light and Power Fund	
<b>Revenues:</b>		<b>Operating Revenues:</b>	
Taxes	\$17,483	Electric rate charges	\$118,186
Charges for services to enterprise funds	4,362	<b>Total operating revenues</b>	<b>118,186</b>
Other revenues	6,049	<b>Operating Expenses:</b>	
<b>Total revenues</b>	<b>27,894</b>	Cost of power	88,452
<b>Expenditures:</b>		Depreciation and amortization	4,579
General government	21,506	<b>Total operating expenses</b>	<b>93,031</b>
Public safety	24,814	Operating income	25,155
Public works	5,176	<b>Nonoperating Revenue (Expenses):</b>	
Health services	1,499	Investment loss	(4,405)
Capital outlay and debt service	2,873	Net increase in fair value of investments	5,064
<b>Total expenditures</b>	<b>55,868</b>	Interest expense	(20,435)
<b>Deficit</b>	<b>(27,974)</b>	<b>Total nonoperating expenses, net</b>	<b>(19,776)</b>
Transfers from other funds and other sources	16,952	Income before transfers	5,379
<b>Net Change in Fund Balance</b>	<b>(11,022)</b>	Transfers to other funds	(3,150)
Fund Balances, Beginning of Year, Restated	18,832	<b>Change in Net Assets</b>	<b>2,229</b>
Fund Balances, End of Year	\$7,810	Net Assets, Beginning of Year	109,795
		Net Assets, End of Year	\$112,024

Sources: City of Vernon's fiscal year 2010–11 audited financial statements.



The city has several enterprise funds, which account for business-type activities such as the acquisition and sale of electricity. The largest of these is the light and power fund, which accounts for the maintenance and operations of the city's electric utility. This fund's expenditures in fiscal year 2010–11 were primarily to acquire power for resale and to pay interest related to revenue bonds that were issued in support of the power department. As shown in Figure 2, its revenues, which are from the sale of electricity, were \$118.2 million during fiscal year 2010–11. Its expenditures were \$93 million for the same fiscal year, mostly for power purchases, and it had an operating income of \$25.2 million.

The city's gas fund accounts for activities related to the city's natural gas utility. Its revenues, which are based on rates charged primarily to businesses for natural gas usage, were \$47.3 million during fiscal year 2010–11, and it had an operating income of \$417,000 for the same fiscal year. The city also has a water fund, which includes revenues from charges to businesses in the city for their water use. Its revenues for the same period were \$6.1 million, and it ended the year with a \$14,000 operating loss.

Until recently, the city had a redevelopment agency (agency) that was established in 1986 as allowed by the then-operative California community redevelopment law. The agency's principal objectives were to improve the commercial environment, provide new public improvements, strengthen the city's economic base, generate employment opportunities, and expand the city's industrial base. Its revenues were \$15.6 million during fiscal year 2010–11, and its expenditures were \$35.7 million. In addition, the agency transferred \$13.8 million to the general fund during the same year. However, legislation in June 2011 dissolved the State's redevelopment program, which affected municipalities with redevelopment agencies, including the city. Therefore, the agency cannot incur any new obligations or debt. Specifically, the agency cannot enter into new contracts or amend existing contracts, renew or extend leases or other agreements, or dispose of or transfer real property or other assets. All assets and responsibilities for closing out the activities of the former agency were transferred to the city as its successor agency. These responsibilities include performing obligations of the former agency in accordance with a schedule of enforceable obligations, such as making payments for bonds and loans.

### **City-Owned Housing**

The city owns a total of 31 housing units, 26 of which are within the city boundary; the remaining five are in Huntington Park. The city's ethics adviser found that residents of city-owned housing include city employees, council members, and relatives of council members and employees. He also reported that, in the past, the city council had the final decision as to who could lease housing from the city, but he was unable to determine what policy and process was used in approving new residents and who actually

approves leases for new tenants. As we discuss later in the report, the city recently created a housing commission that is responsible for establishing policies regarding who can lease or buy the city's property.

## Scope and Methodology

The Joint Legislative Audit Committee (audit committee) directed the California State Auditor (state auditor) to conduct an audit of the management and finances of the city and its power department. Specifically, the audit committee directed us to address the objectives listed in Table 1.

**Table 1**  
**Methods of Addressing Audit Objectives**

AUDIT OBJECTIVE	METHOD
1. Review and evaluate the laws, rules, and regulations significant to the audit objectives.	Reviewed relevant laws, regulations, and other background materials applicable to charter law cities.
2. Review the existing city charter and determine if it, and any proposed changes to it, comply with applicable laws and promote sound operational business practices. To the extent possible, compare the charter, and any proposed changes, to the charters for a sample of other charter law cities similar to the City of Vernon (city).	<ul style="list-style-type: none"> <li>• Reviewed the existing city charter and proposed changes to it.</li> <li>• Reviewed the city's progress in implementing governance reform measures.</li> <li>• Identified other charter law cities in California similar to the city, and compared the city charter, including proposed changes, to the charters of the other cities selected.</li> </ul>
3. Describe the current governance structure of the city and the Light & Power Department (power department), including determining the roles, responsibilities, and authority of elected officials, employees, contractors, and consultants with key governance or operational roles.	<ul style="list-style-type: none"> <li>• Reviewed the organizational chart, job and duty statements for selected executive employees, and other supporting documents.</li> <li>• Interviewed executives and other employees to determine their roles, responsibilities, and authority.</li> <li>• Reviewed whether any executives were holding multiple office positions and determined whether there were issues related to dual office holding.</li> <li>• Obtained an understanding of the roles of consultants in management roles.</li> <li>• Assessed the city's compliance with its conflict-of-interest code.</li> </ul>
4. For both the city and the power department: a. Examine operational structures and assess the management controls and practices. Determine whether the controls over significant financial and administrative functions provide reasonable assurance that practices are consistent with established policies and are appropriate.	<ul style="list-style-type: none"> <li>• Interviewed city employees and reviewed relevant documents.</li> <li>• Requested and reviewed established policies and procedures.</li> <li>• Reviewed management letters from the independent financial auditor of the city's financial statements.</li> </ul>
b. Review the current compensation for high-level staff, elected officials, and consultants to determine how the salaries, benefits, and pension packages are determined and approved. To the extent possible, compare the compensation packages to those for a sample of other similar cities and power departments.	<ul style="list-style-type: none"> <li>• Interviewed city employees and reviewed relevant policies and procedures.</li> <li>• Reviewed whether any executives were holding multiple office positions and determined how their compensation was established.</li> <li>• Evaluated the appropriateness of the methodology used for the city's salary survey conducted in May 2011.</li> <li>• Reviewed council meeting agenda packets and meeting minutes.</li> </ul>

AUDIT OBJECTIVE	METHOD
	<ul style="list-style-type: none"> <li>• Examined the compensation of executives.</li> <li>• Reviewed the results of the California Public Employees' Retirement System's audit of the city.</li> <li>• Compared the duties, responsibilities, and qualifications of certain city positions with those of other selected cities.</li> </ul>
<p>c. Identify and trend the major revenue sources and expenditures for the most recent five-year period. Determine the reason for any significant or unusual fluctuations or trends.</p>	<ul style="list-style-type: none"> <li>• Obtained and reviewed the audited annual financial statements for fiscal years 2006–07 to 2010–11.</li> <li>• Identified trends in major revenue sources and expenditures for fiscal years 2006–07 to 2010–11.</li> <li>• Assessed the reasons for any significant or unusual financial fluctuations and trends.</li> </ul>
<p>d. For the most recent five-year period, select and review a sample of revenues and expenditures. Determine whether such transactions were properly approved and are appropriate.</p>	<ul style="list-style-type: none"> <li>• Interviewed city employees to determine internal controls over revenue and expenditure transactions.</li> <li>• Obtained and reviewed policies and procedures for expenditure transactions.</li> <li>• Ensured that data recorded in the city's enterprise resource planning (ERP) system was complete by reconciling expenditure and revenue totals for the city's governmental funds to the amounts reported in the audited financial statements. This reconciliation found that all expenditures and revenues in the city's ERP system for these funds were recorded in its audited financial statements.</li> <li>• Reviewed selected contracts and determined whether the scopes of work, including any deliverables, were clearly articulated and defined.</li> <li>• Reviewed a selection of expenditure transactions to assess internal controls.</li> <li>• Reviewed a selection of revenue transactions to assess internal controls. This review did not disclose any weaknesses in internal controls for revenues.</li> </ul>
<p>e. Review the contract bidding, approval, and monitoring policies and procedures to determine compliance with any applicable laws, rules, regulations, or best practices.</p>	<ul style="list-style-type: none"> <li>• Interviewed city employees and reviewed ordinances and relevant policies and procedures.</li> <li>• Identified the applicable laws, rules, regulations, and best practices.</li> <li>• Determined whether the city's ordinances, policies, and procedures comply with applicable laws, regulations, and best practices.</li> </ul>
<p>f. For the most recent five-year period, select and review a sample of contracts, including professional services contracts, and determine if the city and the power department adequately followed policies and procedures related to contract bidding and approval, identified and mitigated conflicts of interest, and ensured adequate performance under the contract.</p>	<ul style="list-style-type: none"> <li>• Used the city's payment records for fiscal years 2005–06 through 2010–11 to select 25 contracts for review based on contracts with the highest payments and other factors we believed were relevant, including contractors that had been mentioned in media reports, had unusual payment patterns, or had known ties to other city contractors or employees.</li> <li>• Determined whether the city adequately followed the city code and good contracting practices related to contract bidding and approval, used well-defined statements of work, included expenditure limits, and had defined end dates.</li> </ul>
<p>5. For the most recent seven-year period, identify the number and value of bonds issued by the city, and determine the following:</p>	<ul style="list-style-type: none"> <li>• Obtained and reviewed bond official statements and other bond sale documents that describe sources and uses for all city bond issuances between fiscal years 2004–05 and 2010–11.</li> <li>• Verified that all bond issuances were included in the audited financial statements.</li> </ul>

AUDIT OBJECTIVE	METHOD
a. Whether the policies and procedures used to manage bond issuances complied with applicable laws and regulations and whether they were consistent with industry standards.	<ul style="list-style-type: none"> <li>• Obtained and reviewed policies and procedures related to bond issuances.</li> <li>• Determined whether the policies and procedures for bond issuances complied with applicable laws and regulations.</li> <li>• Compared the city's policies and procedures for bond issuances to those of other cities reviewed.</li> <li>• Interviewed city employees regarding the processes related to issuing bonds.</li> </ul>
b. The purpose of each bond issued and if the bonds were well defined and properly approved.	<ul style="list-style-type: none"> <li>• Reviewed the terms of bond indentures.</li> <li>• Obtained and reviewed the minutes of meetings at which bond issuances were decided by the city council.</li> <li>• Obtained and reviewed bond approval documents.</li> </ul>
c. Whether bond proceeds were used appropriately.	<ul style="list-style-type: none"> <li>• Determined through interviews with city employees how bond-related expenditures are tracked.</li> <li>• Obtained and reviewed supporting documentation for the use of bond proceeds.</li> <li>• Selected certain bond proceeds and reviewed whether the uses were appropriate based on the terms of the bond indenture documents.</li> </ul>
d. The status of debt service and its impact on the city's finances or operations.	<ul style="list-style-type: none"> <li>• Reviewed audited financial statements and city budgets to identify debt service on outstanding bonds.</li> <li>• Analyzed the impact of debt service on the city through audited financial statements, the city budget, and other documents.</li> <li>• Used a finance and energy expert to evaluate the city's decisions to enter into interest rate swap agreements related to bonds issued.</li> </ul>
6. For the power department:	
a. For professional services contracts active in the past five years, identify the services provided to the power department under those contracts.	Reviewed professional service contracts as part of the 25 selected contracts described above.
b. For the most recent five-year period, identify the number and value of bonds issued, and determine the following:	<ul style="list-style-type: none"> <li>• Obtained and reviewed official statements and other bond sale documents that described the sources and uses for all power department bond issuances between fiscal years 2006–07 and 2010–11.</li> <li>• Verified that all bond issuances were included in the audited financial statements.</li> </ul>
i. Whether the policies and procedures used to manage bond issuances complied with applicable laws and regulations and whether they were consistent with industry standards.	<ul style="list-style-type: none"> <li>• Obtained and reviewed policies and procedures related to bond issuances.</li> <li>• Determined whether the policies and procedures for bond issuances complied with applicable laws and regulations.</li> <li>• Compared the city's policies and procedures for bond issuances to those of other cities reviewed.</li> <li>• Interviewed city employees regarding the processes related to issuing bonds.</li> </ul>
ii. The purpose of each bond issued and if the bonds were well defined and properly approved.	<ul style="list-style-type: none"> <li>• Reviewed the terms of bond indentures.</li> <li>• Obtained and reviewed the minutes of meetings at which bond issuances were decided by the city council.</li> <li>• Obtained and reviewed bond approval documents.</li> </ul>

AUDIT OBJECTIVE	METHOD
iii. Whether bond proceeds were used appropriately.	<ul style="list-style-type: none"> <li>• Determined through interviews with city employees how bond-related expenditures are tracked.</li> <li>• Obtained and reviewed supporting documentation for the use of bond proceeds.</li> <li>• Selected certain bond proceeds and reviewed whether the uses were appropriate based on the terms of the bond indenture documents.</li> </ul>
iv. The status of debt service and its impact on the city's finances or operations.	<ul style="list-style-type: none"> <li>• Reviewed audited financial statements and city budgets to identify debt service on outstanding bonds.</li> <li>• Analyzed the impact of debt service on the city through audited financial statements, the city budget, and other documents.</li> <li>• Used a finance and energy expert to evaluate the city's decisions to enter into interest rate swap agreements related to bonds issued.</li> </ul>
v. Actions the power department has taken to minimize the negative impacts of debt service on the department.	<ul style="list-style-type: none"> <li>• Interviewed city employees regarding the current state of indebtedness and the impact on the city and obtained an understanding of any actions employed to minimize the impact of the debt.</li> <li>• Used a finance and energy expert to evaluate the city's decisions to enter into interest rate swap agreements on bonds issued.</li> </ul>
vi. Whether the power department's financial stability has been or will be negatively impacted by its debt service.	Conducted an analysis based on documents gathered and assessed the financial stability of the power department.
7. Review and assess any other issues that are significant to the operations and finances of the city or the department.	No other issues came to our attention.

We acknowledge that the city provided us with a wide variety of information and assistance during the audit; however, we encountered challenges in accessing city staff and information. Although any single instance we discuss below may not rise to the level that would need to be disclosed in order to comply with auditing standards, we noted that, when considered in total, this audit presented difficulties that are highly unusual given our experience with other auditees. We perform our work by following generally accepted government auditing standards, which hold that testimonial evidence obtained under conditions in which persons may speak freely is generally more reliable than evidence obtained under circumstances in which persons may be intimidated. Generally, this means that we are able to talk with individuals without having management or its representatives present. However, at the outset of the audit, we learned that the city and its outside legal counsel intended to have legal counsel staff sit in as note takers and observers during our meetings with city executives. We ultimately agreed that, when we interviewed its executive staff, the individual executive could decide whether he or she wanted the city's legal counsel present. While most executives asked for legal counsel to be present during our initial interviews, they generally did not request the presence of legal counsel for follow-up meetings. However, the city administrator requested the presence of outside legal counsel at each meeting we held with him during the audit. When executives consented, we taped the initial meetings, as well as all meetings with the city administrator.

Additionally, as a part of any audit, we request information to analyze related to the objectives of the audit. However, we encountered obstacles in efficiently obtaining information from the city and its financial adviser. For example, in response to our initial request for information, the city's outside legal counsel provided us several CDs that were supposed to be responsive to some of the items in our initial information request. Upon reviewing the CDs, we found that much of the information was extraneous and had no relevance to the audit.

Further, we asked on several occasions whether the city had a complete listing of contracts and a central filing location for contracts. City staff indicated to us that neither existed, but later, during a tour of the city clerk's office, the city clerk acknowledged that his staff maintained approved contracts in a file room as well as a contract list. We also asked whether the city maintained an organized list of the city council's resolutions to allow us to more readily locate resolutions related to various actions. In response, the city provided us a CD containing its resolutions and ordinances, but the files were labeled only by resolution or ordinance number, and were not electronically searchable. Approximately six weeks into our fieldwork, the city's information technology manager provided us access to the city's database, which allowed us to search city council resolutions by keyword. However, approximately two months later we learned that the city did, in fact, maintain an organized list of city council resolutions, which we were finally able to obtain.

Finally, we made several information requests to the city and its financial adviser concerning its decision making related to interest rate swaps and energy transactions. In one request, we asked that the city provide us the information presented to the city council related to its approval of seven separate transactions. In response, the city provided us two CDs containing approximately 37,000 files. Each of these 37,000 files represented one page of a larger document, and they were not in a format that could be searched electronically. Further, none of the files were labeled as to their contents or organized in response to the seven items in our request. We undertook considerable effort in an attempt to review this information, including having the state auditor's information technology staff convert these 37,000 files to a searchable format for our review, but we found little information that was responsive to our request.

In a second request relating to documents that the city's financial adviser asserted would be provided to us, we requested supporting analyses for the city's interest rate swap and energy transactions between 2004 and 2012. In response, the city's financial adviser, through the city, provided us numerous electronic documents,

again not organized in any useful way. According to the review by our finance and energy expert, these documents proved to be mostly unresponsive to our request. Further, the city and its financial adviser failed to respond to our subsequent request for an organized and complete response to our original request. These difficulties were exceptional and caused a delay in our ability to complete our fieldwork and report to the Legislature. In an attempt to resolve the issues previously described, we issued an administrative subpoena and our legal counsel met and conferred with legal counsel for the city. As a result of this process we were able to address some of our informational needs, but were not able to fully resolve the issues in the subpoena as of June 25, 2012.

**Assessment of Data Reliability**

In performing this audit, we relied upon various electronic data files extracted from the information systems listed in Table 2. We adhere to the standards of the U.S. Government Accountability Office, which require us to assess the sufficiency and appropriateness of computer-processed information. The table shows the results of this analysis.

**Table 2**  
**Methods Used to Assess Data Reliability**

INFORMATION SYSTEM	PURPOSE	METHODS AND RESULTS	CONCLUSION
City of Vernon's (city) enterprise resource planning system (ERP system)* (data as of November 2011)	To identify the city's revenues, expenditures, and contracts for the period July 1, 2005, through November 28, 2011.  To categorize and quantify various forms of compensation provided to city employees between May 2011 and November 2011.†	We performed data-set verification procedures and electronic testing of key data elements and did not identify any issues.  During interviews with city staff, we identified several areas of concern associated with the user access controls securing the ERP system. In addition, we were unable to test the accuracy of specific revenue transactions because a majority of these transactions are imported from other systems into the ERP system at a summary level. Moreover, the contract management module does not contain a complete listing of all contracts the city has entered into, and we were unable to determine how many of the contracts were missing. As a result of the above issues, we did not conduct accuracy and completeness testing of the ERP system's data.‡	Undetermined reliability for the purposes of this audit.

Sources: Interviews with city staff and data collected from the city.

\* The ERP system contains various modules for financial management, contract management, and payroll.

† The city implemented the ERP system's payroll module on the first payroll date in May 2011. We obtained data from the city's payroll module through the last pay date in November 2011.

‡ We were able to conduct limited completeness testing on a segment of the financial data in the ERP system. Specifically, we reconciled the data related to the city's governmental funds to amounts recorded in the city's audited financial statements for fiscal years 2006–07 through 2009–10.

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## Chapter 1

### THE CITY HAS TAKEN STEPS TOWARD REFORM, BUT MUCH MORE WORK REMAINS

#### Chapter Summary

The City of Vernon (city) adopted a governance reform package with the goal of promoting accountability and transparency, including various reform measures on housing, contracting, and internal policies and procedures. Although the city is making progress in enacting some reform measures, it has not developed some policies and procedures necessary to implement them. For example, the city amended its charter to address the voter-approved change to remove the at-will status of city employees, but it has not yet developed an alternative employment structure. In addition, although the city has made some progress in implementing a number of reform measures related to a state senator's direction to double its electorate, full reform of the city's housing practices will take years to achieve.

Further, the city needs to take additional steps to reform its personnel and compensation practices. Specifically, the city has not established minimum qualifications for several of its executive positions—including the city administrator, city treasurer, and city clerk—to ensure that individuals hired have the proper qualifications and experience to succeed in their roles. The city also has not established a clear and comprehensive written process for hiring and periodically evaluating its executives. According to the city administrator, the city has been without a director of human resources since July 2009, but it is in the process of hiring an individual who will be responsible for addressing these concerns.

We also noted weaknesses with the salary survey the city completed in May 2011 in response to concerns about its executive salaries. Specifically, the city did not consider some important factors when it made comparisons of its executive salaries to those in other cities. Moreover, the city's salary and benefit survey, as well as the city's ethics adviser, recommended reducing the council members' salaries to \$25,000 per year, and while the city council agreed to reduce its members' salaries to the recommended level, it chose to do so only upon the completion of the members' current terms. As of July 2012 the council members' salaries remained at \$55,800.

Despite financial difficulties, the city continues to provide a number of employees longevity payments—additional monthly compensation based on length of service—which can be up to 25 percent of their monthly salary. We found that from

May through November 2011, the city paid more than \$1.2 million in longevity pay, which is nearly 8 percent of its total payroll expenditures. Finally, some current and past city executives may have received legally questionable retirement benefits.

### Certain Reform Measures Designed to Increase Accountability and Transparency Lack Adequate Planning and Implementation

The city has adopted a number of governance reform measures to promote accountability and transparency. Appendix A summarizes the city's reported status on all of its reform measures and provides page references for those reforms we discuss in the report. Further, for the limited number of reform measures that we do not discuss in this report, we include any concerns with the status that the city reported, if applicable.

#### Recommended Reforms for the City of Vernon

1. Increase accountability and transparency through reforms to the City of Vernon's (city) charter.
2. Implement the recommendations from the city's independent ethics adviser—whom the city engaged in February 2011 to review and evaluate its policies and procedures over internal controls, reimbursement of expenses to city staff, selecting and paying consultants, and ethics and conflict of interest—as soon as feasible.
3. Double the city's electorate by establishing an independent housing commission, spinning off the city's housing stock to the housing commission, and constructing approximately 50 new housing units.
4. Appoint an independent reform monitor for a period of four years.
5. Improve workers' rights for police, fire, and other public employees.
6. Establish a good-neighbor program aimed at improving the quality of life of residents in surrounding communities by providing air quality mitigation and funding recreational opportunities.

Source: State Senator Kevin de León's letter to the city dated August 22, 2011.

Many of these reform measures were based on recommendations proposed by a state senator in response to the proposed legislation to disincorporate the city. We present the state senator's recommendations in the text box. To address one of the state senator's recommendations, in February 2012, the city appointed its independent ethics adviser, with whom it had been working since February 2011, to serve as an independent reform monitor for a four-year period. In this role, he is to assess and make recommendations regarding ongoing compliance with laws governing conflicts of interest and transparency in government and suggest ways to improve and enhance related practices, procedures, and policies. The independent reform monitor is also to review the city's governance reform measures and initiatives and recommend measures and initiatives that are in the best interest of the city. By July 31, 2012, the independent reform monitor is required to issue a written report to the city and Legislature detailing his findings and recommendations, with further reports due every six months thereafter while serving in this role.

As of January 2012 the city indicated that it had completed 40 of its 69 reform measures. Examples of significant completed measures include appointing an independent reform monitor; establishing an advisory committee to review electric rates; performing a salary survey for city executives and council members; placing several

charter amendments on the November 2011 ballots, as shown in the text box; training staff on various governance issues (such as ethics, open meeting laws, and public records act requests); adopting policies concerning nepotism, travel, and collective bargaining; and establishing an environmental commission. These actions indicate that the city has made substantial progress toward improving accountability and transparency in its governance, but much more remains to be done.

Based on our review of certain reforms that the city indicates are completed or partially completed, we concluded that the actions the city has taken do not presently achieve their full benefit, because either the city has not developed the necessary policies and procedures to fully implement these changes or the actions to complete the reform measures may take up to several years to complete. Our review of the city's efforts to implement the reform measures focused on selected reforms related to our audit objectives.

For example, the city indicated that the reform measure to remove the provision in its charter mandating that employees serve at the will of the city council is complete because the voters have approved a charter amendment to remove this provision. According to an analysis by the city attorney, the previous charter provision barred the city from adopting alternative employment ordinances, such as civil service rules, which would promote hiring on the basis of qualifications and fitness. Eliminating the requirement that all employees work at the will of the city council, however, does not by itself have the immediate effect of changing the existing employment status of nonunion city employees, but rather gives the city the option to adopt civil service rules or other similar policies.

According to the city administrator, the city is in the process of assessing various civil service options and currently does not have a timeline or plan for establishing a new employment system. The city administrator further stated that the city intends to hire a human resources director who will be responsible for analyzing, selecting, and implementing a new employment system. As of May 2012 the city was taking applications for the human resources director position and

### Recent Voter-Approved Amendments to the City Charter

In response to a state senator's recommendation for increased accountability and transparency, the City of Vernon (city) proposed the following amendments to its charter, which the voters approved in November 2011:

- Limit council members to two five-year terms in office, with a lifetime ban thereafter.
- Reaffirm the long-standing policy of ensuring the payment of prevailing wages on public works projects.
- Remove the provision mandating at-will employment for city employees.
- Eliminate restrictions on the city council's authority to remove the city administrator and to reduce the city administrator's compensation.
- Require the city to maintain a housing commission to oversee the day-to-day management, leasing, and maintenance of city-owned housing.
- Retain an independent reform monitor for four years to review city policies and recommend governance reform measures.
- Require a special election to fill vacancies on the city council, and prohibit the appointment of council members by the city council.
- Prohibit council members from increasing their compensation in excess of cost-of-living adjustments.
- Remove the restriction on the use of revenue from the city's light and power fund.
- Require a city council ordinance establishing a process allowing for open and competitive bidding on city service contracts.

Sources: Voter election pamphlets for the city's November 2011 special municipal elections and the city clerk's certification of these elections.

expects to fill the position within the coming months. Until a new employment system is in place, city employees continue to serve at the will of the city council and the city has yet to realize the benefits of the intended reform.

The city indicated that another of its reform measures was completed when its voters approved a charter amendment removing the restriction on the city's use of revenue from its Light & Power Department (power department). Previously, for a period between August 2010 and November 2011, the charter restricted the use of power department revenues solely to supporting the power department's operations. Removing the restriction enables the city to use power department revenues for other purposes, including transfers to its general fund. However, the city has not established a formal policy describing when it is appropriate to transfer funds from the power department and specifying the purposes for which these transfers can be made.

The city administrator indicated that covenants for the power department's bonds (bond covenants) govern the transfers of power department revenues. Our legal counsel agrees that the bond covenants do have the potential effect of placing such a restriction on transfers, primarily because the city cannot transfer revenue in a way that would impair the bondholders' interest. However, these restrictions in the bond covenants are not designed to protect the overall financial situation of the city. By establishing a formal policy, the city will be in a better position to inform its ratepayers about how and for what purposes the city is using revenues from the power department and to better manage the city's debt.

This policy is especially critical given that the city intends to use nearly \$15 million in power department revenues to pay for general fund activities during fiscal year 2012–13. According to the assistant finance director, since fiscal year 1987–88 the city has transferred roughly \$194 million in power department revenues to the general fund and other city funds. Also, as we discuss later, the legality of making such transfers, under certain circumstances, is currently in litigation that does not involve the city directly as a party.

Another voter-approved amendment to the city charter requires the city to adopt an ordinance establishing a process allowing for open and competitive bidding for service contracts. Although the city indicated that this reform measure is complete because the voters approved the charter amendment, it has not yet adopted an ordinance defining this legally required competitive bidding process. In January 2012 the city stated that it was reviewing competitive bidding ordinances in surrounding jurisdictions and planned to adopt its own competitive bidding process by April 2012. In May 2012 the city stated that its legal consultant was drafting

***Although the city indicated that the competitive bidding reform measure is complete because the voters approved the charter amendment, it has not yet adopted the ordinance that outlines how the competitive process will work.***

the ordinance, with the plan of presenting it to the city council in July. In Chapter 2 we discuss the weaknesses we noted in the city's contracting practices in further detail.

The city also has initiated several reform measures to address the state senator's direction to increase the number of housing units in the city, and thereby the city's voting population, and to address the independent ethics adviser's housing recommendations. Despite the city's efforts to complete a number of housing-related reform measures, full reform of its housing practices, including the building of additional housing units, will take several years to achieve and will require sufficient planning. Specifically, in September 2011 the city established a housing commission to advise the city council on all matters related to housing within the city. The city is now required to maintain this commission under a charter amendment approved in November 2011. The housing commission's responsibilities include recommending a housing policy for city council approval, setting and adjusting rental rates, and advising the city council on whether the city should continue to own housing.

Since establishing the housing commission, the city has completed several related reform measures, including appointing commission members and adopting a conflict-of-interest code for them. Also, in October 2011 the city council approved the housing commission's proposed rental housing policy, which specifies the city's commitment to manage its housing at the highest level of fairness and impartiality and states that all rents charged by the city will be based on a market valuation. Following the passage of the housing policy, the housing commission adopted leasing procedures with respect to the initial leasing of its housing units.

In January 2012 the housing commission established a rent schedule for all city-owned housing based on prevailing market rental rates. The city's current rental rates are significantly lower than the market rates in this schedule. For example, the city currently charges just \$360 per month for a three-bedroom, two-and-a-half-bath unit. The new schedule calls for the rental rate for this unit to be increased to \$1,700, which is \$1,340 (80 percent) higher than the current rent. The new market rates will be applied incrementally, with the first increase beginning August 1, 2012, and the full increase not taking effect until July 2015. These incremental increases mean that residents in city-owned houses will continue to receive rental rates that are below market rates for several years, delaying the full effect of this reform.

In addition, the city council was expected to make a decision by February 2012 regarding whether it will continue to own housing. In February 2012 the city's housing commission approved a recommendation to the city council to divest the city-owned

*Despite the city's effort in completing a number of housing-related reform measures, full reform of its housing practices will take several years to achieve and will require sufficient planning.*

Huntington Park units as they become vacant. Although the city council discussed this recommendation at a February 2012 council meeting, it did not take action. As of May 2012 the housing commission had not yet made any recommendation to the city council regarding the potential disposition of the remaining city-owned housing units.

Further, although the city stated that it plans to complete the construction of approximately 50 new housing units by August 2014, it has not developed a detailed timeline for achieving this goal. When we asked the city about its detailed housing plan, it referred us to its recent request for proposals (RFP) to construct a new housing development within the city, indicating that the RFP contained a timeline. However, the RFP only includes a mid-July 2012 deadline for contractors to submit their proposals. Also, the city has not developed a comprehensive plan for constructing the 50 new housing units, which should include identification of funding sources, development of construction proposals, and other related information. We would expect the comprehensive plan to also include specific activities, priorities, coordination efforts, and incremental target dates that would allow the city to more closely monitor its efforts and report detailed progress to the public and decision makers. The city was expected to develop a comprehensive plan and submit it to the housing commission for review and approval during the commission's April 2012 meeting, but it did not do so.

### **More Improvement Is Needed in the City's Personnel and Compensation Practices**

Although the city has begun reforming its personnel and compensation practices, more needs to be done. For example, despite the importance of having well-qualified individuals in executive positions, the city has not yet established minimum qualifications for some of its key executive positions and also does not periodically assess the performance of its executives. In addition, we found that for the city's May 2011 salary survey of its executive positions, which was part of the city's reform effort, the city may not have chosen positions in the most appropriate cities for comparison. Moreover, despite its financial difficulties, the city has a generous longevity program that allows eligible employees to receive a monthly payment of up to 25 percent of their base salary. Finally, we found that some city employees may have received legally questionable retirement benefits.

*The city has not established minimum qualifications for the key executive positions of city administrator, city treasurer, and city clerk.*

### ***The City Needs to Strengthen Its Management of Executive Positions***

The city has not established minimum qualifications for the key executive positions of city administrator, city treasurer, and city clerk. Although the city charter and codes describe the duties for these positions, neither source addresses the minimum qualifications required—such as knowledge, skills, education, and experience. We would expect a city hiring an individual to fill an executive position to require formal education in the applicable field as well as previous professional municipal or equivalent experience in a similar position. For example, the National Civic League describes the minimum qualifications for a city manager or city administrator as follows: either a master’s degree with a concentration in public administration, public affairs, or public policy and two years’ experience in an appointed managerial or administrative position in a local government, or a bachelor’s degree and five years of such experience. Without establishing minimum qualifications and job duty statements for all of its executive positions, the city cannot ensure that the individuals hired to lead the city possess the necessary education, experience, skills, and knowledge to successfully perform their duties. As a positive step, the city recently developed a job description to establish the minimum education and experience required for the open city attorney position, which did not have a job description before February 2012.

The city also does not have a clear and comprehensive hiring process for executives. According to the personnel director, in the past, the city administrator’s office has handled executive hirings. The city administrator initially told us there was a hiring process and that all of the documentation should be in the personnel files. However, in our review of the personnel files for the five current executives who were either hired or appointed to their respective positions between 2007 and 2012,<sup>3</sup> including the city administrator and fire chief, director of personnel and business services, director of light & power, finance director and city treasurer, and city clerk and risk manager, we did not find any documentation to support past hiring decisions. The documentation we expected to find would have demonstrated that the city advertised for the open positions, received interested candidates’ applications and résumés, interviewed and evaluated potential candidates, and made a recommendation to the city council. Although the city administrator stated that he participated in a formal hiring process when he was hired into the fire chief position, we did not find evidence of this process in our review of personnel files.

***The city does not have a clear and comprehensive hiring process for executives.***

<sup>3</sup> The current director of the community services and water departments was appointed to his position before the period of our review.

### Hiring Steps for Executive Positions

- Utilize a search firm to conduct a broad search for the most qualified candidates.
- Identify the City of Vernon's (city) needs for the position.
- Utilize representatives of the League of California Cities as advisers in the process (i.e. to help rank applicants).
- Interview at least five of the top-ranked applicants.
- Perform a full background check on the [city] council's first choice.
- Place proposed appointment on city council agenda.

Source: City's hiring steps for executive positions, titled "Hiring Procedures—Management," effective February 2012.

Following our inquiries, in February 2012 the city provided us a one-page bulleted list of the hiring steps it indicated have been followed for hiring executive positions. We present this list in the text box.

However, the city's recent offering of its formal written hiring steps is high-level and incomplete. The steps do not identify the roles and responsibilities of key city staff who participate in the hiring process for executives, nor do the steps state how to document the hiring process. Having a clear and comprehensive process for the selection and hiring of its executives will increase the transparency of the city's hiring decisions. We did note that the city has developed job bulletins for the three open positions of city attorney, human resources director, and health officer, and that it is using consultants to manage the searches for individuals to fill these positions.

Moreover, we did not find written periodic appraisals of executives' performance in the city's personnel files. Periodic, thoughtful, and well-documented performance appraisals are important to ensure that the individuals entrusted with the city's executive positions are performing according to expectations and meeting the city's goals. Additionally, appraisals provide accountability regarding an executive's job performance, as well as a basis for awarding future salary increases. When we discussed our concerns regarding the city's personnel practices with the city administrator, he stated that the city is planning to hire a human resources director who will be responsible for correcting many of the concerns we identified. According to the city administrator, the city has been without a human resources director since July 2009.

### ***The City May Not Have Included the Most Appropriate Cities in Its Executive Salary Survey***

In April 2011 the city council directed the city administrator to perform a salary survey to assess the reasonableness of executive salaries, which he completed in May 2011. This salary survey became the basis for the city's most recent salary resolution—the city council's approval of executive salary levels in July 2011. Table 3 presents the salary survey results and shows the salaries adopted as a result of the survey. Prior to this resolution, according to the salary survey, six of the city's executive positions—the city administrator, city attorney, city clerk, director of human resources, power department director, and risk manager—



did not have a resolution-established salary. In preparing its recommendations, the city considered whether salary reductions were necessary to bring salaries into line with those in comparable jurisdictions, while also seeking to ensure that it remained competitive in attracting and retaining the most qualified executives. As a result of the salary survey, the city established salary levels for these six positions that were higher than the average for the cities surveyed except for one, decided to leave the salary levels unchanged for four other positions, and reduced the salary level for the position of finance director by nearly \$130,000 annually, a 38 percent reduction in pay. However, even after the reduction, the finance director’s salary still exceeded the survey average by \$57,000.

**Table 3**  
**Salaries Adopted Based on the City of Vernon’s Salary Survey**

POSITION TITLE	RESOLUTION ESTABLISHED SALARY AT TIME OF SURVEY	ADOPTED	AVERAGE OF ALL CITIES SURVEYED*
City administrator <sup>†</sup>	–	\$267,000	\$215,000
City attorney <sup>‡</sup>	–	252,000	215,000
City clerk <sup>§</sup>	–	150,000	121,000
Director of community services	\$220,128	220,128	156,000
Director of human resources <sup>  </sup>	–	196,000	151,000
Director of light & power <sup>#</sup>	–	262,000	262,000
Finance director	339,996	210,000	153,000
Fire chief	199,188	199,188	200,000
Health officer/director of health and environmental control	193,440	193,440	248,000
Police chief	185,364	185,364	194,000
Risk manager <sup>**</sup>	–	163,000	122,000

Sources: City of Vernon (city) May 2011 salary survey for executives, which was based on 2009 salary information that cities and counties reported to the State Controller’s Office and city council resolutions approving executive salaries.

Note: Pink shading represents adopted salary amounts which exceed the average of all cities surveyed.

\* The average column shows the California State Auditor’s calculation of the average pay for all positions included in the city’s salary survey.

† The previous incumbent’s salary was \$384,000, effective May 2009.

‡ The previous incumbent’s salary was \$341,556, effective December 2006.

§ The previous incumbent’s salary was \$101,076, effective December 2007.

|| The previous incumbent’s salary was \$300,000, effective April 2008.

# The previous incumbent’s salary was \$384,000, effective July 2010.

\*\* The current risk manager has been the risk manager since 2007 and is paid in his hiring classification as chief deputy city attorney. His current salary is \$233,700.

Our review of the salary survey raised questions about the depth and thoroughness of the city's analysis and whether the city may have chosen positions in the most appropriate cities for comparison. To conduct the salary survey, the city chose both a small and a large sample of local cities, gathered information on executive salaries in those cities from the 2009 data on local government compensation prepared by the State Controller's Office, and compared the averages to the May 2011 salaries of its executives. Specifically, according to the salary survey, the small sample includes Southern California cities that operate their own electric and water departments. The large sample includes cities that are within a 5-mile radius of the city, and also includes the cities in the small sample and two other cities that are primarily industrial. The city reported that it compared its executive salaries to the average salaries of the top quartile<sup>4</sup> of the surveyed cities in the large and small samples, as well as to the average of the cities in the small sample.

***By comparing its executive salaries to the top quartile of the surveyed cities, the city had skewed the average of executive salaries upward.***

However, when we compared the city's proposed new salaries to the average executive salaries in the surveyed sample of cities, we noted that by comparing its executive salaries to the top quartile of the surveyed cities, the city had skewed the average upward. For example, the city compared its city administrator salary to the average salary in the top quartile of the large sample and to the average of the small sample, which were \$267,550 and \$271,852, respectively. Based on this comparison, the city proposed a new salary for the city administrator of \$267,000. However, our analysis showed that the city's proposed new salary for the city administrator position is \$52,000, or 24 percent, higher than the average city administrator salary for all of the surveyed cities. Similarly, the city set a proposed new salary for the finance director of \$210,000, which is significantly less than the current salary of \$339,996 for that position. Although the proposed salary is slightly higher than both the average salary of the top quartile of the large sample and the average salary of the small sample, at \$203,000 and \$209,000, respectively, we noted that it is more than \$57,000, or 37 percent, higher than the average salary for all of the surveyed cities, which was \$153,000. In fact, we noted that the city's proposed new salaries exceed the average salaries for seven of its 11 positions.

In addition, the city's selection of the cities for its small and large samples was based on two criteria: geographic proximity and the nature of services provided. Further, according to the salary survey methodology, city staff simply matched the job titles of its executives to those in the selected cities. The city did not consider

<sup>4</sup> The top quartile generally represents the average salaries in the top 25 percent of the range in the sample of surveyed cities.

job descriptions to identify relevant compensable factors, including education, experience, or organization size and structure, as well as the scope of responsibilities and duties and qualifications. Therefore, it may not have chosen positions in the most comparable cities for comparison. Generally, the city's comparisons included executives from some of the largest cities in Southern California, including Los Angeles, Anaheim, Riverside, Pasadena, and Burbank. Including these cities in its comparison is problematic because they overshadow the city in the size and structure of their organizations, including the scope of services they provide, their budgets, and the number of employees their executives oversee. Two examples—city attorney and director of health and environmental control (city health officer)—highlight the weaknesses in the city's methodology for conducting the salary survey.

For its city attorney position, the city used the annual salaries of the Anaheim and Pasadena city attorneys, which made up the top quartile of the large sample. The Anaheim and Pasadena city attorney's offices each have 30 positions and annual operating budgets of \$5.7 million and \$6.4 million, respectively. In addition, the Anaheim and Pasadena city attorneys oversee a number of programs and services, including legal administration, civil matters, and prosecution. For example, the Pasadena city attorney's office reported that in fiscal year 2010–11 its prosecutors handled more than 6,000 cases, and lawyers in its civil division managed a caseload of approximately 100 lawsuits. In contrast, Vernon's city attorney has more limited responsibilities, as the position manages just five positions, including two attorney positions, and an approved budget of \$3.6 million for fiscal year 2011–12 of which \$3 million was budgeted for outside legal services with contracts that are managed by the city administrator's office. Further, the city attorney's duties include, among other tasks, preparing and transmitting legal opinions; reviewing proposed contracts, bond and financing papers, and insurance policies; monitoring the status of claims and lawsuits; and representing the city before courts and administrative proceedings. Although we recognize that Vernon's city attorney may handle a broad range of legal matters, this position does not have the level of managerial responsibility that the Anaheim and Pasadena city attorneys have, nor are its responsibilities for litigation and prosecution comparable to those of the Anaheim and Pasadena city attorneys.

For the city health officer position, because there are few local entities in Southern California with their own health department, the city used the maximum annual salaries of the director of public health for the City of Pasadena (Pasadena public health director) and the director of public health for Los Angeles County (county public health director) for its comparison. As shown in Table 4 on the following page, the annual salary for the city health officer,

*The city's comparisons included executives from some of the largest cities in Southern California, which is problematic because they overshadow the city in size and structure of their organizations.*

while much less than that of the county public health director, is higher than that of the Pasadena public health director. The city's salary survey concluded that its health officer's current salary was appropriate due to the importance of health and environmental control in industrial cities, and it recommended that the salary for this position remain unchanged.

**Table 4**

**City of Vernon's Salary Survey Comparison for the Health Officer and Director of Health and Environmental Control**

CITY/COUNTY	ANNUAL SALARY MAXIMUM	PERCENTAGE BY WHICH THE SALARY VARIES FROM THE CITY OF VERNON'S SALARY
Los Angeles County	\$309,494	60 percent
City of Pasadena	186,688	(3) percent
City of Vernon	193,440	

Source: City of Vernon May 2011 salary survey for executives, which was based on 2009 salary information that cities and counties reported to the State Controller's Office.

When we compared the Pasadena and county public health directors' responsibilities, which are based on their organizations' size and structure, to those of the health officer for Vernon, we found that they are not comparable. Specifically, the Pasadena public health director is responsible for planning, directing, and coordinating a variety of public health and environmental health programs and, among other duties, for providing consultation and medical oversight to clinical programs and offering advice and guidance to physicians, laboratories, hospitals, and other health care providers in matters pertaining to the diagnosis, investigation, control, and prevention of communicable diseases for Pasadena's 137,000 residents. In fiscal year 2011–12, the Pasadena public health director directed the preparation and administration of an operating budget of \$11.5 million and a staff of 90.

The Los Angeles County public health department's (county public health department) final budget shows that in fiscal year 2011–12 the county public health director presides over a department with nearly 4,400 positions and an annual budget of nearly \$851 million. The county public health department administers 39 programs and operates 14 health centers, through which it provides a variety of services and operations, such as direct medical services, environmental health, and the control and prevention of communicable diseases. Moreover, the county public health director's scope of responsibilities and duties are expansive in that he is responsible for all public health functions, including surveillance and control of both communicable and noncommunicable diseases and health protection for the county's 9.8 million residents.

In contrast, the city health officer for Vernon manages a department of eight employees and has a budget of \$1.2 million to provide services to the 1,800 businesses located in the city and the 112 city residents. These programs and services are focused primarily on environmental health issues, such as food safety, solid waste management, rodent and vector control, hazardous materials and underground tank monitoring, occupational health, and industrial hygiene. Unlike the departments managed by the two positions in the salary comparison, the city does not offer any direct medical or clinical services. We recognize that the city health officer is responsible for environmental health duties and responsibilities, but the Pasadena and county public health directors perform similar duties, as well as significant additional public health duties. Therefore, we fail to see the rationale behind the city's comparison.

Additionally, the city did not consider other compensable factors, such as minimum education and experience required, which can significantly influence the salary of the positions. The city's comparison of its health officer to the Pasadena and county public health directors shows how disparate the minimum education and experience requirements can be. For example, the Pasadena public health director position requires graduation from medical school, four years of experience as a public health physician, board certification in a medical specialty, and expertise in epidemiology. Although the minimum requirements for the county public health director are more general, the current county public health director's biography states that he possesses a doctoral degree in medicine and master's degrees in public health and finance. Additionally, he served as a state director of public health. In contrast, the city's minimum qualifications for its health officer require an individual to have only a valid certification of registration as an environmental health specialist and at least five years of experience in an environmental health agency.

As another part of its May 2011 salary survey, the city compared the salaries and benefits paid to its council members to those of council members of charter law cities in Southern California that operate an electric utility or gas enterprise. As Table 5 on the following page shows, the city's council members were being paid \$68,052 per year, significantly more than their counterparts in other cities besides Los Angeles. The salary survey recommended that the city reduce council members' salaries to \$25,000 per year and eliminate certain health benefits. In May 2011 the city council adopted a resolution to reduce its members' salaries to the recommended level, but to do so only upon the completion of the members' current terms. Under this resolution, the first salary reduction took place in April 2012 and the final reduction will take place in 2016. In June 2011 the city council members voted to voluntarily relinquish 18 percent of their salaries for the remainder of their terms. The resolution indicates that the

*We fail to see the rationale behind the city's comparison of its health officer with the other health officer positions and note that the city did not consider compensable factors such as minimum education and experience required in setting the salary.*

city council based this reduction on the 18 percent reduction in the salaries of the members of the State Legislature. As a result of this action, effective July 2011, the annual salary for council members was lowered to \$55,800. The city's independent ethics adviser stated in July 2011 that it was in the city's best interest to reduce city council members' annual salaries to \$25,000 immediately, but in response the city council discussed with the ethics adviser its reaffirmation of the May 2011 resolution, which was to implement the salary reduction only after the current council members' terms were completed. The city council did approve, effective July 2011, the elimination of certain health benefits for council members and their spouses and dependents. Specifically, the city no longer pays or reimburses medical-related expenses not covered by insurance, no longer provides or reimburses for long-term care insurance, and has eliminated health and dental insurance coverage after retirement.

**Table 5**  
**Cities Included in the City of Vernon's Survey of Council Members' Salaries and Benefits**

CITY	ANNUAL SALARY
Anaheim	\$18,000
Burbank	12,899
Long Beach	31,349
Los Angeles	178,795
Pasadena	16,411
Riverside	39,408
Vernon*	68,052

Source: City of Vernon (city) May 2011 salary and benefits survey for council members, which was based on 2009 salary information that cities reported to the State Controller's Office.

Note: Each city included in the survey is a charter city in Southern California that operates an electric utility and/or a gas enterprise.

\* The city's salary level is as of May 2011. Effective July 2011, the annual salary for council members was lowered to \$55,800.

### ***Many City Employees Receive Generous Longevity Payments***

Despite the city's financial difficulties, many of its employees can receive generous longevity payments—additional monthly compensation based on length of service—of up to 25 percent of their monthly salary. Specifically, from May through November 2011, 218 of the city's 284 employees<sup>5</sup> received a longevity payment under one of two longevity programs, described in the text box.

<sup>5</sup> This is the number of employees who received a longevity payment from May through November 2011.

The original longevity program (tier 1 in the text box), established in 1986, is the more generous of the two programs and continues to cost the city a significant amount of money each year. In June 1994 the city closed the original longevity program to new employees and adopted the second longevity program (tier 2 in the text box), with payments limited to 5 percent of base pay. However, as of November 2011, 114 city employees continued to receive payments under the original longevity program.

As shown in Table 6, the city’s payroll data shows that longevity pay from May through November 2011 totaled more than \$1.2 million, which was nearly 8 percent of the city’s overall payroll expenditures for the same period. Just over \$1 million, or 82 percent, of the city’s longevity payments were made to the 114 employees eligible for the original longevity program. Of these, the vast majority—99 of 114—have 20 or more years of service with the city, which qualifies them to receive a 20 percent longevity payment on top of their monthly salary. Between May and November, the city paid each of these 99 employees an average of \$9,367 in addition to their base salary. During this same period, the average payment for employees in the second longevity program was \$2,139. On an individual employee basis, the original longevity program is nearly five times more costly than the more recent longevity program. This generous longevity program places a further strain on the city’s finances. We acknowledge that current employees may have a vested right to the longevity payments. However, if the city can lawfully modify this benefit without impairing such a right, it should consider doing so.

**City of Vernon Longevity Program**

**Tier 1: Employees Hired On or Before June 30, 1994\***

Upon attaining five years of service	5 percent of base pay
Upon attaining 10 years of service	10 percent of base pay
Upon attaining 15 years of service	15 percent of base pay
Upon attaining 20 years of service	20 percent of base pay
A fire captain upon attaining 30 years of service†	25 percent of base pay

**Tier 2: Employees Hired After June 30, 1994\***

Upon attaining five years of service	5 percent of base pay
--------------------------------------	-----------------------

Sources: City of Vernon’s (city) Personnel Resolution 2011-129 (resolution), memorandum of understanding (MOU) between the city and the Vernon Firefighters Association, and MOU between the city and the Vernon Police Officers’ Benefit Association (VPOBA) for fiscal year 2011–12.

The resolution specifies that the years of service for employees not covered by a collective bargaining agreement must be consecutive and uninterrupted.

\* For VPOBA employees, the hire date is July 1, 1995.

† According to the deputy city treasurer, there are currently no employees receiving longevity payments of 25 percent above their base salary as of May 2012.

**Table 6**  
**City of Vernon’s Longevity Program Expenditures**  
**May Through November 2011**

2011	ORIGINAL LONGEVITY PROGRAM		SECOND LONGEVITY PROGRAM		TOTAL EMPLOYEES	TOTAL LONGEVITY EXPENDITURES
	EMPLOYEES	EXPENDITURE	EMPLOYEES	EXPENDITURE		
May through November	114	\$1,032,612	104	\$222,487	218	\$1,255,099
Average longevity bonus per employee		9,058		2,139		5,757

Source: California State Auditor’s analysis of data obtained from the City of Vernon’s (city) enterprise resource planning system payroll module. The city implemented this payroll module on the first payroll date in May 2011 and provided us the payroll data through the last pay date in November 2011. The city’s previous payroll system did not separately track longevity payments.

Our calculation of longevity expenditures included payments made to employees under the original and second longevity programs. We did not include longevity payments made for special circumstances, such as when an employee took a leave of absence because of a work-related injury.

### ***Some City Employees May Have Received Legally Questionable Retirement Benefits***

The city may have inappropriately classified two employees as safety employees, entitling them to more generous retirement benefits and requiring the city to pay a higher contribution to their retirement, as shown in Table 7. For example, in March 2005 the city reported its chief deputy city attorney, who also holds the positions of city clerk and risk manager, under a safety classification. State law allows a safety classification for public prosecutors, public defenders, and public defender investigators who are primarily engaged in the active enforcement of criminal laws within any court operating in a county. Although this individual holds other positions within the city, he indicated to us that he spends the majority of his time performing duties associated with the city attorney's office, which include reviewing and settling claims, monitoring litigation, and reviewing contracts. We do not consider these to be the duties of a prosecutor who is primarily engaged in the active enforcement of criminal law. Moreover, the city did not have a job description detailing that the primary duties and responsibilities of the chief deputy city attorney were to engage in active enforcement of criminal law. Consequently, we conclude that his job duties and responsibilities are inconsistent with a safety classification because they do not appear to be primarily prosecutorial.

**Table 7**  
**City of Vernon's Retirement Coverage**  
**Group Rates**

COVERAGE GROUP	EMPLOYEE CONTRIBUTION*	EMPLOYER CONTRIBUTION*	BENEFIT FACTOR†
Miscellaneous	8 percent	16.32 percent	2.7 percent at age 55
Safety	9 percent	29.91 percent	3 percent at age 50

Sources: City of Vernon's (city) fiscal year 2010–11 audited financial statements; the contribution rates are for fiscal year 2011–12 and were provided by the deputy city treasurer.

\* This percentage represents the employee or employer contribution to retirement as a percentage of the employee's compensation.

† The benefit factor represents the percentage of final compensation received for each year of service, and the minimum retirement age to receive the full benefit factor.

In addition, in September 2010 the city's fire chief took on the responsibility of city administrator while retaining his position as fire chief. According to the city's personnel records, although the city administrator simultaneously holds two positions, he was paid as the fire chief, and he continued to receive all benefits associated with the fire chief position. During an October 2011 interview with us about his duties, he stated that he agreed to become the city administrator only if he did not receive an increase in salary and



continued to be compensated at the pay level of fire chief. As a result, he also continues to receive safety retirement benefits associated with the fire chief position. These benefits would not be associated with a city administrator position. When we asked him in the same interview about how his time is split between the city administrator and fire chief positions, he stated that he currently spends very little time in the operational area of the fire department and that he relies heavily on the assistant fire chief and other fire department officers. Further, he said that when the city council asked him to be city administrator, it took into consideration that the fire department could exist and continue on very well without him being present all the time. He indicated that fire department staff report back to him and give him status updates, but that as far as his dedicated time, the “lion’s share” is spent doing city administrator work. In his capacity as city administrator, he is responsible for managing the day-to-day operations of the city and overseeing all city departments. These duties are inconsistent with a classification entitled to receive safety retirement benefits. Moreover, from May through November 2011, the city administrator received nearly \$8,300 in additional compensation that is typically reserved for firefighters, such as hazardous materials pay, fire science certificate pay, urban search and rescue pay, and a uniform allowance. Because, according to his own statement, he dedicates the “lion’s share” of his time to the role of city administrator, he may not be eligible for such additional compensation.

In addition to the compensation issues we observed, in April 2012, the California Public Employees’ Retirement System (CalPERS) issued an audit report on the city’s compliance with payroll reporting and member enrollment processes related to the city’s retirement contract with CalPERS. The audit report includes a number of findings that question the accuracy of the city’s reporting and enrollment processes. We present these findings in the text box.

**California Public Employees’ Retirement System’s (CalPERS) audit of the City of Vernon (city) resulted in the following 10 findings and one observation:**

- The city failed to provide information necessary to determine the accuracy of retirement benefits, reportable compensation, and membership enrollment in the retirement system.
- CalPERS was unable to determine whether pay rates and earnings were accurately reported for nine individuals working concurrently in multiple positions because the city failed to provide documentation in conformance with the Public Employees’ Retirement Law and its contract with CalPERS.
- The city submitted erroneous information to support the enrollment of three ineligible individuals into CalPERS membership, which provided them with excessive service credit and the erroneous purchase of additional service credit. The city also incorrectly reported individuals who performed services as independent contractors.
- The city failed to notify CalPERS when an elected officer was convicted of perjury and thus forfeited several years of service.
- The city incorrectly reported five attorneys under a safety retirement classification, which provides an enhanced retirement benefit formula.
- The city reported earnings for six individuals that exceeded the compensation limit established by the federal Internal Revenue Code, which was \$245,000 for 2009.
- The city reported incorrect pay rates and also improperly reported compensation that was not reportable for six individuals.
- The city incorrectly reported certain payroll information, mostly related to special compensation such as longevity payments, to CalPERS for 15 individuals.
- The city failed to properly report special compensation related to uniforms for employees in the miscellaneous retirement group.
- The city overreported special compensation to CalPERS for one individual.
- CalPERS observed that an employee held two positions simultaneously as the fire chief and interim city administrator, but that all earnings were reported under the safety coverage group, which would result in a higher retirement allowance. CalPERS indicated that the city must report each position separately and identify the percentage of time spent in each position, along with the base pay rate and retirement coverage group.

Source: CalPERS Office of Audit Services, Public Agency Review, City of Vernon, dated April 27, 2012.

*We noted that CalPERS reached the same conclusions that we did concerning the chief deputy city attorney and city administrator.*

We noted that CalPERS reached the same conclusions that we did concerning the chief deputy city attorney and city administrator. Specifically, CalPERS found that the city incorrectly reported five attorneys under a safety coverage group, which would result in enhanced retirement benefits. It identified that four of the attorneys were no longer working as employees for the city, while one attorney—the chief deputy city attorney—remained employed by the city and continued to be erroneously reported under the safety classification. CalPERS noted that the city failed to provide documentation or evidence to substantiate that any of the five attorneys' duties were to engage in active enforcement of criminal law. As a result of the city's failure to supply adequate information, CalPERS concluded that the attorneys were not eligible for a safety classification. In addition, CalPERS noted that even though the city administrator simultaneously held the position of fire chief, the city continued to report all earnings under the safety coverage group, which would result in a higher retirement allowance. CalPERS indicated that the city must report each position separately and identify the percentage of time spent in each position. CalPERS noted that its audit report does not constitute the final determination with regard to the findings included in the report and that the appropriate CalPERS divisions will notify the city of the final determinations and provide appeal rights at that time. In late May 2012 CalPERS issued determination letters to seven current and former city officials outlining its decisions related to membership and compensation based on its audit report. The letters summarized CalPERS' plans to reduce the pension of a former city top official and deny six other officials, including the individual currently serving as city administrator and fire chief, all or part of their retirement membership or their reported compensation used to calculate their pensions. These seven officials have 30 days from the date of the determination letters to appeal the decisions.

### **Recommendations**

To increase accountability and transparency in its governance, the city should ensure that specific reforms are appropriately implemented. Specifically, it should:

- Develop an implementation plan containing sufficient detail to establish the activities and coordination required to successfully implement an alternative new employment system so that its nonunion employees are no longer at-will employees of the city council.

- Determine whether it will continue to own housing and communicate its decision to the public as soon as appropriate. Should the city decide to retain ownership of the housing, it should continue the effort to develop policies and procedures that are necessary to ensure fairness and impartiality in its management of city-owned housing. It should also continue the effort to develop a comprehensive plan to construct additional housing in the city.
- Develop a formal policy that describes the circumstances under which revenues can be transferred from its power department, and the limits and permissible uses of transferred revenue.

To ensure that it develops complete and appropriate personnel policies and procedures, the city should continue its efforts to hire an experienced human resources director. The new human resources director should ensure that the city's policies and procedures include, at a minimum, the following:

- Requirements for performing and documenting the analyses and justifications for appointments, including promotions, to management positions.
- Requirements for minimum qualifications, desirable qualifications, and job duties for all city executive positions.
- A periodic appraisal process for executives.
- An improved methodology for and analysis of future salary surveys, ensuring that they are performed by staff or a consultant with experience and expertise in the area of salary surveys.

The city should determine whether employees have a vested right to longevity payments and whether it can legally reduce or discontinue the original longevity program as a means to reduce its costs.

To ensure accurate reporting and payment of retirement benefits, the city should work with CalPERS to resolve the reported findings and observation noted in its report within a reasonable period of time.

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## Chapter 2

### WEAK CONTROLS PERMEATE THE CITY'S CONTRACTING PRACTICES FOR SERVICES AND CONSULTANTS

#### Chapter Summary

Inadequate contracting policies and weak internal controls have resulted in poor service and consultant contract practices by the City of Vernon (city). Of the service and consultant contracts we reviewed, for many the city did not impose a limit on expenditures and frequently failed to specify a period of service. Additionally, some service and consultant contracts included a poorly defined scope of work, and the related invoices lacked sufficient detail, making it difficult to verify the services received. Further, the city rarely used a competitive bidding process when selecting contractors for the contracts we reviewed. The city has acknowledged some of these weaknesses and intends to implement changes to correct its practices, but other weaknesses we identified have not yet been addressed. In particular, although the city's electorate has approved changes to the city charter that call for the adoption of a city ordinance requiring competitive bidding for service contracts, the city has not yet adopted such an ordinance. The city also lacks adequate policies and procedures governing travel and expense reimbursement, making those areas vulnerable for abuse.

We also noted that the city did not always comply with the disclosure requirements of the conflict-of-interest code (conflict code) it adopted under the Political Reform Act of 1974 (reform act). This conflict code requires, in part, that the city make a written determination as to whether each consultant it hires performs duties that require disclosure of the consultant's financial interests. Thus, we expected to find, for each consultant, either a statement of economic interests or the city's determination that disclosure was not necessary. However, with limited exceptions, we found neither. We also found that before 2010, the city did not always ensure that employees filed statements of economic interests.

#### The City's Contracting Practices for Services and Consultants Need Improvement

There is no general state law that requires California cities, including charter cities, to use competitive bidding or to follow other best practices in public contracting. Instead, cities have the discretion to adopt their own practices related to services and consultants. We reviewed a selection of the city's contracts for

***We noted several problems in the city's contracting practices for services and consultants, including contracts with no termination dates, no limit on expenditures, and poorly defined scopes of work or deliverables.***

services active between 2007 and 2011 and originally approved by the city council between September 2000 and December 2010. Using the city's enterprise resource planning (ERP) system payment data for the period of July 2005 through November 2011, we selected 25 contracts for review either because they received among the highest payments during that period or because of other factors that we believed made them relevant to review. During this period, the city charter did not require competitive bidding for services and consultants. Nonetheless, because there are certain widely used best practices in public contracting, we reviewed a selection of the city's public contracts to determine whether the contracts formed during this period reflected those best practices.

We noted several problems in the city's contracting practices for services and consultants, including contracts with no termination dates, no limit on expenditures, and poorly defined scopes of work or deliverables. We also noted that the city's monitoring of payments made to contractors is inadequate and that it makes minimal use of competitive bidding. As shown in Table 8 beginning on page 44, our analysis of selected contracts and related expenditures during fiscal years 2005–06 through 2011–12 revealed problems with 21 of the 25 contracts reviewed. Because of these poor contracting practices, the city may not be receiving the best value when procuring services and consultants. The city has recently taken steps to remedy some of the problems we observed with its contracting practices. However, many of the actions do not go far enough, as we noted that eight of the contracts we found problems with were still active as of March 2012, and other reforms were not yet implemented as of May 2012.

Complicating our efforts to review the city's contracting practices was that the city does not maintain a complete list of contracts. The city clerk's office maintains a manually entered list of contracts that the city council has approved dating back to 2005, but this list does not contain the value of the contracts or specify whether they are active. It also does not include contracts approved before 2005, some of which may still be active. Further, the city implemented the contract management module of its ERP system to manage and track the city's contracts. However, the list of contracts is incomplete because the city does not require departments to use the ERP system's contract module to track their contracts. Although the contract module automatically assigns a unique number to each contract, the city does not use this automatically assigned contract number. Rather, the city manually assigns each contract a different identifying number in the city clerk's list, and it does not use this number in the contract module. Because the manual list and the contract module contain no common information beyond the contractor name, we were unable to determine which contracts in the city clerk's manual

list corresponded to contracts recorded in the contract module. The city's inability to provide a complete contract list meant that we could not use either of these sources as the basis for selecting contracts for review. Instead, we used the payments made to vendors that were recorded in the city's ERP system to select vendors for review. However, the city's failure to use its ERP system to track contracts denies city management a tool that it could use to manage and control contracts in a more efficient manner.

Finally, for one contractor—Sadler Strategic Media, Inc.—the city informed us that no formal written agreement existed and that those services were secured through its outside legal counsel. As shown in Table 9 on page 49, between July 2010 and November 2011 the city paid this contractor over \$1 million for media services related to fighting the city's disincorporation. Thus, as shown in Table 8 beginning on the following page, we were only able to review the invoices that the city paid, which we noted lacked sufficient detail for the city to understand the services it was being charged that the outside legal counsel had routed to the city for payment.

***Contracts Were Sometimes Awarded Without Limits on Expenditures or Duration***

In some instances, the city awarded contracts without a provision placing a limit on the expenditures. As Table 8 shows, 13 of the 25 contracts we reviewed did not include a limit on the total amount that the contractor would be paid. Between July 2005 and November 2011 the city's ERP system payment data shows disbursements to these 13 contractors totaling more than \$105 million. Seven of those 13 contracts were still active as of March 2012. In one example, the city awarded a contract to Project Labor Group, Inc. in June 2005 for consulting, engineering, security, and administrative services but did not include a limit on expenditures. Instead, the contract indicated that the city would compensate the contractor on a time and materials basis. Time and materials contracts are not necessarily a bad practice, but they require close oversight to monitor costs. As of November 2011 the city had paid the contractor nearly \$5.2 million.

***For one contractor, no formal agreement existed and those services were secured through the city's outside legal counsel—between July 2010 and November 2011 the city paid this contractor over \$1 million for media services related to fighting the city's disincorporation.***

**Table 8**  
Summary of Problems Found in City of Vernon's Contracts Reviewed

CONTRACTOR/VENDOR NAME	CITY COUNCIL APPROVAL DATE*	AMOUNT	ACTIVE AS OF MARCH 2012	NO END DATE	NO DOLLAR LIMIT	NO USE OF PAYMENT LOG TO MONITOR EXPENDITURES	SCOPE OF WORK AND/OR DELIVERABLES NOT CLEARLY DEFINED	INVOICE DETAIL LIMITED/ NONEXISTENT	COMPETITIVE BIDDING NOT USED	CONTRACTS WITH EXCEPTIONS	EXCEPTIONS				
											NO USE OF PAYMENT LOG TO MONITOR EXPENDITURES	SCOPE OF WORK AND/OR DELIVERABLES NOT CLEARLY DEFINED	INVOICE DETAIL LIMITED/ NONEXISTENT	COMPETITIVE BIDDING NOT USED	CONTRACTS WITH EXCEPTIONS
American Electric Power	September 5, 2000	\$53.75 per Mwh <sup>†</sup>				X					X				
BLX Group LLC	November 15, 2010	\$375-\$685 per hour <sup>‡</sup>	X	X	X	X			♦		X				
Citigroup Energy, Inc. (Energy)	September 5, 2000	\$42 per Mwh <sup>†</sup>				X			♦		X				
Citigroup Energy, Inc. (Gas)	June 7, 2006	\$423,374,475 (prepayment of gas)	X			§			♦						
General Pump Company, Inc.	March 29, 2010	\$114,021													
Gursey, Schneider & Co. LLP	August 27, 2007	\$110 to \$350 per hour		X	X	X	X		♦		X				
Hansolo Building Services	September 4, 2007	\$288,830							♦						
J. D. Hicks & Associates	August 10, 2009	\$19,230.76 every two weeks (not to exceed \$500,000)				X			X		X				
Lake Street Associates, Inc.	November 17, 2004	\$17,500 <sup>  </sup> per month				X		X	X		X				
Latham & Watkins LLP	November 5, 2003	\$240 to \$590 per hour; 2012 rates up to \$945 per hour	X	X	X	X	X		♦		X				
Law Offices of Eric T. Fresch, Ltd.	January 4, 2010	\$525 per hour <sup>#</sup>	X	X	X	X	X		♦		X				
Michael B. Montgomery	November 1, 2010	\$20,000 per month				X		X	♦		X				
Nevada Renewable Power	December 6, 2010	\$160 per hour			X	X	X		♦		X				
Nielsen, Merksamer, Parrinello, Mueller & Naylor, LLP	November 15, 2010	\$50,000 advance payment; billings at \$120 to \$865 per hour	X	X	X	X	X		♦		X				
Pat Fresch	January 12, 2009	\$62.50 per hour, 40 hours per week	X	X	X	X	X		X		X				



CONTRACTOR/VENDOR NAME	CITY COUNCIL APPROVAL DATE*	AMOUNT	ACTIVE AS OF MARCH 2012	NO END DATE	NO DOLLAR LIMIT	NO USE OF PAYMENT LOG TO MONITOR EXPENDITURES	EXCEPTIONS			CONTRACTS WITH EXCEPTIONS
							SCOPE OF WORK AND/OR DELIVERABLES NOT CLEARLY DEFINED	INVOICE DETAIL LIMITED/ NONEXISTENT	COMPETITIVE BIDDING NOT USED	
Petrelli Electric, Inc.	April 20, 2009	\$47 to \$168 per hour plus equipment charges	X		X	X			X	X
Port Canaveral Power Consultants, Inc.	August 2, 2010	\$180 per hour	X	X	X	X		X		X
Project Labor Group, Inc.	June 29, 2005	\$3,999 to \$18,750 per month		X	X	X		X		X
Rhino Construction Services	August 16, 2010	\$165,000						X		X
Richards, Watson & Gershon	July 13, 2009	\$125 to \$460 per hour			X	X			◆	X
Sadler Strategic Media, Inc.	■	■	■	■	■	X		X	◆	X
Salt River Project	September 5, 2000	Not specified				X				X
Tara Energy, Inc.	August 2, 2010	\$300 per hour		X	X	X		X		X
Trico Construction (Construction management)	January 5, 2005	6 percent to 8 percent of project cost plus \$38 to \$125 per hour		X	X	X		X		X
Trico Construction (House remodel)	April 16, 2007	Not to exceed \$165,000 per housing unit							◆	
<b>Totals</b>			<b>8</b>	<b>10</b>	<b>13</b>	<b>20</b>	<b>11</b>	<b>10</b>	<b>9</b>	<b>21</b>

Sources: California State Auditor's analysis of selected contracts provided by the City of Vernon (city).

X = Contracts containing exceptions

◆ = We did not test competitive bidding practices for all service and consultant contracts because we found that the city did not use competitive bidding for nine of the 12 that we initially reviewed.

■ = The city informed us that no formal written contract existed between it and Sadler Strategic Media, Inc., but that its services were secured through the city's outside legal counsel. As a result, we were only able to review the invoices that the city paid, which its outside legal counsel had routed to the city for payment.

\* In some instances, contracts were approved by another governing body of the city.

† Megawatt hour.

‡ Consultant was also paid 0.175 percent of funds under management and 0.60 percent of principal and/or notional amount for execution of any capital, market, derivative, or other similar transaction.

§ The city prepaid for the gas under the contract and monitors its delivery.

|| The city amended the contract in April 2008 to raise the monthly fee to \$17,500.

# The city amended the contract in February 2010 to raise the hourly fee to \$525.

***In January 2010 the city awarded a contract, without a spending limit, to a law firm to provide legal services for its power and gas departments. Between July 2005 and November 2011, the city paid the law firm more than \$5.4 million.***

In another example, in January 2010 the city awarded a contract, without a spending limit, to the Law Offices of Eric T. Fresch, Ltd. to provide legal services for its Light & Power Department (power department) and gas department. For this contract, the city agreed to pay an hourly fee of \$450 for the attorney who would be primarily providing the legal services.<sup>6</sup> Additionally, we noted that the city had past contracts to have the same attorney from this law firm provide various services, including serving as city attorney and city administrator at separate times. Between July 2005 and November 2011, the city paid this law firm more than \$5.4 million.<sup>7</sup> Although it is not unusual for a city to contract with outside counsel on an hourly basis, guidance provided by the Association of Corporate Counsel advises that it is important to have various cost controls in place to ensure that the engagement serves the client's needs in a cost-effective way. These controls include such practices as encouraging competition among outside counsel, careful invoice review by someone qualified to assess both the need for legal services and the quality of the services provided, and negotiating bill discounts. When the city does not include expenditure limits in contracts, it is more difficult to control costs and to ensure that the city receives the full value of the services for which it pays. Additionally, without contract limits it cannot accurately project expenditures.

Compounding the problem of not having a limit on expenditures for these 13 contracts, the city was not using payment logs to track and monitor payments made to the contractors for these 13 contracts, as well as seven other contracts. Payment logs are a commonly used tool for contract managers and accounting staff to monitor the progress of a contractor's work and to ensure that amounts paid to a contractor do not exceed the limit in the contract. According to the assistant finance director, city staff can generate various contractor payment reports using the city's ERP system to determine the amount paid to a contractor or request this information from the finance or purchasing departments at any time. However, these reports cannot be effective contract-monitoring tools unless the city establishes policies requiring managers to use them when approving and paying contractor invoices. As a positive step, in February 2012, in response to our review, the power department director required staff to begin using payment logs to monitor payments of contracts with the power department. When combined with the city's planned reform to impose expenditure caps, this will be an effective monitoring tool.

<sup>6</sup> As shown in Table 8, the contract was amended in February 2010 to raise the hourly fee to \$525 per hour.

<sup>7</sup> Our analysis of payment data obtained from the city's ERP system is as of November 25, 2011. However, since this contract was not terminated until May 1, 2012, the contractor continued to receive additional payments and has been paid more than the amount shown in Table 9 on page 49.

As Table 8 shows, 10 of the 25 contracts we reviewed did not have an ending date. Six of these 10 contracts were active as of March 2012. A July 2011 report by the city's independent ethics adviser indicated that the city had satisfactorily resolved its problems with automatically renewing contracts, but we would expect the city to heed its ethics adviser's other recommendation of requiring all contracts to include ending dates and expenditure limits. For example, in November 2010, the city approved a contract with BLX Group LLC, agreeing to pay the firm's staff fees of up to \$685 per hour. This contract did not include an end date but stated that it would continue until terminated by either party. As shown in Table 9 on page 49, from July 2005 to November 2011, the city paid this firm almost \$10.7 million under this and previous contracts.<sup>8</sup> Moreover, from July 2005 to November 2011, the city paid nearly \$62 million to the 10 contractors with contracts that had no ending dates. Lacking ending dates, most of these contracts will continue until either party decides to terminate the contract and some do not address termination. However, prudent contracting practices include requirements for specifying beginning and ending dates of services to ensure that limits exist on the period for the contractor to perform work. Further, by ending contracts periodically, the city has an opportunity to seek new bids for the contracted services and better ensure that it is paying competitive rates for those services.

*From July 2005 to November 2011, the city paid nearly \$62 million to the 10 contractors with contracts that had no ending dates.*

### ***The Scope of Work Was Poorly Defined in Many Contracts, and Invoices Lacked Detail***

Many contracts we reviewed lacked a well-defined scope of work or deliverables, making it difficult for the city to monitor and assess whether the nature and value of the services received were consistent with those billed and paid. As a best practice, a contract should include a clear and concise scope of work and should clearly identify any expected deliverables, allowing the contract manager to monitor progress and review contract compliance.

Table 8 shows that for 11 of the 25 contracts, the city had poorly defined scopes of work or deliverables. Five of these 11 contracts were active as of March 2012. For example, one of these 11 contracts was with Nevada Renewable Power to perform work with the city's redevelopment agency. This contract's scope of work stated that the consultant would advise and assist the executive director of the redevelopment agency regarding the development and implementation of alternative energy resources.

<sup>8</sup> Our analysis of payment data obtained from the city's ERP system is as of November 25, 2011. However, since this contract was still active as of March 2012, the contractor continued to receive additional payments through at least March 2012 and has been paid more than the amount shown in Table 9 on page 49.

***Exacerbating the vague scope of work, invoices provide only a one-page spreadsheet summarizing the consultant's hours for each day and listing of various projects worked on with no details regarding the actual work performed or the deliverables provided.***

However, this scope of work does not provide any specific information about what specific work product or deliverable the consultant was to provide. This contract compensated the consultant at \$160 per hour, and the city paid the consultant nearly \$765,000 between July 2006 and February 2011 under this contract and other contractual arrangements.<sup>9</sup> Additionally, in terms of deliverables for this contract, the only requirement placed on the consultant was to submit monthly invoices for services and expenses.

In another example, the city paid Port Canaveral Power Consultants, Inc. nearly \$1.7 million between July 2005 and November 2011<sup>10</sup> to assist the city in all aspects of planning, developing, licensing, erecting, and commissioning energy projects and lists six services that the consultant is to perform. However, none of the services have a specific outcome expected from the consultant. The contract, which was still active as of March 2012, compensates the consultant at \$180 per hour for up to 2,080 hours a year. Exacerbating this vague scope of work, invoices provide only a one-page spreadsheet summarizing the consultant's hours for each day, listing the various energy projects worked on, and often providing only brief comments on the general nature of each day's work, with no details regarding the actual work performed or the deliverables provided. The power department director also receives the consultant's review of the monthly billings from the operator of the Malburg Generating Station (generating station) and a status report for energy projects in development. However, review of the generating station billings is not specifically listed as one of the consultant's six services, and the status report does not show which activities the consultant has been assigned. According to the power department director, beyond receiving these documents and his close regular interaction with the consultant, he does not review any additional documentation before approving the invoices for payment. We recognize that close interactions with the consultant may provide some insight into the consultant's work. However, more clearly defining the expected deliverables and requiring more detailed invoices would allow for more effective monitoring of the consultant's work and cost.

<sup>9</sup> This contract was executed in December 2010 and terminated in February 2011, but the consultant worked for the city under several other contractual arrangements for the power department before December 2010.

<sup>10</sup> Our analysis of payment data obtained from the city's ERP system is as of November 25, 2011. However, since this contract was still active as of March 2012, the contractor continued to receive additional payments through at least March 2012 and has been paid more than the amount shown in Table 9 on page 49.

**Table 9**  
**City of Vernon's Total Expenditures for Selected Contractors and Vendors**

CONTRACTOR/VENDOR NAME	CONTRACT TYPE	PAYMENTS BY FISCAL YEAR										TOTALS
		2005-06	2006-07	2007-08	2008-09	2009-10	2010-11	2011-12*	TOTALS			
American Electric Power	Energy	\$14,091,300	\$14,091,300	\$14,137,200	\$10,945,380	\$6,600,500	\$3,841,860	-	\$63,707,540			
BLX Group LLC	Consulting	208,260	774,121	3,647,200	1,930,262	1,960,401	1,339,377	\$823,065	10,682,686			
Citigroup Energy, Inc. †‡	Energy	-	5,326,441	21,248,848	46,779,978	28,113,699	23,629,926	2,613,291	127,712,183			
General Pump Company, Inc.	Services	33,951	51,445	67,545	102,418	226,487	15,001	197,956	694,803			
Gursey, Schneider & Co. LLP	Consulting	1,800,173	1,917,637	2,037,017	567,458	252,680	157,205	-	6,732,170			
Hansolo Building Services	Services	458	-	322,798	3,943	-	-	-	327,199			
J. D. Hicks & Associates	Services	97	1,738,523	2,224,309	1,506,293	569,151	115,384	-	6,153,757			
Lake Street Associates, Inc.	Consulting	162,500	150,000	165,000	210,000	87,500	-	-	775,000			
Latham & Watkins LLP	Legal	636,250	488,841	4,613,986	3,592,987	4,635,345	4,308,734	4,355,221	22,631,364			
Law Offices of Eric T. Fresch, Ltd.	Legal	18,033	940,905	1,288,868	1,152,271	870,142	913,416	237,353	5,420,988			
Michael B. Montgomery	Legal	-	-	-	-	-	300,465	100,672	401,137			
Nevada Renewable Power	Consulting	-	2,900	19,960	152,956	329,712	259,248	-	764,776			
Nielsen, Merksamer, Parrinello, Mueller & Naylor, LLP	Services	-	-	-	-	-	916,979	534,738	1,451,717			
Pat Fresch	Services	-	-	-	52,437	142,538	128,688	54,875	378,538			
Petrelli Electric, Inc.	Services	-	-	8,321,916	9,971,499	8,740,846	8,888,255	4,743,660	40,666,176			
Port Canaveral Power Consultants, Inc.	Consulting	11,156	190,508	297,902	333,611	363,230	320,102	161,898	1,678,407			
Project Labor Group, Inc.	Services	-	1,952,932	2,514,277	726,691	-	-	-	5,193,900			
Rhino Construction Services	Services	-	-	-	11,225	5,987	506,509	55,180	578,901			
Richards, Watson & Gershon	Legal	-	-	-	-	978,710	1,031,762	102,068	2,112,540			
Sadler Strategic Media, Inc.	Consulting	-	-	-	-	-	549,647	452,498	1,002,145			
Salt River Project	Energy	3,702,468	4,821,916	11,644,111	7,654,984	1,884,455	95,908	-	29,803,842			
Tara Energy Inc.	Consulting	-	-	-	-	177,899	64,200	-	242,099			
Trico Construction †	Consulting/Services	-	2,982,934	3,260,332	1,072,341	458,099	107,688	-	7,881,394			

Source: California State Auditor's analysis of data obtained from the City of Vernon's enterprise resource planning system, financial management module.

\* Expenditures for fiscal year 2011-12 include only those payments recorded between July 1, 2011, and November 25, 2011.

† We tested two contracts with this contractor.

‡ Payments in this table do not include \$423 million prepayment to Citigroup Energy, Inc. for a 15-year supply of natural gas.

In addition to the previous example, we found other instances in which the city approved and paid invoices that did not include sufficient details describing the work performed. Specifically, for invoices paid on 10 of the 25 contracts we reviewed—including three contracts that were active as of March 2012—neither the contract managers nor the finance department staff required sufficient supporting documentation for approval and payment of the invoices. As an example, we reviewed four invoices for Nevada Renewable Power, the consultant that worked for the redevelopment agency discussed previously and found that all four included only brief descriptions of tasks that the consultant performed, such as “work on renewable projects” and “meetings with counsel on power pooling arrangements.” However, the invoices did not include sufficient information to describe the consultant’s progress toward the development and implementation of alternative renewable energy resources. The city paid the contractor’s invoices, which ranged from \$26,000 to more than \$31,000 per month for the four invoices we reviewed. In another example of insufficient invoice detail, the city council approved a resolution in November 2004 to contract with Lake Street Associates, Inc. for industrial real estate services and agreed to pay the consultant on a monthly basis without any required invoices. Because no invoices were required for payment, it is unclear what this consultant accomplished. When invoices are not required or do not include sufficient detail explaining the services provided, the city lacks an effective way to verify that the services received are consistent with the terms of the contract and that the contractor’s charges are appropriate.

The selection of contracts we reviewed included contracts with various outside law firms that advised the city on a variety of matters. We acknowledge that legal services are often unique or specialized. Nonetheless, we would expect the city to manage these outside legal services effectively. We reviewed selected invoices from one of the three active agreements that the city has with Latham & Watkins LLP, and found that the invoices the city paid lacked the detail necessary to allow the city to monitor the work performed. In one notable example, the June 2011 invoice from this law firm included more than \$530,000 in charges described only as “review of city administrative matters.” Beneath that heading, the invoice listed the total hours charged for the month by each attorney and staff member but contained no further detail or description of the work they performed. From July 2005 through November 2011, the city has paid this law firm more than \$22.6 million. Regardless of the specialization associated with these services, we would still expect a public entity to closely monitor the services provided by requiring sufficiently detailed invoices.

***Invoices from one law firm that we reviewed showed that its June 2011 invoice included more than \$530,000 in charges described only as “review of city administrative matters” with no further detail of the work performed.***

The city lacks policies and procedures requiring contracts to have a sufficiently developed scope of work and clearly described deliverables, or to require sufficiently detailed invoices, to verify that the services are received and are consistent with the scope of work and required deliverables. According to the city's finance director, who signed his approval on many of the invoices we reviewed, it is not his role to review or question invoices after they are approved by the executive overseeing each department. Because neither the contract managers nor the finance department are providing an appropriate review of the sufficiency of documentation before issuing a payment, the city risks making payments for services that are inconsistent with the original contract or that were not received. Moreover, given the fiscal constraints facing the city, it is imperative that its staff, particularly those in its finance department, ensure that all contractors' invoices are valid before approving them for payment.

#### ***Competitive Bidding Was Rarely Used in the Contracts We Reviewed***

The city rarely used a competitive bidding process to award the contracts we reviewed. Competitive bidding is generally favored in the context of public contracting, subject to various exceptions such as when the dollar value of a contract is so low that competitive bidding would be inefficient, when there is a compelling public safety need that calls for immediate acquisition of the goods or services, or when the service needed is so specialized that only one provider can fill the need. As previously shown in Table 8, we reviewed the bidding process for 12 contracts and found that the city did not use a competitive bidding process for nine of the contracts. For example, the city awarded one contract in January 2009 for \$62.50 per hour and up to 40 hours per week,<sup>11</sup> to Pat Fresch, a consultant hired to provide sales and customer relations services for the city's gas department. Rather than seeking competitive bids for this contract, which would have allowed the city to compare the cost and experience of various consultants that may have responded, the resolution approving the contract states that the city council determined that awarding the contract to this consultant was necessary and in the public interest. However, the resolution and accompanying documentation do not include an explanation for the city council's determination. Moreover, because the consultant was a relative of the individual who was the city administrator at the time, the city council's decision gives the appearance of favoritism in the contract award. In May 2012

***We reviewed the bidding process for 12 contracts and found that the city did not use a competitive bidding process for nine of the contracts.***

<sup>11</sup> If the consultant works 40 hours per week and 52 weeks per year at the hourly rate of \$62.50, this equates to an annual contract maximum of \$130,000.

*With no evidence of rebidding, the city extended a real estate consulting contract four times between November 2005 and November 2008 before letting it expire one year later.*

the power department director terminated this contract effective June 8, 2012. Over an approximate three-year period, the city paid this consultant \$379,000.<sup>12</sup>

In another instance, the city council approved a resolution in November 2004 to contract with Lake Street Associates, Inc. for assisting the city in the acquisition and sale of industrial real estate, again justifying the contract by stating that it was in the public interest and a necessity to approve this consulting agreement. However, just as in the earlier example, the city council did not explain or document a reason for not putting the contract up for bid. With no evidence of rebidding, the city then extended the real estate consulting contract four times between November 2004 and November 2008 before letting it expire in November 2009. The city also increased the contract's value from \$150,000 to \$210,000 per year and, without requiring any invoices, paid this consultant a total of \$775,000 in fiscal years 2005–06 through 2009–10.

Finally, we reviewed a contract awarded to General Pump Consulting, Inc. for the rehabilitation of an industrial well that the city council awarded using a competitive bidding process that generally followed best practices, except that the city did not inform potential vendors as to how it would score their bid proposals. In this instance, the director of the city's Community Services and Water Departments (community services director) said his departments had worked with both potential vendors in the past and selected one of them because the vendor had the lowest cost and because the city believed the vendor had worked in a more diligent and professional manner than the other vendor on past city projects. Following our review of this contract, the community services director provided us with a draft copy of a bid proposal scoring sheet that he stated will be included in the next contract his department offers for bid.

The provisions of the Vernon City Code (city code) that were in effect during our period of review authorized purchases and contracts for supplies, services, equipment, and the sale of real property through a competitive process using, among other things, three bids. However, these provisions were not mandatory, and other related provisions of the city code authorized a noncompetitive process based on the city's purchasing agent's finding of public interest and necessity to do so. Moreover, the city has not defined the circumstances required for a determination that a purchase or contract is in the public interest and a necessity.

<sup>12</sup> This contract began in January 2009, and our analysis of payment data obtained from the city's ERP system is as of November 25, 2011. However, since this contract was still active as of March 2012, the contractor continued to receive additional payments through at least March 2012 and has been paid more than the amount shown in Table 9 on page 49.



Without a required competitive bidding process and clearly defined criteria for when avoiding competitive bidding is appropriate, the city is not ensuring that it receives the best price for the services it purchases by promoting competition.

### ***The City Intends to Implement Policies to Address Contracting Weaknesses***

As shown in the text box, the city plans to take a number of steps to reform its contracting practices, including certain issues that we observed. In November 2011 the voters approved an amendment to the city charter requiring the city to establish a process for open and competitive bidding on service contracts. In response to the voters' approval to amend the charter, the city stated that it planned to adopt an ordinance establishing a competitive bidding process for service contracts by early April 2012, but the city administrator stated that the city was still working on this ordinance as of May 2012. Further, the changes made to the charter require that this competitive process apply to services but not to purchases of goods. The provisions of the city code that currently allow for noncompetitive purchasing based on a finding of public interest and necessity, if not repealed, may still serve as a way to avoid a competitive process.

In response to its independent ethics adviser's report, the city also stated that it will address contract issues, including ensuring that its contracts have expenditure limits and ending service dates, in a comprehensive contract policy document that it intends to present to the city council in July 2012 for its review and approval. Establishing policies to govern its contracting process will be a positive step toward reform, but for these policies to be effective, the city needs to ensure that staff both implement and follow these policies and that it also applies these policies to currently active contracts.

#### **Planned Contracting Reforms**

- Adopt a policy of reviewing all city contracts and amending them, as necessary, to impose an end date and expenditure limit.
- Adopt a policy to review and rebid all professional services contracts at least once every three years.
- Adopt a policy of training lead staff on professional services contracts, especially for legal services, to negotiate for the best rates or rates similar to those provided to other government agencies.
- Adopt a policy amendment requiring sign-off of invoices for professional services by the initiating department.
- Prohibit rate increases during the term of a contract as a general practice. Identify contracts that permit rate increases and identify exceptions, where necessary. Tie rate increases in future contracts to indexes.
- Review all consultant/contractor contracts and ensure compliance with city contractor requirements. For contracts that do not meet the criteria, transfer the work to a city employee or modify the status of the contractor to that of a city employee.

*Source: City of Vernon: Good Governance Reform Implementation Matrix, Ongoing Reform Measures, January 2012.*

### **Inadequate Controls Over Certain Other Expenses Expose the City to Unnecessary Risk**

The city's inadequate policies and procedures and lack of sufficient reviews of expenditures related to credit cards and travel increase the risk that abuse could occur and remain undetected. For example, the city has weak controls in place to review the appropriateness of credit card charges, which for the three months

we reviewed during fiscal year 2011–12 ranged between \$9,200 and \$18,500 each month. As of May 2012 the city had a total of 13 credit cards assigned to its executives and certain other managers, most of which have a revolving credit limit of \$10,000 each.<sup>13</sup> We observed that credit cards are typically used for expenses such as travel, meals, and office supplies.

According to the finance director, the executives are responsible for approving credit card statements, which include their staff's transactions as well as their own. He noted that before paying the city's credit card bill each month, the finance department ensures that executives provide receipts for their charges, but he said that the finance department is not responsible for questioning the appropriateness of credit card charges. Rather, according to the finance director, the ultimate approval of credit card payments is done by the city council when it approves a summary of all city payments at regular city council meetings.

Although the city council makes the final approval of payments, we believe it is unreasonable to expect council members to have knowledge of and to perform a detailed review of each executive's credit card charges for appropriateness. Instead, we would expect the city to establish internal controls that include specifying appropriate uses of city credit cards as well as a review and approval of credit card statements by someone other than the cardholder. These procedures would help identify concerns and problems before they reach the city council.

In addition, we noted that the city's policy for travel and expense reimbursements, which it adopted in November 2011, could be strengthened to better control costs and avoid the potential for abuse. The city's policy applies to both the city council and staff. The policy establishes dollar limits for meals while traveling, but the policy is vague concerning whether employees can exceed these limits if a receipt is provided. Also, the policy does not place a dollar limit on the cost of hotel accommodations, but instead states that employees should choose reasonably priced accommodations based on the travel location and that they should select government lodging rates when available. Lacking limits on travel costs, the city leaves itself open to the types of abuses that have occurred in the past, when former city officials took trips and claimed reimbursement for excessive expenses for hotels and meals.

***Lacking limits on travel costs, the city leaves itself open to the types of abuses that have occurred in the past, when former city officials took trips and claimed reimbursement for excessive expenses for hotels and meals.***

<sup>13</sup> Of the 13 managers, 12 have a revolving credit limit of \$10,000 each, while the remaining manager has a revolving credit limit of \$5,000.

### **The City Did Not Always Ensure Compliance With Its Conflict Code Regarding Financial Disclosure**

The reform act is the central conflict-of-interest law governing the conduct of public officials in California. The act declares that public officials should perform their duties in an impartial manner, free from bias caused by their financial interests. The reform act requires each government agency, including a city such as Vernon, to adopt a conflict code that includes a list of designated positions that must file statements of economic interests annually and on assuming or leaving office. The city's conflict-of-interest policy, adopted in October 2010, states that with respect to consultants that do not fill a designated position, the city administrator shall determine in writing if a particular consultant performs a range of duties requiring disclosure under this conflict code.

Although we found that the city is generally ensuring that individuals required to file statements of economic interests under its conflict code do so, we noted instances in which they did not. Specifically, our review of selected leadership positions for filing years 2005 through 2010 found a few instances in which individuals did not file their required forms. For example, the city did not have statements of economic interests for the individuals in its city clerk position until 2010. However, for the most recent year completed at the time of our review—calendar year 2010—we noted that the city ensured that the executives we reviewed filed the required statements.

In addition to requiring executives to file statements of economic interests, the city's conflict code requires that the city determine whether consultants need to file these statements, based on the duties they perform. The city administrator's written determination must include a description of the consultant's duties and a statement of the disclosure required. Under the city's conflict code, a copy of that determination must be filed with the city clerk and a second copy forwarded to the city council. However, our review found that the city generally has not required its consultants to file statements of economic interests, and the city administrator has not made the required written determination of whether each consultant performs a range of duties requiring disclosure. The city uses several consultants to provide it with advice on significant financial transactions, such as bond issues, city financing, and the purchase of assets, and we believe the city should have considered whether or not they needed to file statements of economic interests.

For example, the city has used one consulting firm for financial advisory and consulting services since 2003. The city's most recent contract with this consulting firm, approved by the city council in November 2010, specifies, among other things, that the consulting

*Although we found the city is generally ensuring that individuals required to file statements of economic interests under its conflict code do so, we noted instances in which they did not.*

firm agrees to provide investment management services for all city funds, provide ongoing advice and evaluation of investment banking recommendations relating to capital market financing, and consult with and advise the city concerning financing, hedging, and asset management opportunities, including the advisability of derivative usage and structured investment product services. The terms of the contract provide for payment to the firm based on hourly fees for its staff, a specified percentage of the funds managed, and a specified percentage of the principal amount for the execution of any capital, market, derivative, or other similar transaction for which the consulting firm provides advisory services. Given the description of services, we would expect the city to have determined that this consulting firm meets the criteria for disclosure—meaning that the individuals working for the city under this consulting contract should have filed annual statements of economic interests. Because the city administrator does not make written determinations of whether its consultants perform duties requiring disclosure, the consultants who should be disclosing their financial interests are not doing so, and the public is not notified of those interests. Further, without these financial disclosures by consultants, the city and the public may be unaware if consultants are acting in their own interests rather than the best interest of the city.

### Recommendations

To better control contract expenditures and ensure that it receives the best value for the services it purchases, the city should:

- Require that all city contracts be entered into its ERP system so that the contract managers and the city can more efficiently and effectively track the city's contract expenditures. The city should also begin using the ERP system's uniquely assigned contract numbers for tracking and generating a list of contracts.
- Require all contracts to have expenditure limits and starting and ending dates for services performed.
- Require contract managers to use logs to monitor payments and the contractor's progress toward completion of required deliverables.
- Require that all contracts contain a well-defined scope of work and deliverables that a sufficiently detailed invoice can be measured against.
- Ensure that contracts include language requiring contractors to provide invoices with sufficient detail so that contract managers can determine whether the services provided are consistent with the scope of work. Further, it should also require the finance

department to review invoices to identify those that lack sufficient detail and return such invoices to the appropriate contract manager to obtain a revised invoice that is sufficiently detailed.

- Continue its efforts to develop and implement policies and procedures for a competitive bidding process, including clearly defining the circumstances under which forgoing competitive bidding is appropriate.

To the extent that the city implements policies that affect contracts, the city should also ensure that it reviews all current contracts and amends them, if necessary, to comply with newly established policies.

To improve its internal controls, better control costs, and prevent abuse from occurring, the city should:

- Require the finance department to review credit card expenditures for appropriateness.
- Revise its travel and expense reimbursement policy to be clear about the expenditure limits for meals, and add a limit for lodging accommodations.

To comply with the reform act, the city should ensure that the city administrator and city clerk are appropriately trained to administer its conflict code. Further, the city should continue to ensure that all city executives file statements of economic interests, as its conflict code requires. With regard to consultants, the city should review its existing contracts and have the city administrator determine which consultants should file statements of economic interests. The city should retain documentation of the city administrator's determinations and also forward them to the city council for review. Finally, the city should ensure that any consultants identified by the city administrator as needing to file statements submit the forms as soon as possible.

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## Chapter 3

### LACK OF SUFFICIENT REVENUE TO SUPPORT GENERAL FUND ACTIVITIES THREATENS THE CITY'S FINANCIAL STABILITY

#### Chapter Summary

For more than 20 years the City of Vernon (city) has operated its general fund at a deficit, and during the five fiscal years 2006–07 through 2010–11, significant increases in general government and public safety expenditures, its two largest cost categories, caused this deficit to increase to the highest levels of the 20-year period. The 49 percent increase in the city's general government expenditures over the past five years is partially attributable to significant increases in its spending on legal and professional services. Over the same period, the city's public safety expenditures increased by 29 percent for salaries and benefits, even though police staffing decreased during the last five years.

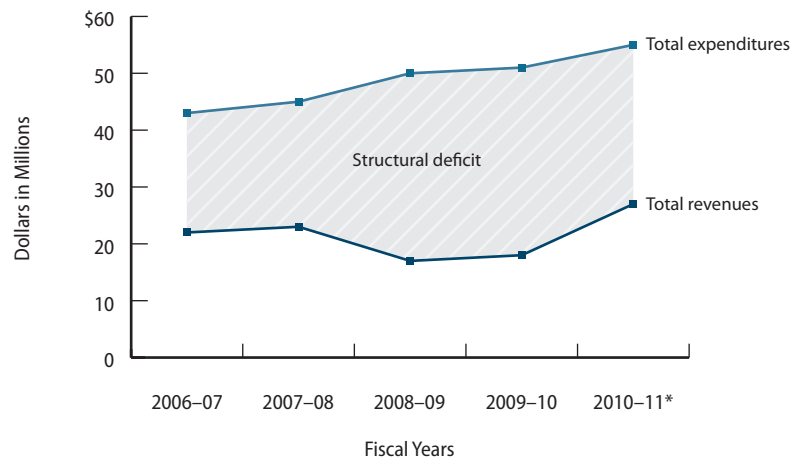
The city's current revenue structure for its general fund does not provide sufficient revenue to pay for the services that the general fund provides. The city has funded past general fund deficits through interfund transfers and loans, reserves, and through one-time revenues such as the sale of property. However, the city's continued and increasing reliance on other funds to cover its general fund deficits is now problematic because the funds once available from these sources have decreased. As a result, to address a projected general fund budget shortfall for fiscal year 2012–13, the city proposed a parcel tax to generate new revenues.

The city's proposed budget presented to the city council has not always contained the elements that are required by the charter. Additionally, the city's budget process lacks detail that would improve the public's understanding of the city's financial challenges. For example, the city displays its budget to the public in an aggregate fashion, making it difficult to clearly see the general fund deficit. The city's budget document also does not discuss the city's efforts to address the general fund deficit. Finally, unlike other cities, the city lacks documented policies for developing and managing its budget. Implementing recommended best practices would be a positive step toward improving the city's budgeting policies.

### Over the Past Five Years the City's General Fund Structural Deficit Has Grown

The manner in which the city has designed the current revenue structure for its general fund does not provide sufficient revenue to pay for the services that the general fund provides. For example, in fiscal year 2010–11 the general fund had revenues of \$27.9 million to cover expenditures of \$55.9 million, leaving a deficit of \$28 million. This revenue structure, which involves a fundamental imbalance of general fund revenues and expenditures, produces what is known as a structural deficit. The city's general fund has operated at a structural deficit for more than 20 years, and over the last five years it has grown to its highest level—with deficits ranging between \$21 million and \$33 million each year. As shown in Figure 3, the city's general fund structural deficit is significant.

**Figure 3**  
City of Vernon's General Fund Revenues and Expenditures  
Fiscal Years 2006–07 Through 2010–11



Sources: City of Vernon's audited financial statements.

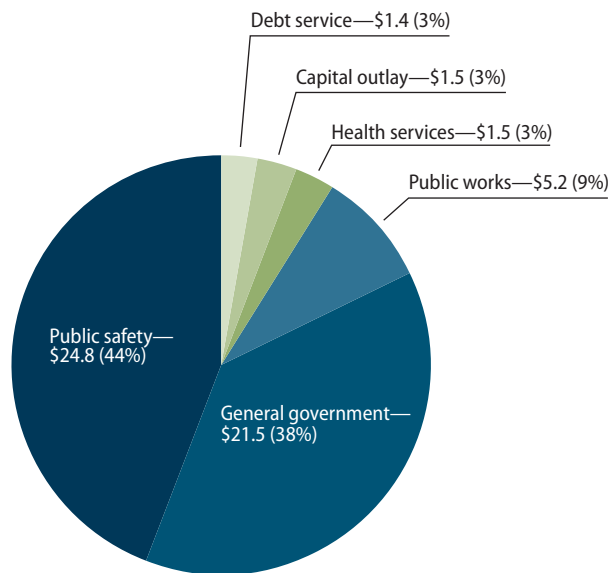
\* In fiscal year 2010–11 the parcel tax fund and hazardous waste fund were consolidated with the general fund, which increased general fund revenues by \$8.7 million and \$589,000, respectively.

During fiscal years 2006–07 through 2010–11, annual expenditures grew from \$43 million to \$55.9 million. This increase occurred for several reasons. Expenditures for public safety—primarily the city's fire and police services—which in fiscal year 2011–12 accounted for 44 percent of general fund spending, rose by 29 percent, from \$19.2 million to \$24.8 million, during this five-year period. These increases were due largely to increased costs of salaries and benefits for police and fire staff, despite reductions in police staffing. General government expenditures, which include basic



administrative and management functions of the city, such as the city council, city administrator, city attorney, finance, and information technology, accounted for 38 percent, or \$21.5 million, of the city’s general fund expenditures in fiscal year 2010–11. During the five-year period, general government expenditures rose by 49 percent, from \$14.5 million to \$21.5 million. Although the increase can be attributed in part to increases in employee benefit costs, such as insurance premiums, the increase in fiscal year 2010–11 in particular was related more to the city’s increased spending on legal and professional services associated with its efforts to combat disincorporation. As shown in Figure 4, the city spent more than 80 percent of its general fund budget on public safety and general government expenditures in fiscal year 2010–11. Changes in the other three largest categories—public works, health services, and capital outlay—were much less significant during the past five years.

**Figure 4**  
**City of Vernon’s General Fund Expenditures**  
**Fiscal Year 2010–11**  
**(Dollars in Millions)**



Sources: City of Vernon’s fiscal year 2010–11 audited financial statements.

In fiscal year 2010–11, the city consolidated its parcel tax and hazardous waste funds with its general fund, which nearly doubled tax revenues to the general fund. The parcel tax fund is used to account for proceeds from the city’s tax on warehouses, truck and freight terminals, railroad facilities, and other distribution facilities. The proceeds of this tax were originally restricted for

*As an industrial municipality with a population of only 112 in 2010, the city does not receive the same tax revenues that cities with large commercial and residential populations receive.*

construction, improvement, and maintenance of streets and bridges and other public rights-of-way, including land acquisition. However, during fiscal year 2010–11 voters adopted an ordinance to expand the use to include police and fire protection services, enabling the city to consolidate the parcel tax fund with the general fund. This consolidation resulted in an additional \$8.7 million in general fund revenue for fiscal year 2010–11. Prior to this change, the city's tax revenue, primarily from its business, sales, and property taxes, contributed an average of \$9 million per year to the general fund.

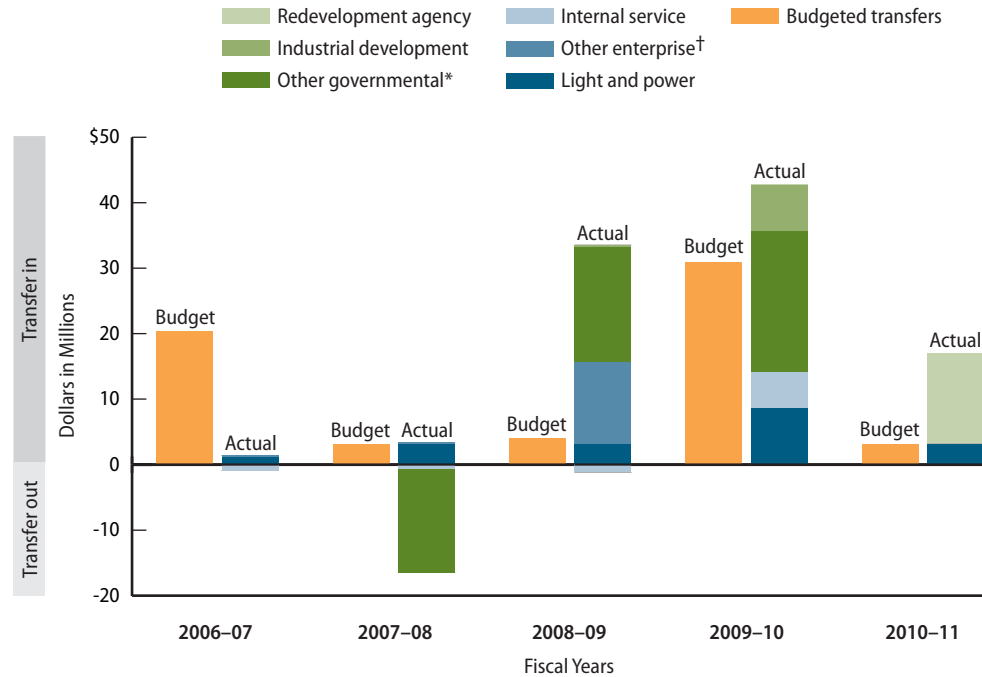
As an industrial municipality, the city does not receive the same level of tax revenues that cities with large commercial and residential populations receive. For example, because the city has no hotels, it receives no occupancy taxes, which many other cities do receive. In addition, the state allocations that it receives from the vehicle license fee and the gas tax are based, in part, on population. With a population of only 112 in 2010, the city receives a much smaller allocation of these revenues than surrounding cities do.

The general fund also receives revenues from certain administrative and overhead cost allocations to the light and power fund (power fund) and the water fund. In fiscal years 2006–07 and 2007–08, these allocations were close to \$9 million, mostly paid from the power fund, but they have since decreased to around \$4 million due to changes in the city's cost allocation method. The general fund's remaining revenues came primarily from special assessments, state and federal grants, licenses and permits, and other sources.

#### ***One-Time Revenues and Some Budget Cuts Made Up for Past General Fund Deficits***

To address past structural deficits and to fund its general fund operations, the city has relied on general fund reserves and one-time revenues, such as the sale of property, as well as transfers from other city funds. Figure 5 shows the general fund budget and actual transfer activity in fiscal years 2006–07 through 2010–11, according to the city's audited financial statements. In fiscal year 2006–07 the city's actual general fund transfers in amounted to a little over \$500,000, but the general fund received \$18.6 million from property sales, which covered all but \$1.5 million of that fiscal year's deficit. In fiscal year 2007–08 the general fund made actual net transfers out of \$13.1 million. These transfers contributed to a \$26.8 million deficit that the general fund covered through property sales of \$7.5 million, with the rest being made up by its reserves.

**Figure 5**  
**City of Vernon's General Fund Transfers (Budget and Actual)**  
**Fiscal Years 2006–07 Through 2010–11**



Sources: City of Vernon's audited financial statements.

Note: Amounts shown are the net transfer to or from the city's general fund.

\* Other governmental transfers are primarily from the parcel tax fund, which consolidated with the general fund in fiscal year 2010–11.

† In fiscal year 2008–09 the water fund made a \$12.3 million operating transfer to the general fund.

For the next three fiscal years, the general fund received large transfers in consisting primarily of reimbursements for capital improvements and public works projects from other city funds, although some transfers in were made to support the general fund operations. The funds that provided these transfers have changed over the years, due in part to fund consolidations. For example, in fiscal years 2008–09 and 2009–10 the city received transfers from the parcel tax fund of \$17.6 million and \$21.7 million, respectively, to reimburse the general fund for prior years' expenditures. However, as shown in Figure 5, the amount of transfers in to the general fund were largely unanticipated in the budgets for those years, particularly for fiscal year 2008–09.

As discussed in the previous section, in fiscal year 2010–11 the parcel tax fund consolidated with the general fund. Even with these additional revenues, the city required transfers from both the Light & Power Department (power department) and the redevelopment agency to support the general fund. The city transferred \$13.8 million from its redevelopment agency, identifying the transfer as a reimbursement to the general fund for previous

***The city is currently forecasting that annual transfers from the power fund will be about \$15 million, including the in-lieu tax and overhead allocation.***

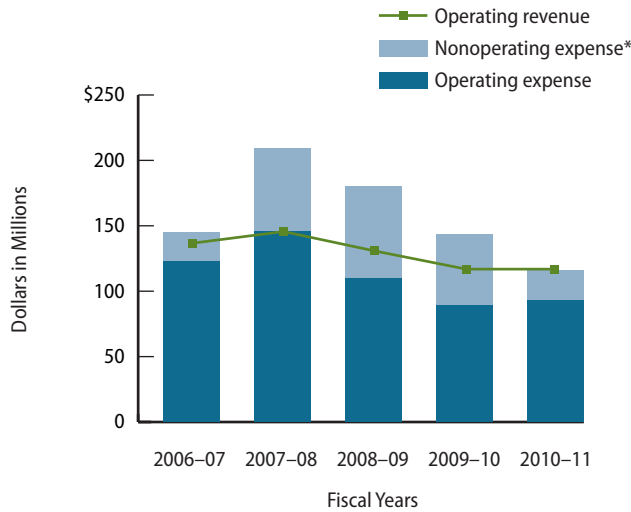
costs that the general fund had incurred for public works projects dating back to 1996. The city also received \$3 million from the power department for the in-lieu-of-franchise tax (in-lieu tax)—a 3 percent surcharge on electric rates. This tax was established by the city and is collected by the power department on behalf of the general fund.

In addition, the general fund has relied on loans from the power fund to support operations. As of June 30, 2011, the loan balance was \$25 million; earlier in the year the general fund repaid \$20 million in the form of environmental emission credits. In December 2011, based on a recommendation from the city's financial auditors, the city council approved a resolution to adopt a plan to repay current and long-term loans owed by the general fund, gas fund, and water fund to the power fund within 15 months. According to the finance director, future transfers from the power fund will not have the expectation of repayment. The city is currently forecasting that annual transfers from the power fund will be about \$15 million, including the in-lieu tax and overhead allocation.

However, the power department is experiencing its own financial difficulties, with a 14 percent decline in operating revenue between fiscal years 2006–07 and 2010–11, due in part to declines in customer demand. Although, as shown in Figure 6, the department's revenues have been sufficient to cover its operating expenses, its high nonoperating expenses have caused the power department to experience losses in every year except fiscal year 2010–11. The power department's nonoperating expenses between fiscal years 2006–07 and 2010–11 were as high as \$70.5 million, due primarily to interest payments on debt obligations and interest rate swaps and decreases in the fair value of swap investments. We discuss the city's bond debt and interest rate swaps in Chapter 4 and Appendix B. As a result of these high nonoperating expenses, the power department had an overall net loss in four of the past five fiscal years.

The city has relied on power department revenues, in the form of loans and transfers to the general fund and other city funds, to support operations, and this reliance is expected to continue into the foreseeable future. As we discuss in the next chapter, changes in the costs to provide electricity, as well as its debt obligations, will pose a significant financial burden on the power department. The city's dependence on transfers from the power fund constricts the resources available to enable the power department to respond to changes in the industry, fluctuations in demand, and operational needs, and has resulted in electric rate increases that are not necessarily reflective of increases in the costs of providing electricity.

**Figure 6**  
**City of Vernon’s Light and Power Fund Operating Revenues Do Not Always Cover Its Expenses**  
**Fiscal Years 2006–07 Through 2010–11**



Sources: City of Vernon’s audited financial statements.

\* Nonoperating expenses are shown net of nonoperating revenues.

The legality of the transfer of operating revenue from the power fund to the general fund is somewhat uncertain due to pending litigation that does not directly involve the city. Proposition 26, which was approved by California voters in the November 2010 election, creates a presumption that a levy or charge imposed by a city is a tax—and therefore subject to approval by two-thirds of a city’s voters—unless it falls within certain exceptions. The most likely exception that would apply to these transfers involves a charge imposed for a specific government service as long as it does not exceed the “reasonable cost of providing the service.” Thus, if the city transfers to its general fund light and power revenues that exceed the direct amount needed to provide light and power services, the transfer could be characterized as a tax, unless the city can demonstrate that the funds deposited are calculated to reimburse the general fund for expenses of the city government that are appropriately charged to the power fund and come within the reasonable cost of providing the service. We note that such transfers are a common practice among many municipalities. However, this sort of transfer is currently the subject of litigation, and the ultimate outcome in this litigation may affect the city’s future ability to continue to transfer light and power revenue to the general fund.

In recent years the city has attempted to cut general fund spending, but these efforts did not significantly reduce the general fund’s structural deficit. In March 2010 the city council passed a resolution

***Despite the city's efforts, actual spending in fiscal year 2010–11 exceeded the budget by \$14.7 million and was \$2.2 million higher than the general fund's actual expenditures for the preceding fiscal year.***

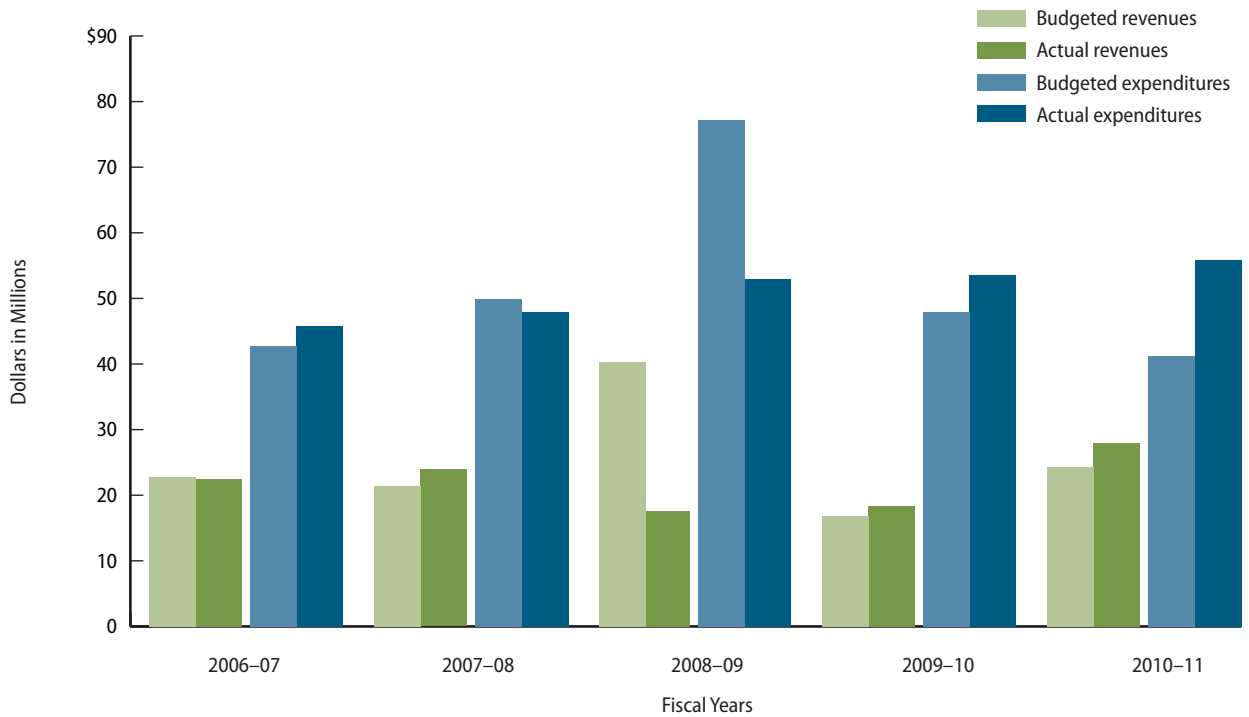
declaring that general fund expenses must equal general fund revenues. In two resolutions that followed, the council authorized the city administrator to make cuts to expenditures and staffing in all city departments, including police and fire, for fiscal year 2010–11. As a result, the city reduced its employee benefits by limiting medical and life insurance benefits to employees only, rather than also paying for dependent coverage, and by requiring most employees to pay the member contribution for retirement, whereas previously the city paid both the employer and the member portion. These two changes were projected to reduce fiscal year 2010–11 general fund spending by \$5 million, and the city expected to reduce spending by an additional \$5 million through staffing cuts. The city's efforts to reduce spending for fiscal year 2010–11 resulted in a 14 percent total reduction in the budgeted general fund expenditures compared to the prior year's budget.

Despite the city's efforts, however, actual spending in fiscal year 2010–11 exceeded the budget by \$14.7 million and was \$2.2 million higher than the general fund's actual expenditures in fiscal year 2009–10. The excess expenditures over the budget were primarily due to legal and professional services to combat the disincorporation effort. However, as shown in Figure 7, the city overspent its general fund budget in three of the past five fiscal years. The overspending occurred primarily in general government and public safety. Public safety expenditures exceeded the budgeted amount in every year except fiscal year 2008–09, with the largest overages attributable to salaries and benefit costs. But as noted in Chapter 2, the city's weak contracting practices, including a lack of expenditure limits on contracts, may also have contributed to the city's overspending during the past several years. Overspending the general fund budget further exacerbates the structural deficit and could send a message to the public that the city is not committed to improving its financial situation by operating within its means.

### ***The Projected General Fund Structural Deficit Has Worsened for Fiscal Year 2012–13***

Despite the city council's resolution to balance general fund expenses against revenues, the city's continued and increasing reliance on other funds to cover the costs of the general fund has recently become problematic. As we describe in the Introduction, in June 2011 state legislation eliminated the redevelopment program, and therefore there are no redevelopment funds available from this program for transfer to the general fund in fiscal year 2012–13. However, certain property tax revenues generated within what was previously the redevelopment zone will be available to the city. Additionally, as a result of declining revenues for the power department, the amounts available for transfer to the general fund have decreased.

**Figure 7**  
**City of Vernon's General Fund Revenues and Expenditures (Budget and Actual)**  
**Fiscal Years 2006–07 Through 2010–11**



Sources: City of Vernon's audited financial statements.

Further, as one of the reform measures it adopted in its efforts to avoid dissolution, the city agreed to establish a \$50 million Environmental and Community Benefit Fund (community benefit fund) and to commit \$10 million for two purposes—\$5 million to assist programs at the Hazard Park Amory Youth Center in Boyle Heights and \$5 million to assist the renovation of Salt Lake Park in Huntington Park. According to an August 2011 city council resolution, the city intends to allocate \$5 million annually for 10 years to the community benefit fund. However, the finance director indicated that the city has not budgeted for the additional \$10 million for the youth center and the park, and that there is no required timeline to fund these commitments.

In addition, according to preliminary figures from a February 2012 city tax presentation, the city has depleted its general fund reserves and has committed to setting aside \$4 million annually to rebuild its reserves. This reserve commitment, combined with the \$5 million community benefit fund obligation, means that the city has earmarked \$9 million as either a new spending commitment or for use in building its reserves for fiscal year 2012–13.

*Although the increased and new parcel tax, if approved, would offset the \$9 million in new spending commitments from the general fund, it would not be sufficient to significantly reduce the general fund's dependence on transfers and one-time revenues.*

The city estimates that the general fund will need \$60 million for fiscal year 2012–13 to maintain public services at their current level and to pay for these new obligations, but the general fund has projected revenues of only \$29 million, leaving an estimated deficit of \$31 million. Since the city's budget for fiscal year 2012–13 was not yet available, we were unable to verify whether or not these preliminary figures were finalized in the budget.

Finally, in February 2012 the city announced a plan to generate additional general fund revenues through an increased and a new parcel tax so that it could maintain the same level of public services. The city proposes increasing its current warehouse parcel tax by 2 cents per square foot and creating a new parcel tax of 23 cents per square foot on properties that were not previously subject to the warehouse parcel tax. If approved by voters, the parcel tax measure is expected to bring in \$16 million annually and would expire in 10 years. This \$16 million in increased and new parcel taxes, combined with projected power department transfers totaling \$15 million, is expected to be sufficient to cover the fiscal year 2012–13 budget deficit. However, although the increased and new parcel tax, if approved, would offset the \$9 million in new spending commitments from the general fund, it would not be sufficient to significantly reduce the general fund's dependence on transfers and one-time revenues.

### ***Increased Transparency and Formal Policies Would Allow the Public to Better Understand the City's Budget Problems***

Municipal budgets serve a number of important functions. For many cities the budget has evolved from a simple projection of future revenues and expenditures to a more sophisticated plan to allocate resources to services and programs based on a city's goals and priorities and to communicate the city's financial condition to decision makers and the public. The City of Vernon's budget, as presented to the public, remains a basic forecast of revenues and expenditures and provides limited value in understanding the city's financial condition.

The city's charter requires that a proposed budget contain certain elements, but the city does not always ensure that these elements are present in the budget given to the city council. For example, the charter requires that the proposed budget contain a comparison of the current fiscal year expenditures with proposed expenditures for the ensuing fiscal year, and reasons for any proposed increase or decrease. However, of the four budgets we reviewed, only two partially fulfilled this requirement. The two most recent budgets, for fiscal years 2010–11 and 2011–12, contain a comparison of current and prior year budgeted expenditures, but the reasons



for variances are not consistently provided, and we were unable to identify any consistent methodology for selecting items for explanation.

In another example, for fiscal years 2009–10 and 2010–11, the previous city administrator made a decision not to include capital outlay—funds used to acquire, maintain, or improve fixed assets such as land, facilities, or equipment—in the budget. Although there is some indication in the meeting minutes that the city administrator may later have provided the council with a proposed capital improvements fund allocation, it was not included as part of the proposed budget, as the city charter requires. Considering that general fund spending for capital outlay during these two fiscal years amounted to \$2.9 million and \$1.4 million, respectively, omitting this information made the budget incomplete.

Further, the approved budget, available to the public on the city’s Web site, lacks basic narrative information that would assist a reader in understanding the city’s financial condition. The Government Finance Officers Association (GFOA)—a professional association of state and local finance officers dedicated to the sound management of government financial resources—recommends that budgets serve as more than a simple presentation of forecast revenues and expenditures, as indicated in the text box. For example, the GFOA recommends that the budget be a tool to facilitate public study and should effectively communicate key economic and fiscal issues to policy makers and the public. However, the city’s current budget does not do this, nor does it provide the level of budget information included in the budgets of other cities we reviewed.

**The Government Finance Officers Association (GFOA) recommends that the government’s budget should serve as the following:**

1. **Policy document.** The budget should address policy issues such as tax policy, funding priorities, and “macro problems” facing the community.
2. **Financial plan.** The budget should show the source and use of resources. It should demonstrate the ability to pay for the services that it funds—not just this year, but into the foreseeable future.
3. **Operations guide.** The budget should show how the entity is organized to deliver services, describe its programs and activities, and provide measures on its effectiveness and efficiency.
4. **Communications tool.** The budget should be prepared in a way that facilitates public study and effectively communicates key economic and fiscal issues to policy makers and the public.

Source: *Financial Management Checklists for Elected Officials*, GFOA publications.

The city’s budget is presented showing estimated expenditures and estimated revenues aggregated into totals representing all of the city’s funds. Such a presentation shows that, overall, the city’s revenues are sufficient to cover expenditures. However, it masks any budget imbalances at the fund level—particularly the structural deficit in the general fund discussed in the previous section—because the estimated expenditures and revenues are not shown for each fund.

For example, for fiscal year 2011–12, the general fund’s structural deficit is projected to be \$28.3 million. However, this deficit is not readily apparent in the city’s budget and must be gleaned through

***The city's budget masks any budget imbalances at the fund level—particularly the structural deficit in the general fund—because the estimated expenditures and revenues are not shown for each fund.***

comparison of the exhibits in the separate documents presented. Specifically, the expenditure budget for fiscal year 2011–12 shows that the city expects to spend \$61.6 million from the general fund, while the separate exhibit of estimated revenues shows that the general fund is expected to collect \$51.1 million, a deficit of \$10.5 million. However, included in the \$51.1 million in revenues are transfers from other funds of \$17.8 million, so general fund expenditures will actually exceed revenues by \$28.3 million.

Since fiscal year 2009–10, the finance department has developed a one-page budget summary for the council that aligns fund revenues with expenditures and clearly shows the deficit, but this document is not included as part of the budget on the city's Web site. As part of the fiscal year 2012–13 budget process, in February 2012 the city communicated the general fund deficit to the public through presentations in a business development committee meeting and information on its Web site. These communications were to support the city's effort to balance its fiscal year 2012–13 budget through a proposed increased and new parcel tax, as discussed in the previous section. However, the city did not acknowledge in these communications that the budget deficit in the general fund was structural and had been ongoing.

We found other cities' budgets significantly more informative because they include information that facilitates public understanding of the budget environment and the issues and concerns facing the cities. For example, like Vernon, the cities of Irwindale, Burbank, and Pasadena experienced deficits in their fiscal year 2011–12 budgets. However, unlike Vernon, these other three cities produced budgets containing elements such as a budget message, a user guide, and summary information to enhance understanding for the average reader. The purpose of a budget message is to articulate the issues and priorities for the upcoming fiscal year and to provide a summary explanation of key choices and decisions made during the budget process, along with their ramifications. The budget message in Irwindale's fiscal year 2011–12 budget reports a projected operating deficit of \$2.3 million in its general fund and includes discussion of the reserve funds used to cover the deficit and the city's efforts to reduce operating costs to avoid future deficits. In the budget summary section, a table of revenues and expenditures by fund clearly shows the \$2.3 million general fund deficit. In contrast, Vernon's budget does not contain similar disclosures regarding the general fund deficit and efforts to address it, even though the city undertook significant efforts to reduce the deficit through staff and benefit reductions for fiscal year 2010–11. Although the city is not legally required to present budgets that are geared toward facilitating public understanding, doing more than is required by law would be beneficial given the city's goal to be more transparent to the public about the financial difficulties it is currently facing.

***Implementing Recommended Policies Would Be a Positive Step Toward Improved Budgeting and Transparency***

Unlike many other cities, the city lacks documented policies that govern how it is to develop and manage its budget. According to the city's finance director, the finance department began drafting budget and financial policies in 2008 or 2009, but its efforts never progressed because of the turnover in city administration as well as the need to deal with the financial crisis of the last few years. The GFOA advises that of all areas of government finance, budgeting requires the most guidance and that improving government budgeting is one of the biggest challenges currently facing local governments. The GFOA also emphasizes that budgeting should have a long-range perspective, and not be simply an exercise in balancing revenues and expenditures one year at a time. Its recommended budget practices encourage governments to consider the longer term consequences of their actions to ensure that the effects of budget decisions are understood over a multiyear planning horizon and to assess whether program and service levels can be sustained. The GFOA recommends that, at a minimum, cities establish and formally adopt policies in three areas—financial planning, revenues, and expenditures—to help frame resource allocation decisions. We evaluated the city against recommended GFOA budget policies and found that it followed or partially followed only four of the 10 recommended policies, as shown in Table 10 on the following page.

For example, the city does not have a financial policy to support long-range financial planning, nor does it have a long-term financial plan to help it assess the impact of financial decisions on the city as a whole and on the general fund in particular. Instead, the finance director stated that the city has done long-term projections for various purposes such as to include in bond official statements, to justify electric rate increases, and, more recently, to forecast revenue-generating scenarios to use in addressing the fiscal year 2012–13 budget deficit. Although these activities for the power department partially satisfy the GFOA's intent of long-range planning, the lack of a comprehensive long-term plan can lead to fiscal stress from certain pitfalls, some of which the city is currently experiencing, such as the need to support the general fund through transfers from other funds or a reliance on one-time revenues, such as selling off assets to finance day-to-day operations. The GFOA states that long-term financial planning, which incorporates feedback from all stakeholders—including the public and elected officials—helps overcome these pitfalls and, through the process of financial forecasting and analysis, can help governments devise strategies to achieve fiscal sustainability.

***The city does not have a financial policy to support long-range financial planning, nor does it have a long-term financial plan to help it assess the impact of financial decisions on the city as a whole and on the general fund in particular.***

**Table 10**  
**Comparison of Government Finance Officers Association’s Recommended Financial Policies With the City of Vernon’s Financial Policies and Practices**

RECOMMENDED FINANCIAL POLICY	CORRESPONDING CITY OF VERNON POLICY OR PRACTICE
<b>Financial Planning</b>	
<i>Balanced budget:</i> Define a balanced operating budget, make a commitment to a balanced budget, and provide for disclosure when significant deviation is planned or occurs.	<i>None.</i>
<i>Long-range planning:</i> Support a financial planning process that assesses the long-term financial implications of current and proposed operating and capital budgets, budget policies, cash management and investment policies, programs, and assumptions.	<i>Partial. The city has developed long-term plans for various purposes, primarily for the Light &amp; Power Department (power department), but has not developed or adopted a comprehensive long-term financial plan.</i>
<i>Asset inventory:</i> Inventory and assess the condition of all major capital assets.	<i>Followed. The Community Services and Water departments develop a five-year capital improvement plan and the power department develops three, five, and 10-year capital improvement plans.</i>
<b>Revenues</b>	
<i>Revenue diversification:</i> Encourage diversity of revenue sources to improve the ability to handle fluctuations in individual sources.	<i>None.</i>
<i>Fees and charges:</i> Specify the manner in which fees and charges are set and the extent to which they cover the services provided.	<i>None.</i>
<i>Use of one-time revenues:</i> Discourage the use of one-time revenues for ongoing expenditures.	<i>None.</i>
<i>Use of unpredictable revenues:</i> Specify how to manage the collection and use of major revenue sources that the entity considers unpredictable.	<i>None.</i>
<b>Expenditures</b>	
<i>Debt capacity, issuance, and management:</i> Specify appropriate uses for debt and identify the maximum amounts of debt and debt service outstanding at any given time.	<i>Partial. Asserts that bond covenants are sufficient.</i>
<i>Reserve or stabilization accounts:</i> Maintain prudent levels of financial resources to protect against temporary revenue shortfalls or unpredicted expenditure situations.	<i>Partial. Informal goal of a \$4 million general fund reserve.</i>
<i>Operating/capital expenditure accountability:</i> Periodically compare actual expenditures to budget and decide on actions to bring the budget into balance if necessary.	<i>None.</i>

Sources: Government Finance Officers Association, *Best Practice, Adoption of Financial Policies (Budget) 2001*, and discussions with City of Vernon finance department staff.

The GFOA also recommends that governments incorporate these policies into their budget document and publicize this and other important financial information on their Web sites. We observed that Burbank, Pasadena, and Los Angeles have established financial policies that are accessible to the public through their Web sites, through either their budget or a separate document. The policies we reviewed for these cities address generally each of the areas that the GFOA recommends.

In addition to failing to develop policies to govern its budget preparation, the city has not developed a centralized process for approving deviations from the budget. The city’s finance department is responsible for helping the city administrator prepare the budget, but the Vernon City Code (city code) places the city

administrator in charge of administering the budget. According to the city administrator, department executives are responsible for monitoring their own budgets, and they notify him if they are unable to stay within their budgets. However, department executives are not required to report to him periodically on the status of their budgets. Rather, he requires them to report only when budget overspending occurs. In response to our inquiries regarding how the city monitors the approved budget, the assistant finance director informed us that managers can access the budget in the city's enterprise resource planning system at any time, but he did not indicate that the finance department performs any centralized monitoring of the approved budget. Further, the assistant finance director said that the city's practice has been to not amend the budget when overspending occurs, because management was trying to identify where and why the variances were occurring. However, without a formal process to monitor and obtain approval for overspending the budget, the city is lacking an important control over its finances.

### **Recommendations**

To address the structural deficit in its general fund, the city should seek long-term solutions to balance the general fund's expenditures and revenues and lessen its reliance on transfers from other city funds. These solutions could include revenue increases, such as the proposed increased and new parcel tax, as well as looking for ways to reduce expenditures. Further, the city should clearly present the general fund structural deficit to the city council and the public in a budget that includes narrative and summary information to help users understand the city's budget process and its priorities and challenges, and that incorporates the elements for improved budgeting practices recommended by the GFOA.

To better guide its budget preparation and improve transparency, the city should develop budget policies, particularly for long-term planning, that incorporate the elements that the GFOA recommends and make these policies available to the public on its Web site. The city should also ensure that its budgets include the information required in the city code. Additionally, the city should improve the monitoring of expenditures against the approved budget by establishing a centralized process to regularly monitor and report to the city administrator and the city council on the status of the budget.

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## Chapter 4

### POORLY EXPLAINED PAST DECISIONS CONTINUE TO NEGATIVELY AFFECT THE LIGHT & POWER DEPARTMENT

#### Chapter Summary

The City of Vernon (city) lacks a policy to guide and provide transparency in its decisions to issue debt. Instead, the city considers the bond covenants in the bond official statements to be a sufficient debt policy. However, bond covenants are transactional and serve to protect bondholders. Additionally, for significant debt decisions we reviewed between 2004 and 2012, agenda documents show that the city council was provided with little to no information that summarized and explained the fiscal impact and potential risks associated with these decisions.

Between December 2004 and January 2012, the city issued more than \$1.3 billion in bond debt primarily from its Light & Power Department (power department). As of March 2012 the city had \$570.8 million in outstanding bond debt as well as two outstanding interest rate swaps for which it is obligated to make fixed interest payments. The city estimates that the annual payments for the bonds and swaps will be more than \$60 million over the next 10 years. Most of the outstanding debt was issued to fund activities of the power department. For example, \$388.1 million is related to bond debt issued to pay for the city's purchase of a 15-year supply of natural gas.

To make the annual payments on its power department bonds, the city pledged power department revenues. However, the power department has struggled to manage this debt burden while maintaining the competitive electric rates necessary to attract new businesses into the city. Based on the city's current electric rates, the power department is forecasting a deficit of \$24 million in the light and power fund (power fund) beginning in fiscal year 2013–14, which the city recognizes will require rate increases.

Our finance and energy expert's review of various energy-related transactions over the past several years indicated a lack of documentation to answer some of the questions surrounding these transactions, which raises concerns about the city's energy strategy. For example, the city sold its power plant shortly after completing its construction and less than two years after it purchased a 15-year supply of natural gas for the plant. Because the city used the proceeds from tax-exempt bonds to purchase the gas supply, selling the plant created the need for the city to also sell its gas supply at a significant discount to an eligible buyer or risk losing the bonds'

*The city has terminated all but two of the swaps it entered into at a cost of \$33.4 million and, as of February 2012, would have had to pay \$47 million to terminate the remaining two.*

tax-exempt status. Additionally, the city was unable to provide documentation of any risk assessment or evaluation of alternatives to the city's choice to purchase 75 percent of the natural gas needed to fuel the power plant at a fixed price.

The city has used interest rate swaps (swaps)—a form of financial derivative—to hedge risks associated with issuing bonds, which is a practice used by other municipalities. However, the city lacked a sufficient process for appropriately evaluating the risks and benefits of swaps before entering into them. Further, some of the swaps that the city entered into were speculative, as the city took a risk that interest rates would change in its favor. Other swaps exposed the city to financial risks that proved to be costly. The city has terminated all but two of the swaps it entered into at a cost of \$33.4 million, but it lacks a clear process for deciding when to terminate those two or any future swaps. As of February 2012 the city would have needed to pay \$47 million to terminate the two remaining swaps.

### **The City's Prior Energy Decisions Have Placed a High Debt Burden on Its Power Department**

The city has not established a debt management policy to guide its decisions and to ensure that it issues debt for purposes that are consistent with its long-term goals. With \$570.8 million in debt outstanding, the city faces debt service payments of more than \$60 million annually for the next 10 years, most of which will be paid from the power fund. However, because of the power fund's debt burden, combined with an estimated annual transfer of as much as \$15 million to the general fund, the city has considered or adopted electric rate increases three times since June 2011. Although a recent study by a city consultant concluded that the city is still the lowest-cost provider of electricity in the area, the business community has voiced concerns about the impact of the rate increases and the city's ability to remain competitive and attract new customers. Finally, our review of the bond issues from 2004 to 2012 found that the city used the proceeds appropriately.

### **The City Lacks a Formal Policy to Guide Decisions to Issue Revenue Bond Debt**

Although the Vernon City Code (city code) authorizes the types of debt the city may issue, the city has not developed a policy to guide its decisions to issue debt and ensure that they are consistent with the city's goals and principles of sound financial management. City charter provisions regarding debt restrict the issuance of general obligation debt to no more than 15 percent of the assessed



valuation of taxable property in the city, but there are no limitations on the issuance of revenue bonds. According to the finance director, historically the city has not issued general obligation bonds.

Consistent with provisions of the city code, the city issued revenue bonds to fund certain costs related to city facilities. A revenue bond is a special type of municipal bond for which repayment is made solely from revenues generated by the activities supported by the bond proceeds, as opposed to taxes. The city council is legally required to approve all revenue bonds prior to issuance, but voter approval is not required. As we discuss in the next section, nearly all of the city's debt is issued for purposes related to the power department and is payable from revenues from the sale of electricity. City officials consult with the city's financial adviser when initiating each proposed bond issue. According to the city's finance director, the financial adviser provides the city with investment services for bond proceeds and surplus city funds, and advises the city on prudent and viable options to procure financing. The city also uses bond counsel to advise it on new and outstanding bond issues, and to ensure that all bonds are issued and managed in accordance with applicable city, state, and federal laws and regulations regarding the issuance of revenue bonds.

We reviewed the debt policies and procedures of neighboring cities with utilities, because most of the city's debt is issued for purposes of the power department. We found that in addition to legal requirements stated in the cities' charter or codes, the cities of Burbank, Pasadena, and Los Angeles all have debt policies available to the public on their Web sites. For example, the City of Pasadena has a policy that addresses its goals for issuing debt, the reasons for which debt can be issued, affordability targets, when to use refunding bonds, the use of derivatives, and the selection of finance consultants and service providers. According to the Government Finance Officers Association (GFOA), having a debt management policy improves the quality of an entity's financial decisions, provides justification for the structure of debt issuance, identifies policy goals, and demonstrates a commitment to long-term financial planning. The GFOA recommends that a debt policy address, among other things, limits on debt; the purposes for which proceeds may be used or prohibited; the use of derivatives; and practices for structuring, issuing, and managing debt.

We found that the city does have an active swaps and derivatives policy, but when we asked the finance director about the city's debt policy, he stated that in addition to the city charter and codes, the city considers the bond covenants in the bond issue official statements to be a debt policy, referring us to the covenants in the January 2012 bond issue relating to restrictions on issuing additional debt. Although these bond covenants provide certain restrictions

*The Government Finance Officers Association indicates that having a debt management policy improves the quality of an entity's financial decisions, provides justification for the structure of debt issuance, identifies policy goals, and demonstrates a commitment to long-term financial planning.*

***The city council received technical documents for the eight bonds totaling \$1.3 billion that the city issued between 2004 and 2012 but received little to no information that summarized and explained the fiscal impact and potential risks associated with the bonds.***

on debt, such as the minimum projected revenue thresholds the city must meet to issue additional debt, the covenants are intended to protect bondholders for a specific bond issue. A proposed debt transaction may not be fiscally prudent or consistent with the goals of the city, but if it does not violate existing bond covenants, the city council will not be prevented from approving the transaction. Further, once the city redeems the bonds, any restrictions and other guiding controls contained in the bond covenants are no longer in effect; thus, over the long term, bond covenants are not a substitute for a stable, broad-based debt policy. Additionally, although the city relies on outside financial consultants to provide debt issuance advice, an internally established debt policy could help ensure that the city's debt-related decisions are in its best interests and follow a consistent approach.

Absent a debt policy to foster transparency and to guide the city's debt decisions, it becomes even more important that the city council be provided sufficient information to weigh all of the risks and benefits of major financial decisions before approval. Further, this information should be available to the public so that stakeholders can understand the impact of the city's debt decisions. However, our review of the city council's agenda packets for the eight bonds<sup>14</sup> totaling \$1.3 billion that the city issued between 2004 and 2012 revealed that, although the city council was provided with technical documents, such as bond official statements, it received little to no information that summarized and explained the fiscal impact and potential risks associated with the bonds.

We obtained information on the bond issuance processes of two other local cities to identify the types of information that those cities make available to decision makers and the public. For the Burbank Water and Power department's (BWP) most recent electric revenue bond issuance of \$35.8 million in refunding bonds and \$52.7 million in capital improvement bonds, we noted a two-page memorandum included in the agenda packet on BWP's Web site that gives a description of the proposed issuance and its purpose. The memorandum includes an analysis section that quantifies the expected benefit of the refunding bonds and discloses the potential risks of the capital improvement bonds. Burbank staff presented this information to both the BWP board and the Burbank city council. Additionally, minutes from the BWP board meetings indicate discussion between board members and staff regarding several aspects of the bond issuance, such as issuance costs, call options, and coverage of debt ratios.

<sup>14</sup> The city also reissued the Vernon Natural Gas Financing Authority Bonds, 2006 Series A, in 2008 to adjust the interest rate for the bonds. The reissue of this bond is not included in our discussion, which covers only new and refunding debt.

We noted that the City of Irwindale (Irwindale) provided a similar level of detail to the city council and the public for its most recent bond issuance. In 2010 Irwindale issued \$7.7 million in refunding bonds for one of its community facilities districts. To inform its city council about this proposed issuance, staff developed a three-page narrative that, like BWP's, provided a summary and analysis of the proposed issuance, including an estimate of the savings resulting from the refunding, the estimated issuance costs, and an indication that the bonds will not be issued if the present value savings are less than a certain amount. Meeting minutes show that the Irwindale city council was also given a presentation relating to the proposed bonds and indicate that there was discussion among council and staff prior to council's approval of the bond resolution.

We did not find the same quality of information available to the Vernon city council, or the public, pertaining to the city's proposed issuances. Although the agenda packets for the recent debt resolutions include a staff report that describes the purpose of the bond issuance and a recommendation for approval, and appear to satisfy the requirements of the Ralph M. Brown Act, which requires the city to hold open meetings, they are not as informative as those of Irwindale or Burbank.

For example, the agenda packet for the issuance of \$419.4 million in refunding bonds in 2009 contains the proposed city council resolution and a one-page staff report from the city attorney to recommend that the city council adopt the resolution. The staff report provides very little insight into the expected result of the refunding bonds, and does not contain a quantified benefit that the city expected to achieve from the transaction. It also does not discuss the potential impact of the refunding bonds on electric rates, although the city would be using electricity revenues to repay the debt.

Further, the staff report raises several significant financial issues but provides no information on the financial implications of these issues or how the refunding bonds would resolve them. For example, the staff report mentions that issuing the refunding bonds "will allow the city to fix its outstanding debt costs, which had risen sharply over the last year due to the collapse of the financial markets" and "will also eliminate the negative 'gas prepay' credit perception." It is unclear what the city attorney meant by "negative gas prepay credit perception" without additional explanation in the memo to the city council. In both of these examples, it would have been more informative for the staff report to explain the problems, using financial information to show the city's fiscal situation before and after the bond issuance, which would allow the city council and the public to understand the need for issuing the refunding bonds. Instead, the staff report indicates only that the "fiscal impact" of the refunding bonds is their approximate par value. The resolution

*The staff report for the issuance of \$419.4 million in refunding bonds in 2009 raises several significant financial issues but provides no information on the financial implications of these issues or how the refunding bonds would resolve them.*

also provided in the agenda packet contains 180 pages of primarily technical documents pertaining to the proposed bond sale. However, the city council and the public would likely have benefited from a more informative staff report that communicated the key elements of the bond issuance and the potential fiscal impact, similar to the information that staff from Burbank and Irwindale provided to their city councils.

Minutes for the meeting at which these bonds were approved provide no additional insight as to what factors the city council considered before approving the bonds, as the minutes provide no indication that any discussion occurred among council members and city staff, or that any other information was presented to the city council. Greater disclosure could provide reassurance that the council members are adequately assessing the impact of these debt transactions and fully understand their fiscal implications before approving them.

In April 2011 the city established the Advisory Committee on Electric Rates (rate advisory committee), comprising one member who is a city official and five members from local businesses who are not city officials. This committee meets periodically to provide input and nonbinding recommendations to the city regarding electric rate increases. The rate advisory committee meeting minutes indicate that the committee members engaged in significant discussion with city staff and consultants about the January 2012 electric system revenue bond issuance. Although as we discuss later in the chapter, the city council ultimately did not heed the committee's recommendation, the rate advisory committee is a positive step toward improving the transparency of the city's financial decisions, including the decisions to issue debt.

***Although the city council did not heed the newly established rate advisory committee's recommendation, establishing such a committee is a positive step toward improving the transparency of the city's financial decisions.***

### ***The City's Debt Is Primarily Paid With Light and Power Revenues***

Between December 2004 and January 2012, the city issued more than \$1.3 billion in bond debt, including refunding debt, 87 percent of which relates to the power department's Malburg Generating Station (generating station) activities and the prepaid gas purchase. As shown in Table 11, the city has \$570.8 million in outstanding bond debt,<sup>15</sup> with some bonds having a final maturity date in 2041. In addition to its bond debt, the city has two outstanding interest rate swaps for which it is obligated to make fixed interest payments. Citywide, the total estimated debt service for the bonds and swaps will be more than \$60 million annually for the next 10 years.

<sup>15</sup> This amount is as of June 30, 2011, except for the Electric System Revenue Bonds, 2012 Series A and B, which are as of their issue date in January 2012.

**Table 11**  
**City of Vernon's Outstanding Debt, by Issuer**  
**(Dollars in Millions)**

ISSUER	BOND TITLE	PURPOSE	ISSUE AMOUNT AND DATE	INTEREST RATE	FINAL MATURITY	AMOUNT OUTSTANDING*	DEBT SERVICE REMAINING TO MATURITY*
City of Vernon	Electric System Revenue Bonds, 2008 Series A (taxable)	To terminate certain interest rate swaps.	\$43.8 issued September 2008	7.4% to 8.59%	July 2038	\$43.5	\$116.6
City of Vernon	Electric System Revenue Bonds, 2009 Series A (tax exempt)	To redeem variable-rate 2006 Gas Prepay Bonds.	\$419.4 issued May 2009	2.5% to 5.5%	August 2021	388.1	476.4†
City of Vernon	Electric System Revenue Bonds, 2012 Series A (tax exempt) and Series B (taxable)	To fund capital improvements and to make a debt service payment due in August 2012 on the 2009 bonds.	\$72.7 issued January 2012	5% to 6.5%	August 2041	72.7†	152.7†
					<b>Subtotals</b>	<b>504.3</b>	<b>745.7</b>
Vernon Redevelopment Agency	Industrial Redevelopment Project, Tax Allocation Bonds, Series 2005 (tax exempt)	To make public improvements.	\$49.4 issued October 2005	3.25% to 5.5%	September 2035	47.0	80.2
Vernon Redevelopment Agency	Industrial Redevelopment Agency, Tax Allocation Bonds, Series 2011 (taxable)	To fund land acquisition and certain redevelopment projects.	\$19.5 issued March 2011	3% to 9.25%	September 2030	19.5	36.8
					<b>Subtotals</b>	<b>66.5</b>	<b>117.0</b>
					<b>Totals</b>	<b>\$570.8</b>	<b>\$862.7</b>

Sources: City of Vernon's audited financial statements for fiscal year 2010-11 and official statements for the bonds listed in the table.

\* Unless otherwise noted, totals are as of June 30, 2011.

† Based on the debt service schedule included in the official statements for the January 2012 Electric System Revenue Bonds.

***The power department's bond debt service payments were \$55.7 million for fiscal year 2010–11, and it has forecasted that its annual payments will be at least at that level for the next 10 years—a significant increase from the previous four fiscal years.***

Of the outstanding debt, \$504.3 million is for three separate bond issues to fund activities of the power department. The largest of these issues, of which \$388.1 million is still outstanding, is debt owed for the city's purchase of a 15-year supply of natural gas. As we discuss later, in 2006 the city decided to prepay for a large portion of the natural gas needed to fuel the generating station. The 2009 bonds refinanced the bonds originally issued by the Vernon Natural Gas Financing Authority (gas authority) in 2006 to finance this purchase. The power department's other two outstanding bond issues are much smaller. In September 2008 the city issued bonds, of which \$43.5 million remains outstanding, primarily to terminate four swap agreements that the city had entered into with bonds issued in 2004 and 2006. We discuss these swap transactions later in the chapter and in Appendix B. The most recent bond issue, occurring in January 2012, has \$72.7 million outstanding and will be used to fund capital improvements to the city's electric system and to provide funds to make an August 2012 debt service payment on another bond issue.

To satisfy the debt service on these three outstanding obligations, the city pledged the revenues of the power fund, which come primarily from the sale of electricity to the city's businesses and residents. As we discuss later in the chapter, the power department has struggled to manage this debt burden while maintaining the competitive rates necessary to attract new ratepayers into the city. Its bond debt service payments were \$55.7 million for fiscal year 2010–11, and the power department has forecasted that its annual payments will be at least at that level for the next 10 years.<sup>16</sup> This level of debt service is a significant increase from the four previous fiscal years, when the annual debt service payments ranged from \$7 million to \$30.8 million.

The annual payments on the bonds just discussed include forecasted annual interest payments of up to \$6 million related to the city's two outstanding swaps. As discussed later in this chapter, the city engaged in a series of swap transactions, two of which remain outstanding. These swaps affect the power department's finances in two ways: The department must make periodic interest payments, and the city is obligated to post collateral if the negative fair market value of both swaps exceeds \$20 million. The fair market value of the swaps fluctuates daily based on the financial markets. As of June 30, 2011, the city had posted collateral of \$5.7 million, but between July 2011 and November 2011, the city's posted collateral ranged from a low of

<sup>16</sup> For fiscal year 2012–13 the total debt service is \$35 million because the August 2012 debt service on the 2009 Electric System Revenue Bonds, Series A, was refunded by issuance of the 2012 Electric System Revenue Bonds, Series B.

\$3.3 million to a high of \$31.6 million. The finance director indicated that the collateral amounts are not included in the debt service estimates, since they are not technically a cost to the city and are difficult to forecast. Nevertheless, they prevent cash from being used for other purposes and may put additional financial strain on the power department.

*Required postings of collateral for swaps prevent cash from being used for other purposes and may put additional financial strain on the power department.*

Also shown in Table 11 are bonds totaling \$66.5 million that the city's former redevelopment agency issued to finance the acquisition of land and various public improvements within the city.<sup>17</sup> The debt service on the redevelopment bonds is paid from property tax revenues collected in the redevelopment project area. For the next 10 years the debt service will be between \$5 million and \$6 million annually. The recent dissolution of redevelopment agencies by state legislation has not affected the source of funds that the successor agency to the redevelopment agency will use to repay the \$66.5 million in debt currently outstanding, and the city expects that the tax allocation will be sufficient to fully retire the debt.

#### ***Electric Rate Increases Are Needed to Meet the Power Department's Obligations***

The power department's primary source of revenue, payments received for electricity, is presently insufficient to meet its bond and other debt obligations, creating a need for an increase in electric rates. Periodically, the city hires a consultant to evaluate whether current electric rates provide sufficient revenue to satisfy the projected costs of the power department's operations and debt service, are transparent and understandable to customers, and are the lowest commercial and industrial rates in Southern California. For the more recent studies, the city also asked the consultant to design electric rates that are sufficient to meet the state-mandated renewable energy requirements.

In May 2011 the power department began presenting the latest results of these studies to its rate advisory committee to obtain input on the proposed rate increases before recommending them to city council. The first study presented to the rate advisory committee, dated May 2011, concluded that the power department would need to raise its electric rates by 16 percent in fiscal year 2011–12 to ensure that net revenues remain at the thresholds required in the bond covenants. After four meetings, the rate advisory committee voted to recommend to the city council an

<sup>17</sup> As discussed in the Introduction, the State's redevelopment agencies were eliminated by state legislation in June 2011.

***The power director reported to the rate advisory committee that the rate increases approved five months earlier would be insufficient to also fulfill the state-mandated renewable energy requirements.***

8 percent rate increase in July 2011, followed by a second 8 percent increase in January 2012 and another 5 percent increase in July 2012, to lessen the immediate impact on businesses of such a large increase. The city intended to use cash reserves to cover the revenue shortfall that would occur as a result of implementing the rate increases over two years. In the last of these four meetings, the power department director indicated that the rate increases, combined with the subsidy from cash reserves, would provide sufficient revenue for the city to meet its obligations. In June 2011 the city council approved both of the 8 percent rate increases, with the 5 percent increase to be considered at a future date.

The consultant's study assumed an annual transfer of approximately \$6 million in light and power revenues to the general fund, consisting of the in-lieu-of-franchise tax and overhead allocations discussed in Chapter 3. However, in a November 2011 rate advisory committee meeting, the power department director indicated that annual transfers to the general fund could be as much as \$15 million because of the expected voter approval of changes to the city's charter to allow monetary transfers from the power fund to support the city's general fund. Also, he reported to the committee that the rate increases approved five months earlier would be insufficient to also fulfill the state-mandated renewable energy requirements.

Further, the power department director indicated that the power department was in the process of issuing new bonds to pay its debt service that was coming due and needed to demonstrate to the credit rating agencies that it had sufficient resources to meet its debt obligations and the State's renewable energy requirements. The power department director proposed passing on the costs of meeting state renewable energy requirements directly to businesses, which the city refers to as a renewable portfolio standard (RPS) pass-through. The rate advisory committee considered this RPS pass-through but voted to delay a decision to allow time for the committee to discuss it at a future meeting.

Despite the rate advisory committee's concerns, in November 2011, less than a week after the rate advisory committee meeting, the proposed RPS pass-through and bond issue were presented to the city council for consideration. The city council unanimously approved both, even after members of the business community and rate advisory committee spoke at the council meeting urging the city council to postpone the decision to allow time to consider alternatives.

The most recent consultant's study regarding electric rates, dated February 2012, projects that, with the current electric rates, which include the two 8 percent rate increases and the RPS pass-through, the power department will experience a deficit



of \$24 million in fiscal year 2013–14. In a March 2012 presentation to the rate advisory committee, the power department director warned that such a deficit, if it occurred, would jeopardize the power department’s credit rating because the power department would fail to meet the minimum revenue amounts required in the covenants of its outstanding bond issues. The credit rating for the power department was downgraded recently, due in part to one rating agency’s concerns that the city’s lower-than-expected revenues were barely sufficient to cover its outstanding debt.<sup>18</sup> The consultant’s new study includes the impact of general fund transfers totaling approximately \$15 million annually and the bond covenant requirement that net income remain at a level of at least 125 percent of debt service. In addition, the study factored in the rates necessary to cover increases resulting from the energy transactions we discuss later in the chapter. Specifically, the department’s power production costs will rise by \$20 million beginning in fiscal year 2016–17, primarily due to increased capacity payments resulting from the sale of the generating station.

*The department’s power production costs will rise by \$20 million beginning in fiscal year 2016–17, primarily due to increased capacity payments resulting from the sale of the generating station.*

To meet these requirements, the power department recommended, based on the most recent consultant’s study, a rate increase of 12 percent in July 2012, which is 7 percent higher than the 5 percent rate increase the committee had previously agreed upon. Additionally, the power department proposed a 5.1 percent increase in July 2013 and a 4.4 percent increase in July of each of the following three fiscal years. The department forecasted that these proposed rate increases would be sufficient to meet its operational and debt requirements, and allow it to begin rebuilding its reserves. In response, the business community again voiced concerns about the reasons for the changing nature of the proposed increases. As of April 2012, the power department and rate advisory committee were still discussing these rate increases, which had not yet been proposed to the city council.

In response to the rate advisory committee’s request, the city hired a separate consultant to perform an independent analysis and comparison of the electrical bills paid by the power department’s customers to those paid by the customers of other Southern California electric utilities. The consultant’s report, completed in March 2012, analyzed seasonal and annual utility bills, inclusive of any taxes and fees, and concluded that of the five nearby utilities providing service to similarly sized end use customers, the city is generally the lowest-cost provider at most levels of power usage. Specifically, depending on customer usage levels, the city’s electric rates are between 3 percent and 15 percent lower than those of

<sup>18</sup> In December 2011 Moody’s Investor Service downgraded the power department’s bonds from an A3 rating to a Baa1 rating.

competing utilities. According to the study, the city is positioned to maintain this advantage despite rate increases because nearby utilities are experiencing similar pressure to meet the State's environmental requirements. Although the city's electric rates are currently lower than those of the surrounding utilities, the consultant acknowledged that the rate advantage between the city and its competitors is eroding. As a result, it may be more difficult to attract and keep businesses in the city.

The business community's concerns regarding the recent large electric rate increases may be the result of the contrast with the city's low electric rates and modest rate increases over the past several years. As Table 12 shows, before the increases in fiscal year 2011–12, the city had made small and steady rate increases of no more than 5 percent in any one year since November 2003. In several rate advisory committee meetings, the power department director explained that the city chose to keep these rate increases lower than the increase in costs, in effect subsidizing electric rates with existing cash reserves. However, because of several factors discussed earlier, the power department's reserves were nearing depletion by June 2011, and the city found that it would no longer be able to subsidize future rate increases.

**Table 12**  
**City of Vernon's Light & Power Department Adopted and Proposed Electric Rate Increases**

DATE IMPLEMENTED	PERCENTAGE INCREASE
November 2003	3 percent
June 2005	4.75 percent
November 2006	5 percent
December 2007	5 percent
January 2009	5 percent
January 2010	4.7 percent
July 2011	8 percent
January 2012	8 percent
<b>Proposed Increases as of March 2012</b>	
July 2012	12 percent
July 2013	5.1 percent
July 2014 to July 2016	4.4 percent (annually)

Sources: City of Vernon credit presentation dated November 2011 and presentation to the Advisory Committee on Electric Rates titled *Fiscal Year 2013 Electric Rate Study Results*, dated March 2012.

### ***Bond Proceeds Were Used for the Stated Purposes***

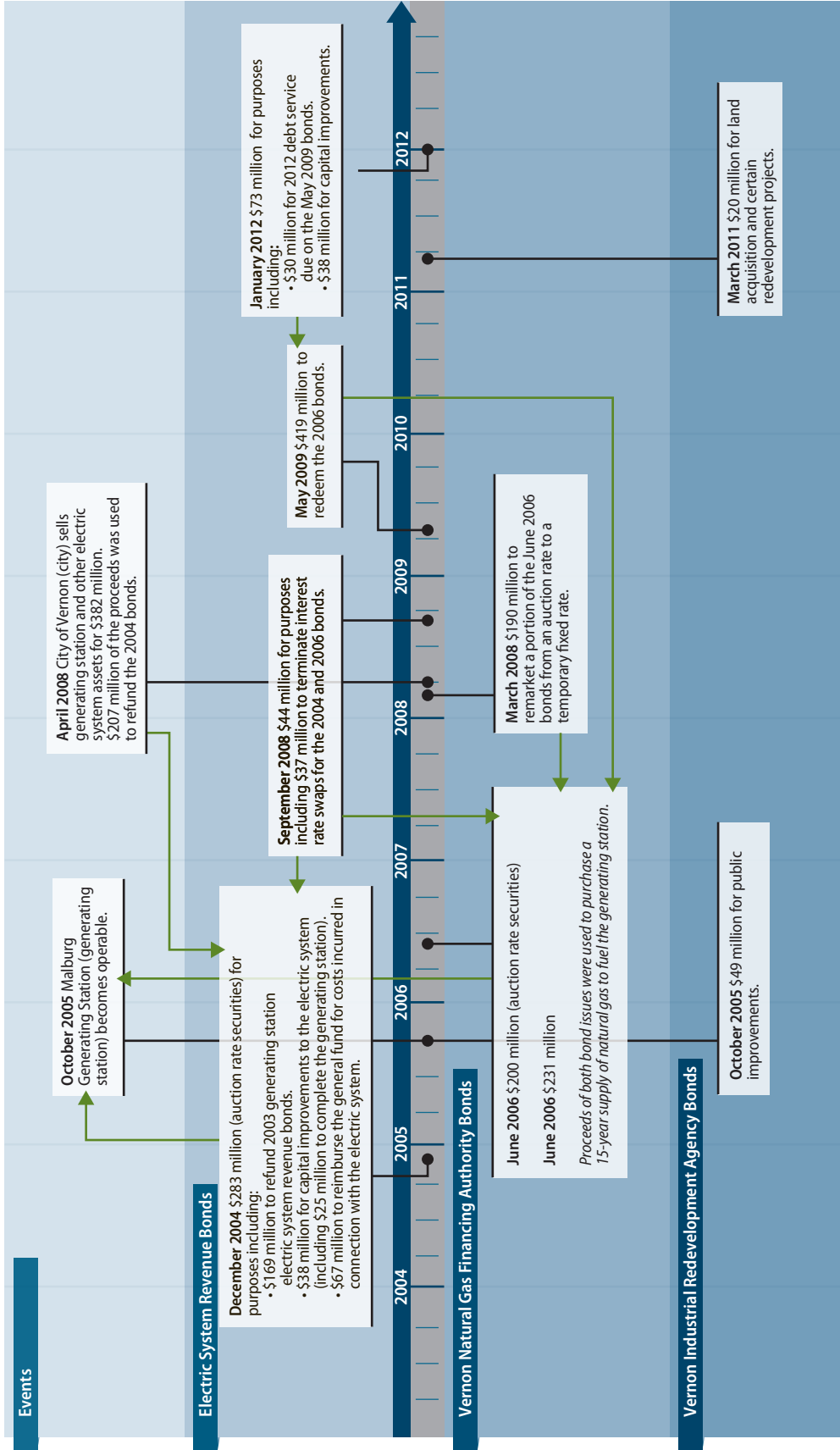
For each of the bonds issued between December 2004 and January 2012, we found that the city was able to show that it used the proceeds for the purposes stated in the covenants of the bond's official statement. Each time the city approved the issuance of these bonds, it adopted a resolution that set out the purposes for which the proceeds could be used. The official statement is a disclosure document about the bond offering, including essential terms and features of the bonds, financial and operating data about the issuer and the project, the intended uses of the bond proceeds, and sources of repayment. The city deposits all bond proceeds directly into a bank trust account. The bank trustee is responsible for ensuring that the city releases funds only in accordance with the bond covenants. To do this, the city must submit a requisition form along with applicable support to the trustee for review.

In our review of the official statements for the \$1.3 billion related to the eight separate bonds issued since 2004, we noted that 87 percent of the debt issued was related to construction of the generating station and the purchase of a 15-year supply of natural gas to fuel the station; prior to this construction the city did not have any outstanding bond debt. As Figure 8 on the following page shows, most of the city's debt can be traced back to the city's decision to enter into these two transactions. For example, the power department's most recent issuance, in January 2012, was for \$72.7 million, of which \$30.1 million was designated to refund the 2009 bonds maturing in August 2012. In explaining the need for these bonds at a November 2011 city council meeting, the power department director explained that if the city did not issue the bonds, it would be unlikely to meet the August 2012 payment on the 2009 bonds.

The \$628 million<sup>19</sup> in bond proceeds allocated for refunding debt has a low risk for misuse because the proceeds are simply paying off existing debt. Therefore, we concentrated our review on those bond proceeds that the city used for other purposes, such as capital improvement or land acquisition. The total amount of bonds issued for purposes other than refunding debt was \$690 million, and we found that these bond proceeds were used appropriately.

<sup>19</sup> In one instance the city issued a series of bonds, the 2012 Series B Electric System Revenue Bonds, primarily to refund existing debt, but the proceeds also included \$3 million for capital projects. We included the total issuance amount of \$35.1 million in this category because the primary purpose was to refund existing debt.

**Figure 8**  
City of Vernon's Bond Issuance and Relationship Timeline



Sources: City of Vernon bond official statements and light and power fund March 2008 credit presentation update.  
Note: Amounts shown do not sum to the total amount of bonds issued because, in addition to the purposes noted, bond proceeds are used to pay costs such as those incurred to issue the bonds and to meet debt service requirements. Arrows indicate relationships between bonds and events.

### **The City Has Not Demonstrated That It Performed the Expected Analysis That Would Provide Financial Justification for Two Significant Energy Transactions**

In 2006 and 2008, the city, with the assistance of its financial adviser, entered into two significant energy transactions: a \$423 million prepaid purchase of natural gas (prepaid purchase) for delivery over 15 years and a \$382 million sale of most of its electrical power generation and transmission assets (electrical power assets). Our finance and energy expert concluded that in neither case has the city shown that it performed the expected valuation analysis or risk assessment of these transactions before entering into them. According to our finance and energy expert, any entity making major financial or capital investment decisions should conduct a comprehensive valuation and risk analysis in order to ensure an informed and prudent decision process. The text box outlines the fundamental principles of that analysis.

#### **Fundamental Principles in Analyzing Energy Transactions**

1. Evaluate the benefits and costs associated with the proposed transaction.
2. Evaluate the risks that the entity would assume as a result of the proposed transaction.
3. Compare the benefits and risks of the proposed transaction against those of the alternatives.
4. Evaluate whether the proposed transaction is at a fair market price.

Source: Analysis Group, Inc.

### ***The City Has Not Demonstrated That It Performed the Expected Financial Analysis to Justify the Purchase of a 15-Year Supply of Natural Gas***

In 2003 the city began building the generating station, which would become the main supply of electricity to customers of the power department. After the generating station became operational in October 2005, the city needed to procure substantial amounts of natural gas to fuel the station. In making the decision to enter into a 15-year prepaid supply of natural gas in June 2006, the city was not able to demonstrate that it performed the expected analysis to evaluate whether the transaction was reasonable or was the best course of action for the city.

Our finance and energy expert indicated that utilities have a variety of options for purchasing natural gas to meet their demand requirements. The simplest option is to buy natural gas at prevailing market prices as the need arises—these are called spot market purchases. Alternatively, utilities can buy natural gas in advance of planned use by entering into contracts that provide for the delivery of natural gas in the future—these are called forward contracts. Utilities can also buy natural gas today and store it—for example, in underground storage facilities—for use later. The price of natural gas—like that of most commodities—rises and falls over time based on market supply and demand, and utilities typically use a combination of these options both to secure a natural gas supply and to manage price fluctuations.

According to our finance and energy expert, one purchasing alternative available to municipalities such as the city and other

tax-exempt entities is to enter into a prepaid purchase of natural gas that provides a supply of natural gas over a period of time. A municipality generally finances a prepaid purchase by issuing tax-exempt bonds. In particular, prepaid purchases enable municipalities to obtain discounts on the market price of natural gas because their borrowing costs—using their tax-exempt status—are usually lower than natural gas suppliers' borrowing costs. Prepaid natural gas purchases are effectively a loan from the municipality to a natural gas supplier, with the principal and interest paid by the delivery of natural gas over time.

As shown in the text box, the city structured the prepaid purchase so that 75 percent of the natural gas was to be delivered at a fixed price. For the remaining 25 percent, the city exchanged the discounted fixed price for discounted spot market prices to be determined at the time of the future delivery, in what is known as a financial fixed-to-floating natural gas swap. In February 2010 approximately four years into the 15-year prepaid purchase, the city terminated the swap agreement, resulting in the city purchasing 100 percent of the natural gas at the fixed price under the contract.

Our finance and energy expert concluded that the city was not able to demonstrate that it performed the analysis that was expected—based on fundamental principles of a comprehensive valuation and risk analysis described earlier—before it entered into the prepaid purchase in 2006. For example, the city should have evaluated its decision to pay a fixed price for 75 percent of the prepaid purchase for a 15-year period, because the decision had potential long-term consequences for the rates charged to customers. Specifically, if natural gas prices were to decline and stay low in the future, the city's customers would be burdened with paying higher rates than necessary, based on the fixed price, for a long time.

In documenting the rationale for its decision, the city should have examined whether its choice was consistent with the purchasing

### Elements of the City of Vernon's 15-Year Prepaid Purchase of Natural Gas

- The contract length is 15 years ending in June 2021.
- Citigroup Energy, Inc. is to deliver an annual amount of approximately 6 million MMBtu\* of natural gas, which the City of Vernon (city) indicated would supply about 75 percent of the natural gas needed to fuel the Malburg Generating Station. The city has the option to vary the daily scheduled amount of natural gas to be delivered under the contract.
- The city paid Citigroup Energy, Inc. \$423 million for the prepaid purchase of natural gas (prepaid purchase).
- To fund the purchase, the city issued tax-exempt bonds with a par value of \$430.8 million and a term of 15 years.
- The tax-exempt status required that the natural gas be used by the city or another qualified user (such as another municipality).
- Seventy-five percent of the prepaid natural gas to be delivered over 15 years had a fixed price of \$6.45 per MMBtu, representing a discount at the time of 79 cents or approximately 11 percent, from the contract price without prepayment of \$7.24 per MMBtu.
- The city entered into a fixed-to-floating swap with Societe Generale to convert 25 percent of the prepaid natural gas to be delivered from a fixed price of \$6.45 per MMBtu to a floating price based on future spot market prices and a discount of 62.5 cents per MMBtu.
- The bonds used to finance the prepaid purchase were refinanced in 2009 because of the 2008 financial crisis and breakdown in the variable-rate bond market. After the refinancing, the city estimated that the fixed price of the prepaid purchase increased from \$6.45 to \$7.50 per MMBtu.

Sources: City of Vernon, Vernon Natural Gas Financing Authority Revenue Bonds (Vernon Gas Project) Series 2006 A-D Credit Presentation, April 2006; City of Vernon, Light and Power Fund Asset Sale—Credit Presentation, June 11, 2007; Bond Transcript for the Vernon Natural Gas Financing Authority variable rate revenue bonds (Vernon Gas Project), June 27, 2006; minutes of the Advisory Committee on Electric Rates meeting, June 6, 2011; Agreement for Purchase and Sale of Natural Gas between Citigroup Energy Inc. and Vernon Natural Gas Authority, June 27, 2006; Memo from BLX to Moody's re. City of Vernon, August 12, 2008; City of Vernon Electric System Revenue Bonds—2009 Series A (Gas Prepay Restructuring Transaction)—Credit Presentation, March 2009.

\* MMBtu is a million British thermal units, a standard measure used for quantities of natural gas.

practices used by other municipal and public utilities—such as whether and how other utilities enter into long-term fixed-price purchases for a substantial portion of their energy needs. In addition, the city should have evaluated whether its choice was a good approach in meeting the city’s objectives for its customers. Similarly, the city should have considered whether a different structure for the prepaid purchase of natural gas—for example, one with a shorter contract length and lower annual quantity purchased, which would affect the discount received by the city and its risk exposure from the transaction—would have been better for the city, based on its objectives for customers. Additionally, given the significant prepaid purchase amount—\$423 million—the city should have evaluated whether the discount it expected to receive from the prepaid purchase was fair and reasonable given the then-forecasted market prices of natural gas and interest rates. A similar analysis but narrower in scope—covering risk, benefits, and cost, as well as an assessment of alternative choices—would have been expected when the city chose to terminate the swap in 2010.

Documents that the city provided to support its decision to enter into the prepaid purchase do not show how the city evaluated this transaction. Specifically, other than a summary of the city’s expected savings in bond-related credit presentations to rating agencies, the city was unable to provide documentation of any risk assessment or evaluation of alternatives to the city’s choice to purchase 75 percent of the natural gas for the prepaid purchase at a fixed price. In addition, the city could not document any comparison of its choice to what was being done by other municipal or public utilities in the marketplace. Although the city was able to show that various investment banks made presentations to it about the prepaid purchase, it was unable to provide documentation regarding how it determined that the winning supplier provided the best deal to the city—in terms of both the price received and the “counterparty credit risk,” which is the risk that the supplier would fail to deliver the natural gas that had already been paid for by the city.<sup>20</sup> As a result of this lack of documentation, our finance and energy expert concluded that the city did not make an informed decision to enter into the purchase of a 15-year supply of natural gas and, as we explain later in this chapter, that the city’s choice to purchase 75 percent of the natural gas at a fixed price was unreasonable.

Similarly, the city was unable to provide the expected financial or risk analysis related to its decision in 2010 to terminate the swap portion of the prepaid purchase, which resulted in the city purchasing the remaining 25 percent of the natural gas at the fixed price.<sup>21</sup> The staff

*As a result of a lack of documentation, our finance and energy expert concluded that the city did not make an informed decision to enter into the purchase of a 15-year supply of natural gas.*

<sup>20</sup> The winning supplier was Citigroup Energy, Inc.

<sup>21</sup> The city terminated the swap with Societe Generale on February 23, 2010, and in the process received a termination payment of \$4.44 million. This payment will offset some of the future cost of the natural gas under the prepaid contract.

report attached to the city resolution that authorized terminating the swap indicated only that the city believed there was a possibility

that natural gas prices would rise, and that therefore it would be prudent to terminate the swap. However, there was no explanation or supporting analysis as to how the city reached this conclusion, other options that it considered, or how this choice fit in with the city's overall natural gas purchasing and price risk management strategy. Additionally, there was no evaluation to confirm that the city received a fair market value when it terminated the swap.

### Sale of the City of Vernon's Electrical Power Generation and Transmission Assets

**Malburg Generating Station (generating station)**—The sale of the generating station involved two principal elements. First, the City of Vernon (city) received a payment of \$287.5 million from the buyer, Bicent Power LLC (Bicent), for the sale. Second, in a leaseback agreement, the city entered into a power purchase contract with Bicent to purchase the power from the generating station for a 15-year period.

**Electrical power transmission assets**—The city sold its interests in Southern California Public Power Authority's Mead-Phoenix and Mead-Adelanto (Arizona/Nevada to California) transmission projects to Starwood Energy Group for \$39.5 million and its interests in the California-Oregon Transmission Project to the Transmission Agency of Northern California for \$55 million.

**Use of sale proceeds**—According to a credit presentation, the city used the total sale proceeds of \$382 million as follows:

- \$207 million to pay off the 2004 bonds that funded part of the generating station's construction.
- \$50 million to fund the city's Industrial Development Program.
- \$39.25 million placed into an escrow account to cover future obligations under the power purchase contract.
- \$77.75 million transferred to the light and power fund.
- \$8 million to pay transaction costs.

**Disposition of the prepaid supply of natural gas**—The city could no longer use its 15-year supply of natural gas to fuel the generating station and eventually sold this supply to a municipal utility.

**Need to purchase natural gas to fuel the generating station**—The leaseback agreement with Bicent requires the city to supply the natural gas to fuel the generating station.

**Sources:** City of Vernon, Light and Power Fund Asset Sale—Credit Presentation, June 11, 2007, and March 2008 update; Lease and Grant of Easements By and Between the City of Vernon and Bicent (California) Malburg LLC, April 2008; Power Purchase Tolling Agreement Between Bicent (California) Malburg LLC and the City of Vernon, April 10, 2008; COV Natural Gas RFP Responses, March 5, 2009; Base Contract for Sale and Purchase of Natural Gas, May 1, 2009; Resolution No. 9510.

### *The City Has Not Demonstrated That It Performed the Expected Financial Analysis to Justify the Sale of Its Electrical Power Assets*

The second significant energy-related decision by the city was to sell most of its electrical power assets shortly after executing its prepaid purchase of a 15-year supply of natural gas to fuel the generating station. These sales were finalized in early 2008 for a total of \$382 million. The text box summarizes these sales. Integral to the sale of the generating station was a leaseback agreement that committed the city to provide the natural gas to fuel the generating station for a 15-year period and in turn to receive the electricity generated. For the right to receive power from the generating station, the city would make escalating monthly payments to the new owner.

Our finance and energy expert concluded that the city could not demonstrate that it performed the analysis that was expected—based on fundamental principles of a comprehensive valuation and risk analysis—before selling these electrical power assets. For example, the city should have conducted an independent valuation of the electrical power assets and the leaseback agreement to determine whether it was receiving a fair market price in the transaction. As part of that valuation analysis, the city should have assessed the payments it would be required to make under the leaseback agreement in comparison to the benefits of using the cash received from the sale of the electrical power assets for other purposes, such as retiring outstanding debt and having



additional funds for the city's industrial development program. The city also should have considered the financial implications of the sale of the electrical power assets on the city's recently executed prepaid purchase of natural gas.

The city was unable to demonstrate that it had performed expected financial analysis justifying the decision to sell the electrical power assets. The documents it provided included the city's presentations to credit rating agencies regarding the sale of these assets. The financial projections contained in these presentations dealt with debt service issues but did not contain any independent evaluation of the benefits and risks associated with the transaction.

The city also provided the first-round responses to its request for proposals to purchase the electrical power assets, but it was unable to provide any information relating to the second—and final—round of bids from which the city chose a winning bidder. Nor was the city able to provide an analysis to demonstrate that it selected the best offer among the final bids for the electrical power assets.

In addition, it is unclear whether the city considered the financial implications that selling the generating station would have on the city's recent 15-year prepaid purchase. After selling the electrical power assets, including the generating station, the city also had to sell essentially all of the natural gas from the prepaid purchase. This was necessary because the city had financed the purchase of the fuel for the generating station with tax-exempt bonds, and the generating station's purchaser was a private entity. Natural gas purchases financed with tax-exempt bonds can be used only by the municipality's retail customers, either directly as a source of heat for its customers or indirectly to generate electricity for its customers. Since the city was able to use only a small portion of the gas for its gas utility, it needed to sell the remainder to another qualified tax-exempt user or use the gas for another qualified purpose. However, the number of qualified bidders that could or would purchase a substantial quantity of natural gas over a 15-year period was limited. The city ultimately sold the natural gas to the Sacramento Municipal Utility District (SMUD). Further, under the terms of the sale, SMUD will pay the city market prices for natural gas less a discount of 25 cents per MMBtu. Thus, for each MMBtu the city sells to SMUD it takes a loss on the sale. The city estimates that it pays \$7.50 per MMBtu under the prepaid gas agreement, but sells this gas to SMUD at a discount of 25 cents from market prices—which have ranged from \$4.58 to \$2.25 per MMBtu between January 2011 and May 2012.<sup>22</sup>

*It is unclear whether the city considered the financial implications that selling the generating station would have on the city's recent 15-year prepaid purchase of natural gas.*

<sup>22</sup> Prices described here are the monthly average of daily spot market prices for SoCal Border as reported by SNL Financial. The natural gas price index specified in the SMUD contract is the Natural Gas Intelligence Bidweek Survey price for Southern Border, Pacific Gas and Electric, which varies slightly.

Moreover, under the leaseback agreement, the city is required to provide natural gas to the generating station for generating electricity. Having sold the natural gas from the prepaid purchase to SMUD, however, the city has to purchase replacement natural gas in order to supply the generating station. Our finance and energy expert concluded that while the disposal of the natural gas was done reasonably, with the city accepting the best offer it received—given that it had already sold the electrical power assets—the city did not produce documents indicating that, prior to the sale, it considered the financial impact of and options for the prepaid natural gas it would no longer be able to use to fuel the generating station.

***The City Has Not Been Able to Demonstrate That the City Council Was Sufficiently Informed Regarding the Risks Associated With Two Significant Energy-Related Transactions***

According to our finance and energy expert, in order for the city council to be sufficiently informed when making major financial decisions such as the 15-year prepaid purchase of natural gas and the sale of electrical power assets, it expected the city to have formally presented relevant risk information to the city council. Our finance and energy expert provided examples of the key risks that would have been important for the city council to consider as part of its evaluation process prior to approving the two transactions.

For the prepaid purchase, the city council should have been informed—such as through a what-if comparison—about the likelihood and effects of a decline in natural gas prices below the price that the city would be paying under the 15-year contract, a scenario in which the city would be purchasing natural gas at above-market prices. This type of analysis would have allowed the city council to weigh the risk that natural gas prices would fall against a potential policy objective of providing stable rates to the city's customers.

Similarly, in considering whether to approve the sale of the electrical power assets, the city council should have been informed of at least two significant risks, according to our finance and energy expert. First, because selling the transmission assets would mean that the city would need to pay to transport electrical power it purchases when necessary to supplement the supply from the generating station to meet demand, the city council should have been informed about the risk that, after selling the transmission assets, the city might ultimately pay more in the future to transport the supplemental electricity than the value it would receive from the sale of these assets. Second, with regard to the sale of the generating station, the city council should have been informed about the risk that the city might incur a financial loss in reselling the natural gas associated with the prepaid purchase. Specifically, the city risked that, due to a limited number of qualified

buyers who would consider purchasing a significant quantity of natural gas over a 15-year period, it might have to offer a significant discount in order to find a buyer.

The documents provided by the city do not indicate that the city had a formal process for communicating the risks of the two transactions to the city council. For example, city council meeting minutes pertaining to the decisions contained no discussion of risks. Similarly, no staff reports or other memoranda were attached to the resolutions approved by the city council for the transactions. The city asserted that in making financial decisions it relies on the advice of its financial adviser and consultants. However, there are no documents from the city's financial adviser and consultants to the city that could be considered sufficiently informative of the risks and benefits associated with the two energy-related transactions.

*There are no documents from the city's financial adviser and consultants to the city that could be considered sufficiently informative of the risks and benefits associated with the two energy-related transactions.*

### ***The City's Choice of a Fixed Price Structure for 75 Percent of Its Long-Term Natural Gas Supply Was Unreasonable***

Our finance and energy expert indicated that, in assessing the prepaid purchase of natural gas, the city should have developed a rationale for initially choosing to purchase 75 percent of the natural gas at a fixed price. In the absence of supporting documents<sup>23</sup> from the city, we asked our finance and energy expert to evaluate whether the city's decisions were reasonable based on the activities of comparable entities and economic principles. Our finance and energy expert concluded that, for the reasons set forth below, it was unreasonable for the city to have chosen a prepaid purchase at a fixed price for such a significant portion of its natural gas requirements for such a long period of time.

First, the city indicated that the prepaid purchase was in the public interest, as it would allow its power department to continue to charge stable rates that promote economic development within the city. However, the city's choice to have a fixed price for a 15-year supply of natural gas covering the bulk of the fuel requirements for the generating station put the city and its customers at risk, because if natural gas prices were to decline in the future, the customers would be burdened with excessively high electricity rates over an extended period of time. It was imprudent for the city to create such a long-term price risk exposure for its customers, who ultimately must bear the cost of the prepaid purchase.<sup>24</sup>

<sup>23</sup> In a meeting between California State Auditor staff, our finance and energy expert, the city, and its financial adviser and consultants on February 8, 2012, the financial adviser informed us that it did not advise the city in choosing what percentage of the prepaid purchase should be at a fixed price.

<sup>24</sup> There may be instances in which procuring a long-term supply of natural gas at a fixed price could be a reasonable alternative to consider, such as if natural gas prices were at historic lows and the economics of exploration and production were such that a further decline in prices was unlikely. At the time the city executed its prepaid purchase, natural gas prices were well above that level.

***The city was imprudent in failing to demonstrate its assessment of the costs, risks, and ramifications of its choices on customers before executing the deal.***

Second, the city's deal structure for the prepaid purchase was considered very complex and unique at the time, and the city had no prior experience with prepaid purchases. Therefore, the city was imprudent in failing to demonstrate its assessment of the costs, risks, and ramifications of its choices on customers before executing the deal. Specifically, the city used a novel prepaid purchase structure that had not been previously used in the market. In a March 2006 presentation to the city, Citibank Energy, Inc.—the supplier that the city ultimately chose for the prepaid purchase—noted that the structures of prior completed contracts in the market had been fairly uniform to date, with the executing party purchasing natural gas at a discount from future spot market prices rather than at a discount from a price fixed at the time of the transaction. In this presentation, Citibank Energy, Inc. further noted that the city's proposed contract would be the first time that a prepaid purchase in the market was structured with fixed-price and market-price components, in which the buyer had the option to vary the scheduled amount of natural gas to be delivered under the contract.

Third, while the city is not subject to regulation by the California Public Utilities Commission, it was imprudent for the city to ignore relevant utility regulations and processes that are in place to ensure that utilities make judicious decisions in the interests of their ratepayers. In particular, many investor-owned utilities, including natural gas utilities in California, are subject to a natural gas cost incentive mechanism that shares the benefits and costs from a utility's purchasing activities with both the shareholders of the utility and the utility's customers. This mechanism protects customers because if the utility makes a decision that turns out to be costly, the utility cannot simply pass on the full cost of that decision to its customers by increasing rates. The utility's shareholders must share the burden of that increased cost.<sup>25</sup> Similarly, the Division of Ratepayer Advocates—an independent consumer advocate within the California Public Utilities Commission—has opposed public utilities' use of fixed-price natural gas contracts with a duration of more than one year.

Fourth, the city's choice to lock in 75 percent of its 15-year supply of natural gas at a fixed price set at a single point in time was inconsistent with prudent purchasing strategies practiced by utilities to manage fluctuations in natural gas prices and provide stable rates in the interest of their customers. One strategy used by utilities is the time-averaging approach,<sup>26</sup> which involves making fixed-price

<sup>25</sup> The city takes an opposing view to this general principle in its November 2007 energy and credit risk management policy, in which it stated that risk calculations associated with energy-related transactions are not critical for a municipal utility such as the city as long as its energy costs may be passed through to its customers.

<sup>26</sup> Richard Goldberg and James Read, "Hedge Timing," *Public Utilities Fortnightly*, May 2012.

purchases over time and in different quantities. This approach provides risk reduction through diversification, in that by spreading purchases over time, a utility avoids having its cost of natural gas depend entirely on the market price on a single day. The city could have implemented this purchasing strategy by first structuring the prepaid purchase such that the city would pay discounted spot market prices over the 15-year period, thus preserving the cost savings from the prepaid purchase. The city could then enter into financial swaps over time to exchange the floating spot market prices for a fixed price to achieve the objective of stable rates for its customers.

### ***Sharp Declines in Market Prices for Natural Gas Have Proven Costly to the City***

Our finance and energy expert advised that while it is possible that natural gas prices could have risen, in which case the city would have benefited from the fixed price, that was uncertain at the time the city made its decisions, and its decision to pay a fixed price for a 15-year supply of natural gas supply was not based on an informed assessment of the benefits and risks. In fact, after June 2006, when the prepaid purchase was completed, the market price of natural gas did rise. By July 2008 the prevailing market price was \$10.48 per MMBtu,<sup>27</sup> and the city benefited during this period of time from its comparatively low fixed price of \$6.45 per MMBtu. Since that time, however, prices have steadily fallen, and in May 2012 the price was \$2.48 per MMBtu. In comparison, the city recently estimated that it is paying about \$7.50 per MMBtu for natural gas from the prepaid purchase, due to the bond refinancing in 2009. Unless market prices rebound to substantially higher levels, going forward the city will pay above-market prices for its natural gas.

Our finance and energy expert advised that the recent decline in natural gas prices is due in large part to the increasing use of production techniques involving horizontal drilling and hydraulic fracturing. The use of these techniques has resulted in increased production as well as large increases in the amount of natural gas reserves that are considered to be economically recoverable. Because of this new technical development, natural gas prices may remain depressed for years into the future. This means that the city's position is unlikely to improve substantially in the near term. Since the cost of natural gas is a key factor in the cost of generating electricity for the city, in the foreseeable future, the city's utility customers will pay more for electricity than they likely would have had the city followed a prudent purchasing strategy.

***The city's choice to lock in 75 percent of its 15-year supply of natural gas at a fixed price set at a single point in time is inconsistent with prudent purchasing strategies practiced by utilities to manage fluctuations in natural gas prices.***

<sup>27</sup> Prices described here are the monthly average of daily spot market prices for SoCal Border as reported by SNL Financial.

***The sale of the generating station has resulted in the city purchasing twice the amount of natural gas it needs and having to dispose of half of it.***

### ***The City Lacks an Integrated Energy Strategy***

In examining the city's process associated with the two significant energy-related transactions discussed in the previous sections, our finance and energy expert concluded that the city has lacked an integrated energy strategy. As an example, our finance and energy expert pointed to the inconsistency between the city's prepaid purchase of natural gas and the subsequent sale of its generating station, which would be using the natural gas. As described earlier, the prepaid purchase was financed using tax-exempt bonds, meaning that the city must own the generating station that uses the natural gas. The city council approved the execution of the prepaid purchase in July 2006. However, in August 2006—just one month later—the city council approved a contract with a financial consultant to advise the city on the sale of the generating station. Although the city was able to find a buyer for the remaining gas under the 15-year contract, it took a financial loss on the sale, as described in the earlier section. In addition, its contract with the private entity that owns the generating station requires the city to purchase the gas needed to fuel the generating station. In effect, the sale of the generating station has resulted in the city purchasing twice the amount of natural gas it needs and having to dispose of half of it. This creates additional complexity without any benefit to the city.

Our finance and energy expert advised that an integrated process to guide the city in its energy-related decisions should have the following attributes:

- Consideration of the city's current and future energy demands.
- Consideration of the sources and costs of the city's short-term and long-term energy supplies.
- Consideration of the reliability of the city's potential energy supplies.
- Consideration of regulatory issues such as compliance with California's new renewable energy requirements.
- Consideration of the impact that the city's decisions have on rates charged to its customers.

Our finance and energy expert reviewed the city's recent activity concerning compliance with California's new renewable energy requirements and concluded that the city is actively considering various options to meet the renewable energy targets required by state law. This process includes discussions at rate advisory meetings of alternatives for procuring renewable generation such

as biogas, solar, and wind, and obtaining city council approval of a renewable energy compliance plan, which includes providing regular updates to the city council on progress. These efforts are noteworthy and show good progress toward complying with the new requirements. However, our finance and energy expert also concluded that the city still has not developed an integrated energy strategy that integrates all elements of its energy needs and sources and that provides a process for ensuring that future energy-related decisions are based on thorough analysis and result in the best outcome for the city.

### The City's Decisions to Use Swaps Have Proven to Be Costly

As we discussed earlier, the city, its redevelopment agency, and the gas authority have issued bonds to fund various activities related to the power department and redevelopment efforts. For some of these bonds, the city used swaps in an attempt to reduce or manage the cost of the interest associated with this debt. Although swaps can be used effectively to manage debt, they are not without risk, and should be entered into only after full consideration of the associated risks and benefits. Some of the swaps were speculative in that the city speculated, or bet, that interest rates would change in its favor. Other swaps exposed the city to financial risks that proved to be costly during the 2008 financial crisis. Although the city consulted with a financial adviser on its swap transactions, our finance and energy expert concluded, based on the documents the city provided to us, that it lacked an effective process for appropriately evaluating the risks and benefits of swaps before entering into them and for deciding when to terminate its current and any future swaps. The city has terminated all but two of the swaps it entered into, at a net cost of more than \$33.4 million. In addition, as of February 2012, the city would have had to pay \$47 million to terminate the two swaps that remain outstanding.

#### ***The City Did Not Evaluate the Benefits, Risks, and Pricing Before Entering Into Swap Transactions***

A swap is a contractual arrangement in which two parties, known as counterparties, agree to exchange, or swap, payments based on two predetermined interest rates with one another periodically over a certain period. Municipalities often use swaps to offset, or hedge, risks associated with the issuance of bonds. For example, the 2006 Series B and Series C bonds that the gas authority issued to fund a portion of the 15-year prepaid gas supply paid a variable interest rate that changed

#### **Types of Swaps Entered Into by the City of Vernon**

- **Floating-to-fixed swap**—The City of Vernon (city) receives payments based on a variable rate and makes payments based on a fixed rate.
- **Fixed-to-floating swap**—The city receives payments based on a fixed rate and makes payments based on a variable rate.
- **Basis swap**—The city receives payments based on one variable rate and makes payments based on a different variable rate.

Source: Analysis Group, Inc.

### Risks Associated With Swaps

**Interest rate risk**—The risk that interest rates will increase or decrease, which can affect payments due under the swap and the market value of the swap.

**Basis risk**—The risk of a mismatch between the variable rate received by the municipality and the variable rate paid by the municipality. Relative changes in the two variable rates can affect payments due under the swap and the market value of the swap.

**Collateralization risk**—The risk that the market value of a swap will decrease enough that the municipality will have to post collateral to serve as a repayment guarantee.

**Counterparty risk**—The risk that the swap counterparty will fail to make required payments, will experience rating downgrades, or will file for bankruptcy protection.

**Liquidity/remarketing risk**—The risk that a municipality will not be able to secure a cost-effective renewal of a letter or line of credit or will suffer a failed auction, or remarketing, with respect to its variable-rate bonds, such as auction rate securities, whose variable interest rates are reset periodically through an auction process. A failed auction occurs when there is insufficient market demand for the auction rate security. This risk is present in synthetic fixed-rate bonds.

**Termination risk**—The risk that a swap will be terminated before its scheduled termination date. Upon an early termination, the municipality either may owe a substantial termination payment to the counterparty or may receive a substantial termination payment from the counterparty, depending on market interest rates.

Source: Analysis Group, Inc.

weekly based on market conditions. At the time that it issued these bonds, the gas authority also entered into a swap agreement known as a *floating-to-fixed swap*, whereby the gas authority paid a counterparty a fixed interest payment in return for receiving a variable interest payment from the counterparty. The counterparty's payments to the gas authority were expected to approximately equal the variable interest payments that the gas authority had to make for the 2006 Series B and Series C bonds. In other words, if the swap worked as intended, any increases in the variable-rate interest paid on the bonds would be offset by increases in interest payments received from the counterparty, thereby creating what is referred to as a *synthetic fixed-rate bond*. This is just one type of swap that parties can choose to enter into; the text box on the previous page describes the three types of swaps the city entered into between 2003 and 2007. Although swaps can help municipalities manage their interest rate risk, they also introduce other risks, and municipalities need to be cognizant of those risks, which are described in the text box. Appendix B contains additional explanations of these swaps and the associated risks.

The city did not demonstrate that it systematically evaluated the benefits, risks, or pricing of these financial tools. According to our finance and energy expert, before entering into a financial transaction such as a swap, the city should have analyzed many factors, including whether the benefits of the proposed transaction outweighed the risks, whether alternative transactions

were superior to the proposed transaction, and whether the city was receiving a fair price for the proposed transaction. The city was unable to provide evidence that it performed such an analysis prior to entering into any of its swap transactions.

### ***The City Entered Into a Series of Risky Swaps***

Our finance and energy expert reviewed the swaps entered into by the city between 2003 and 2007 and analyzed the relationship between the swaps and their associated bonds. Table 13 provides summary information about the swaps entered into by the city. We noted that the city consulted with a financial adviser before entering into each swap transaction. Nonetheless, it is the responsibility of



the city to ensure that it enters into these types of transactions only after a thorough evaluation and with an understanding of the benefits and risks. As can be seen in the last column of the table, the swaps had various purposes, depending on the relationship between the type of swap entered into and the associated bonds. These purposes are described in more detail in Appendix B. Perhaps most notably, the city entered into four swaps in which it speculated, or bet, that interest rates would change in a way that favored the city. Speculative transactions can be risky, and although the city made a profit totaling almost \$3.1 million on three of the four speculative swaps, it lost \$1.6 million on the fourth speculative swap. As shown in the table, the city has terminated all but two of the swaps, making net termination payments of \$33.4 million. As of February 2012 the two remaining swaps had a negative value of \$47 million, which is the amount the city would have needed to pay to terminate those swaps at that time.

**Table 13**  
**Swaps Entered Into by the City of Vernon and Their Associated Bonds**

SWAP NAME	INITIAL AGREEMENT DATE	SWAP TYPE	TERMINATION DATE	TERMINATION RECEIPT OR (PAYMENT)	ASSOCIATED BOND TYPE	NET EFFECT OF SWAP
<b>2003</b>						
A&B	July 2003	Basis	October 2006	\$1,550,000	Variable	Speculative transaction
C No. 1	March 2003	Forward fixed-to-floating	May 2007*	3,220,000 <sup>†</sup>	Fixed	Synthetic variable-rate bond
C No. 2	July 2003	Basis	October 2006	730,000	Fixed	Speculative transaction
<b>2004</b>						
A	December 2004	Floating-to-fixed	NA	(28,526,104) <sup>‡</sup>	Variable	Synthetic fixed-rate bond
B	December 2004	Floating-to-fixed	NA	(18,514,068) <sup>‡</sup>	Variable	Synthetic fixed-rate bond
D	March 2006	Floating-to-fixed	April 2010	(4,700,000)	Variable	Synthetic fixed-rate bond
<b>2005</b>						
No. 1	February 2006	Basis	February 2007	818,280	Fixed	Speculative transaction
No. 2	February 2007	Basis	December 2008 <sup>§</sup>	(1,625,000)	Fixed	Speculative transaction
<b>2006</b>						
All	June 2006	Floating-to-fixed	April 2010	(15,356,000)	Variable	Synthetic fixed-rate bond
B&C	June 2006	Floating-to-fixed	April 2010	(18,050,000)	Variable	Synthetic fixed-rate bond

Sources: Analysis Group, Inc's analysis of the City of Vernon's (city) swap confirmations, amended confirmations, and termination agreements from 2003 through 2010; audited financial statements for fiscal year 2010-11; swap summary dated February 2011; bond offering documents from 2003 through 2006; and redevelopment agency staff report dated December 2010.

NA = Not applicable.

\* In June 2003, the city elected to terminate the portion of the swap through April 2008 in exchange for a termination payment.

<sup>†</sup> The net termination amount includes the \$4,170,000 received by the city for the partial termination in June 2003 and the \$950,000 paid by the city for the full termination in May 2007.

<sup>‡</sup> The 2004 A swap and 2004 B swap are still open. The termination amount reflected is the fair value of the swap as of February 2012.

<sup>§</sup> The 2005 No. 2 swap was terminated after Lehman Brothers filed for bankruptcy in 2008. In November 2010 the city finalized the termination agreement and agreed to pay a termination payment of \$1,625,000.

<sup>||</sup> The city entered into four swaps associated with the four subseries of the 2006 Series A bonds.

### ***The City Did Not Follow Best Practices, or Its Own Belatedly Adopted Guidelines, When Deciding to Enter Into Swaps***

Since at least 2003 the GFOA has published best practices for state and local governments' use of swaps and other similar products.<sup>28</sup> The GFOA recommends that state and local governments "be cautious" and use financial products such as swaps only after the government entities have developed "a sufficient understanding of the products" and "the internal staffing and expertise to properly manage and evaluate these products." Further, the GFOA recommends that government entities should have "methods for measuring, evaluating, monitoring, and managing risks," including basis risk, interest rate risk, and termination risk, among others. These best practices can be implemented to form a basic evaluation process for a municipality that intends to use swaps.

In July 2005, having already entered into a number of swap transactions, the city council adopted guidelines for the use of swaps and other derivative products (guidelines). The key elements of the guidelines are described in the text box and are consistent with GFOA best practices.

The guidelines list certain restrictions for the city, most notably that the city is not to use swaps for *inherently speculative purposes*.<sup>29</sup> The guidelines also specify analyses that the city needs to perform before entering into swap transactions. Such analyses include an evaluation of the expected benefits to the city against the potential risks of entering into a swap, an analysis to determine whether a synthetic fixed-rate bond will generate material savings versus a traditional fixed-rate bond, and an analysis to determine whether the proposed pricing for a swap is fair.

Table 14 shows our finance and energy expert's analysis of the city's level of adherence to GFOA best practices and the city's own guidelines when it entered into each swap transaction. According to our finance and energy expert, only a limited number of the documents provided by the city contained partial

#### **The City of Vernon's Key Guidelines for Interest Rate Swaps**

1. Interest rate swaps (swaps) are not to be used for inherently speculative purposes.\*
2. The City of Vernon (city) shall obtain an independent validation that the pricing of the swaps reflects fair market value.
3. The city should provide the following information to the city council:
  - a. Identification of the expected benefits and the risks of the proposed swap.
  - b. Analysis of the expected benefits and the risks of the proposed swap, including sensitivity and breakeven analyses.
  - c. Analysis of the impact of the proposed swap on the city's interest rate exposure and budgets.
  - d. Impact of the proposed swap on the city's credit rating.
  - e. Exposure from involuntary termination of the proposed swap.
4. The city should analyze the following risks associated with proposed swaps:
  - a. Counterparty risk
  - b. Termination risk
  - c. Tax risk
  - d. Basis risk
  - e. Tax-exemption risk
  - f. Liquidity/remarketing risk
5. A synthetic fixed-rate bond issuance or other transactions resulting in the city having a fixed pay obligation should be expected to generate material savings versus a comparable fixed-rate bond offering.

Source: *Guidelines for Utilization of Interest Rate Swaps & Other Derivative Products*, City of Vernon, July 2005.

\* The city amended its guidelines in May 2006, and deleted this restriction.

<sup>28</sup> *Use of Debt-Related Derivatives Products and the Development of a Derivatives Policy*, GFOA, May 2003.

<sup>29</sup> The city amended its guidelines in May 2006 and deleted this restriction.

consideration or quantification of the risks and benefits associated with the swaps. These documents included, for example, proposals and presentations from the city’s financial adviser recommending that the city enter into swap transactions. Although some of these documents contained descriptions of the risks associated with the proposed swap transactions, they did not include any analysis or quantification of the risks in a manner that would be consistent with the city’s guidelines or GFOA best practices.<sup>30</sup> A single document prepared by the city’s financial adviser included a quantification of interest rate risk. However, this analysis was performed after the city had already entered into the swap transactions. In addition, the quantification was limited in scope and did not provide an overall assessment of the risk exposure of the swaps.

**Table 14**  
**City of Vernon’s Adherence to Its Interest Rate Swap Guidelines and to Published Best Practices**

SWAP	DOCUMENTATION PROVIDED FOR INITIATION OF SWAP		
	VALIDATION OF FAIR MARKET VALUE OF TRANSACTION	IDENTIFICATION OF EXPECTED BENEFITS AND POTENTIAL RISKS*	FINANCIAL ANALYSIS OF EXPECTED BENEFITS AND POTENTIAL RISKS
<b>2003</b>			
A&B	None	Partial	None
C No. 1	None	None	None
C No. 2	None	None	None
<b>2004</b>			
A	None	None	None
B	None	None	None
D	None	None	None
<b>2005</b>			
No. 1	None	Partial	None
No. 2	None	None	None
<b>2006</b>			
A	None	None	None
B&C	None	None	None

Sources: City of Vernon (city) audited financial statements for fiscal years 2003–04 through 2006–07, credit presentations from 2004 through 2007, relevant city resolutions from 2003 through 2007, relevant city meeting minutes from 2003 through 2007, swap and bond memos and presentations from and correspondence with the city’s financial adviser from 2003 through 2007, bond offering documents from 2003 through 2006, swap confirmations and amended confirmations from 2003 through 2007, and credit rating agency reports from 2004 through 2007.

\* The city only provided documents identifying swap benefits and risks for the 2003 A&B swap and the 2005 No. 1 swap. The information provided in the documents is incomplete and not supported by detailed analysis.

<sup>30</sup> One of these proposals included a postexecution version with assertions that the 2005 No. 1 swap was “within the execution parameters” of the guidelines, that the risk-benefit of the transaction was “acceptable,” and that the decision to enter into the swap was “right” for the city. However, analysis supporting these assertions was not provided by the city.

***Obtaining a swap at a competitive interest rate is crucial because small differences in the contract terms can lead to millions of dollars in future interest costs to the city.***

In addition, the city did not demonstrate that it verified that the swap transactions it entered into were executed at fair market value, meaning that the interest rates being swapped were fair to the city. Although one document prepared by the city's financial adviser states that it would solicit information from multiple parties to ensure a competitive market interest rate, the city was unable to provide any documents demonstrating the actual process that was used to confirm competitive pricing and fair market value. Obtaining a swap at a competitive interest rate is crucial because small differences in the contract terms can lead to millions of dollars in future interest costs to the city.

Furthermore, the city was unable to provide documentation demonstrating that it informed the city council, redevelopment agency, and gas authority of its evaluation of potential risks, benefits, or fair pricing of the swaps. Therefore, it is unclear how these governing bodies made informed decisions before approving the swaps. For example, the governing board of the gas authority passed a resolution finding that the swaps associated with the 2006 bonds created a synthetic fixed-rate bond that reduced interest rate cost compared to issuing traditional fixed-rate bonds. Although such a finding is consistent with the city's guidelines for entering into a swap used to issue a synthetic fixed-rate bond, the city was unable to provide documents showing what information was provided to the board for it to make this determination.

***The City Has Not Followed a Clear Process in Deciding When to Terminate Its Swaps, nor Could It Demonstrate That It Performed the Customary Financial Analysis***

As of May 2012 the city had terminated all but two of its swaps, but it has not followed a clear process in deciding when to terminate, or pay off, the swaps. Nearly all of the swaps were terminated after their associated bonds were retired. However, keeping swaps open after the associated bonds have been retired can expose a municipality to additional risks that require careful consideration, because the swaps no longer serve as a hedging tool. For example, as discussed earlier, the city created synthetic fixed-rate bonds by issuing the 2006 Series B and Series C variable-rate bonds and then entering into a separate floating-to-fixed swap agreement with a counterparty, but when it retired these 2006 bonds, it did not terminate the associated swaps. Consequently, it was exposed to interest rate risk—in this case, the risk that interest rates would remain low and that its payments to the counterparty would be high. Subsequently, the interest rates have remained low, resulting in the city receiving lower interest payments from the counterparty and the city needing to make higher payments

on the swap. If the associated bonds had still been outstanding, the city's high payments on the swap may have been offset by the reduced interest payments on the variable-rate bonds.

Our finance and energy expert indicated that it would have expected the city to consider several factors in deciding whether or not to terminate its swaps at a given time, including the following:

- Financial benefits and costs associated with the termination.
- Cost of holding on to the swap versus the cost of borrowing funds to terminate.
- City's near-term and long-term cash flow needs.
- Impact of not terminating on the city's credit rating.
- Hedging purpose of the swap.
- Risk of needing to post additional collateral.

As Table 15 on the following page shows, the city provided only limited documentation demonstrating that it analyzed the factors discussed above when considering terminating its swaps. In addition, the city's guidelines state that it is to actively manage its swap program and prepare a report at least twice per year describing the status of its swaps. However, the city provided us only the report for June 2011, and this report does not meet all of the requirements in the city's guidelines. Without considering the factors described above, the city cannot demonstrate that it was able to make an informed decision that terminating the swaps would benefit the city. Additionally, after deciding to terminate a swap, it would have been customary for the city to confirm that the termination amount was at a fair market price. However, it appears that the city did not receive such confirmations when it terminated its swaps. Appendix B provides additional examples and explanations regarding the lack of financial analysis supporting various city decisions to terminate swaps.

Despite the significant liability it carries as a result of the two outstanding 2004 swaps, the city has not provided a consistent strategy for deciding the conditions under which it will terminate these two swaps. The failure to terminate these swaps has been costly to the city. It made interest payments to the swap counterparty of \$11.4 million during fiscal years 2009–10 and 2010–11. Further, had the city terminated these swaps in February 2012, it would have had to make termination payments of approximately \$47 million. This is over 80 percent more than it would have paid eight months prior, when the payment to terminate these swaps would have been \$26 million. Our finance

and energy expert identified only a few documents that reference the potential termination of these swaps. These documents show a changing strategy for terminating the swaps, but there is no detailed analysis to support this strategy. For example, according to one rating agency report, the city will terminate the two outstanding swaps if their value improves to approximately negative \$10 million, but no analysis was provided to support this decision. Without a well-reasoned strategy, the city is failing to effectively manage these liabilities.

**Table 15**  
**Ongoing Management and Analysis of Interest Rate Swaps by the City of Vernon**

SWAP NAME	DOCUMENTATION PROVIDED FOR ONGOING SWAP MANAGEMENT				STATUS
	REPORTING AND MONITORING*	INTERIM TERMINATION ANALYSIS†	ANALYSIS AT TERMINATION‡		
<b>2003</b>					
A&B	Partial	None	None		Terminated
C No. 1	Partial	None	Partial		Terminated
C No. 2	Partial	None	None		Terminated
<b>2004</b>					
A	Partial	None	NA		Open
B	Partial	None	NA		Open
D	Partial	None	None		Terminated
<b>2005</b>					
No. 1	Partial	None	None		Terminated
No. 2	Partial	None	NA§		Terminated
<b>2006</b>					
A	Partial	Partial	None		Terminated
B&C	Partial	Partial	None		Terminated

Sources: City of Vernon (city) audited financial statements for fiscal years 2003–04 through 2010–11, credit presentations from 2004 through 2011, relevant city resolutions from 2003 through 2011, relevant city meeting minutes from 2003 through 2011, swap and bond memos and presentations from and correspondence with city's financial adviser from 2003 through 2012, bond offering documents from 2003 through 2012, swap confirmations, amended confirmations and termination agreements from 2003 through 2010, and credit rating agency reports from 2004 through 2011.

NA = Not applicable.

\* The city provided regular swap updates in its annual audited financial statements, however, these financial statements did not contain a complete reporting and monitoring analysis. Additionally, the city only produced one *Interest Rate Swap Monitoring Report*, which was for the 2004 A and 2004 B swaps for the period ending June 30, 2011.

† The city provided one document from its financial adviser that discussed the potential termination of the 2006 swaps. However, the recommendations made in the document are not supported by detailed analyses.

‡ The city provided one document from its financial adviser recommending a partial termination of the 2003 C No. 1 swap. The recommendations made in the document are not supported by detailed analyses.

§ The 2005 No. 2 swap was terminated after Lehman Brothers filed for bankruptcy in 2008.

## Recommendations

To ensure that it issues debt when doing so is in the best interests of the city and is consistent with its long-term financial goals, the city should establish a comprehensive debt policy that includes the elements that the GFOA recommends and make the debt policy it establishes available on its Web site.

To ensure that the city council and public are well informed regarding proposed debt decisions, the city should provide summary information that clearly explains the costs, risks, and benefits related to the proposed decisions in its agenda packets, and should provide these in advance on its Web site.

To ensure that it can demonstrate sufficient analysis and provide justification for its decisions on significant energy-related transactions, the city should develop an integrated energy strategy that examines all elements of its energy needs, sources, and objectives. As part of the strategic initiative, the city should create a formal process and guidelines that include the following:

- Identifying the benefits and risks of proposed transactions.
- Quantifying the benefits and risks of proposed transactions.
- Evaluating and comparing proposed transactions against alternative proposals.
- Quantifying the impact of proposed transactions on short-term and long-term rates paid by the city's energy customers.
- Seeking an independent validation of the fair market value of proposed transactions.
- Documenting and communicating the findings of the evaluation process to the city council.

If the city plans to continue to rely on the advice of its consultants, it should develop a process for the consultants to provide written documentation that would enable the city to satisfy the above-mentioned process and guidelines.

To minimize the continuing financial losses on the two currently outstanding swaps, the city should develop a clear process for deciding how it will terminate these swaps based on the cost and future risk to the city.

To ensure that any future decisions to enter into swaps are carefully considered, the city should develop and follow a process that thoroughly analyzes the risks and benefits of the potential swap transaction. As part of this process, the city should specifically disallow the use of derivatives for speculative purposes and should require the retention of the documents and analyses that support the decision to enter into the swap.

We conducted this audit under the authority vested in the California State Auditor by Section 8543 et seq. of the California Government Code and according to 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 specified in the scope section of the report. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Respectfully submitted,



ELAINE M. HOWLE, CPA  
State Auditor

Date: June 28, 2012

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For questions regarding the contents of this report, please contact Margarita Fernández, Chief of Public Affairs, at 916.445.0255.



## Appendix A

### CITY OF VERNON GOOD GOVERNANCE REFORM MEASURES

The City of Vernon (city) adopted a number of reform measures, many of which were based on recommendations proposed by a state senator and the city's independent ethics adviser. These reform measures are intended to improve governance and increase accountability and transparency. The city tracks its progress on these reform measures and presents updates periodically on its Web site. Table A on the following page presents a summary of the status of the city's reform measures and our comments on the selected reforms we reviewed.

As of January 2012 the city reported that it had implemented 40 of the 69 reform measures. However, as we discuss in the report and show in Table A, for some reforms the city still has more to do to achieve the intended benefit of the reforms it reports as complete, and for others it will be years before the change takes effect.

**Table A**  
**City of Vernon Good Governance Reform Measures**

NO.	REFORM MEASURE	CITY REPORTED STATUS	AUDITOR COMMENT ON STATUS (IF APPROPRIATE)	PAGE NUMBER WHERE DISCUSSED IN REPORT
<b>City Council and Elections</b>				
1	<b>Term limits:</b> Establish council member term limits.	<b>Complete:</b> In November 2011 city voters passed a charter amendment limiting council members to two five-year terms in office, with a lifetime ban thereafter.	The terms of office that began before the enactment of the charter amendment would not apply toward the two-term limit.	
2	<b>City council compensation increases:</b> Establish salary and benefit limits for city council members.	<b>Complete:</b> In November 2011 city voters passed a charter amendment prohibiting council members from increasing their salary and benefits in excess of cost-of-living adjustments.	Complete.	
3	<b>City council salary compensation:</b> Complete a salary and benefits survey of council members in comparable jurisdictions.	<b>Complete:</b> In May 2011 the city council approved a resolution limiting council members' salaries to \$25,000, effective after the end of current terms. It also reduced benefits, effective July 2011.	The first reduction of a council member's salary to \$25,000 will occur in April 2012. The salary reductions for all council seats will not be complete until 2016.	33-34
4	<b>City council salary compensation:</b> Reduce council member salaries effective immediately to the levels set forth in the May 2011 resolution, rather than at the end of each member's term.	<b>Complete:</b> The city council has discussed and reaffirmed the resolution fixing salaries of council members at \$25,000, effective at the end of their terms.	The first reduction of a council member's salary to this level will occur in April 2012. The salary reductions for all council seats will not be complete until 2016—this is not immediate as called for in the reform.	33-34
5	<b>City council appointments:</b> Prohibit the city council from appointing successors.	<b>Complete:</b> In November 2011 city voters passed an amendment prohibiting the city council from making appointments to vacant council seats under any circumstances.	Complete.	
6	<b>City council appointments:</b> Repeal the ordinance concerning city council appointments, as it will be in conflict with the new charter provision (item 5).	<b>Ongoing:</b> The repeal of this ordinance was to be placed on the February 7, 2012, city council agenda.	Complete.	
7	<b>Special election ordinance:</b> Adopt an ordinance to allow special elections on nonestablished dates.	<b>Complete:</b> In August 2011 the city council adopted an ordinance allowing it to call elections on nonestablished election dates.	Complete.	
8	<b>Elections:</b> Hold elections every two years with staggered four-year terms for council members, with two seats up at one election and three seats up in the other election.	<b>Complete:</b> The city has decided to maintain its existing election schedule.	Did not review. However, the city's reporting its status as complete when it chooses not to implement a reform is, in our view, misleading.	
9	<b>Travel policy for council members.</b>	<b>Complete:</b> In November 2011 the city council adopted a written formal travel policy for city employees and council members that includes specific guidance related to the purchase of economy airline tickets.	The travel policy needs clarification of whether expenditure limits can be exceeded if a receipt is provided, and a specific expenditure limit for lodging needs to be set.	54

NO.	REFORM MEASURE	CITY REPORTED STATUS	AUDITOR COMMENT ON STATUS (IF APPROPRIATE)	PAGE NUMBER WHERE DISCUSSED IN REPORT
<b>Contracting</b>				
10	<b>Competitive bidding:</b> Establish an open and competitive bidding process for service contracts by ordinance.	<b>Complete:</b> In November 2011 city voters passed an amendment allowing for an open and competitive bidding process for city service contracts.	As of May 2012 the city council had not adopted an ordinance to establish a competitive bidding process for service contracts.	24-25
11	<b>Competitive bidding:</b> Establish an open and competitive bidding process for city service contracts by ordinance if the charter amendment allowing for an open and competitive process on city service contracts is approved.	<b>Ongoing:</b> City review of competitive bidding ordinances in surrounding jurisdictions is in process. It planned to adopt an ordinance by April 3, 2012.	As of May 2012 the city council had not adopted an ordinance to establish a competitive bidding process for service contracts.	24-25
12	<b>Contracts:</b> Require all contracts, including professional service contracts, to include ending dates and/or expenditure caps.	<b>Ongoing:</b> City staff and outside counsel are developing a comprehensive policy relating to city contracts. A comprehensive contract policy resolution is to be adopted by the city council by July 3, 2012.	The city should apply the new comprehensive policy to all active city contracts.	43, 46, and 47
13	<b>Contracts:</b> Review and rebid professional service contracts at least once every three years.	<b>Ongoing:</b> City staff and outside counsel are developing a comprehensive policy relating to city contracts. A comprehensive contract policy resolution is to be adopted by the city council by July 3, 2012.	The city should apply the new comprehensive policy to all active city contracts.	51-53
14	<b>Contracts:</b> Require lead staff on professional service contracts, especially for legal services, to negotiate for best rates or rates similar to those provided to other government agencies.	<b>Ongoing:</b> City staff and outside counsel are developing a comprehensive policy relating to city contracts. A comprehensive contract policy resolution is to be adopted by the city council by July 3, 2012.	The city should apply the new comprehensive policy to all active city contracts.	
15	<b>Contracts:</b> Require that the review and sign-off of professional service invoices by the initiating division or department be reinforced either through a policy amendment or by memorandum from the city administrator.	<b>Ongoing:</b> City staff and outside counsel are developing a comprehensive policy relating to city contracts. A comprehensive contract policy resolution is to be adopted by city council by July 3, 2012.	The city should apply the new comprehensive policy to all active city contracts. In addition, the city should implement a policy to require all active contractors to include language requiring contractors to provide sufficiently detailed invoices. If invoices lack detail the finance department should reject them for payment.	47-51
16	<b>Contracts:</b> Prohibit increases in compensation rates during the term of the contract; however, if an increase is necessary, require the increase to be tied to the most appropriate index or cost-of-living rate.	<b>Ongoing:</b> A review of current contracts to identify those that permit rate increases is underway. The city is to complete its reviews and notify consultants by July 3, 2012, of the new practice and adopt a resolution seeking to amend contracts accordingly, where necessary.	Did not review.	
17	<b>Contracts:</b> Review contracts with individuals to make sure the criteria for contractors or consultants are being met. If any contracts do not meet this criteria, take steps to transfer the work to city employees or change the status of contractor to employee.	<b>Ongoing:</b> A review of all contractor and consultant contracts for compliance is underway. The city was to complete the reviews and implement any changes by March 1, 2012.	Did not review.	

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NO.	REFORM MEASURE	CITY REPORTED STATUS	AUDITOR COMMENT ON STATUS (IF APPROPRIATE)	PAGE NUMBER WHERE DISCUSSED IN REPORT
<b>City-Owned Housing</b>				
18	<b>Housing commission:</b> Establish an independent housing commission.	<b>Complete:</b> In November 2011 city voters passed an amendment requiring the city to maintain its recently created housing commission to oversee the day-to-day management, leasing, and maintenance of city-owned housing.	Complete.	
19	<b>Housing commission:</b> Appoint members.	<b>Complete:</b> In August 2011 the city council appointed seven members to the housing commission.	Complete.	
20	<b>Housing commission:</b> Adopt a conflict-of-interest code.	<b>Complete:</b> In August 2011 the city council adopted a conflict-of-interest code for the new housing commission.	Complete.	
21	<b>Housing policy:</b> Adopt a housing policy to be applied to all housing owned by the city.	<b>Complete:</b> In October 2011 the city council adopted a housing policy as recommended by the housing commission.	Complete.	
22	<b>Housing commission rent survey:</b> Set rates on a market basis.	<b>Ongoing:</b> The housing commission was to establish market rents by February 9, 2012.	<i>The housing commission proposed that the new market rate be applied in annual increments, with the full rate increase not taking effect until July 2015.</i>	25
23	<b>Housing commission:</b> Make a recommendation regarding divestment of city-owned housing.	<b>Ongoing:</b> The housing commission was to make a recommendation to the city council regarding whether the city should divest its ownership of city-owned housing by February 9, 2012.	<i>As of May 2012 the housing commission has not made a recommendation to the city council about whether the city should continue to own housing.</i>	25-26
24	<b>Housing commission:</b> Make a recommendation regarding new housing units.	<b>Ongoing:</b> A housing commission recommendation on housing development opportunities was to be prepared by March 8, 2012.	Did not review.	
25	<b>Convey city housing to housing commission.</b>	<b>Ongoing:</b> Transfer of the city's housing interest to the housing commission was to be completed by May 1, 2012, pending legal analysis to determine whether the housing commission can hold the titles.	Did not review.	
26	<b>Double the city's population:</b> Develop new housing units.	<b>Ongoing:</b> A comprehensive plan for the construction of approximately 50 new noncity-owned housing units was to be submitted to the housing commission by April 12, 2012.	<i>As of May 2012 the city had not developed a comprehensive plan.</i>	26
27	<b>Property management firm for city housing.</b>	<b>Ongoing:</b> Prepare a request for qualification for a third-party property management firm to take over primary management of city-owned housing. The housing commission will establish the time frame.	Did not review.	
<b>Employment Relations</b>				
28	<b>At-will employment:</b> Remove the "at-will" provision in the city charter.	<b>Complete:</b> In November 2011 city voters passed an amendment removing the at-will employment provision for city employees.	<i>Eliminating the "at-will" provision did not immediately change the existing employment status of city employees. The city needs to adopt and implement an alternative employment policy.</i>	23-24
29	<b>Prevailing wage policy:</b> Maintain a prevailing wage policy.	<b>Complete:</b> In November 2011 city voters passed an amendment requiring that the city comply with prevailing wage laws for public works projects.	Complete.	

NO.	REFORM MEASURE	CITY REPORTED STATUS	AUDITOR COMMENT ON STATUS (IF APPROPRIATE)	PAGE NUMBER WHERE DISCUSSED IN REPORT
30	Living wage policy: Establish a living wage program for city employees and contractors.	Complete: In October 2011 the city council adopted by ordinance a living wage policy.	Did not review.	
31	Fire and police department collective bargaining: Continue to allow for collective bargaining by police and firefighters.	Complete: In August 2011 the city council adopted a policy to continue to work in cooperation with the fire and police departments.	Did not review.	
32	Collective bargaining neutrality: Establish collective bargaining neutrality for city workers.	Complete: In August 2011 the city council adopted a policy of collective bargaining neutrality.	Did not review.	
33	Prevailing wage policy: Adopt a policy of supporting a prevailing wage policy, regardless of the charter amendment election result.	Complete: In August 2011 the city council adopted a prevailing wage policy.	Complete.	
<b>Executive Salaries</b>				
34	Executive salaries.	Complete: The city conducted a salary survey and on May 26, 2011, the city council passed a resolution adjusting executive salaries where necessary, to be consistent with comparable jurisdictions.	The city may not have chosen positions in the most comparable cities for comparison in its executive salary survey.	28-33
35	Market salary comparison studies.	Complete: Staff have established calendar notifications to ensure that the next market comparison studies for executives and other key staff positions are conducted by May 2014.	Future executive salary surveys should be performed by staff or a consultant with experience and expertise in salary surveys.	
36	City administrator removal and compensation: Remove the charter provision that limits the ability to remove the city administrator.	Complete: In November 2011 the city voters passed an amendment removing the limitations on the removal of the city administrator and changes to the city administrator's compensation.	Complete.	
<b>Good Neighbor Program</b>				
37	Sustainable Development and Energy Efficiency Commission (SDEEC).	Complete: In November 2011 the city council by ordinance established the SDEEC and appointed its members.	Did not review.	
38	Sustainability action plan.	Ongoing: The SDEEC was to develop and recommend to the city council a sustainability action plan by May 2012.	Did not review.	
39	Environmental and Community Benefit Fund (ECBF): Establish a substantial and long-term ECBF to help mitigate the decades of noxious air released from the city.	Ongoing: The city is in the process of identifying a funding mechanism for the ECBF, and a recommendation is to be submitted to the city council by July 3, 2012.	The city has not identified a funding source for the ECBF.	67
40	Trash hauling franchise program.	Ongoing: An updated trash hauling franchise program and policies were to be presented to the city council by June 5, 2012.	Did not review.	
<b>Independent Reform Monitor</b>				
41	Independent reform monitor: Appoint an independent reform monitor for a period of no less than four years.	Complete: In November 2011 city voters passed an amendment requiring the city to hire an independent reform monitor for four years to review city policies and recommend governance reform measures.	Complete.	
42	Independent reform monitor contract.	Complete: In January 2012 the city council approved a new four-year reform monitor contract with John Van de Kamp, commencing February 15, 2012.	Complete.	

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June 2012

NO.	REFORM MEASURE	CITY REPORTED STATUS	AUDITOR COMMENT ON STATUS (IF APPROPRIATE)	PAGE NUMBER WHERE DISCUSSED IN REPORT
<b>Operations</b>				
43	<b>Light and power fund transfers:</b> Remove the charter provision prohibiting transfers from the light and power fund to the general fund.	<b>Complete:</b> In November 2011 city voters passed an amendment removing the prohibition on transfers from the light and power fund.	<i>The city needs to develop a formal policy to describe the circumstances under which revenues can be transferred from the light and power fund and the limits and permissible uses of transferred revenue.</i>	24
44	<b>Electric rates ad hoc committee.</b>	<b>Complete:</b> In April 2011 the city passed a resolution establishing an Advisory Committee on Electric Rates.	Complete.	
45	<b>Travel policy for city employees.</b>	<b>Complete:</b> In November 2011 the city council adopted a written formal travel policy for city employees and council members.	<i>The travel policy needs clarification of whether expenditure limits can be exceeded if a receipt is provided, and a specific expenditure limit for lodging needs to be set.</i>	54
46	<b>Operations:</b> Hold executive meetings.	<b>Complete:</b> Regular department head meetings began in July 2011 and are held on a biweekly basis.	Did not review.	
47	<b>Operations:</b> Provide Assembly Bill 46 updates.	<b>Complete:</b> Provide updates about Assembly Bill 46 to city employees, with plans to do so on an ongoing basis as needed.	Did not review.	
48	<b>Operations:</b> Adopt a nepotism policy.	<b>Complete:</b> In August 2011 the city council adopted a nepotism policy.	Did not review.	
49	<b>Operations:</b> Provide training for the city clerk.	<b>Complete:</b> The city clerk attended training in complying with the Ralph M. Brown Act and Public Records Act in September 2011 and in election regulations in January 2012, and will do so on an ongoing basis as needed.	Complete.	
50	<b>Operations:</b> Participate in the Independent Cities Association (ICA) and California League of Cities (League).	<b>Complete:</b> The city administrator attended various ICA and League events in 2011 and 2012.	Did not review.	
51	<b>Operations:</b> Adopt a media policy and provide media training.	<b>Ongoing:</b> The city council adopted a media policy in November 2011, and media training for department heads and others is scheduled by June 2012.	Did not review.	
52	<b>Operations:</b> Hire a city attorney.	<b>Ongoing:</b> The city has started the process of searching for a city attorney with municipal law and redevelopment experience.	In progress.	27-28
53	<b>Operations:</b> Determine the need for an assistant city administrator and assistant fire chief.	<b>Ongoing:</b> The city is to decide whether it wants the city administrator-fire chief to continue to serve in dual capacity and whether he will have assistants in each role—discussion and possible action by May 2012.	<i>As of May 2012 the city administrator-fire chief continued to serve in dual capacity.</i>	
54	<b>Operations:</b> Hire a human resources director.	<b>Ongoing:</b> The city plans to hire a human resources director by June 2012.	In progress.	28
55	<b>Operations:</b> Conduct a study of the police department.	<b>Ongoing:</b> The city is seeking an independent firm to complete a study of the police department services, staffing, and costs in comparison to other industrial cities by July 2012.	Did not review.	

NO.	REFORM MEASURE	CITY REPORTED STATUS	AUDITOR COMMENT ON STATUS (IF APPROPRIATE)	PAGE NUMBER WHERE DISCUSSED IN REPORT
56	Operations: Establish consulting relationships with executives in other cities.	Ongoing: The city plans to establish an ongoing consulting relationship with city administrators and city managers from other Southern California cities and League representatives to review best practices by September 2012.	Did not review.	
57	Business Development Committee.	Ongoing: In January 2012 the city established a Business Development Committee to explore ways to improve the business climate in the city. The committee is to make recommendations to the city council by July 2012.	Did not review.	
<b>TRAINING AND COMPLIANCE</b>				
<b>Political Reform Act</b>				
58	Campaign disclosure training.	Complete: The city clerk attended training on January 5, 2012, and will do so on an ongoing basis as needed.	Complete.	
59	Conflict-of-interest statements training: Timely filing.	Complete: The city clerk attended training on January 5, 2012, and will do so on an ongoing basis as needed.	Complete.	
60	Conflict-of-interest statements training: Accessibility and retention.	Complete: The city clerk attended training on January 5, 2012, and will do so on an ongoing basis as needed.	Complete.	
61	Conflict-of-interest statements: Provide written guidance.	Complete: The city has prepared an information package containing written guidance from the California Fair Political Practices Commission on preparing and filing conflict statements.	Did not review.	
62	Conflict-of-interest statements: Provide written instructions on compliance with the California Government Code, Section 1090.	Ongoing: The city is developing a comprehensive compliance manual covering the California Government Code, Section 1090; the Political Reform Act of 1974; the Ralph M. Brown Act; and the Public Records Act. The manual was to be completed by April 2, 2012.	On April 27, 2012, the city provided us a draft of the comprehensive manual, which it plans to finalize in time for its annual compliance training scheduled for early July 2012. Because the manual was not final, we did not review it.	
63	Conflict-of-interest codes: Adopt/update the conflict-of-interest codes for all city agencies.	Ongoing: A review of the existing conflict-of-interest codes is underway; any necessary updates will be adopted by October 2012.	Did not review.	
<b>Ethics</b>				
64	Ethics training: Provide ethics training in accordance with California Government Code, Section 53235.	Complete: The city has retained outside legal counsel with expertise in political law, and in June 2011, city staff completed ethics training; it will receive periodic training as needed in accordance with state law.	Complete.	
65	Ethics training: Develop a compliance manual.	Ongoing: The city is developing a comprehensive compliance manual covering the California Government Code, Section 1090; the Political Reform Act of 1974; the Ralph M. Brown Act; and the Public Records Act. The manual was to be completed by April 2, 2012.	On April 27, 2012, the city provided us a draft of the comprehensive manual, which it plans to finalize in time for its annual compliance training scheduled for early July 2012. Because the manual was not final, we did not review it.	

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NO.	REFORM MEASURE	CITY REPORTED STATUS	AUDITOR COMMENT ON STATUS (IF APPROPRIATE)	PAGE NUMBER WHERE DISCUSSED IN REPORT
<b>Brown Act</b>				
66	<b>Brown Act compliance training.</b>	<b>Complete:</b> City staff attended training in September 2011 and will attend additional training beginning in the fall of 2012.	Complete.	
67	<b>Brown Act compliance materials.</b>	<b>Ongoing:</b> The city is developing a comprehensive compliance manual covering the California Government Code, Section 1090; the Political Reform Act of 1974; the Ralph M. Brown Act; and the Public Records Act. The manual was to be completed by April 2, 2012.	On April 27, 2012, the city provided us a draft of the comprehensive manual, which it plans to finalize in time for its annual compliance training scheduled for early July 2012. Because the manual was not final, we did not review it.	
<b>Public Records Act</b>				
68	<b>Public Records Act compliance training.</b>	<b>Complete:</b> City staff attended training in September 2011 and will attend additional training beginning in the fall of 2012.	Complete.	
69	<b>Public Records Act compliance materials.</b>	<b>Ongoing:</b> The city planned to post a Public Records Act compliance policy on its Web site by January 17, 2012. The city is developing a comprehensive compliance manual covering the California Government Code, Section 1090; the Political Reform Act of 1974; the Ralph M. Brown Act; and the Public Records Act. The manual was to be completed by April 2, 2012.	On April 27, 2012, the city provided us a draft of the comprehensive manual, which it plans to finalize in time for its annual compliance training scheduled for early July 2012. Because the manual was not final, we did not review it.	

Sources: City of Vernon's (city) *Good Governance Reform Implementation Matrix*, updated January 17, 2012, and discussions with city staff.



## Appendix B

### INTEREST RATE SWAP TRANSACTIONS

As discussed in Chapter 4, the City of Vernon (city) entered into various interest rate swaps (swap) in an attempt to manage its debt. This appendix provides additional background regarding the use of interest rate swaps and the specifics of these transactions.

#### ***Municipalities Use Swaps Primarily to Offset Risks Associated With Issuing Bonds***

A swap is a contractual arrangement in which two parties, known as counterparties, agree to exchange, or swap, payments based on two predetermined interest rates with one another periodically over a certain period. There are several types of swaps that parties can choose to enter into—the text box describes the three types of swaps the city entered into between 2003 and 2007. Municipalities often use swaps to offset, or hedge, risks associated with the issuance of bonds. For example, as shown in Figure B.1 on the following page, when issuing a variable-rate bond,<sup>31</sup> a municipality might also enter into a corresponding floating-to-fixed swap to convert the variable-rate bond to a synthetic fixed-rate bond. In this instance, the municipality's strategy would be to have the variable payment it pays on the bond be canceled out by the variable payment it receives from the counterparty in the swap, effectively leaving the municipality with a fixed payment obligation similar to that of a fixed-rate bond.<sup>32</sup> Such a combination of a variable-rate bond with a swap is referred to as a *synthetic fixed-rate bond*. Alternatively, a municipality can create a synthetic variable-rate bond by issuing a fixed-rate bond and then entering into a fixed-to-floating swap.

#### **Types of Swaps Entered Into by the City of Vernon**

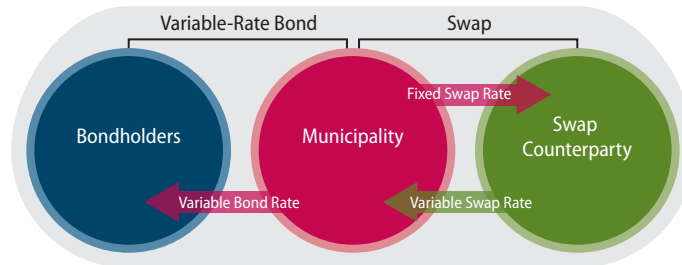
- **Floating-to-fixed swap**—The City of Vernon (city) receives payments based on a variable rate and makes payments based on a fixed rate.
- **Fixed-to-floating swap**—The city receives payments based on a fixed rate and makes payments based on a variable rate.
- **Basis swap**—The city receives payments based on one variable rate and makes payments based on a different variable rate.

Source: Analysis Group, Inc.

<sup>31</sup> A variable-rate bond is a bond that pays interest to investors at a rate that is periodically reset based on market conditions.

<sup>32</sup> A fixed-rate bond is a bond that pays interest to investors at an unchanging rate.

**Figure B.1**  
A Swap Used to Create a Synthetic Fixed-Rate Bond



Source: Analysis Group, Inc.

### Risks Associated With Interest Rate Swaps

**Interest rate risk**—The risk that interest rates will increase or decrease, which can affect payments due under the interest rate swap (swap) and the market value of the swap.

**Basis risk**—The risk of a mismatch between the variable rate received by the municipality and the variable rate paid by the municipality. Relative changes in the two variable rates can affect payments due under the swap and the market value of the swap.

**Collateralization risk**—The risk that the market value of a swap will decrease enough that the municipality will have to post collateral to serve as a repayment guarantee.

**Counterparty risk**—The risk that the swap counterparty will fail to make required payments, will experience ratings downgrades, or will file for bankruptcy protection.

**Liquidity/remarketing risk**—The risk that a municipality will not be able to secure a cost-effective renewal of a letter or line of credit or will suffer a failed auction, or remarketing, with respect to its variable-rate bonds, such as auction rate securities, whose variable interest rates are reset periodically through an auction process. A failed auction occurs when there is insufficient market demand for the auction rate security. This risk is present in synthetic fixed-rate bonds.

**Termination risk**—The risk that a swap will be terminated before its scheduled termination date. Upon an early termination, the municipality either may owe a substantial termination payment to the counterparty or may receive a substantial termination payment from the counterparty, depending on market interest rates.

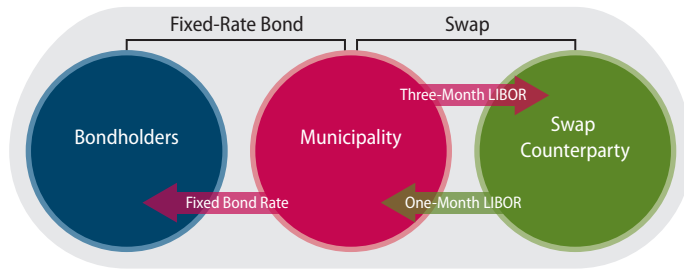
Source: Analysis Group, Inc.

Municipalities create synthetic fixed-rate bonds when they believe they can achieve a lower bond interest rate with this bond structure than they would with a traditional fixed-rate bond, thus lowering future interest payments. However, when municipalities issue synthetic fixed-rate bonds, the variable rate received by the municipality from the counterparty in the swap may not perfectly match the variable rate paid by the municipality on its variable-rate bond. The risk to the municipality of a mismatch is referred to as basis risk. Therefore, the net interest obligation of the municipality will still vary to some extent, meaning that a synthetic fixed-rate bond is riskier to the municipality than a traditional fixed-rate bond. In addition, synthetic fixed-rate bonds expose the issuing municipality to other risks that are not present in traditional fixed-rate bonds, including liquidity/remarketing risk, counterparty risk, and termination risk. The text box defines the various types of risks associated with the city's swaps, including those used to create synthetic fixed-rate bonds.

A municipality may also use a swap as a speculative, or betting, tool that increases its exposure to additional types of risk. For example, according to our finance and energy expert, a swap is considered speculative when the municipality bets on, or actively takes a position on, a particular direction of future interest rate movements and the swap serves no purpose in reducing the risks of the associated bond. Rather than limiting its risk exposure to movements in interest rates, the municipality uses swaps

to make “bets” on a particular direction of interest rates to make financial gains. For example, as shown in Figure B.2, after issuing a fixed-rate bond, a municipality might enter into a basis swap in which it makes variable payments based on one type of interest rate (the three-month LIBOR<sup>33</sup> in this example) and receives variable payments based on a second interest rate (such as the one-month LIBOR).

**Figure B.2**  
**A Basis Swap Used for Speculative Purposes**



Source: Analysis Group, Inc.

The municipality expects to gain a payoff based on a speculative view that the difference between the rates of the one-month LIBOR and the three-month LIBOR will increase in the future or put differently, the one-month LIBOR will rise relative to the three-month LIBOR in the future; however, if the rates move contrary to the direction anticipated by the municipality, the municipality will lose money on the swap. Such a swap does not hedge against the risks of the underlying fixed-rate bond, which has known future interest payments, but instead exposes the municipality to many risks, including the risk that the difference between the two interest rates will decrease (i.e. the one-month LIBOR will fall relative to the three-month LIBOR) and counterparty risk. Similarly, a municipality can take a speculative position by entering into a basis swap after issuing a variable-rate bond when the basis swap does not hedge against the risks of the variable-rate bond.

Depending on the type of swap and associated bond, swaps can help municipalities manage their interest rate risks. When the city issued synthetic fixed-rate bonds, for example, it used

<sup>33</sup> The LIBOR, or London Interbank Offered Rate, is the average interest rate that leading banks in London charge when lending to other banks. It is frequently used as the basis for defining interest rates in swap transactions. The LIBOR differs depending on the duration, including a one-month rate and a three-month rate.

floating-to-fixed swaps to mitigate the interest rate risk of its variable-rate bonds. However, entering into any swap, no matter its purpose, also introduces risks, and municipalities need to be cognizant of those risks.

### **Detail Regarding Speculative Basis Swaps Entered Into by the City**

As we described in Chapter 4, some of the interest rate swaps entered into by the city were speculative and exposed it to considerable risk. Our finance and energy expert concluded that the 2003 A&B swap, the 2003 No. 2 swap, the 2005 No. 1 swap, and the 2005 No. 2 swap were speculative transactions in which the city entered into basis swaps after having issued either fixed-rate or variable-rate bonds—similar to the example in Figure B.2. These swaps did not hedge the risks of the associated bonds; exposed the city to risks, including basis risk; and resulted in the city taking a speculative position on future interest rate movements that would yield financial benefits only if interest rates moved according to the city's expectation.<sup>34</sup> These swaps did not conform to the city's swap guidelines or the Government Finance Officers Association's best practices due to their speculative nature. Although the city made a profit totaling almost \$3.1 million on three of the four speculative swaps, it lost \$1.6 million on the fourth speculative swap.

Several documents presented to the city by the city's financial adviser indicate that the 2003 A&B and 2005 No. 1 basis swaps were risky, were undertaken for speculative purposes, and did not manage the risks of their associated bonds. For example, regarding the 2003 A&B swap, the city's financial adviser submitted a proposal to the city in July 2003 to enter into a basis swap associated with the 2003 Series A and Series B bonds. The city's financial adviser projected that the city would receive payments under the swap, assuming that the two rates to be swapped would revert to historical levels (according to the proposal, the difference between the two variable interest rates was then at a historical low), but stated that the city could end up making payments under the swap if interest rates did not move back to past levels. Similarly, in proposing the 2005 No. 1 swap in January 2006, the city's financial adviser submitted a presentation to the city regarding a "basis swap opportunity" to be associated with the city's 2005 bonds, in which the city would achieve savings "if [the] historical relationship

<sup>34</sup> In addition, the city entered into the fixed-to-floating 2003 C No. 1 swap, which it used to create a synthetic variable-rate bond. This swap exposed the city to risks including interest rate risk, similar to those associated with a variable-rate bond. This swap was also a special type of swap called a forward swap, meaning that swap payments were not scheduled to begin for some time after the swap was entered into. While our finance and energy expert did not conclude that entering into this swap was speculative, it noted that none of the documents provided show a financial analysis of the benefits and risks of entering into that swap.

repeats itself.” In other words, the purpose of both of these proposed swaps was for the city to experience a financial gain under the speculative position that history would repeat itself and interest rates would return to historical levels. Neither of these basis swaps hedged the risks of their associated bonds.

### **The Floating-to-Fixed Swaps Used to Create Synthetic Fixed-Rate Bonds Exposed the City to Risks That Turned Out to Be Costly**

Our finance and energy expert concluded that the city used the floating-to-fixed 2004 A, 2004 B, 2004 D, 2006 A, and 2006 B&C swaps with their associated variable-rate bonds to create synthetic fixed-rate bonds, similar to the example shown previously in Figure B.1. Entering into these swaps hedged the interest rate risk associated with the city having issued variable-rate bonds but exposed the city to several other risks, including basis risk, liquidity/remarketing risk, and collateralization risk, that would not be present with traditional fixed-rate bonds. These risks were largely due to the variable rate the city received on the 2004 and 2006 swaps differing from the variable rate it paid on the associated bonds, meaning that the 2004 and 2006 swaps only partially hedged the interest rate risk of the associated variable-rate bonds, as became apparent during the 2008 financial crisis.

During the crisis in the financial markets in 2008, the basis and liquidity/remarketing risks present in the 2004 and 2006 swaps were realized when the interest rate that the city needed to pay on its variable-rate bonds increased because the auction-rate bond<sup>35</sup> market failed to work. When the auction failures occurred—a realization of liquidity/remarketing risk—the city was forced to pay penalty interest rates in excess of 12 percent. These rates were far higher than the variable interest rate the city was receiving under the swaps—a realization of basis risk. Thus, during the financial crisis, the hedge used to create the synthetic fixed-rate bonds became ineffective, which negatively affected the city’s finances. This impact is exemplified in the city’s audited financial statements for fiscal year 2007–08, in which the city estimated that its fiscal year 2008–09 interest expense for the 2006 Series A bonds and 2006 A swaps would be \$11.5 million, a 55 percent increase over the city’s estimate of \$7.4 million a year earlier. This increase was caused by the risks realized with the swaps and the associated bonds. Our finance and energy expert noted that many other municipalities, some of which issued synthetic fixed-rate bonds, experienced similar issues during the financial crisis.

<sup>35</sup> Most of the city’s 2004 and 2006 variable-rate bonds were auction-rate securities, for which variable interest rates are reset periodically through an auction process.

Soon after the onset of the financial crisis, the city retired and restructured its 2004 and 2006 variable-rate bonds, using the proceeds from the sale of its electrical power generation and transmission assets and the issuance of additional fixed-rate bonds. However, the city did not terminate the 2004 and 2006 swaps when it retired the associated bonds because, according to some documents provided, the city believed it could eventually pay lower termination payments if interest rates rose in the future. Without associated bonds, the swaps exposed the city to the risk that declines in interest rates would increase the city's payments under the swaps and decrease the swaps' market values. The city's audited financial statements demonstrate that interest rate risks increased after the city retired the associated bonds. For example, the city's audited financial statements for fiscal year 2006–07, before the associated bonds were retired, described the 2004 A swap as being "structured to reduce the City's exposure to interest rate risk." After the city retired the associated bonds, the audited financial statements for fiscal year 2007–08 described the 2004 A swap as "[increasing] the City's exposure to interest rate risk."

The city terminated the 2006 swaps and the 2004 D swap in April 2010 by making termination payments of \$38.1 million. The city continues to hold the 2004 A and 2004 B swaps, and according to a document provided by the city's financial adviser, the city paid its swap counterparty \$11.4 million over fiscal years 2009–10 and 2010–11 to cover amounts owed for these two swaps. Furthermore, as of February 2012 these swaps had a market value of negative \$47 million, which is the amount the city would need to pay the counterparty to terminate the two swaps at that time.

### **The City's Decision to Terminate Certain Swaps Used to Create Synthetic Fixed-Rate Bonds Was Unsupported by Adequate Financial Analysis**

As we describe in Chapter 4, the city was unable to demonstrate that it performed the financial analysis that would typically support the use of its synthetic fixed-rate bonds. Here, we provide additional detail regarding the termination of the swaps used in those transactions.

As shown in Table 15 in Chapter 4, the city did not provide documentation demonstrating that it had performed the financial analysis that would be expected to ensure that terminating the 2004 D swap and the 2006 swaps was beneficial. Nor did the city provide any analysis demonstrating why it chose to leave the 2004 A and 2004 B swaps open when it terminated the other swaps. Further, the city did not provide documents showing that the termination amounts represented a fair price to the city.

In order to terminate the 2004 D, 2006 A, and 2006 B&C swaps in April 2010, the city had to pay the swap counterparties, because interest rates had fallen, meaning that the city would have owed future payments under the swaps if they remained open. As shown in Table 13 in Chapter 4, the city's termination payments for these swaps totaled more than \$38 million. These termination payments were partially funded through bonds the city issued in 2008.

In the various documents the city provided, our finance and energy expert was not able to identify documents that analyzed the termination of the 2004 D swap and found only one document from the city's financial adviser that analyzed the potential termination of the 2006 A and 2006 B&C swaps. This document, along with a board resolution and city council meeting minutes, shows that the city changed its opinion over time about whether to terminate the 2006 swaps and provided little analysis to support this changing opinion. For example, in February 2009, the city stated an intention to terminate the 2006 swaps if interest rates rose sufficiently, which its financial adviser expected to occur sometime in the next three years. Then, less than two months later, the Vernon Natural Gas Financing Authority stated, without supporting analysis, that the 2006 swaps were being kept open in order to hedge risks associated with the city's 2009 bond offering. Finally, less than a year later, the city and a Light & Power Department (power department) consultant recommended to the city council, without a supporting analysis, that it should terminate the swaps in order to reduce the city's financial liability and maintain its AA credit rating, and because the power department consultant and other financial advisers did not expect interest rates to rise in the near future.<sup>36</sup> Soon after, the city council acted on this recommendation to terminate the swaps. Because the city has not provided documentation explaining, among other things, the rationale for its changing view of future interest rate movements, the basis for the city's decision to terminate these swaps is unknown and not supported by adequate financial analysis.

### **The City's Decision to Terminate the 2003 and 2005 Speculative Basis Swaps and the 2003 Fixed-to-Floating Swap Was Unsupported by Adequate Financial Analysis**

As we discussed in Chapter 4, our finance and energy expert concluded that the city's 2003 and 2005 basis swaps were speculative transactions. The city terminated these swaps at various points in time from 2006 to 2008 that were unrelated to

<sup>36</sup> All things being equal, an increase in interest rates would lead to a lower termination payment on these swaps.

the retirement of their associated bonds. As shown in Table 13 on page 101 in Chapter 4, the city received termination payments from the counterparty upon termination of some of these swaps and made termination payments to the counterparty upon the termination of others. Overall, the city received net payments totaling approximately \$1.5 million after terminating these swaps. The city, however, did not provide documentation demonstrating that it performed the expected financial analysis to support its decisions to terminate these swaps at the times it did. In addition, the city did not provide documentation showing that the termination amounts represented a fair price to the city. Therefore, it is unknown how the city evaluated these swap terminations and what information, if any, was conveyed to the city council to aid it in making informed decisions.

Our finance and energy expert found only a single document that contained analysis relevant to the termination of these swaps. This document, a June 2003 memorandum from the city's financial adviser, proposed that the city terminate a portion of the 2003 C No. 1 swap.<sup>37</sup> In the document, the city's financial adviser stated that declines in interest rates had resulted in an increase in the market value of the swap and recommended that the city consider capturing that value by terminating a portion of the swap. The financial adviser's memorandum discussed, at a basic level, how the city's view of future expected interest rate movements should affect its decision to terminate a portion of the swap. Further, the memorandum referred to an attached schedule that purportedly quantified the benefit or cost of the swaps under different assumptions regarding future interest rates; however, the city could not provide the schedule showing this analysis. The financial adviser's memorandum also proposed a process that it would use to obtain a fair price for terminating this swap. Again, the city could not provide any information about how it used this document to inform its decision to terminate a portion of this swap in June 2003, or whether the proposed process to obtain a fair price was ultimately followed.

### **The City Has No Clear Strategy for Terminating the Two Outstanding 2004 Swaps**

Our finance and energy expert concluded that the city has not articulated a clear strategy for deciding the conditions under which it would terminate the two swaps that remain open—the 2004 A and 2004 B swaps—nor has it performed the expected analysis that would help it develop such a strategy. Our finance and energy

<sup>37</sup> The 2003 C No. 1 swap was a forward fixed-to-floating swap.



expert identified only a few documents that reference the potential termination of these swaps. These documents show a changing strategy for terminating the swaps, but the strategy is not supported by any of the expected analysis. For example, in a March 2009 presentation to credit rating agencies, the city stated that under “normal” market conditions it would have terminated the swaps, but that interest rates had fallen to near historic lows, potentially causing increased termination payments.<sup>38</sup> The presentation also noted that the city had the necessary funds to make termination payments, was prepared to terminate the swaps should interest rates rise (resulting in a lower termination cost), and has factored in the carrying costs of the swaps in its financial projections. Then, in a November 2011 presentation to credit rating agencies, the city stated that it anticipates terminating the 2004 B swap in 2017, and a chart in the presentation implies that the city will hold the 2004 A swap through its maturity in 2037. No documents provided explain the change in the city’s stated intentions from 2009 to 2011.

Keeping these swaps open has been costly to the city. In addition to the interest payments the city makes to the swap counterparty, as of February 2012, the large negative position of the 2004 A swap has required the city to post collateral of \$8.5 million with its swap counterparty, meaning that it cannot use those funds for general purposes.

<sup>38</sup> In general, as interest rates decline, the termination payment for a floating-to-fixed swap increases.

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*(Agency response provided as text only.)*

Latham & Watkins LLP  
355 South Grand Avenue  
Los Angeles, California 90071-1560

June 7, 2012

Ms. Elaine M. Howle\*  
State Auditor  
Bureau of State Audits  
555 Capitol Mall, Suite 300  
Sacramento, California 95814

Re: Audit of the City of Vernon

Dear Ms. Howle:

We are writing in response to the Draft Report that was provided to the City of Vernon in two separate pieces on May 31, 2012 and June 4, 2012 with intermittent updates to various sections over the past few days. In light of assurances that the Auditor “absolutely wants to receive and publish the City’s response,” we respectfully request that our response be included in full without any edits.

Although you have provided little time to respond to your draft report, we and the City team are providing our summary responses to your report in Attachment 1 to this letter. In addition, we are providing in Attachment 2 a 584-page detailed summary of the audit staff’s many requests to the City over the past 10 months together with the correlated responses previously provided by the City. Although we have no objection to many of the recommendations set forth in your report (principally because they are simply restatements of procedures the City already employs or was in the process of adopting as part of the historic and comprehensive reforms the City has been implementing), we do have substantial objections to many of the so called “findings” set forth in the Draft Report. We think the report contains serious factual errors and mischaracterizations and, perhaps more importantly, reflects improper lack of objectivity that has permeated this exercise for the last ten months.

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Even a cursory review of the Draft Report reveals that it is riddled with serious mischaracterizations designed to misrepresent the facts. For example, the Draft Report states that the City has failed to take sufficient steps to implement its reforms. That ignores the over 70 reform measures currently underway and the oversight in the implementation of those reforms by former Attorney General John Van de Kamp acting as the City’s Reform Monitor together with Robert Stern, former General Counsel of the Fair Political Practices Commission. The Draft Report also improperly suggests that the City’s historical energy transactions lacked adequate consultation and consideration. Indeed, the City engaged preeminent consultants, financial advisors, and attorneys during each of these transactions including, but not limited to, Bond Logistix Group (BLX), Orrick Herrington, and K&L Gates. These firms represent the top tier firms in their respective disciplines and in fact represent many agencies and jurisdictions in California.

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Furthermore, the auditors reviewed only 25 contracts, all of which were entered into prior to the City’s historic reforms and close to half of which are not and have not been active for some time. Moreover, the auditors had unfettered access through the City’s contracting and accounting system

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\* California State Auditor’s comments begin on page 177.

Ms. Elaine M. Howle  
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⑧ to over 600 contracts that were active during the five-year period, 2005–2006 through 2010–2011, they stated they were using for their review. In fact, 20% of these contracts were outside the auditors' own stated timeframe and more than half of these contracts were "not tested" for use of competitive bidding procedures.

④ Further, the report appears to be drafted with one goal in mind: to minimize and ignore the historic reforms underway and focus instead on events that occurred several years ago. The reforms stem from a long audit of the City's governance practices by renowned experts, including former California Attorney General John Van de Kamp, Cynthia Kurtz, former Pasadena City Manager, and Robert Stern, former California Fair Political Practices Commission General Counsel. Based on recommendations included in two comprehensive reports, the City agreed to implement over 70 reforms and has been continuing to work with Mr. Van de Kamp and his team to become a model of good governance.

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① The Draft Report also contains several incorrect statements designed to cast aspersions on the City. Most notably, the report falsely accuses the City of not providing certain documents to the audit staff when the indisputable truth is that your staff has had unbridled and unfettered access to every piece of paper and every electronic file in the City's possession. In numerous instances, as Attachment 2 reveals, the audit team has asked for, and received, the same documents on multiple occasions.

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③ Our response is organized in sections, designed to mirror the 4 chapters in your report. As noted at the outset, we do not quarrel with many of the proposed recommendations. But we do take substantial issue with the false qualitative assertions contained in chapters 1 and 2 and with the material factual errors and omissions of fact that permeate all chapters of the report. We have set forth the purported findings and corresponding recommendations, followed by the City's response.

③ In short, in many respects, the Draft Report strays from the ostensible purpose of your engagement: to provide the JLAC with an objective assessment of the questions outlined by Senator De Leon. The Draft Report is neither objective nor neutral; rather, it appears designed to justify the ten months of work and millions of dollars of taxpayer funds expended to create a report that simply rehashes the same issues that gave rise to the reforms already underway in the City. Finally, many of the purported findings and recommendations are untethered to the practical realities of running an industrial city that is home to more than 1,800 businesses and 50,000 hardworking men and women.

Best Regards,

⑩ *(Signed by: David J. Schindler)*

David J. Schindler  
of LATHAM & WATKINS LLP

Enclosures

ATTACHMENT 1

City of Vernon Response to California State Auditor Report Entitled:  
"City of Vernon: Although Reform is Ongoing, Past Poor Decision Making Threatens Its Financial Stability"

FINDINGS, RECOMMENDATIONS, AND THE CITY'S RESPONSE

A. General Comments and Response to the Draft Report's Scope of Review

The Draft Report's introductory comments appear internally inconsistent and contradict the audit team's own findings and analysis as well as the factual record.

The Draft Report states that the audit team "encountered challenges in accessing City staff and information" and faced "significant obstacles in efficiently obtaining information from the City and its financial adviser." (Draft Report 23-24). Those statements are difficult to reconcile with the fact that the Draft Report is over 155 pages in length, including appendices and tables. More importantly, the City made available millions of pages of documents to the audit team, including focused responses to specific inquiries. The City also provided unfettered access to all documents and information within the City's control and possession, including privileged communications. (9) (11)

We recognize that it might have been difficult for the audit team to digest and interpret the millions of pages it requested from the City. The volume of material at issue, however, stemmed solely from the over ten-year scope the audit team selected for its review, and the audit team's focus on the City's historical practices as opposed to its current ones. Moreover, the City made every effort to facilitate the audit team's review. Since the audit began in September 2011, the City has gone above and beyond making reasonable efforts to accommodate the audit team. The Draft Report fails to mention that the City permitted the audit team to step into the shoes of any City employee and even provided unfettered access to all City documents and physical space. Indeed, during the audit, the City provided the auditors with their own badges to walk around the City at their leisure, their own private conference room, their own keys, and accompanying phone, printer, and copier access. The City also provided the auditors with their own City code book and a laptop with log-in credentials to access all of the City Clerk's files on Laserfiche and all of the financial data in the City's Eden system. The auditors were also permitted to search any employees' offices, to open their drawers and personal space to find any and all documents and to review literally the City's entire electronic databases at will. As indicated by the attached index, City staff also fielded hundreds, if not thousands, of requests from the veritable army of staff auditors assigned to this matter. (12) (9) (13) (1)

The City went to great lengths to cooperate with the audit team, even when the auditors were rude, disrespectful, and inconsiderate of the City's work force. To date, the City has spent hundreds of thousands of dollars and over a thousand hours of employee and attorney time responding to the audit. City employees have answered hundreds of questions, in phone calls, emails, interviews, impromptu verbal conversations, and meetings. The behavior of the auditors has, in fact, often bordered on harassment. City employees have explained again and again to the auditors what the documents mean even when the documents speak for themselves. The auditors' own inability to understand the documents and financial information is perhaps the problem. For example, one of the auditors even admitted to City staff that his "lack of accounting background" is keeping him from understanding the City staff's answers to his questions. In other instances, it was not uncommon for some members of the audit team to stampede into City staff's offices and call their personal cell phones to follow up on an email request made just a few minutes prior. (13) (14) (13)

The Draft Report misleadingly indicates that the City provided inaccurate information about its access and organization of contracts and resolutions. (Draft Report 24-25). More specifically, the Draft Report states that City staff initially stated that the City did not maintain an organized list of the City Council's resolutions, but was later provided access to the City's database by the City's information technology manager, which allowed the audit team to search City Council resolutions by keyword. (Draft Report 25). It also states that City staff initially told the audit team that a complete listing of contracts and a central filing location for contracts did not exist, "but later, during a tour of the City's Clerk's office, the City Clerk acknowledged that his staff maintained a contract file and a contract list." (Draft Report 24). Such statements are patently untrue and misleading. First, shortly after the entrance conference on September 27, 2011, the City provided the audit team with two CDs containing all City ordinances and resolutions from 2003 to the present, as well as a listing of contracts from 2007 to the present. Second, early on, the audit team was given a laptop with log-in credentials to access all of the City Clerk's files on Laserfiche and all of the financial data in the City's Eden system. Third, these statements appear to stem from the audit team's ongoing practice of asking individuals without relevant knowledge to provide information regarding topics outside their expertise and job duties, only then to have the audit staff purport to reflect an alleged absence of policies governing that topic, or to claim they had received inaccurate information (which is, of course, untrue). As the audit team was made aware at the outset, and as indicated on the City's website, part of the City Clerk's responsibilities includes "maintaining, duplicating and distributing all city documents . . . ." The audit team should have asked the City Clerk's office for information about any City documents, including contracts, as opposed to approaching random City staff that are not charged with maintaining the City's records.

The Draft Report also falsely indicates that the State Auditor was somehow forced to issue an administrative subpoena because of the City's lack of cooperation. Any objective review of the facts demonstrates that the decision to issue a subpoena here was political and divorced from the facts. Indeed, it is curious that the press was informed of the issuance of subpoena almost before it was received by the City. But, more importantly, notably absent from the Draft Report is any mention of the millions of pages of documents that have been made available for the audit teams' unfettered review. Similarly absent from the Draft Report is mention of the fact that virtually every document called for in the subpoena has already been provided, or made available to the audit staff.

Finally, the City made available to the audit team all of its documents under its control related to each of its energy transactions. As made clear to the audit team, all of the documents were made available in hard copy and were provided in the electronic format in which they were maintained. Any suggestion that the City made it difficult for the audit team to review information relating to its complex energy transactions is simply untrue.

#### CHAPTER 1: THE DRAFT REPORT MINIMIZES THE CITY'S HISTORIC REFORMS UNDERWAY AND INCORRECTLY SUGGESTS THAT THE CITY HAS NOT UNDERTAKEN OTHER REFORMS.

##### A. The Draft Report fails to acknowledge the City's plan to implement its historic reforms.

##### Finding:

Certain reform measures designed to increase accountability and transparency lack adequate planning and implementation.

**Recommendation:**

To increase accountability and transparency in its governance, the City should ensure that specific reforms are appropriately implemented.

**City's Response:**

The Draft Report alleges that the City has not developed a plan or adequate policies necessary to implement its reform measures. (Draft Report 28). The City respectfully disagrees. The City takes its commitment to implementing all of its good governance reforms very seriously. In October 2011, the City created a Good Governance Reform Implementation Matrix (Reform Matrix) that sets forth the City's implementation plan in a clear enumerated chart listing each of the City's good governance reforms, the authorizing documents (each of which is described in greater detail below) setting forth the particular reform measure and related directives, the requisite action items to implement each reform measure, the then-current status, and the projected implementation and completion timeline. Copies of the October 2011 Reform Matrix were disseminated to City Council members and City staff, made available to the public at City Council meetings, and posted on the City's website. Further, large scale versions measuring 3 feet by 3.5 feet were created and posted in each department, which the audit team saw repeatedly during their ten months of fieldwork. In January 2012, the Reform Matrix was updated to reflect the City's progress and new developments to that point. The City is currently working on a further updated Reform Matrix.

The reforms stem from a long audit of the city's governance practices by renowned municipal governance excerpts. In February 2011, the City engaged noted attorney John Van de Kamp to serve as its Independent Ethics Advisor. Mr. Van de Kamp is a former California Attorney General, L.A. County District Attorney, and California State Bar president. To assist, Mr. Van de Kamp enlisted the services of: Ms. Cynthia J. Kurtz, former Pasadena City Manager, and Mr. Robert M. Stern, former California Fair Political Practices Commission (FPPC) General Counsel. Mr. Van de Kamp and his team were given broad powers to independently review and assess Vernon's governance policies and practices. More specifically, Mr. Van de Kamp and his team independently reviewed and assessed Vernon's internal controls, policies, and procedures with respect to: (1) the Political Reform Act of 1974, Government Code section 1090, the Brown Act, the Public Records Act, and conflict of interest requirements; (2) reimbursement of expenses and payments of invoices; (3) the selection of consultants and their agreements; and, (4) ethics and conflicts of interests, including training and education. On July 29, 2011, Mr. Van de Kamp issued a comprehensive initial report, as well as a final report on January 31, 2012, with dozens of recommendations on improving existing policies and procedures and further enhancing Vernon's municipal administration.<sup>1</sup>

State Senator Kevin de Leon came out and supported the recommendations in Mr. Van de Kamp's Independent Report and offered an additional series of six Critical Path Reforms to improve the City's governance and further its efforts to become a model city in an August 22, 2011 letter to the City.

The City has implemented the recommendations in Mr. Van de Kamp's Report and Senator de Leon's letter to the City, memorialized on City Resolution Nos. 2011-147 and 2011-149, August 25, 2011, as well as on its Reform Matrix. Since August 25, 2011, the City has completed or made significant progress with regard to each of Mr. Van de Kamp and Senator de Leon's recommendations.<sup>2</sup> In addition, the City undertook

<sup>1</sup> On January 3, 2012, City Council extended Mr. Van de Kamp's role as the Independent Reform Monitor to February 15, 2016. Both reports are available on the city's website.

<sup>2</sup> The City's progress with each of these good governance reform measures is included on a municipal reform matrix and timeline publicly available on the City's website, [http://www.cityofvernon.org/good\\_governance\\_reforms/](http://www.cityofvernon.org/good_governance_reforms/).

its own review and decided to implement a number of good governance reforms on April 19, 2011, City Resolution No. 2011-69. Below is a brief synopsis from the city's Reform Matrix of the status of each of the reforms.

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#### Completed Reforms<sup>3</sup>

1. Department Head Salaries. The City completed a salary survey and adjusted department head salaries to levels comparable to peer jurisdictions. (City Resolution No. 2011-85, May 26, 2011).
2. Council Salary & Benefits. The City completed a salary and benefits survey of Council members and reduced Council Member salaries by 18% immediately, reduced Council Member salaries to \$25,000 effective at end of term, and reduced benefits, effective on July 1, 2011. (City Resolution Nos. 2011-87, May 26, 2011, and 2011-93, June 7, 2011).
3. Electric Rates Ad Hoc Committee. On May 5, 2011, the City established an ad hoc advisory committee on electric rates to review and make recommendations on current pricing. The Electric Rates Committee includes the City Administrator, three business representatives, and two labor representatives. The City Council adopted the committee's joint recommendation with the Director of Light & Power to increase rates. (City Resolution No. 2011-112, June 23, 2011). The committee continues to meet quarterly.
4. Council Term Limits (Charter Amendment). The City reviewed term limits and called for an election to amend the City Charter, setting term limits at two five-year terms with a lifetime ban thereafter. The measure was approved by the voters and term limits are now in effect. (See Resolution No. 2012-04, January 3, 2012).
5. Prevailing Wages (Charter Amendment). The City placed on the ballot an amendment to the City Charter to maintain a prevailing wage policy, which passed unanimously. (See Resolution No. 2012-04, January 3, 2012).
6. Prevailing Wages (Policy). To implement the ballot measure on a prevailing wage policy (see number five above), the City adopted a Prevailing Wage Policy. (Resolution No. 2011-149, August 25, 2011).
7. At-Will Employment (Charter Amendment). The City placed on the ballot an amendment to the City Charter to eliminate the at-will employment requirement for City employees, which passed unanimously. (See Resolution No. 2012-04, January 3, 2012).
8. City Administrator Removal and Compensation Provisions (Charter Amendment). The City placed on the ballot an amendment to the City Charter that removed obstacles to removing or changing the compensation for the City Administrator, which passed unanimously. (See Resolution No. 2012-04, January 3, 2012).

<sup>3</sup> As was explained to the audit team, the labeling of reforms in the matrix as "completed" or "ongoing" is an internal designation assigned by the city to better monitor their progress with each of the reforms.



9. Housing Commission (Charter Amendment). The City established an independent Housing Commission and placed on the ballot an amendment to the City Charter to require the City to maintain a Housing Commission, which passed sweepingly. (See Resolution No. 2012-04, January 3, 2012).
10. Independent Reform Monitor (Charter Amendment). The City placed on the ballot an amendment to the City Charter to appoint an Independent Reform Monitor for a period of no less than four years, which passed unanimously. (See Resolution No. 2012-04, January 3, 2012).
11. City Council Appointments (Charter Amendment). The City placed on the ballot an amendment to the City Charter to prohibit the City Council from appointing any Council member, which passed unanimously. (See Resolution No. 2012-04, January 3, 2012).
12. City Council Appointments (Repeal Ordinance). Upon passage of the November 22, 2011 ballot measure regarding City Council appointments, the City repealed Vernon City Code § 2.90. (City Ordinance No. 1192, February 21, 2012).
13. Special Election Ordinance. The City adopted an ordinance to allow special elections on non-established election dates. This ordinance allowed the City to hold an election to vote on the charter amendments described in this section.
14. City Council Compensation Increases (Charter Amendment). The City placed on the ballot an amendment to the City Charter to establish salary and benefits limits for senior City officials, which passed sweepingly. (See Resolution No. 2012-04, January 3, 2012).
15. Light & Power Fund Transfers (Charter Amendment). The City placed on the ballot an amendment to the City Charter to allow transfers from the Light & Power Fund to the General Fund, which passed unanimously. (See Resolution No. 2012-04, January 3, 2012).
16. Bidding Process on City Service Contracts (Charter Amendment). The City placed on the ballot an amendment to the City Charter to establish an open and competitive bidding process for City service contracts, which passed unanimously. (See Resolution No. 2012-04, January 3, 2012).
17. Independent Reform Monitor (Contract). The City appointed Mr. Van de Kamp for a four-year period, which included additional powers to audit the City, review service contracts, enforce good governance measures, and report annually to the California Legislature. (See number ten above and Resolution No. 2012-06, January 3, 2012).
18. Fire and Police Department Collective Bargaining. The City continues to allow for collective bargaining by the Police and Fire departments and adopted a policy of cooperation with the Fire and Police departments. (Resolution No. 2011-149 § 5, August 25, 2011).

19. Collective Bargaining Neutrality. The City established collective bargaining neutrality for City workers and adopted a policy of remaining neutral with regard to collective bargaining with City workers. (Resolution No. 2011-149 § 6, August 25, 2011).
20. Living Wage Policy. The City established a living wage program for City employees and contractors and the City Council adopted by ordinance an appropriate living wage policy. (Ordinance No. 1187, October 4, 2011).
21. Sustainable Development and Energy Efficiency Commission (SDEEC). The City established SDEEC through an ordinance to oversee major City projects to ensure adherence to the City's environmental standards and to make recommendations to the City. (Ordinance No. 1188, November 1, 2011). The SDEEC is comprised of seven members: three business representatives, one environmental representative, and one environmental justice representative. The SDEEC held its inaugural meeting on February 29, 2012 and continues to meet monthly. City Council adopted the SDEEC's recommended Work Plan and Budget for fiscal year 2012–2013, a mandatory Commercial Recycling Policy pursuant to AB 341, and a Sustainability Action Plan. (City Resolution Nos. 2012-71, 2012-72, and 2012-73, May 15, 2012).
22. Sustainability Action Plan (SDEEC). The City adopted the SDEEC's recommended Sustainability Action Plan to guide the City in developing and maintaining a sustainable infrastructure. The City's plan being used by the UCLA Engineering Extension Recycling Management Program as a "best management case study" and is expected to be presented in Washington D.C. as a national model. (City Resolution No. 2012-73, May 15, 2012).
23. Campaign Disclosure Training. On January 5, 2012, the City conducted training for the City Clerk to review campaign disclosure statements and to ask for supplemental information as needed.
24. Conflict of Interest Statements – Timely Filing. On January 5, 2012, the City had a training for the City Clerk to ensure that conflict of interest statements upon assuming office and leaving office are timely filed.
25. Conflict of Interest Statements – Accessibility and Retention. On January 5, 2012, the City had a training for the City Clerk to ensure that all conflict of interest statements are readily accessible and kept for at least seven years.
26. Conflict of Interest Statements – Written Guidance. The City now provides all affected incoming employees, as well as all affected employees annually during the filing period, with the California Fair Political Practices Commission Form 700 Packet and Reference Pamphlet as written guidance regarding compliance with filing requirements for conflict of interest statements.
27. Ethics Training. The City retained outside legal counsel with expertise in Political Reform Act, Public Records Act, and Brown Act compliance to review City policies and provide annual training. Outside counsel provided ethics training to all City Council members and staff on June 21, 2011. The 2012 annual training will take place

in early July or as soon thereafter as the vacant City Council seat is filled pursuant to the results of the June 5, 2012 election. Annual ethics training will continue to occur each July.

28. Housing Commission Appointments. On August 2, 2011, the Mayor appointed, and the City Council ratified, seven members to the Housing Commission, including three residents, three business representatives, and one Vernon business employee. The Housing Commission's inaugural meeting was held on August 11, 2011, and the Commission continues to meet monthly.
29. Housing Policy. The City adopted the Vernon Rental Housing Policy recommended by the Housing Commission. (Resolution No. 2011-175, October 18, 2011). (See Chapter 1, Section C of the City's Response).
30. Housing Commission Rent Survey. The Housing Commission engaged three qualified independent appraisers to conduct a rental survey and formed a subcommittee to review and analyze the appraisal reports and meet with each of the appraisers. The subcommittee presented its recommendations on market rates to the Housing Commission on January 26, 2012. The Housing Commission held a public hearing on the proposed rates on February 9, 2012, where it received significant testimony from many residents, and approved the market rates recommended by the subcommittee.
31. Housing Commission Recommendation – Divestment. Ordinance No. 1183 § 2.121(c) and Mr. Van de Kamp's Report recommended that the Housing Commission, within 180 days of its first meeting, provide the City with recommendations about the City's ownership of rental properties and whether divestment was appropriate. The Housing Commission has fulfilled its requirement. (See Chapter 1, Section C of the City's Response).
32. Conflict of Interest Code for Housing Commission. The City approved the conflict of interest code adopted by the Vernon Housing Commission. (City Resolution No. 2011-156, September 20, 2011). At the August 31, 2011 Housing Commission meeting, the City notified appointees of reporting and disqualification requirements.
33. Brown Act Compliance Training. The City completed Brown Act compliance training on September 28, 2011 and will hold annual training each July beginning in 2012, in conjunction with the Public Records Act compliance training and ethics training schedule.
34. Public Records Act Compliance Training. The City completed Public Records Act training on September 28, 2011 and will hold annual Public Records Act compliance training each July beginning in 2012, in conjunction with the Brown Act compliance training and ethics training schedule.
35. Internal Financial Controls, Record Keeping, Policies for Consultants – Review Contractor Requirements. The City reviewed current contracts for consultants and terminated one contract that did not meet the criteria for contractors and consultants. The respective department head is currently seeking to fill the position through the City's employment recruitment process for non-management positions.

36. Internal Policies and Procedures Related to Payments to any Individual Affiliated with the City – Implement Written Policy. The City has adopted a written Travel and Expense Reimbursement Policy for City Council members and employees, modeled after the City of Pasadena's travel policy. (Resolution No. 2011-187, November 15, 2011). The City will issue written advisories to all City Council members when changes to these policies occur. (Resolution No. 2011-187, November 15, 2011).
37. Internal Policies and Procedures Related to Payments to any Individual Affiliated with the City – Market Comparison Study. The City has conducted a market comparison study for department heads and other key staff positions and established calendar notifications to ensure triennial review. (Resolution No. 2011-85, May 26, 2011). The "salary survey" is further discussed in Chapter 1, Section E(b) of this response.
38. Operations – Department Head Meetings. The City began regular meetings of department heads in July 2011, which are now held on a bi-weekly basis, the day after each regular City Council meeting.
39. Operations – Nepotism Policy. The City has adopted a nepotism policy modeled on the policies of comparable jurisdictions, including Pasadena and Glendale, and repealed Resolution 5314, an outdated nepotism policy. (Resolution No. 2011-137, August 2, 2011).
40. Operations – City Clerk Training. The City Clerk completed training on compliance with the Brown Act and Public Records Act on September 28, 2011, and completed election regulations training on January 5, 2012. In addition, the City has retained an independent elections consultant for all elections since 2006 to provide oversight and ensure compliance with municipal elections regulations.
41. Operations – ICA and League Participation. City officials, including the City Administrator and at least two City Council members, attended Independent Cities Association (ICA) seminars in July 2011 and February 2012 and the annual League of California Cities (LCC) conference in September 2011. Additionally, the City Administrator attended the LCC City Manager's Department Meeting in February 2012, and City officials have been regularly attending the LCC Los Angeles County Division meetings. Lastly, the City is participating in the LCC's new Strong Cities Strong State campaign and website, and the City's Public Information Officer, with assistance from Ms. Cynthia Kurtz, is working to develop Vernon's profile for the website.
42. Quarterly Budget Reports to City Council. On May 15, 2012, staff reported to the City Council on the status of the City's budget status for the first three quarters of the 2011–2012 fiscal year, July 2011 through March 2012. The report indicated that the City was mostly in line with its revenue and expenditure projections for the year.

#### Ongoing Reforms

43. Convey City Housing Stock to Housing Commission. It has been determined by appropriate legal counsel that the Housing Commission does not have the proper authority to hold title to the City's housing stock.

44. Housing Commission Recommendation – New Housing Units. Ordinance 1183 § 2.121(d) directed the Housing Commission to provide the City with recommendations about the development of housing in or in close proximity to the City. Soon after, this directive was subsumed by Senator De Leon’s recommendation that the City work toward the goal of doubling the City’s electorate through the construction of approximately fifty new non-City owned housing units within three years, with a significant affordability component. See section below for additional information.
45. Double the City’s Population: Develop New Housing Units. Per Resolution 2011-149 § 4, the City Administrator, Director of Community Services and City Treasurer are developing a plan to construct approximately fifty new units within three years, provide City-owned land and gap funding as necessary to attract investment, and allocate a portion of the units as low-income. (See Chapter 1, Section C of the City’s Response).
46. Property Management Firm for City Housing. The City Council passed Ordinance 1183 establishing the Vernon Housing Commission and accompanying subcommittee to oversee the management, leasing, and maintenance of the City-owned housing stock. It adopted the Vernon Rental Housing Policy, established market rates for all units, established an implementation schedule to bring current tenants into compliance with market rents and lease-up procedures for prospective tenants, and adopted a new-standard one-year lease. The Housing Commission is working on other procedural items, including transitional hardship appeal procedures for existing tenants and lease enforcement procedures, and will begin the pursuit of a third-party property manager in July or August 2012.
47. Business Development Committee. The City Administrator established an ad hoc advisory committee for business development to make recommendations to the City Council on ways to improve the business climate in the City. The ten-member Business Development Committee consists of: the Mayor Pro-Tem, a City Council Member appointed by the Mayor, the City Administrator, three business representatives, a real estate developer, a real estate broker, and two labor representatives. The committee held its inaugural meeting on January 25, 2012, and continues to meet monthly.
48. Task Business Development Committee with Review of City’s Financial Situation and Budget. On February 8, 2012, the City gave a presentation to the Business Development Committee regarding the City’s projected General Fund deficit for the 2012–2013 fiscal year and a proposed special parcel tax to close the gap. The presentation identified the primary reasons for the projected shortfall: (i) the dissolution of the RDA; (ii) decreased Light & Power Department revenues; and (iii) depleted reserves; and explained that a significant, stable and reliable tax source like the proposed parcel tax was long overdue. The presentation outlined how the tax would be assessed, who would be impacted, and the proposed implementation timeline. On April 11, 2012, the City gave a presentation to the Business Development Committee regarding the numerous employee and consultant expenditure reductions the City has implemented over the last five years and the current savings those cuts reflect, and provided additional information the projected deficit would have on City services. The City intends to continue visiting these types of issues with the Committee and seek its recommendations.

49. Environmental and Community Benefit Fund (ECBF) and Committee. The ECBF shall receive funding of \$5 million annually for ten years, with annual consumer price index adjustments. Each fiscal year beginning 2012–2013, the City Administrator and City Treasurer shall provide a joint recommendation for allocation from the City's annual budget to the ECBF. The ECBF shall be managed by a nine-member committee with diverse representation from the State Legislature and nearby communities.

At the time the commitment to the ECBF was made in August 2011, although the State had recently enacted legislation (ABx1 26) to dissolve all redevelopment agencies (RDAs), because it simultaneously enacted legislation (ABx1 27) establishing a voluntary alternative redevelopment program to enable participating redevelopment agencies to continue to exist, the City's RDA was a viable funding option for the ECBF, and the City intended to pursue special legislation, similar to what the City of Industry employs, to effectuate the use of RDA funds for this purpose. It was not until the State Supreme Court overturned ABx1 27 on December 29, 2011, that the City learned its RDA was no longer a viable funding source. The City had fully complied with all requirements of the voluntary alternative redevelopment program to that point.

For fiscal year 2012–2013, the City intends to allocate a portion of its reserves and funding for capital improvements to the ECBF, as well as continue to pursue creative alternative funding options through discussions with the Vernon Chamber of Commerce, managers of similar funds, and other consultants and advisors as appropriate.

The City intends to solicit appointments to the ECBF Committee in June or July 2012 and establish the committee and arrange for its first meeting in July or August 2012.

50. Hazard Park Armory Youth Center and Salt Lake Park Programs. The City Administrator has been negotiating potential programs with the respective representatives of Hazard Park Armory Youth Center in Boyle Heights and renovation projects at Salt Lake Park in Huntington Park and expects to present recommendations to the City Council in June or July 2012. Appropriate funds have been allocated in the 2012–2013 proposed budget to enable certain programs to commence if approved by the City Council.
51. Hazard Park and Salt Lake Park Allocations Timetable Should Await Clarity Regarding RDA Funding. The City will establish an appropriate timetable by July 31, 2012, once proposals have been approved by the City Council, and the 2012–2013 budget has been adopted.
52. Trash Hauling Franchise Program. The City passed an ordinance in February 2010 suspending acceptance of franchise agreement applications and has notified its 18 current franchised trash haulers that existing franchise agreements expire on December 31, 2014. The Health Director is currently preparing an updated Trash Hauling Franchise Program for review by the Sustainable Development and Energy Efficiency Commission (SDEEC), who will make recommendations to the City Council for final approval. The updated program is expected to be presented to the SDEEC in the Fall of 2012.

53. Bidding Process on City Service Contracts (Ordinance). The November 22, 2011 open and competitive bidding process ballot measure passed unanimously (see item 16 above) and outside legal counsel and Ms. Kurtz are drafting this ordinance in conjunction with the comprehensive contract policy. (See items 59-63 below). The ordinance is expected to be presented to the City Council on July 3, 2012.
54. Conflict of Interest Statements – Written Instructions on 1090 Compliance. The City has worked with outside counsel who possesses expertise in political law to develop a comprehensive compliance manual that covers California Government Code section 1090. The comprehensive compliance manual will be issued and utilized at the annual ethics training scheduled for July 2012. (See item 27 above).
55. Ethics Training. The City has worked with outside counsel who possesses expertise in political law to develop a comprehensive compliance manual that covers ethics training. The comprehensive compliance manual will be issued and utilized at the annual ethics training scheduled for July 2012. (See item 27 above). The manual will be posted on the City's website after the training is completed.
56. Conflict of Interest Codes. The City's ethics attorneys at Reed & Davidson are reviewing existing codes and preparing conflict of interest codes for the city's newest commissions, Vernon Housing Commission and SDEEC, and for any new City agencies that may be established. The City will adopt any necessary code updates or amendments by October 2012, in accordance with the FPPC's biennial review requirements.
57. Brown Act Compliance Materials. The Brown Act compliance policy was prepared by Reed & Davidson and adopted by the City Council. (Resolution No. 2011-196, December 6, 2011). Reed & Davidson also developed a comprehensive compliance manual that includes a chapter on Brown Act compliance. The manual will be issued at the annual Brown Act training scheduled for July 2012. (See item 33 above).
58. Public Records Act Compliance Materials. The Public Records Act compliance policy was prepared by Reed & Davidson and adopted by the City Council. (Resolution No. 2011-197, December 6, 2011). The policy is posted on the City's website along with the City's standard Public Records Request Form. Reed & Davidson also developed a comprehensive compliance manual that includes a chapter on Public Records Act compliance. The manual will be issued at the annual Public Records Act training scheduled for July 2012. (See item 34 above).
59. Internal Financial Controls, Record Keeping, Policies for Consultants – Contract End Dates. Outside legal counsel and Ms. Kurtz are preparing a comprehensive contract policy including end dates and/or expenditure caps. The comprehensive policy is expected to be presented to the City Council on July 3, 2012, in conjunction with an ordinance establishing the open and competitive bidding process for City service contracts. (See item 53 above).
60. Internal Financial Controls, Record Keeping, Policies for Consultants – Contract Review. Outside legal counsel and Ms. Kurtz are preparing a comprehensive contract policy to review and rebid professional service contracts at least once every three years. The

comprehensive policy is expected to be presented to the City Council on July 3, 2012, in conjunction with the ordinance establishing the open and competitive bidding process for City service contracts. (See item 53 above).

61. Internal Financial Controls, Record Keeping, Policies for Consultants – Best Rate Negotiation. Outside legal counsel and Ms. Kurtz are preparing a comprehensive contract policy to require lead staff on professional service contracts, including legal services, to negotiate for best rates or rates similar to those provided to other government agencies. The comprehensive policy is expected to be presented to the City Council on July 3, 2012, in conjunction with the ordinance establishing the open and competitive bidding process for City service contracts. (See item 53 above).
62. Internal Financial Controls, Record Keeping, Policies for Consultants – Review and Sign-Off of Invoices. Outside legal counsel and Ms. Kurtz are preparing a comprehensive contract policy to require review and sign-off of professional service invoices by the initiating department. The comprehensive policy is expected to be presented to the City Council on July 3, 2012, in conjunction with the ordinance establishing the open and competitive bidding process for City service contracts. (See item 53 above).
63. Internal Financial Controls, Record Keeping, Policies for Consultants – Contract Rate Increases. Outside legal counsel and Ms. Kurtz are preparing a comprehensive contract policy to disallow compensation rate increases during the term of the contract with an exception for external factors that significantly affect rates requiring increases to be tied to the most appropriate index or cost of living rate. The comprehensive policy is expected to be presented to the City Council on July 3, 2012, in conjunction with the ordinance establishing the open and competitive bidding process for City service contracts. (See item 53 above).
64. Operations – Media Policy and Training. The City has adopted a media policy (Resolution No. 2011-186, November 15, 2011), and will conduct media training sessions in July or August 2012, once the vacant City Council seat is filled pursuant to the results of the June 5, 2012 election, and the City Attorney, HR Director, and Health Director positions have been filled pursuant to the recruitment process outlined in item 65 below.
65. Operations – City Attorney. The City is undergoing an open, transparent, and competitive hiring process to hire a permanent City Attorney and key management positions, with the use of a professional search firm. After interviewing three search firms in early 2012, the City Council selected Roberts Consulting Group to conduct the search for a new City Attorney. That process is nearly complete and the City anticipates hiring a City Attorney in June or July 2012. (See Chapter 1, Section E(a) of the City's Response).
66. Operations – Assistant City Administrator and Assistant Fire Chief. In January 2012, two existing employees were reclassified to the position of Assistant to the City Administrator to assist with the full spectrum of City Administration matters. The Assistant Fire Chief position is currently occupied.



- 67. Operations – HR Director. The City currently has separate Human Resources and Personnel Departments and is in the process of hiring a highly qualified HR Director pursuant to the procedures outlined in item 65 above and Chapter 1, Section E(a) of the City’s Response. The City expects to hire an HR Director in June or July 2012. In due time, the City intends to seek recommendations from the HR Director on the appropriate establishment and organization of all City departments.
- 68. Operations – Police Department Study. On April 3, 2012, the City issued a RFP for a study on Police Department staffing and costs to eleven qualified consultants and posted the RFP on the City’s website. Matrix Consulting Group was ultimately selected and expects to complete the study by mid to late July 2012.
- 69. Follow Through on Recommendations. The City formally committed to the implementation of all of the recommendations in Mr. Van de Kamp’s Report (Resolution Nos. 2011-147 and 2011-149 § 1), and will develop a resolution to address any recommendations where the City’s implementation timeline may differ significantly from that recommended

**B. The Draft Report fails to acknowledge the City’s ongoing efforts to develop an alternative employment structure to remove the at-will status of employees.**

④

**Finding:**

The City has not yet developed and does not have a plan to develop an alternative employment structure to remove the at-will status of City employees.

**Recommendation:**

The City should develop an implementation plan to implement an alternative new employment system so that its non-union employees are no longer at-will employees of the City Council.

**City’s Response:**

The Draft Report alleges that the City does not have a plan to implement an alternative employment structure. (Draft Report 31). The City respectfully disagrees. The process of implementing an alternative employment structure is ongoing. The City took its first step toward the consideration of an alternative employment system in August 2011, when the City Council placed on the November 8, 2011 ballot a measure amending the charter to eliminate the at-will employment requirement for non-union, non-contract City employees. The ballot measure was unanimously passed by the voters. As explained above, the City is currently in the process of recruiting a highly qualified HR Director who, along with the prospective City Attorney and appropriate legal counsel, will be tasked with conducting a thorough analysis of alternative employment systems and presenting all findings and recommendations to the City Administrator and City Council.

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**C. The City Administrator and Director of Community Services have provided continuous updates on the housing development process to the City Council and the Housing Commission at their respective meetings and will continue to do so until the process is completed.**

**Finding:**

The City has yet to develop a comprehensive housing plan.

**Recommendation:**

The City should determine whether it will continue to own housing and communicate its decision to the public, as soon as appropriate. If so, the City should continue the effort to develop policies and procedures that are necessary to ensure fairness and impartiality in its management of City-owned housing. It should also continue the effort to develop a comprehensive plan to construct additional housing in the City.

**City's Response:**

④ The Draft Report alleges that the City does not have a comprehensive housing plan and allegedly does not communicate its housing related decisions to the public. (Draft Report 33). The City respectfully disagrees. Recommendations and decisions related to the City's housing stock, whether on potential divestment, development, or otherwise, are deliberated and determined at public meetings of the Housing Commission and City Council. All decisions, and the rationale for decisions, are communicated in real time to members of the public in attendance at the meetings and are available to all interested parties through the respective meeting minutes that are posted on the City's website. Further, the City's Public Information Officer issues public releases on items that may be of particular note to the community.

Furthermore, the City has been working diligently to implement its housing related goals. On February 9, 2012, the Housing Commission recommended that the City divest its units in Huntington Park. The City Council initially received and discussed the recommendation on February 21, 2012, but no action was taken. On June 5, 2012, the City Council determined that divestment of the Huntington Park units would not be prudent at this time based on market conditions and voted to retain City-ownership of the units and continue leasing them through the Housing Commission.

As discussed in the aforementioned section on the City's good governance reforms, the City established the independent Vernon Housing Commission to oversee the management of City-owned housing. As also discussed previously, the Housing Commission prepared and the City Council subsequently adopted a Vernon Rental Housing Policy. The policy was prepared with significant input and advice from Legal Counsel to the Housing Commission, who is also the Vice Chair of the California Fair Employment and Housing Commission. The policy places a strong emphasis on fairness and impartiality, commits to adherence to all applicable federal and state fair housing laws, requires that rents be set at a market rate, and provides for transitional procedures to bring existing tenants into compliance.

Further, the Housing Commission has established market rents for all units, set an implementation schedule to bring current tenants into compliance with market rents, adopted a new standard one-year lease, and created lease-up procedures for prospective tenants that require quarterly advertising of housing opportunities, the establishment of a wait list through a random lottery process, and credit and background checks on prospective lessees. To determine the market rates, the City engaged three qualified independent appraisers to conduct a rental survey and formed a subcommittee to review and analyze the appraisal reports and meet with each of the appraisers. The Commission is expected to begin the consideration and pursuit of a third-party property manager in July or August 2012, consistent with Reform Measure No. 50 discussed in the previous section.

The City is working to develop a comprehensive plan regarding the construction of additional housing. On April 19, 2012, the Director of Community Services issued a RFP for the "52nd Drive Housing Development" to thirty-two developers, including CalVets and Southern California Association of Non Profit Housing (SCANPH), and posted the RFP on the City's website. The RFP was prepared by the Director of Community Services and Legal Counsel to the Housing Commission and Vice Chair of the California Fair Employment and Housing Commission. The City seeks to find a single developer to construct and manage the new rental housing development, and the RFP sets forth broad development and financial parameters in an effort to obtain a wide range of proposals to assist the City in identifying all opportunities. Proposals are due on July 12, 2012, and a pre-submission meeting was held on June 4, 2012. Approximately fifteen developers attended this meeting, in which site parameters were discussed, along with the proposal requirements and the City's selection criteria. The City intends to formulate its comprehensive plan based on what it learns from the proposals and related responses it receives. Below is some additional information on the process to date.

The Director of Community Services advised the City Administrator and City Council that in order to allow for additional housing within the City, the City would need to amend the Housing Element, and possibly other related elements, of its General Plan, as well as adopt certain environmental documents in compliance with the California Environmental Quality Act. Staff would also need to amend its Zoning Ordinance accordingly. In October 2011, the City issued a RFP for the General Plan amendment and related work to eleven qualified consultants, advertised the RFP through Integrated Marketing Systems, and posted the RFP on the City's website. Despite significant interest from numerous consultants, only Hogle-Ireland, Inc. submitted a proposal. Fortunately, Hogle-Ireland met all of the requirements at a reasonable price and had performed similar high quality work for the City in the past. The City Council engaged the services of Hogle-Ireland on December 6, 2011. On February 9, 2012, Hogle-Ireland gave a PowerPoint presentation on housing development options and opportunities to the Housing Commission. The presentation identified the nine most suitable locations within the City for housing development and provided the advantages and disadvantages of two types of developments: (1) concentrated residential units; and (2) caretaker and live/work units. Hogle-Ireland welcomed input from the Commission on any additional sites that may be suitable for housing as well as any potential hazards or impediments that were not otherwise identified at the nine sites discussed. As a courtesy, the same presentation was made to the Vernon Chamber of Commerce. Hogle-Ireland will make the presentation to the City Council on June 19, 2012, where staff will present any recommendations from the Housing Commission, obtain input from the community, and seek direction from the City Council on what types of housing should be considered in the Housing Element update.

Three of the nine locations identified by Hogle-Ireland as suitable for housing are owned by the City. Of the three, a two-acre parcel located at 4675 52nd Drive was determined by the City and the consultant to be the most ideal based on its extremely close proximity to Maywood, an exclusively residential community with a nearby elementary school, park and retail and commercial establishments, and the absence of any existing structures on the site. As such, the City prepared the "52nd Drive Housing Development" discussed earlier.

**D. The Draft Report fails to acknowledge the City's current interfund transfer related reforms.**

④

**Finding:**

The City has not established a formal policy describing when it is appropriate to transfer funds from the Power Department and specifying the purposes for which these transfers can be made.

**Recommendation:**

The City should develop a formal policy that describes the circumstances under which revenues can be transferred from its Power Department, and the limits and permissible uses of transferred revenue.

**City's Response:**

The Draft Report alleges that the City does not have a policy regarding transfers from the Light & Power Department to the General Fund. (Draft Report 31-32). This is untrue. The City has many internal policies and procedures governing the use and transfer of Light & Power revenues that are included in a broader scope of policies and procedures available in the City Charter (Article 8), City Code (Article 4), resolutions, ordinances, bond indentures, and the annual internal control risk assessments that are submitted to the City's outside auditor, Macias Gini & O'Connell, in connection with the certification of the City's finances. A few of the policies and procedures governing the use and transfer of Light & Power revenues include, but are not limited to the following:

1. Cash and Investment Policies and Procedures (Official)
2. Cash Receipt Policies and Procedures
3. Purchasing and Cash Disbursement Policies and Procedures
4. Information Technology Policies and Procedures
5. Energy and Credit Risk Policies and Procedures
6. Electric Service Policies and Procedures (Official)
7. Identity Theft Prevention Program Policies and Procedures (Official)
8. Financial Policies and Procedures

The City has begun to implement additional reforms relating to revenue transfers. Resolution No. 2012-04 dated January 5, 2012 removes restrictions on the use of revenues from the City's Light & Power enterprise in order to reduce the General Fund deficit.

In addition, the City will review other municipalities' power revenue transfer policies and develop a formal policy that meets the City's long term plans.

- E. The Draft Report fails to acknowledge the City's extensive efforts to hire a HR Director and inaccurately challenges the methodology and analysis included in the City's salary survey.**

**Finding:**

The City has been without a Director of Human Resources since July 2009 and has not established minimum qualifications for several of its executive positions. It also has not established a process for hiring and evaluating its executives, and did not consider important factors when it made comparisons of its executives' salaries to those in other cities.

**Recommendation:**

The City should continue its efforts to hire an experienced human resources director to ensure that the City's policies and procedures include:

- Requirements for performing and documenting analysis and justifications for appointments, including promotions, to management positions;
- Requirements for minimum qualifications, desirable qualifications, and job duties for all City executive positions;
- A process for periodic appraisal of executives; and
- Improved methodology and analysis of future salary surveys by ensuring that they are performed by staff or a consultant with experience and expertise in the area of salary surveys.

**City's Response:**

**a. The City has taken great efforts to hire a HR Director**

The Draft Report alleges that the City lacks personnel and compensation practices, (Draft Report 35), minimizing the City's extensive search efforts for a HR Director.

As discussed in the aforementioned section on the City's good governance reforms, Mr. Van de Kamp, with strong support from Senator De Leon, recommended, and the City Council approved, the implementation of an open, transparent, and competitive hiring process for key management positions, including the HR Director, that includes: (i) identifying the City's needs for the respective position; (ii) utilizing a professional search firm to conduct the recruitment; (iii) utilizing appropriate non-City representatives as advisors in the process (i.e., to help rank applicants and determine finalists); (iv) interviewing several of the top-ranked applicants; and (v) running a full background check on the City Council's first choice.

The City is currently following the aforementioned recruitment procedures for three vacant management positions: City Attorney, HR Director, and Health Director. In order to find qualified search firms to conduct these executive recruitments, the City issued a RFP to eleven search firms and posted the RFP on its website in November 2011. Five proposals were received and a review panel consisting of Mr. Van Kamp, the City Administrator, two City Council members, and an outside legal advisor, reviewed and ranked the proposals. Ultimately, the City Council selected Roberts Consulting Group to conduct the City Attorney recruitment, while the Hawkins Company was selected to conduct the HR Director recruitment, and Alliance Resource Consulting was selected to conduct the Health Director recruitment.

Each search firm developed a professional recruitment brochure that provided some basic information on the City and respective positions and departments, highlighted the key duties, challenges, and opportunities of each, and outlined the minimum and desired qualifications. The information for the brochures was based on meetings with the City Administrator and other appropriate management and staff and some basic documentation provided by the City (i.e. City and department organizational charts and budgets, job descriptions, a summary of employee benefits, etc).. The brochures were posted on the City's website and copies were made available at key public locations throughout City Hall and at the Vernon Chamber of Commerce.

At the close of the application periods, each search consultant provided the City with a general update, including how many applications were received that met or exceeded the minimum and desired qualifications, and set a date for a review panel to meet to discuss and rank the applicants. Generally, the three to five highest ranking applicants are invited to interview with the City Council.

As of the date of this response, the City will have conducted the review panel meetings and established interview dates for the highest ranking candidates for each of the three positions. The City expects to complete the process for each in June and July 2012.

Any claims that other management positions lack appropriate qualifications, etc. is also misleading. As discussed with the audit team, a majority of the City's current and recent department heads have or had been with the City for many, many years (over twenty in most cases and over thirty in some) and have or had been promoted through the ranks within their respective departments during their extensive tenures with the City. As the audit team is aware, the personnel files for many of these individuals document such a progression. That being said, the City concurs with Mr. Van de Kamp's recommendation to hire a qualified HR Director and looks forward to working with the person so-hired to further the City's objectives of instituting best municipal practices related to employment and personnel practices.

**b. The City's Salary Survey included relevant methodology and thorough analysis.**

19

The Draft Report's assertion that the City's salary survey was based on invalid methodology and analysis misrepresents the analysis included within the report and the data relied upon. It is also apparent that the audit staff does not actually dispute the survey methodology; rather, they have made their own qualitative determination as to the salary levels they believe the City should adopt. Yet, that exercise runs afoul of the audit staff's mission.

The Salary Survey Data was taken from California State Controller's website. The City considered comparable cities based on industrial cities and cities which operated their own utilities. The City is unique in that it has 1,800 industrial businesses that employ 50,000 workers. Other factors that the City considered were the City's far smaller staffing levels than other larger cities. However, the workload for City directors is the same or greater than the cities used in the salary survey. For example, the City's Health Director is a "hands on" director who routinely participates in food inspections and oversees environmental remediation in the field. As the City is an industrial city, the Health Department is typically the lead agency in remediation clean up and works closely with the Federal Environmental Protection Agency (EPA) and Department of Toxic Substance Control (DTSC). The City of Pasadena Public Health Department neither reviews nor oversees property remediation.

3

The Draft Report misleadingly claims that the salary survey did not consider the job descriptions of executive positions in other cities. Indeed, the analysis included in the salary survey demonstrates the falsity of that finding. For example, in regard to the Treasurer/Finance Director, other cities that own their own utility hire multiple executives to oversee the finances of the city and their utilities. For example, the City of Glendale employs a City Treasurer, Finance Director, and Finance Water & Power Assistant General Manager who make \$125,916, \$166,713, and \$162,252 per year, respectively. In addition, the City of Burbank employs a City Treasurer, Finance Services Director, and Water and Power Chief Financial Officer who earn \$131,759, \$169,666, and \$173,460 per year, respectively. The City of Vernon Finance Director/Treasurer handles the same duties of these three individuals and receives \$210,000.

As discussed with the audit team, when the Human Resource Director is hired, the Director will determine and document the most appropriate methodology in determining future salaries.

- F. The Draft Report fails to acknowledge the City's implementation of an automatic discontinuation of its earlier longevity program. (20)

**Finding:**

The City continues to provide a number of employee's longevity payments of up to 20 percent of their monthly salary.

**Recommendation:**

The City should determine whether employees have a vested right to longevity payments and whether it can legally reduce or discontinue the original longevity program as a means to reduce its costs.

**City's Response:**

The Draft Report's recommendation that the City needs to reduce or eliminate its longevity program, (Draft Report 45), ignores the fact that the respective program will begin to phase itself out in 2014 and 2015. (20)

As the Draft Report discusses, the City currently has two longevity programs. Under the newer program, employees hired on or after July 1, 1994 who attain five years of consecutive uninterrupted service are eligible to receive a longevity payment of five percent of their base pay. Under the earlier program, employees hired on or before June 30, 1994 who meet the respective consecutive uninterrupted service requirement are eligible to receive longevity payments of the respective percentage of their base pay up to twenty percent as follows: five percent after five years, ten percent after ten years, fifteen percent after fifteen years, and twenty percent after twenty years. The Vernon Police Officers Benefit Association (VPOBA) generally follows the same two longevity programs, but uses June 30 and July 1, 1995 demarcation dates.

As the City has explained to the audit team, the earlier program will effectively begin to phase itself out on July 1, 2014, approximately a year-and-a-half from now. Based on the hire dates of all 271 full-time employees as of the date of this response, the maximum number of employees that would be eligible to receive a twenty percent longevity payment as of June 30, 2014 would be 115, seventy-three of which would have twenty-five years of service or more. Beyond that, only one VPOBA employee would achieve eligibility to receive a twenty percent longevity payment on or before June 30, 2015.

The City is continuously exploring ways to reduce its expenditures in line with its commitment to provide the highest level of service at the lowest possible cost, and intends to task the soon to be hired HR Director and City Attorney with a review of the longevity program, along with other compensation and benefits programs, and ask them to make recommendations regarding any appropriate modifications thereto.

**CHAPTER 2: THE DRAFT REPORT REFLECTS A FUNDAMENTAL MISUNDERSTANDING OF THE COMPLEX LEGAL AND CONSULTING CONTRACTS NECESSARY TO RUN A PURELY INDUSTRIAL CITY AND SAFEGUARD ITS SURVIVAL IN THE FACE OF UNPRECEDENTED POLITICAL ATTACKS. (3)**

The audit team's findings and recommendations related to the City's contracting practices demonstrate a fundamental misunderstanding of the City's function as an industrial city and the unique services it requires. This chapter also ignores the City's historic and comprehensive contracting related reforms that began in July 2011. (4)

Fundamentally, in Table 8 of their Draft Report, the auditors list the twenty-five contracts they reviewed in conjunction with this audit. They state that they reviewed contracts for services approved by the City Council between September 2000 and December 2010 and that were active between 2007 and 2010. The City has approximately 100 active contracts, of which the auditors only reviewed 25. Rather than choosing a randomly generated sample, they chose contracts that “received among the highest payments during that period or because of other factors that [the auditors] believed made them relevant to review.” (Draft Report 53). Their sample of contracts lacks a sound methodological explanation which leaves their findings vulnerable to selection bias and non-generalizability. This subjective selection did not create a statistical example that can be extrapolated to the City as a whole. The auditors similarly provide no explanation of these “other factors” that the auditors found noteworthy. For 13 of the 25 contracts the auditors reviewed, more than half of their sample, they did not even test for whether competitive bidding was used. Further, some of the contracts selected by the auditors had already been flagged by the City for the exact reasons noted by the auditors, and the City was already in the process of fixing the relevant issues. Of the City’s approximately 100 active contracts, more than half of these were entered into or renewed by the City after beginning their period of historic reforms. Although the auditors had access to these contracts, the auditors reviewed only those contracts that predate this period and that do not reflect the extensive contract reforms undertaken by the City and its current practices.

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Further, the auditors define their own audit objective and methodology as looking only at “contracts for the most recent five-year period, fiscal years 2005–06 through 2010–2011,” and the City’s adherence to policies and procedures related to contract bidding and approval for said contracts (Draft Report 21); however, 20% of the contracts they reviewed were entered into prior to this period, and over 50% were “not tested” for use of competitive bidding procedures. This decision to focus on old contracts and outdated contracting practices calls into question the auditors’ motive for this audit. If the auditors had focused on the City’s reformed practices, they could have provided useful and applicable recommendations to assist the City in its transition to a more transparent and methodological municipality. The auditors’ focus on past flaws that the City had both acknowledged and begun to reform before the commencement of the audit was misplaced and inefficient. However, the City will respond to each of the auditors’ findings and recommendations, below.

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**A. The Draft Report fails to acknowledge that the City is already in the process of implementing a comprehensive contracting policy.**

**Finding:**

Inadequate contracting policies and weak internal controls have resulted in poor service and consultant contract practices by the City.

**Recommendation:**

The City should develop a comprehensive contracting policy to address the contracting weaknesses the auditors observed and apply this policy to current and future contracts.

**City’s Response:**

The Draft Report alleges that the City’s contracting policies are weak and inadequate because some older contracts have “no termination dates, no limit on expenditures, and poorly defined scopes of work or deliverables,” that the City’s “monitoring of payments made to contractors is inadequate,” and that



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the City “makes minimal use of competitive bidding.” (Draft Report 53). The audit team’s finding does not reflect the City’s current practices, nor does it acknowledge that its sample is not reflective of the City’s past contracting practices as a whole. As the audit team well knew, the City has been working on implementing a comprehensive contracting policy as part of the reform process. While the City recognizes that the process is not yet complete, it is making great progress toward establishing a more clearly defined, documented, and comprehensive contracting policy. Although discussed in greater detail in Chapter 1, included below is a brief description of some of the City’s recent efforts to establish a comprehensive contracting policy encompassed within the City’s historical reform package.

- Bidding Process on City Service Contracts (Charter Amendment). The City passed an amendment to the City Charter to establish an open and competitive bidding process for City service contracts. (See Resolution No. 2012-04, January 3, 2012). The City is in the process of implementing the elements of the competitive bidding process.
- Internal Financial Controls, Record Keeping, Policies for Consultants – Review Contractor Requirements. The City has reviewed and updated contracts with individuals to ensure that each individual meets the criteria for contractors and consultants.
- Bidding Process on City Service Contracts (Ordinance). The City adopted an ordinance on April 3, 2012 to establish an open and competitive bidding process for City service contracts.
- Internal Financial Controls, Record Keeping, Policies for Consultants – Contract End Dates. Per its ongoing reforms, the City is requiring all contracts, including professional service contracts, to include end dates and/or expenditure caps. As the auditors were made aware and yet fail to acknowledge in their report, the City is currently implementing this policy and will memorialize it in its comprehensive contract policy resolution on July 3, 2012.
- Internal Financial Controls, Record Keeping, Policies for Consultants – Contract Review. Per its ongoing reforms, the City is reviewing and rebidding professional service contracts at least once every three years. As the auditors were made aware and yet fail to acknowledge in their report, the City is currently implementing this policy and will memorialize it in its comprehensive contract policy resolution on July 3, 2012.
- Internal Financial Controls, Record Keeping, Policies for Consultants – Best Rate Negotiation. Per its ongoing reforms, the City is requiring lead staff on professional service contracts, especially those for legal services, to negotiate for best rates or rates similar to those provided to other government agencies. As the auditors were made aware and yet fail to acknowledge in their report, the City is currently implementing this policy and will memorialize it in its comprehensive contract policy resolution on July 3, 2012.
- Internal Financial Controls, Record Keeping, Policies for Consultants – Review and Sign-Off of Invoices. Per its ongoing reforms, the City is requiring that the review and sign-off of professional service invoices by the initiating body be reinforced through a policy amendment or memorandum of the City Administrator. As the auditors were made aware and yet fail to acknowledge in their report, the City is currently implementing this policy and will memorialize it in its comprehensive contract policy resolution on July 3, 2012.

- Internal Financial Controls, Record Keeping, Policies for Consultants – Contract Rate Increases. Per its ongoing reforms, the City is in the process of adopting a general practice disallowing compensation rate increases during the term of the contract with an exception for external factors that significantly affect rates and requiring increases to be tied to the most appropriate index or cost of living rate. As the auditors were made aware and yet fail to acknowledge in their report, the City is currently implementing this practice and will memorialize it in its comprehensive contract policy resolution on July 3, 2012.

**B. The Draft Report fails to acknowledge that the City already tracks its current contracts in its accounting system.**

**Finding:**

The City does not maintain a complete list of contracts or require departments to use the accounting system's contract module to track their contracts.

**Recommendation:**

The City should require that all City contracts be entered into its accounting system to efficiently and effectively track the City's contract expenditures. The City should also begin using the enterprise system's uniquely assigned contract numbers for tracking and generating a list of contracts.

**City's Response:**

- ② The Draft Report alleges that the City does not maintain a complete list of contracts. (Draft Report 54). The audit team's finding does not reflect the City's current practices, nor does it acknowledge that its sample is not reflective of the City's past contracting practices as a whole. The City is already in the process of entering all contracts into its accounting system to better track related contract expenditures.
- ⑦ To include in its report, the auditors reviewed older contracts that the City concurs were not all entered in its accounting system. However, as discussed with the auditors during the audit, the City has reformed its contracting practices, and current contracts meet this criterion.

Pursuant to items 59 to 63 in Chapter 1, Section A of the City's Response, the City is currently working on a comprehensive contract policy to improve and clarify the City's contracting procedures. In line with the new contract policy, the City intends to utilize the Eden contract management module more extensively to more effectively monitor contracts and payments made pursuant to a particular contract.

The City's accounting system ("Eden") has the following modules: (1) Accounts Payable, (2) Accounts Receivable, (3) Budget Preparation, (4) Contract Management, (5) Fixed Assets, (6) General Ledger, (7) Inventory Control, (8) Payroll, (9) Project Accounting, and (10) Purchasing. The City is currently assessing whether to acquire other modules, including Utility Billing, Code Enforcement, Licenses and Permits, among others. The City is in the process of fully implementing the Contract Management module.

Moreover, the City had nearly 60 active contracts as of June 1, 2012 that are contained in Eden, both in the Contract Management module and the Purchasing module. The concurrent use of these modules provides heightened controls and mechanisms to better monitor and track payments and deliverables associated with a particular contract. Furthermore, over 600 contracts and nearly 10,000 purchase orders have been entered into the Eden Contract Management module since it was established

in late 2007. When a contract is entered into Eden, it generates a unique contract number (e.g., XX-0000) as a form of identification to track all activities throughout the term of the contract. For each contract, the Eden system contains the date, vendor information, account number, description of service, insurance information, department being charged, approval queue, and any attachments such as a resolution, agreement, staff report, memorandum, attorney approval as to form, proposal, or quote.

The Eden contract is routed to the department head for approval. Once approved, the contract is automatically sent to the Risk Management office for approval. The Risk Management Department only approves the contract if sufficient proof of insurance is provided. Once all approvals are received, the purchasing department issues a purchase order to the contractor or consultant. The purchase order includes a unique purchase order number, as well as the unique contract number from Eden for future reference and processing of invoices.

**C. The Draft Report fails to acknowledge that the City has already reformed its policies to require expenditure limits and start and end dates.**

④

**Finding:**

Most of the contracts the auditors reviewed did not impose a cap on expenditures or specify a period of service.

**Recommendation:**

The City should require all contracts to have expenditure limits and starting and ending dates for services performed. The City should also ensure that it reviews all current contracts and amends them, if necessary, to comply with newly established policies.

**City's Response:**

The Draft Report alleges that the City improperly entered into contracts without an expenditure limit or start and end date. (Draft Report 55). The audit team's finding does not reflect the City's current practices, nor does it acknowledge that its sample is not reflective of the City's past contracting practices as a whole. Per the City's ongoing reforms, the City is already in the process of requiring all contracts to have expenditure limits and start and end dates for services provided, if applicable. To include in its report, the auditors reviewed older contracts, some of which the City concurs failed to have either an expenditure cap or a specified period of service. However, as the auditors well know, the City has reformed its contracting practices, and its current contracts contain these criteria. Pursuant to items 59 to 63 in Chapter 1, Section A of the City's Response, the City is currently working on a comprehensive contract policy to improve and clarify the City's contracting procedures.

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The Light & Power Department follows detailed "New Contract Requisition Procedures" for all new and renewing contracts. While this is the current practice, as the audit team knows, the Light & Power Department is currently developing a formal policy that will be submitted to the City Council for approval. Under this policy, for contracts valuing less than \$25,000 the following procedures are used:

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1. The department requests a proposal from the Vendor/Contractor/Consultant.
2. A department manager submits a memo to the department head with an attached proposal for review and approval.

3. The department creates a contract in the Eden System to proceed with the order and approval process. The approval matrix to generate a Purchase Order from a contract is as follows:
  - a. Account/Business Supervisor: Confirms the accounting and coding inputs are correct;
  - b. Risk Management: Confirms all insurance requirements are met;
  - c. Department Manager: Reviews and approves the contents;
  - d. Director: Confirms and approves the contract; and
  - e. Purchasing: Creates a Purchase Order and submits the Purchase Order form to the department and the Vendor/Contractor/Consultant.
4. The department creates a folder to retain all documents supporting the Purchase Order, such as proposals, memoranda, requests, invoice copies, partial payment copies, and payment history.

For contracts valued at more than \$25,000, the City follows additional procedures. Once a department manager receives the department head's approval, the department manager must take two additional steps:

1. Forward the proposal/agreement to the legal department for review and approval.
2. Submit a staff report to the Mayor and City Council Members for review and approval at the targeted City Council meeting date.

Most City contracts contain a "not to exceed" amount and, depending on the type of contract, start and end dates. If a contract is for a specific service, such as repairs or maintenance, then the contract will be based on a "not to exceed" amount. Such a contract will not be paid in full until the job is complete and supporting documents – such as a completion letter, packing slip, and consultant work summary report, as billed – have been received, verified, and approved by a department manager. If the contract is for a specific time frame, such as consultant services, then the contract will be based on a start and end date with a compensated hourly rate or a "not to exceed amount" per fiscal year. Each purchase order that is issued has an expenditure limit. In order to adjust the expenditure limit, a change order must be issued. Depending on the dollar amount of the change order, City Council approval or ratification may be necessary. In addition, the purchase order must be reissued each fiscal year if it covers more than one year.

The agreement typically has a commencement and end date which is attached to the purchase order. While many agreements are issued on an annual basis and expire at the end of the year, others are for a specific project and end when the project is complete. For example, the City recently retained a consultant to update its General Plan. While a schedule was provided to complete the scope of work, outside forces, such as delayed approval by the State or public feedback, could require that the schedule be extended.

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The auditors fail to consider the reality that in many contracting situations, including some or all of these elements is unreasonable. For example, a legal services contract is heavily dependent on the complexity of the legal situations that arise. It is nonsensical to include either an end date or an expenditure

limit in such a contract, and, moreover it is contrary to common practice. Further, many service contracts do not need an end date because they are at the will of both the City and the contractor.

The reference to the legal services contract with no expenditure cap in the Draft Report is inappropriate. The audit team knew, and failed to note, that the City Attorney drafted this contract to be terminable within 30 days or sooner. The scope of this contract was directed by City management. The contract was meant to be transitional and of short duration. Most of the City's contracts can be terminated in 30 days or less. Requiring that a month-to-month contract be submitted to the City Council for renewal every 30 days does not enhance accountability or control for the City. If management no longer requires the services of the counterparty, it terminates the contract. If management does not need a certain level of service from the counterparty, it simply informs the counterparty to stop working on a particular matter.

As the audit team is aware, the City is already in the process of reviewing and amending all active contracts to ensure that they comply with the City's recently adopted reforms. On May 18, 2011, the Interim City Attorney emailed all department heads and requested that all departments identify any contracts with "evergreen clauses," i.e., those contracts with automatic renewal clauses. The City Attorney's office reviewed all such identified contracts. The City Attorney's office determined that some contracts did have an "evergreen clause," which the City then amended to exclude the evergreen clause. Since then, and as the audit team is aware, the City has not entered into any contracts with evergreen clauses.

**D. The Draft Report fails to acknowledge that the City has always monitored payments made to contractors.**

**Finding:**

The City does not use payment logs to track and monitor payments made to contractors.

**Recommendation:**

The City should require contract managers to use logs to monitor payments and the contractor's progress toward completion of required deliverables.

**City's Response:**

Based upon a review of contracts entered prior to the City's historic reform package. The Draft Report alleges that the City does not monitor its contracts. (Draft Report 56). The City respectfully disagrees. The City already monitors payments and the contractor's progress toward completion of required deliverables. The Eden financial system includes a number of different payment logs, such as paid invoices listing, check history listing, expenditure reports, and others. City Managers periodically review these reports, as well as all warrant registers, to monitor payments issued to a particular consultant. Pursuant to items 59 to 63 of Chapter 1, Section A, the City is continuing to improve its monitoring practices by establishing a comprehensive contract policy to improve and clarify the City's contracting procedures.

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Currently, each Contract in the Community Services Department is monitored by the assigned Contract Administrator, and a running log of all payments is kept on file with a copy of the purchase order. Contracts are monitored in two ways. First, a payment log is maintained in Excel to be used for quick reference to determine payment status and balance. Second, contracts are monitored in the Eden Contract Management module. Each contract generated in Eden is given a contract number that tracks all activities,

such as partial payment, change orders, contractor information, requisition number or contract number, account number, payment method, authorized purchase order funds, total billed to date, remaining purchase order funds, invoice number, invoice date, invoice amount, amount paid, and date submitted.

Eden also contains a purchase order module and a contract module. These modules contain the following information to assist staff in tracking contracts: (1) unique purchase order number; (2) unique contract number; (3) tracking system for change orders; (4) status of the purchase order, i.e., partial or complete; (5) total amount of the purchase order as supported by a resolution; (6) scope of work for the project as supported by a resolution; (7) start date of the project; (8) department that issued the contract; (9) list of paid invoices, including check dates and amounts; and (10) amount expended in each fiscal year.

- ④ **E. The Draft Report fails to acknowledge that the City has already reformed its policies to require well-defined scopes of work.**

**Finding:**

Some City contracts lack a well-defined scope of work or deliverables, making it difficult for the City to monitor and assess whether the nature and value of the services received were consistent with those billed and paid.

**Recommendation:**

The City should require that all contracts contain a well-defined scope of work and deliverables that a sufficiently detailed invoice can be measured against.

**City's Response:**

The Draft Report alleges that some City contracts improperly lacked a well-defined scope of work. (Draft Report 58). The audit team's finding does not reflect the City's current practices, nor does it acknowledge that its sample is not reflective of the City's past contracting practices as a whole. The City is already in the process of reviewing its contracts to ensure they include a well-defined scope of work and deliverables to measure detailed invoices against. Pursuant to items 59 to 63 of Chapter 1, Section A, the City is currently working on a comprehensive contract policy to improve and clarify the City's contracting procedures. The City currently adheres to this procedure for all contracts.

Every contract contains a scope of work and service or equipment/material cost. Anytime an invoice for services rendered is received, the City requires that the contractor include a detailed report explaining the work that was done for the City. This is reviewed by multiple managers and must be approved by the department head. If a service is a one-time expense, then the contractor must submit a completion notice and supporting documentation for the City to confirm that the service was completed based on the approved scope of work. If an equipment/material purchase is a one-time expense, then a proof of delivery, such as a packing slip, is required to inspect and confirm that the equipment/material arrived safely and was received by City staff. For both service and equipment/material purchases, supporting documents are submitted to the department head as a package, which includes the invoice signed by a department manager, all supporting documents, and the purchase order. Once the department head signs off on the materials, City staff makes a copy of the package for records and submits the original to the Finance Department for payment.

If the service or equipment/material purchase contract includes a term to pay as different levels of service are completed, then a partial payment form is submitted with the invoice and supporting documentation for approval. A partial payment form includes a description, the amount paid, and the remaining balance in the approved purchase order's "not to exceed" amount. Once the service is complete or the equipment/material is received, then the City repeats these steps.

**F. The Draft Report fails to acknowledge that the City requires detailed invoices.**

**Finding:**

The invoices on some service and consultant contracts lack sufficient detail, making it difficult to verify the services received.

**Recommendation:**

The City should ensure that contracts include language requiring contractors to provide invoices with sufficient detail and that the Finance Department review and return invoices lacking sufficient detail to the appropriate contract manager to obtain a revised invoice.

**City's Response:**

The Draft Report alleges that the City accepts invoices that lack sufficient detail. (Draft Report 59). The audit team's finding does not reflect the City's current practices, nor does it acknowledge that its sample is not reflective of the City's past contracting practices as a whole. The City is already in the process of reviewing all active contracts to ensure that contracts include language requiring contractors to provide invoices with sufficient detail. Pursuant to items 59 to 63 of Chapter 1, Section A, the City is currently working on a comprehensive contract policy to improve and clarify the City's contracting procedures. (22)

Currently, all invoices are required to specify the work performed for the billing period. Some are fairly generic in nature, such as billing for a monthly service like street sweeping or janitorial services. However, if extraordinary work is performed, then specific information must be provided to confirm that the invoice matches the work performed. For work that is billed periodically, such as consulting work on a specific project, the invoice must reflect the work completed to date, preferably by percentage of tasks performed, along with supporting documentation on labor, materials, and equipment expenses.

Each contract is monitored by an assigned Contract Administrator. The Administrator is responsible for reviewing invoices, comparing invoices with the work completed to date, overseeing the preparation of partial payments, and logging all payments to date. The work described in the work plan is typically broken down by task. Submitted invoices reflect the number of hours worked on each task and the percent of completion. If the Contract Administrator agrees with the invoice, a partial payment is processed. If the Contract Administrator disagrees with the invoice, it is returned with a request to modify the invoice to more accurately reflect the work completed to date. After the department head has approved payment, a copy of the invoice is forwarded to the purchasing department, where the invoice is reviewed to ensure that required information is provided prior to the invoice being paid.

The City also follows a detailed invoice approval process, as follows: (24)

1. The department receives an invoice from the Finance Department.

2. The department takes the invoice, packing slip, and supporting documents for services provided and verifies charges, totals, and quantities.
3. The department forwards the invoice, packing slip, and supporting documents for services provided to a department manager for review and approval.
4. If the invoice is tied to a purchase order, all related charges and items have been verified, and the purchase order is complete, then all approved supporting documents are attached to the invoice and submitted to the department head for final approval. Once the department head provides final approval to process the payment, the purchase order is closed. All invoices, packing slips, and other documents that have been reviewed and verified will have an approved stamp or initials to indicate that it is appropriate to pay the invoice.

If the invoice is ordered on a purchase order and is only a partial billing, a partial payment form is prepared and all supporting documents, invoices, and packing slips are attached and submitted to the department head for final approval to process payment. All supporting documents, invoices, and packing slips will be initialed by the appropriate personnel indicating that all charges have been verified and can be processed for payment.

If the invoice is not ordered on a Purchase Order, the invoice, packing slip, and supporting documents are attached with the appropriate initials of the person reviewing and verifying the charges for services provided. This packet is submitted to the department head for final approval to process the payment.

5. If the Purchase Order is complete, the department submits the signed Purchase Order green copy, invoice, packing slip, and supporting documents for services provided to Purchasing for payment. The Purchase Order blue-copy and a copy of the invoice, packing slip, and supporting documents for services provided is kept for the City's files.

If the Purchase Order is not complete, the department submits the partial payment form, invoice, packing slip, and supporting documents for services provided to Purchasing for payment. The Purchase Order remains open until it is complete, at which point the final payment procedure is followed.

If the invoice is not ordered on a Purchase Order, the department submits the invoice, packing slip, and supporting documents for services provided to Purchasing for payment. A copy of the invoice, packing slip, and supporting documents for services provided is kept for the City's files.

- ④ **G. The Draft Report fails to acknowledge that the City is already in the process of implementing a competitive bidding process.**

**Finding:**

The City rarely used a competitive bidding process when selecting contractors for the contracts reviewed by the City. Although the City's electorate has called for the adoption of a City ordinance requiring competitive bidding for service contracts, the City has not yet adopted such an ordinance.



**Recommendation:**

The City should continue its efforts to develop and implement policies and procedures for a competitive bidding process, including clearly defining the circumstances under which forgoing competitive bidding is appropriate.

**City's Response:**

The Draft Report alleges that the City failed to utilize competitive bidding when selecting contractors. (Draft Report 61). The audit team's finding does not reflect the City's current practices, nor does it acknowledge that its sample is not reflective of the City's past contracting practices as a whole. In an effort to provide greater accountability and transparency, the City is already in the process of implementing an open and competitive bidding process for City service contracts by ordinance pursuant to items 16 and 53 of Chapter 1, Section A. As discussed with the auditors, the City is currently reviewing competitive bidding ordinances from surrounding jurisdictions to help it formulate its own process. This process will be prominently posted on the City's website, as will a description of the desired service for which bids are being sought.

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California law and Vernon City Code allow for negotiated transactions. While some departments chose to engage in competitive bidding procedures, Light & Power chose to undertake negotiated transactions for personal service contracts, consistent with California law and City Code. Recent amendments to the City Charter forbid this, and Light & Power is in the process of adopting competitive bidding procedures in compliance with these new amendments.

The Light & Power Department currently employs a competitive bidding process for contracts to purchase materials. Under the "Three Bid" requirement:

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1. A department manager submits a request to Purchasing to find pricing for materials.
2. Purchasing submits pricing from three vendors to the department manager.
3. The department manager selects the bid that best meets the cost, quality, and time requirements needed.
4. The department manager submits a memorandum to the department head with the proposal attached for review and approval.
5. The department creates a Contract in the Eden System to proceed with the order and approval process.

The Community Services & Water Department uses a RFP process to select service contracts for projects over \$25,000 in value. This process has been followed for numerous years, for projects varying from janitorial services to the engineering design of a bridge. For projects that are less than \$25,000 in value, the department seeks multiple quotes through an informal process. The department uses the procedures in the Caltrans Local Assistance Procedures Manual as a guideline in developing an RFP process and selecting a service provider.

Under the RFP process, the City's Contract Administrator for the project develops the specific description of the product or service to be provided, a schedule of work, a proposal format, and criteria for selection to be included in the RFP. The RFP also specifies what needs to be included in the proposal, which typically includes a work plan, proposed staffing, resumes, schedules, experience of the firm, and references. If the RFP is for engineering, architectural, or other consulting service work, the City requests that the proposer submit a cost proposal in a separate sealed envelope. If the proposal is for a service other than consulting, then the City typically requires that the proposer submit a cost proposal. After the RFP is prepared, it is forwarded to the City Attorney's office for approval as to form. Once approved, the department obtains City Council approval to seek proposals for the requested work. When this approval is received, the department either advertises the RFP, mails the RFP directly to consultants or contractors that perform the work being requested, or both. Any substantive questions raised by a proposer that arise prior to the submittal date of the RFP are answered in writing and provided to all who received a copy of the RFP.

The department creates a Selection Committee to review received proposals. Once the deadline for proposals passes, the submitted proposals are delivered to each member of the Selection Committee for review and ranking. The Committee discusses the strengths and weaknesses of each proposal and creates a preliminary ranking of the proposals. The Committee may choose to interview top ranked proposers, and a final selection is made. Upon selection, the cost and final scope of work is negotiated, and the negotiated contract is presented to the City Council for approval.

- ④ **H. The Draft Report fails to acknowledge that the City is already reforming its travel and expense reimbursement policy.**

**Finding:**

The City lacks adequate policies and procedures governing travel and expense reimbursement.

**Recommendation:**

The City should require the Finance Department to review credit card expenditures for appropriateness. The City should revise its travel and expense reimbursement policy to be clear about the expenditure limits for meals, add a limit for lodging accommodations, and specifically disallow certain types of expenditures.

**City's Response:**

The Draft Report alleges that the City lacks adequate policies governing travel and expense reimbursement. (Draft Report 65). The City respectfully disagrees. The audit team's finding does not reflect the City's current practices, nor does it acknowledge that its sample is not reflective of the City's past contracting practices as a whole. The Finance Department already reviews credit card expenditures for appropriateness. In fact, credit card statements go through multiple layers of review and approval. Department heads review credit card statements. The Accounts Payable department reviews the statements to make sure all receipts are included. The Finance Director reviews and signs the credit card statements. In addition, credit card purchases used for travel are approved by the requestor's supervisor. Credit card purchases are processed through the purchasing department, which provides an additional layer of review.

The City is already in the process of reviewing and amending its reimbursement policy as part of the City's recently adopted reforms. The City's intent with regard to its travel and expense reimbursement

policy is only to reimburse up to \$10 per breakfast, \$15 per lunch, and \$20 per dinner. However, if the meals cost less than the allotted amounts, the employee is only reimbursed for the amount on the receipts. The City concurs that this sentence in its reimbursement policy needs to be rewritten to clarify the issue, and it is already in the process of undertaking this reform. (See Resolution 2011-187).

As stated in the City's travel policy, "City officials and employees should choose reasonably priced accommodations based on the location of the business meeting or conference. Government rates should be selected when available." With increases in inflation, rising costs, and pricing differences among locations, it is unreasonable to set a limit on lodging accommodation. The City's travel policy was modeled on the policy followed by the City of Pasadena, which does not set limits on accommodations. In addition, the Independent Ethics Advisor affirmed the City's travel policy and made no recommendation to add a limit for lodging. The new travel reimbursement form requires management approval, including by the City Administrator and the City Council. The City will review additional municipalities' travel policies and consider disallowing certain types of expenditures if deemed reasonable and appropriate.

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**I. The Draft Report fails to acknowledge that the City is already in the process of improving the administration of conflict code.**

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**Finding:**

The City did not always comply with the disclosure requirements of the conflict of interest code it adopted under the Political Reform Act of 1974 by making a written determination as to whether each consultant it hires must disclose its financial interests. The City did not always ensure that required employees filed statements of economic interest.

**Recommendation:**

The City should ensure that the City Administrator and City Clerk are appropriately trained to administer its conflict code. The City should continue to ensure that all City executives file statements of economic interests. The City should review existing consultant agreements and determine which need to file statements of economic interests, and retain documentation of these determinations to forward to the City Council for review.

**City's Response:**

The Draft Report alleges that the City is not in compliance with its conflict of interest code. (Draft Report 66-67). The audit team's finding does not reflect the City's current practices, nor does it acknowledge that its sample is not reflective of the City's past contracting practices as a whole. Pursuant to item 54 of Chapter 1, Section A of the City's response, the City has already drafted policies to include in the comprehensive compliance manual regarding administration of the City's conflict codes. Independent counsel is currently reviewing the policy. The policy also includes procedures pertaining to the City Administrator's determinations upon review of services provided by consultants.

The City Clerk has been trained to administer the conflict code to ensure that conflict of interest statements are filed upon assuming and leaving office, as well as annually, and that all conflict of interest statements are readily accessible and kept for at least seven years. As the audit team well knows, this training was completed on January 5, 2012. The City's annual compliance training for the council members and Staff is scheduled for early July 2012, or as soon thereafter as the newly elected council member is seated. Furthermore, the City provides all affected incoming employees annually during the filing period with

written guidance regarding compliance with filing requirements for conflict of interest statements, namely, the California Fair Political Practices Commission Form 700 Packet and Reference Pamphlet.

③④ **CHAPTER 3: THE DRAFT REPORT FAILS TO ACKNOWLEDGE THAT THE AUDITORS' FINDINGS RELATING TO THE GENERAL FUND AND BUDGET ARE ALREADY FOLLOWED BY THE CITY OR ENCOMPASSED WITHIN THE CITY'S REFORM EFFORTS.**

In Chapter 3, the auditors discuss various aspects of the City's general fund and budget policies. Before addressing each of the auditors' findings individually, it is important to note the auditors' failure to recognize the level of expertise of the established and highly regarded consultants retained by the City to advise it on its budget policies.

For example, Macias, Gini & O'Connell, LLP (MGO) is a renowned statewide certified public accounting and business management firm with an impressive list of cities and agencies as clients. MGO has prepared the City's audited financial statements since the fiscal year ending June 30, 1999. Aside from serving as the City's auditor, MGO also provides services to clients ranging from CalPERS, the world's largest public pension system, to California's largest local governments, including the Counties of Los Angeles, San Diego, and Sacramento. Additional clients include LAX, Los Angeles, San Diego, Sacramento, San Francisco, and San Jose. Additional information regarding MGO's history, staff, and accomplishments is available at <http://www.mgocpa.com/go/mgo/>.

- A. The Draft Report fails to acknowledge that the City is already in the process of evaluating long-term solutions to balance the General Fund to decrease its reliance on interfund transfers.**

**Finding:**

The City's current revenue structure for its General Fund does not provide sufficient revenue to pay for the services that the General Fund provides. The City has increased reliance on other funds to cover its General Fund deficits. The City's budget process lacks detail that would improve the public's understanding of the City's financial challenges. The City's budget document does not discuss the City's efforts to address the General Fund deficit.

**Recommendation:**

The City should seek long-term solutions to balance the General Fund and lessen its reliance on transfers from other City funds. Further, the City should clearly present the general fund structural deficit to the City Council and the public in a budget that includes narrative and summary information and that incorporates the elements recommended by the GFOA.

**City's Response:**

The Draft Report alleges that the City does not have a plan to address the General Fund structural deficit, and that the City fails to present the general fund deficit to the public. (Draft Report 81). The City respectfully disagrees. Much of the information requested by the auditors can be found in the City budget published in the annual audited financial statements. The City fully discloses its transfer activity in its financial statements in accordance with GAAP. This information is available through the City Clerk's office, the Finance Department, and the City's website. In addition, these audited financial statements, as well as other

key financial data, are filed annually, pursuant to the City's disclosure agreement, with national and state repositories. They are attached to the Single Audit Report (Form SF-SAC) which goes to the United States Department of Commerce as Collecting Agent for the Office of Management and Budget. They are filed with the California State Controller's Office, Division of Audits and attached to the City's Financial Transactions and Compensation Report filed with the California State Controller's Office, Division of Accounting and Reporting. Finally, this information is provided to the rating agencies and attached to the City's bond offerings and the City's continuing disclosures.

Increases in the General Fund expenditures are attributable to an increase in the cost of labor, mainly overtime cost and health and pension benefits, in certain departments. Like many other cities, including Los Angeles, Pasadena, Colton, Glendale, Anaheim, and Burbank, the City had an established General Fund revenue source from transfers from the Light & Power fund. The Light & Power Department is an enterprise department of the City; as such, after it satisfies all of its bond debt covenants, the City may transfer all available net revenues to its general fund. Available Light & Power net revenues have been impacted in the last three years by (1) the loss of several million dollars in wholesale power sales due to the ISO (shortened from "independent system operator") market redesign and switch to "NODAL" pricing; (2) the impact of the recession on Light & Power sales; and (3) the interruption in the normal electric rate increases to recover increased costs stemming from California House Speaker John Perez's unsuccessful disincorporation bill. The structural deficit only exists if the General Fund can no longer be supported by the Light & Power Department. Other cities face similar concerns; for example, half of the City of Commerce's General Fund revenues comes from Commerce Casino. In addition, many costs have risen, including increased CalPERS contributions, insurance premiums, and supply prices, in particular for fuel.

As the audit team is aware, and fails to report, the City has taken numerous steps toward creating long-term solutions to balance the General Fund and creating a better public policy. For example, the City Council retained an Independent Ethics Advisor who recommended the creation of a Business Development Committee. This committee was formed and is actively working with the City toward a better public policy. Further, as recommended by the Advisor, City staff prepared a quarterly progress report outlining the City's budget for the City Council and the public. The City will continue these quarterly reports and is working with the Advisor to further improve the report. The City has also created the Business Development Committee to assist in developing solutions to balance the General Fund. In addition, the City has been working with the Vernon Chamber of Commerce to identify other revenue streams to create a long-term solution to the General Fund deficit.

The City has sought to decrease reliance on transfers from other City funds, such as by proposing a parcel tax for the General Fund. The City has retained outside consultants to craft increases in General Fund revenues to reduce general transfers from the Light & Power enterprise. The City is currently pursuing more revenue to address the deficit, rather than reducing expenditures that would lead to a reduction in City services. The City has consolidated various funds, including the interfund loan accounts, with the General Fund in order to reduce inflexibility and undue complexity in budgeting, accounting, and other phases of financial management. While the City is seeking alternative funds to decrease its reliance on the Light & Power fund, it cannot eliminate this reliance completely because of its dearth of revenue streams. The City's long-term plan must still rely to some extent on the transfer of revenues from the Light & Power fund, a practice that is not uncommon among municipalities that own their own utilities. For example, a January 8, 2012 article in the Pasadena Sun states that the City of Pasadena transferred nearly \$16 million (8% of revenues) from its utilities to its general fund. The Pasadena Water and Power fund is allowed to transfer up to 16% (\$32 million) of its revenues to the General Fund. If Pasadena did not make these transfers, its general fund would also have had a structural deficit.

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However, the City has adopted multiple resolutions to address the General Fund structural deficit.

- In Resolution No. 2010-33 dated March 1, 2010, the City Council took action to reduce certain compensation and benefits of its employees to reduce the City-wide cost of providing services without reducing its service levels.
- In Resolution No. 2010-34 dated March 1, 2010, the City Council took action to reduce certain payments of premiums for insurance for life, health, and dental benefits of its employees to reduce City-wide cost of providing services without reducing its service levels.
- In Resolution No. 2010-47 dated March 29, 2010, the City Council declared that total General Fund governmental activities expenses must equal total General Fund governmental activities revenues and authorized and directed the City Administrator to submit and present the appropriate action required to achieve this balance.
- In Resolution No. 2010-49 dated April 6, 2010, the City Council authorized and approved the termination of interest rate swap transactions, approved the related termination agreements, and authorized certain other matters relating thereto.
- In Resolution No. 2010-50 dated April 19, 2010, the City Council authorized the City Administrator to take appropriate actions to reduce total general fund governmental activities expenses in the Police Department and Fire Department, including a reduction in force, to reduce general fund's deficit.
- In Resolution No 2010-133 dated September 20, 2010, Vernon voters adopted Measure B, which allows the proceeds of the existing special parcel tax on warehouses and similar uses to be spent on police and fire protection services. In Resolution No. 2011-39 dated March 15, 2011, the City Council authorized the execution of a consulting services agreement by and between the City of Vernon and NBS to review revenue base, provide funding alternatives, and implement funding solutions. The revenue consultant provided a report detailing many potential revenue solutions available to the City. (See Exhibit 1).
- In Resolution No. 2012-04 dated January 5, 2012, Vernon voters adopted Measure I to remove the restriction on the use of revenues from the City's Light & Power enterprise. At the February 21, 2012 Regular City Council Meeting, there was a public discussion on the special parcel tax, where the City Council, ethics monitor, City Administrator, department heads, City employees, citizens, and business leaders were present to voice their opinions.

The Internal Control Risk Assessments contained in the City's annual budgets show the actions of City management to identify key issues and communicate those issues to the City's senior management and outside independent auditors. As the minutes from the November 2, 2009 Regular City Council Meeting show, the City Council and the public were made aware of the City's general fund's deficit, and the City communicated its intent to reduce it.

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- B. The Draft Report fails to acknowledge the City's current budget policies and procedures which incorporate GFOA findings and City Code requirements.**

**Finding:**

The City lacks documented policies that govern how to develop and manage its budget. The City's budget process has not always contained the elements required by the Charter or recommended by the GFOA. The City has not developed a centralized process for approving deviations from the budget.

**Recommendation:**

The City should develop budget policies that incorporate City Code requirements and GFOA recommendations and make these policies available to the public on its Web site. Additionally, the City should establish a centralized process to regularly monitor and report on the status of the budget.

**City's Response:**

The Draft Report alleges that the City lacks a comprehensive budget policy. (Draft Report 82). The City respectfully disagrees. The City's resolutions, ordinances, and charter sections govern the budget process. The auditors were provided historical budgets adopted by elected officials through a public hearing process. In addition, the City's current practices were repeatedly communicated to the auditors via e-mail with attachments.<sup>4</sup>

The City's policy is to become an "A" rated utility. As such, it covenanted in its bond resolutions several requirements concerning debt, the use of debt, debt coverage ratios, prudent utility practices, and the forward capital needs of its utility. These covenants were carefully drafted in consultation with bond counsel, Orrick, Harrington & Sutcliffe LLP (Orrick); outside financial advisor, Bond Logistix (BLX); underwriting banks, Banc of America Securities, Morgan Stanley, RBC Capital Markets, Citigroup, De La Rosa & Co., Lehman Brothers, and Barclays; consulting engineering firms, R.W. Beck, Inc. and Navigant; and national rating agencies, Moody's and Standard & Poor's. It is important to remember that while bond covenants require a majority vote of hundreds of millions of bond holders, who are third parties independent of the City, City Council resolutions can be easily repealed.

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In preparation for the budget, the Finance Department first emails a time schedule with five completion phases: (1) Initial Budget, (2) Revised Budget, (3) Proposed Budget, (4) Final Budget, and (5) Approved Budget. Department heads receive an electronic standard budget template to complete. The budget template includes a budget summary, budget detail, payroll detail, and several accounts detail tabs. In the budget detail, there are five columns: approved budget, fiscal-year trend, proposed budget, and two variance columns by approved budget to fiscal year trend and proposed budget to fiscal year trend. The approved budget and fiscal year trend columns are filled with the approved budget numbers and projected fiscal-year trend numbers based on the MMR report from Eden. Once the initial budgets are complete, the managers forward the initial budget to the department head for review. The Director then reviews the budget with each division manager to address any questions or suggestions before submitting the initial budget to the Finance Department.

In Phase 2, Revised Budget, the Finance Department reviews the initial budget and recommends revisions or highlights any errors to be corrected. In Phase 3, Proposed Budget, the City Administrator

<sup>4</sup> The City's current practices were communicated to the auditors via e-mail with attachments on the following dates: December 20, 2011; January 11, 2012; February 28, 2012; February 29, 2012; March 6, 2012 (12:33 PM); March 6, 2012 (4:21 PM); March 6, 2012 (5:02 PM); March 7, 2012 (1:54 PM); March 7, 2012 (2:01 PM); March 23, 2012 (2:19 PM); March 23, 2012 (8:20 PM); March 26, 2012 (8:22 AM); March 26, 2012 (10:20 AM); March 26, 2012 (10:25 AM); March 26, 2012 (10:49 AM); March 28, 2012; April 18, 2012 (10:34 AM); April 18, 2012 (4:25 PM); April 18, 2012 (4:28 PM); May 3, 2012; May 7, 2012; May 8, 2012; May 10, 2012; May 14, 2012; May 15, 2012.

reviews all budgets. Once this is completed, the City Administrator recommends a Final Budget to the Honorable Mayor and City Council for approval.

②9 The City's Official Budget Policy is contained in the Vernon City Charter, Article VIII. The most recent budget satisfies the requirements of the Vernon City Charter, Article VIII. In addition, it goes beyond what is required by providing the following:

1. An estimate of the revenues and expenditures for each City department for the ensuing fiscal year. (See section VIII(a)).
2. A comparison of expenditures for the current fiscal year with proposed expenditures for the ensuing fiscal year and reasons for the proposed increase or decrease. (See section VIII(b)). Current practices and procedures go beyond what is required by also providing a comparison of revenues and expenditures for the current fiscal year budget with the ensuing fiscal year budget; by providing object details; and by providing Monthly Management Reports, Revenue Status Reports, Expenditures Status Reports, Budget by Fund Reports, and General Fund's Budget to Actual reports in the financial statements.
3. An estimate of money needed for contingent or emergency purposes. (See section VIII(c)). The City's financial statement reflects the net assets available for contingent or emergency purposes.
4. An estimate of all anticipated revenues. (See section VIII(d)).
5. An estimate of the tax rate necessary to meet the expenditures proposed. (See section VIII(e)). When revenues and reserves cover the expenditures proposed, the proposed tax rate increase is assumed to be zero.
6. A recommendation for the amount of funds to be allocated to capital outlay. (See section VIII(f)).
7. A recommendation for amounts to be appropriated, with corresponding explanations, in such detail as the City Council may direct. (See section VIII(g)).
8. Such further information as the City Administrator may deem advisable to submit, subject to approval by the City Council. (See section VIII(h)). Current practices and procedures go beyond what is required by also providing City-wide budget summaries.

②9 The City has taken many steps to develop its budget policies, practices, and procedures and to incorporate GFOA's recommendations. The City identified and listed the GFOA's recommended practices. The City formed various committees to address long-term non-financial goals and objectives. Capital expenditures issues are disclosed in the City's financial statement Notes 5. The City's Reform Matrix currently serves as a framework for prioritizing issues. Fund structure issues, consolidation issues, comparative analysis issues, major versus minor fund issues, capital expenditure issues, and debt issues are clearly addressed in the footnotes of financial statements prepared by management. As recommended by the City's Independent Ethics Advisor, City staff prepared a quarterly progress report outlining the City's budget for the City Council and the public. The City will continue these quarterly reports and is working with the Advisor to



further improve the report. The City has and will continue to post its budget and financial statements on its website. The website is currently being updated to make it more user-friendly.

The City provides an official statement to the national public which includes its audited financials and, pursuant to agreements with all bond trustees, the City provides an annual disclosure statement to national and state repositories. Long-term debt issues are disclosed in the City's financial statement at Notes 6 and Note 7. Note 6 addresses the debt service over the entire life of the debt; Note 7 addresses the risks associated with the derivative instruments before the City took the conservative approach to implement GASB 53 two years prior to its effective date. (See Note 16 of the City's June 30, 2008 Audited Financial Statements). Long-term debt issues are also addressed in every bond official statement, presentation made by the City to rating agencies, and continuing disclosure requirements by the SEC, all of which is readily available to the public.

Issues related to function, performance measures, organizational structure, and human resources are all currently addressed in the Reform Matrix under the supervision of an Ethics Monitor. Statistical and supplemental information issues are presented in the City's marketing material as well as in its financial statements. The June 30, 2011 financial statements lay out the efforts made over the past few years with regard to understandability and usability.

For the past few years, the City has had the Monthly Management Report available in real time. It has served as an integral part of the City's budgeting process for the past two years. This report can be generated instantaneously in the Eden Accounting System, which exports to Excel with additional fields identifying its location in the City's financial statements.

#### **CHAPTER 4: THE DRAFT REPORT IMPROPERLY SUGGESTS THAT THE CITY'S HISTORICAL ENERGY TRANSACTIONS LACKED ADEQUATE CONSULTATION AND CONSIDERATION.**

⑤

The auditors reviewed a variety of financial and energy-related transactions including multiple bond transactions from 2004 to the present and four swap transactions from 2003 to 2006. Before addressing each of the auditors' findings individually, it is important to note the auditors' failure to recognize the level of expertise of the established and highly regarded consultants retained by the City to advise it on its financial and energy decisions.

⑥

BLX Group is registered with the MSRB as a municipal advisor and with the SEC as a municipal advisor and investment adviser. BLX's full complement of pre- and post-debt advisory services include debt strategy and debt structure, bond pricing review and analysis, swap advisory and monitoring, investment management, structured products, arbitrage compliance, and post-issuance compliance, as well other integrated solutions for tax-exempt transactions. Today, BLX assists municipalities across the country in evaluating, structuring, and implementing key investment strategies for their tax-exempt transactions, including but not limited to the California Communities Joint Powers Authority, the California Department of Water Resources, the Statewide Community Infrastructure Program, the Colburn Music School, and the City of Oakland. Its extensive participation in designing new products for the public finance industry coupled with its comprehensive knowledge of available investment opportunities helps it maximize the economics of each transaction.

- A. **The Draft Report fails to acknowledge the City's current debt policies and procedures and that the City is already in the process of reforming its debt policy.**

**Finding:**

The City has not established a debt management policy to guide its decisions and to ensure that it issues debt consistent with its long-term goals and principles of sound financial management.

**Recommendation:**

The City Council should establish a comprehensive debt policy that includes GFOA recommendations and make it available on the City's website.

**City's Response:**

① The Draft Report alleges that the City does not have a comprehensive debt management policy. (Draft Report 91-92). The City currently relies on the expertise of multiple consultants and advisors to provide comprehensive debt management guidance. The City is working with these advisors to develop a comprehensive plan that governs the City's issuance of debt. The City's long-term debt issues are disclosed in the City's financial statement Notes 6 and 7, as well as in every bond's official statement, presentation to rating agencies, and continuing disclosure requirements to the SEC, all of which is readily available to the public.

In addition, the Finance Department has already begun an in-depth analysis of the City's financial condition similar to the review conducted by the auditors. The City agrees with the need for an amended debt policy that looks to both the immediate financial needs of the City and longer-term planning. As the audit team was informed, this is exactly why the City has undertaken this review and period of reform.

② During one of BLX's meetings with the state auditors, BLX discussed multiple bond transactions from 2004 to the present, as well as four swap transactions from 2003 to 2006. As discussed during the meeting, BLX acted as the City's financial advisor in connection with the listed transactions. In that role, BLX advised the City on various issues, including rate exposure, basis risk, transaction costs, covenant obligations, security, redemption or refunding flexibility, termination risk, and counterparty credit risk. Further, BLX discussed with the City the relative costs and benefits of a synthetic fixed rate bond over a traditional fixed rate bond. BLX advised the City how to structure its swaps in order to hedge its interest rate risk, rather than to speculate on the direction of future interest rates, so that all of the City's swap transactions met the definition of a qualified hedge under the IRC Treasury Regulations. The swaps entered into by the City covered, in whole or in part, all of one or more groups of substantially identical bonds of the issuer. Further, all of the swap contracts were primarily interest-based, were entered into with unrelated parties, and were included in the determination of yield on the related bonds.

③ BLX prepared detailed reports and financial analyses related to each bond issuance, which were presented to the City Council. These and other reports regarding bond issuances are filed with state and national repositories and contain current audited financial statements, notice of any significant events, and updates on all relevant aspects of the Light & Power enterprise, including rates, customer loads, current operating results, and any other information that is material to a knowledge and understanding of the then-current financial position of the Light & Power Department. The public has access to these reports independent of the City in connection with every bond financing undertaken by the City since December 2004.

For example, in 2003, the City issued bonds to finance construction at the Malburg Generating Station (MGS). The bond transaction was complex, involving an interest rate swap to hedge against interest rate increases and an Irrevocable Direct Pay Letter of Credit with Bank of America and JP Morgan Chase

Bank. The Letter of Credit secured the payment of principal and the purchase price of the bonds, thereby improving the bond credit rating. Four banks, two financial services firms, and four law firms participated in this transaction. BLX advised the City on its 2003 Swaps in order to hedge the City's BMA exposure. BLX advised on the details of the swap transaction, various options available to the City, the projected outcome of the swap, the risks accompanying such a transaction, and various other issues.

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The 2004 Bonds were issued to raise additional funds for the project and refinance the prior debt because of regulatory and construction delays that impeded the timely completion of the MGS. Again, these bond transactions were complex, involving an interest rate swap that allowed the City to pay a fixed interest rate while Morgan, Stanley & Co. accepted the risk of variable interest rates. All bonds were designated as Auction Rate Securities, with the interest rates determined through a Dutch auction process. Additionally, the City obtained municipal bond insurance to secure a AAA credit rating for the bonds.<sup>5</sup> Two banks, two financial services firms, two insurance agencies, and six law firms participated in this transaction. BLX advised the City on its 2004 Swaps, which the City entered into to hedge its variable rate exposure while achieving the lowest cost of financing. As such, the amortization of the swaps (i.e., the scheduled reductions of the notational amount of the swaps) perfectly matched the amortization of the 2004 Bonds. Such a transactional structure was commonly utilized by California municipalities, especially electric utilities. While an informed and economically sound transaction at the time, the full expected savings from the 2004 Bonds were not ultimately realized due to (1) the collapse of the auction rate market; (2) the collapse of the bond insurer, XL Capital, which was a AAA-rated bond insurer at the time of issuance; and (3) the historically unprecedented low long-term interest environment which led to the broad economic collapse in 2008. These macroeconomic factors were unforeseeable at the time of issuance.

Throughout California and the country during the 2002–2007 period, thousands of municipalities elected to enter into synthetic fixed-rate deals. The City Council knew the risks inherent in the transactions; the risks were acceptable given the historic yield curves over the preceding 30 years. The City analyzed fixed-rate bonds versus synthetic fixed-rate bonds, but no one, the City included, predicted the financial collapse. The City tracked its swap portfolio daily, and its financial advisor monitored the yield curve trends. At the time the City terminated two of its swaps, interest rates had moved up sharply and the City reacted quickly. Subsequent to that time, interest rates have dropped significantly and the swap termination values have risen. The City Council was advised by the Light & Power Department that the termination of the 2003 and 2005 swaps would result in a net monetary gain to the City. The transaction terminations were handled entirely by the City's financial advisor BLX.

BLX advised the City on its 2005 Swaps in order to decrease the City's debt service cost on its bonds, including on the details of the swap transaction, various options available to the City, the projected outcome of the swap, the risks accompanying such a transaction, and various other issues.

When the MGS became operational, the City's need for reliable natural gas to fuel the plant increased. Unfortunately, the natural gas markets were volatile in 2005. In June 2006, to stabilize the cost of gas required to fuel the MGS, the City entered into a fifteen-year contract to purchase a pre-paid supply of natural gas from Citigroup Energy. BLX consulted the City with regard to its decision to pre-purchase a 15 year forward supply of natural gas from Citigroup. Specifically, the City undertook this purchase in response to extreme volatility in the natural gas market due to Hurricane Katrina. The City also hired the Siemens Company subsidiary, New Energy Associates to advise. New Energy Associates undertook a detailed study of the utility's load and generation assets, its transmission entitlements to external SP 15 power markets, and the

<sup>5</sup> Municipal bond insurance unconditionally guaranteed the payment of all principal and interest due on the bonds.

Western Electricity Coordinating Council's gas and energy price forecasts. This study enabled the City to assess the operations of its power plant and the forecasted fuel costs. The City sought to secure a long-term supply of natural gas at a fixed price that was within its current electric rate structure in order to mitigate its largest variable cost.

In June 2006, the City financed the fifteen-year natural gas contract by issuing municipal bonds. This bond transaction was similarly complex, involving five separate interest rate swap agreements with Citibank. The Series A Bonds were designated as Auction Rate Securities, with the interest rates determined through a Dutch auction process. Additionally, to secure a AAA credit rating for the bonds, the City obtained municipal bond insurance. It also entered into a Remarketing Agreement with Citigroup Global Markets, Inc. to sell any excess natural gas the City did not need. Two banks, three financial services firms, one insurance agency, and five law firms participated in this transaction. The prepaid natural gas contracts and subsequent bond offering were heralded by Energy Risk magazine as a "Deal of the Year." New IRS rules had been enacted to permit tax-exempt prepayment transactions. The City's contract with Citigroup Energy was only the third deal executed under these revised IRS rules, and was the only deal of its kind executed by a California municipality. The prepaid natural gas contract was also the first major fixed-rate natural gas transaction completed in the U.S. While the 2006 Bonds originally funded the purchase of 75% of the natural gas needed to operate the Malburg Generating Station, the City entered into a gas commodity swap agreement for 25% of the fixed gas supply swapped to a floating price, effectively reducing the City from a 75% to a 56% fixed price gas supply.

33 BLX similarly advised on the 2006 Swaps. The City entered into these swap transactions to hedge its variable interest rate exposure by securing a floating rate from Citigroup that closely correlated with the floating rates on the 2006 Bonds. BLX discussed this synthetic fixed rate structure with the City Council, including the additional risks of using such a structure over a traditional fixed-rate structured but believed, as did multiple other municipalities and electric utilities, that the significant interest rate savings to be achieved by using the synthetic fixed rate structure outweighed the additional risks.

While this fixed price gas contract covered 75% of the City's fuel needs, the City contemporaneously entered into a commodity swap for gas which lowered the fixed price exposure to 56%. Gas prices during the time period the transaction was entered were fluctuating between \$12 and \$14. The price of the transaction matched the market's forward price curve on gas prices.

In addition to these consultation services, BLX prepares credit presentations for the rating agencies and interviews investment banks to serve the City in the capacity of underwriter for debt issuances or of banker for project finance transactions. BLX also consults the City in connection with the electric rate design of the City's Light & Power Department. Further, BLX advises on the options to procure financing to meet the City's needs as authorized by the City Council. For example, the Council receives requests by the various department heads for asset acquisitions. The Council then authorizes the City Administrator or the particular department head to reach out to the City's financial advisor to evaluate if public finance is a prudent and viable option to acquire the asset. This process is especially undertaken in regards to the City's enterprise departments, such as Light & Power, Gas, and Water, where capital costs can be substantial and the repayment of debt is supported by a pledge of the surplus net revenues of such enterprise department.

- B. The Draft Report fails to acknowledge the vast amount of financial information available to the public.**

**Finding:**

The City Council was provided with little or no information that summarized and explained the fiscal impact and potential risks associated with significant debt decisions.

**Recommendation:**

The City should provide sufficient information related to the proposed decisions in its agenda packets and should provide these in advance on its website.

**City's Response:**

The Draft Report alleges that the City did not provide the City Council with sufficient information regarding its debt decisions. (Draft Report 94). The City respectfully disagrees. As discussed above, the City's financial information is available to the public from multiple sources, including its published annual audited financial statements, the City's website, and national and state repositories. All information that concerns Light & Power rates and debt is sent to the Rate Advisory Committee. The City posts meeting minutes on its website and has open discussion in public Council meetings before making decisions regarding the City's debt. As the audit team is well aware, the Light & Power Department is also in the process of developing a new procedure to increase transparency and post more information on the City's website. (34)

Further, for all eight bond issues, the City Council received, prior to consideration for authorization, BLX credit presentations, underwriting bank analysis, Standard & Poor's and Moody's reports, and a complete transcript of documents from Orrick (bond and disclosure counsel), which included resolutions approving the City's official statement describing the bond financing in significant detail understandable to an individual of average, unsophisticated financial background. Further, the credit and investor presentations addressed the issues of financial implications. (35)

**C. The Draft Report fails to acknowledge that the City is already reforming its energy policies and procedures. (36)**

**Finding:**

The City lacks documentation regarding its energy strategy.

**Recommendation:**

The City should develop an integrated energy strategy including formal process and guidelines that include identifying and quantifying the benefits and risks of proposed transactions, validating and comparing proposed transactions against alternative proposals, quantifying the impact of proposed transactions on short-term and long-term rates paid by the City's energy customers, seeking an independent validation of the fair market value of proposed transactions, and documenting and communicating the findings of the evaluation process to the City Council.

**City's Response:**

The Draft Report alleges that the City does not have a comprehensive energy strategy. (Draft Report 106, 120). The City respectfully disagrees. The City currently relies on the expertise of its advisor,

36 BLX, with regard to its energy policies and decisions. On March 15, 2012, the Director of Light & Power, the Energy Resource Manager, and the Assistant Finance Director updated the City's Energy and Credit Risk Management Policy that sets the parameters of energy transactions. A copy of the policy was provided to the auditors as a response to a data request. The Policy is currently undergoing further review that incorporates the auditors' findings. Moreover, and as the audit team was made aware, a new Integrated Resource Plan is being developed to address current City Council-approved energy resources procurement policies, such as complying with RPS legislation.

33 The auditors' question the City's decision to sell its electrical power assets. However, the auditors' criticism ignores the financial conditions at the time these decisions were made. The City chose to go forward with the MGS "sale" because its benefits far outweighed the benefits of the other option: a prepaid gas transaction, which would have remained revenue neutral had the markets remained stable. The costs associated with the prepayment of gas rose only slightly because of the MGS sale. As the audit team knows, the primary cost component was the collapse of the global financial market.

Since 2001, when the California energy market was still deregulated, the City has completed several internal departmental energy studies and objectives and commissioned several studies from outside consulting firms. In 2007 and 2008, the City wanted to further optimize the benefits of its Electric System resources while reducing the impact of the volatile California electric market. The City decided to sell virtually all of its major transmission assets and rely on the California transmission system to provide for transmission of energy imported into the City. The City also decided to sell, and thereby transfer the risk of, operating and maintaining the MGS to a third-party. The decision to sell the City's energy generation and transmission assets was motivated by at least the following:

1. The shut-down of the MGS in September 2007 for 71 days because of equipment failure, and repairs that took over a year to complete.
2. The City's desire to build a 914 megawatt, combined-cycle generating facility. In 2009, the City abandoned these plans and terminated its application for the facility.
- 37 3. The creation of the California Independent System Operator ("CalISO"), which eliminated the utilities' monopoly.
4. The expense of operating the MGS. In 2008, the City spent \$182.8 million to operate the Light & Power Department. After the sale of the MGS, the Light & Power Department's expenses were reduced by 56% to \$109.7 million.

The City retained the services of Lehman Brothers to sell its energy generation and transmission assets through an auction procedure. In addition, BLX acted as the City's financial advisor, and Latham & Watkins LLP and K&L Gates acted as the City's legal counsel.

**D. The Draft Report fails to acknowledge that the City is already in the process of implementing a policy that governs the hiring of consultants.**

**Finding:**

City officials consult with the City's financial advisor when initiating each proposed bond issue.

**Recommendation:**

The City should develop a process for consultants to provide written documentation that would enable the City to satisfy the above-mentioned process and guidelines.

**City's Response:**

The Draft Report alleges that the City does not have a comprehensive process for hiring consultants. (Draft Report 122). The City respectfully disagrees. Despite the comprehensive hiring practices discussed in Chapters 1 and 2 that the Light & Power Department adheres to when hiring consultants, as discussed with the auditors, the department is currently developing additional procedures to govern the retention of consultants.

- E. **The Draft Report fails to acknowledge the City's use of financial consultants to advise the City in its swap transactions.**

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**Finding:**

The City did not evaluate the benefits, risks, and pricing prior to entering into swap transactions.

**Recommendation:**

The City needs to develop and follow a process that thoroughly analyzes the risks and benefits of potential swap transactions.

**City's Response:**

The City elected the process of utilizing a nationally recognized bond and disclosure counsel firm, Orrick, and its wholly owned investment and financial advisory subsidiary, BLX, to advise, guide, analyze, structure, and disclose all aspects of its bond debt, interest rate swaps, and capital markets transactions. These firms were instrumental in writing the legislation in California and several other states authorizing the state and local governments to enter into swaps and other hedging instruments. The City's stated policy and objective then, as now, is to attain the status of an "A" rated utility.

The City used interest rate swaps to manage and reduce the interest rate costs associated with its outstanding bonds. BLX advised the City regarding certain "basis" swap transactions. These basis swaps were done on a post-issuance basis but related to the specific bond issues. These swaps were entered into to provide the City with additional positive cash flow, thereby reducing the overall cost of the related bonds. The City's interest rate swap transactions were described in documents created by its financial advisor, discussed in every report issued by two national rating agencies since 2004, and alternative proposals were detailed by leading national investment banks seeking to act as the City's swap counter party.

The City employed a nationally recognized financial consulting firm ("FA") and underwriting banks prior to entering into each interest rate swap transaction. Its FA and underwriting banks created documents and undertook mathematical exercises in order to properly advise the City on each of the transactions. The City's management and Council received numerous reports and information about the risks and benefits of all the swap transactions. The City's FA supplied a detailed book, written by the FA and the City's bond counsel titled "Interest Rate Swaps, Application to Tax-Exempt Financing" in early 2005 which led to the Council requesting the bond counsel to draft up policies on swaps, which the Council subsequently

approved. In 2003 the use of these hedging instruments was quite new and many organizations were unfamiliar with their dynamics or structures. The City policy decision was to let its FA and bond counsel guide it through the use of these products in connection with its debt issuance.

The GFOA guidelines in 2003, while very helpful, were very brief regarding advice on the proper management of these instruments. (See GFOA Best Practice-Debt Management Policy, 1995 and 2003). Rather the GFOA, in 2003 published Fitch Ratings guide to swaps (see "Guidelines for the Effective Use of Swaps") which the GFOA itself made clear do not represent the official position of the GFOA. The GFOA did not fully develop a derivatives policy until 2005 and after, about the time the City tasked its bond counsel to draft policy guidelines for the use of these instruments. (See GFOA Advisory, "Use of Debt-Related Derivatives Products and the Development of a Derivatives Policy" 2003, 2005, and 2010; but see "GFOA Recommended Practice: Use of Debt—Related Derivative Products and the Development of a Derivatives Policy," October, 2005).

The City understood the risks mentioned by the auditors. All of these points, as well as many others, are discussed in a book supplied to the City management and its Council by the FA entitled "Interest Rate Swaps, Application to Tax-Exempt Financing" (published in 2004 by BLX and Orrick). The City's evaluation of the interest rate and basis risk was based upon the analysis prepared by its FA and other advisors of expected trends and markets movements at the time the transactions were entered into. The City directed its FA to negotiate fair market prices on these transactions and carefully monitor these transactions until they were/are terminated. The City addressed counterparty risk by insisting upon counter party banks of the highest credit ratings (AA in many cases). The City addressed the liquidity/remarketing risks in its auction rate securities issuance by entering into its remarketing agreements with one of the top 5 international underwriting banks. The City recognized and accepted the risk of termination based upon discussions with its advisors' evaluation of the historic interest rate environment and forecasts.

The City experienced increased costs in connection with its interest rate swaps because of the collapse of the financial markets, which began in 2008, and caused a severe worldwide recession and whose negative market effects continue to this day, with historic low interest rates and commodity prices. The City did not anticipate the risk of the melt down of the financial markets. The City considered the risks and benefits of swaps in an historically normal interest rate environment, as was forecasted by leading industry analysts and the City's advisors at that time.

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At the time that the City entered into all of its swap transactions, the risks were acceptable based upon the advice of the team of experts the City employed from its FA to the various international banking and underwriting firms. Despite the fracture of the credit markets, the City has always maintained its BBB+/A- credit ratings. In August 2008, the City was able to achieve an increase in its rating from BBB+ to A-. However, during a recent financing in 2012, the City was placed back to BBB+/A- due to the effects of the severe recession on its Light & Power enterprise.

The City's intent in entering into all of its swap transactions was to manage interest rate costs associated with its bonds. These basis swaps were done on a post-issuance basis but related to the specific bond issues. These swaps were entered into to provide the City with additional positive cash flow, thereby reducing the overall cost of the related bonds. BLX discussed in detail at various meetings and conference calls with the City the appropriateness of these transactions. The Council authorized BLX to negotiate fair market prices on these transactions and carefully monitor them until termination.

In three of these transactions, the City received net cash at termination. In the fourth, the City



terminated the swap when counter party Lehman Brothers filed bankruptcy, thereby breaching the swap agreement. At that moment in time, the City's position was positive. The City did not anticipate the bankruptcy trustee to advance the "novel" argument that the termination date was not relevant to determining value. The sum paid to Lehman's bankruptcy estate was settled upon after the City consulted with its legal and financial advisors and determined that even if the City prevailed in litigation, it would cost more than the amount paid.

The gas bond swaps with Citigroup and the Series D swaps with Morgan Stanley were terminated for a total cost of \$33.4 million in early 2010. The City had extensive discussions with Citigroup in 2009 about terminating just the Citi swaps for \$55 million at the time of the gas bond refunding. Several factors prevented that option from being attained, not the least of which was market access for another large series of bonds to retire the swaps.

The City, after numerous meetings and discussions with its FA and Citi, decided to leave the swaps outstanding in order to insure that the refunding would be successful—since the re-priced portion of the gas bonds (\$190 million) was due in early August 2009.

When the interest rate market rose dramatically in early 2010, the City used its available cash position to terminate all the Citi swaps (which had a mandatory termination date in about a year) and the "short yield curve" Morgan swaps for \$33.4 million. The remaining two Morgan long yield curve swaps were left outstanding on advice of the City's financial team. The expectation was that the yield curve on the long rate end would recover, thus dramatically reducing the costs of termination of these swaps, despite the annual carry of about \$6 million. The City has been advised by its experts that small movements in the long term rates will reduce the termination values on those swaps by 80% over the near term.

- F. The Draft Report fails to acknowledge the City's use of financial consultants to advise the City in its various financial transactions and the extensive analysis undertaken by the City and its advisors regarding all financial decisions.**

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**Finding:**

The City was unable to provide any financial or risk analysis related to its decision in 2010 to terminate the swap portion of the prepared purchase.

**Recommendation:**

The City should develop a strategy to terminate the two outstanding swaps at the lowest cost. It should also develop a policy to ensure that it appropriately analyzes and documents the risks and benefits of any future swap transactions.

**City's Response:**

The Draft Report alleges that the City does not have a plan to terminate its two outstanding swaps. (Draft Report 10). The City respectfully disagrees. Further, the auditors used Appendix B to make substantive arguments about the City's use of swaps. While this information should have been provided in the body of the report and is inappropriate for an appendix, the City will respond to these arguments as well.

The City has clearly set forth in multiple credit reports submitted to its Council as well as to the national rating agencies, the plans it articulated for the restructuring of its collapsed debt, bankrupt bond insurers, bankrupt counterparties, and credit downgraded top 5 international banks. This strategy includes projected swap termination dates. The City essentially undertook two major finance transactions that included swap instruments as hedging tools. The 2004 Morgan Stanley bonds to build the power plant and the 2006 gas bonds to fund the major operating costs (fuel) of the power plant. Both of these financings were structured as was normal in the marketplace during those times.

However, the financial market meltdown, which began in 2008, affected these plans. First, the bond insurers that supported the AAA ratings for the bonds went bankrupt. Next, the then largest bank holding company in the world, Citigroup, was downgraded from AA to questionable survival status. Each credit report set forth a strategy for swap termination—but all such objectives were tempered by the condition of the markets. The rating agencies clearly understood this, which is supported in the rating reports they issued during this time period.

The City was presented with the option to terminate the gas bond swaps when it refunded the gas bonds in April 2009. The effort would have required the City to borrow an additional \$55 million in bond debt to terminate those swaps at that time. In addition to constrained market access during 2009, the majority of the City's advisors felt the termination price was too high given the then expectation of future interest rate trends. The termination of the gas bond swaps as well as the Series D Morgan swaps for a total cost of \$33.4 million in early 2010 proved a fleeting fortuitous opportunity for the City. Just this week the New York Port Authority terminated its swaps for \$60 million after three years of Board rancor and indecision on just when the time would be right. Similarly, the City of Oakland today struggles with an enormous swap position with Goldman Sachs and keeps putting off the decision of timing to termination.

The City, like these agencies, is not able to predict the course of a dysfunctional credit market. The City currently relies on the expertise of its advisor, BLX, with respect to its energy policies and decisions. Various parts of the City's government – the Light & Power Department, City Administration, the Finance Department, and BLX – regularly engage in discussions about the termination of the swap agreements.

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It was common practice during this period to retire the collapsed synthetic fixed-rate bonds and leave the swaps outstanding, which was the same policy followed by numerous other California municipalities. This practice tracked market forecasts from the U.S. Treasury, among others, that interest rates would rise from historic, 40-year lows and thus allow the City to terminate the swaps at substantially lower costs. The City's policy for the termination of the swaps has been, and continues to be, discussed with the rating agencies, and the issues are fully set forth in all the rating agency credit presentations. The City Council received all of the rating agency credit presentations and rating agency reports which fully analyzed the swap portions of the transactions. BLX tracks the swap positions hourly on a daily basis and communicates such with the City's Finance Department.

The City has had extensive discussions with its financial advisor and the rating agencies about the timeline for the termination of these swaps. BLX has advised the City that the most prudent path in today's market is to follow the daily market rather than picking a pre-determined level for termination. No real basis exists upon which to develop a strategy to determine the best timing for an interest rate swap termination. Any such effort is inherently a prediction of future interest rates, a speculative matter at best, and, in today's market, a highly risky proposition. However, the City is making every effort to terminate its hedging interest

rate swaps instruments since the financial crisis caused its hedging transactions to become ineffective. In addition, unlike most governments, the City took the conservative approach, and implemented GASB 53 two years prior to its effective date to keep the public fully informed of the risks associated with those instruments and the financial impact those instruments were having on the City. The City acknowledges that, as interest rates drop to historically low levels, the termination values of the swaps will increase. Similarly, as interest rates rise, as leading market forecasts expect in the near term, the termination values will decline substantially. The City has represented to its credit markets and rating agencies that given near interest rate trends, it expects to terminate both swaps at a total amount of \$20-25 million.

The rating agencies supported the City's articulated goals and policies to terminate the swaps at reasonable pricing levels as articulated by the City's FA in the City's Credit Reports during these financial market troubles. The City's FA has continuously updated the forecasted financial performance of the City's Light & Power Enterprise and provided the rating agencies the complete Light & Power cost picture, including the gas bonds, swap carry, and net revenue coverage levels.

### CONCLUSION

Although the City has no objection to many of the recommendations set forth in the Draft Report, it takes substantial issue with the false qualitative assertions and the material omissions of fact that permeate the report. The report contains several false statements designed to cast aspersions on the City, including that the City did not provide certain documents to the audit staff, a ridiculous proposition wholly divorced from the facts. With regard to its substantive findings, the audit team chooses to ignore the past year, during which the City undertook a lengthy process of historic reforms, a process that the City admits is still underway. In fact, most, if not all, of the City's findings merely restate issues of which the City is already aware and which are already contained in the City's reform efforts.

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For example, the auditors criticize the City's administrative policies, including its lack of a human resources director, while failing to mention the lengthy list of reforms the City is implementing and the City's current arduous search to fill that position. Next, the auditors take issue with the City's contract policies and procedures but incorrectly report on the City's current policies and ignore the City's contract reform efforts. The auditors also accuse the City of not having a budget policy and make no mention of the City's numerous resolutions, ordinances, and charter sections that govern the budget process. Finally, the auditors attack the City's past debt and energy transactions and accuse the City of not having any policies to govern these decisions. However, the auditors knew, but did not mention, that the City relies on the expertise of numerous well-respected consultants to advise it on its budget, debt, and energy policies and decisions.

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The brazen disregard for the facts, the omission of the effect of the City's reform efforts on many of the auditors' findings, and the lack of discussion of the numerous professional consultants who advise the City on many of its policies and financial decisions call into question the professionalism of this Draft Report. However, the City takes its commitment to implementing all of its reforms very seriously, and it will take the auditors' recommendations into account as it continues to reform its governance.

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## Comments

### CALIFORNIA STATE AUDITOR'S COMMENTS ON THE RESPONSE FROM LATHAM & WATKINS LLP, ON BEHALF OF THE CITY OF VERNON

To provide clarity and perspective, we are commenting on the Latham & Watkins LLP, City of Vernon's (city) response to our audit. The numbers below correspond to the numbers we have placed in the margin of the city's response.

The city provided two other documents as part of its response that we have not included in our report. The first document ("Attachment 2"), prepared by its outside legal counsel, is a 584 page list of the purported requests we made during the audit and what the city asserts to have produced in response to each request. It is unclear what value the city believes this document adds to its response. For example, over 240 pages of this document is simply a list of resolutions, minutes, and ordinances from the city council and other governing bodies. The second document ("Exhibit 1"), titled City of Vernon Alternative Funding Strategies July 2011, was produced by NBS, a city consultant. Again, it is unclear what value this document adds to the city's response. The city had previously provided this document to us in May 2012 and we understand that it is the basis for the parcel tax that the city is proposing to begin assessing in fiscal year 2012–13.

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The city's overall response to our findings and recommendations is puzzling. On the one hand, it indicates that it has no objection to many of our audit recommendations, yet on the other hand, it voices substantial objections to many of the report's findings. However, under generally accepted government auditing standards, which we follow, the findings form the basis for recommendations. In addition, in many cases throughout its response the city expresses disagreement with our findings—particularly those in which we report that the city lacks procedures—but then later acknowledges that it is taking steps to develop procedures to implement our recommendations. For example, on page 141, the city says in its response that it disagrees with our statement that it does not have a plan to implement an alternative employment structure. However, later in the same paragraph, the city states that it is currently in the process of recruiting a human resources director who will be tasked with conducting a thorough analysis of alternative employment systems.

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Throughout its response, the city makes repeated references to what it believes are "factual errors" in the report. At every step of the audit process, we sought to ensure that our understanding of the facts, as they pertain to the findings included in the report,

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are correct. In fact, we held multiple briefings with city staff for this purpose. Consistent with our customary practices, the audit staff repeatedly encouraged city staff to contact us at any time, including during the draft review period, if it had any concerns regarding factual accuracy. Despite these repeated communications from our office to the city, it did not contact us at all during the review period. Instead, it waited until the end of the review period, and made these assertions in its formal, written response. Even more regrettable than the timing of these assertions is the fact that they are so overstated, vague, and, at times, utterly without direct reference to what is described in the report and exaggerate the language of our findings to be more negative than we stated. Therefore, we cannot respond in any meaningful way to most of them. Nonetheless, we carefully reviewed and considered whether the information the city provided in its response warranted any changes to our report text and determined that the city's response did not require us to change any text in our report. Finally, we followed generally accepted government auditing standards in conducting this audit, which require that we gather sufficient and appropriate evidence to provide a reasonable basis for our findings and conclusions. Therefore, we stand by our findings, conclusions, and recommendations.

- ④ We disagree with the city's notion that our report fails to acknowledge its plan to implement reforms. While the city may disagree with our placement and discussion of certain reform measures, we certainly considered its efforts as they relate to our findings. In addition to the city's reforms that we primarily discuss in chapters 1 and 2, we devote Appendix A entirely to written discussion of the city's reported status of its 69 reform measures, and our assessment of the city's status for certain of its reform efforts. However, as we note in our report and Appendix A, the city's progress in some cases is incomplete. In fact, Appendix A lists a number of reforms that the city asserts are complete that, when we assessed the city's efforts, we found more needed to be done before certain reforms could be considered fully implemented. Moreover, although the city states that many of its reforms are "ongoing," we noted that the last update of the status of its "Good Governance" reforms on its Web site was dated January 2012.
- ⑤ The city misrepresents what we concluded concerning its energy transactions. As we state on pages 18 to 19 and 89 of our report the city could not provide evidence—after repeated requests—to demonstrate that either it or its financial adviser and consultants performed valuation analyses or risk assessments for the two significant energy transactions our finance and energy expert reviewed.

We do not question the expertise of the city’s consultants, including its financial adviser. However, the city council—not its consultants—is responsible for ensuring that the financial and energy transactions are in the best interest of the city.

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As we discuss on page 42 and Table 8 on pages 44 and 45 of our report, eight of the 25 contracts we reviewed, or nearly one-third, were active as of March 2012. Further, all 25 contracts were active during the period of time that the Legislature asked us to review for contracts—fiscal years 2006–07 through 2010–11.

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We chose not to review competitive bidding procedures on all service and consultant contracts because we found that competitive bidding was not used for nine of the 12 contracts we did test for that particular attribute. Given the number of contracts we found that were not bid competitively, testing additional contracts for this attribute would not have changed our conclusion that the city rarely uses the best practice of competitive bidding to obtain the best price for service and consultant contracts. To acknowledge this decision, we added a footnote to Table 8 on page 45 of our report.

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As noted in the Scope and Methodology on page 17 of our report, the city provided us with a wide variety of information and assistance during this audit. However, we encountered difficulties obtaining information from the city that are highly unusual given our experience with other auditees and that resulted in the California State Auditor (state auditor) issuing an administrative subpoena for certain records. Further, as noted on page 18, in response to one request where we asked the city to provide us the information presented to the city council related to its approval of seven separate transactions, the city provided us two CDs containing 37,000 files. However, each file represented one page of a larger document, was unlabeled, and was in an unsearchable electronic format. Thus, for the city to assert that we had “unbridled and unfettered access” to its records and employees is a complete mischaracterization of the challenges we had working with the city to conduct this audit.

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We noted that the city submitted the cover letter to its response under the signature of its outside legal counsel, rather than under the signature of the city administrator or an appropriate representative of the city council. While we certainly understand that counsel, and especially a city attorney, often plays an integral role in advising a city as it participates in, and responds to an audit, one of the more notable aspects of this audit has been the unusually prominent presence of outside legal counsel for the city. Unfortunately, city executives and employees frequently deferred to

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outside legal counsel at key meetings with our office where it would have been more representative and more informative had the city executives been able to articulate their views directly.

- ⑪ While preparing our draft audit report for publication, page numbers shifted. Therefore, the page numbers that the city refers to in its response do not correspond to the page numbers in our final report.
- ⑫ We disagree. Table 1 beginning on page 14 of our report lists the audit objectives the Joint Legislative Audit Committee requested that we perform, along with the methods we used in addressing each one. The audit period we reviewed varied, depending on the objective, but was always through fiscal year 2010–11. Further, as noted on page 15, we used the city’s payment records for fiscal years 2005–06 through 2010–11 to select 25 contracts for review based on contracts with the highest payments and other factors we believed were relevant. All 25 contracts had payments during this period and eight of these contracts were active as of March 2012.
- ⑬ The city’s description of how we exercised our right to obtain the information necessary to respond to the Legislature’s questions is unprofessional, exaggerated, and inaccurate. Despite the extraordinary nature of the statutory right of access to information that the Legislature has provided, we always exercise this right in a respectful, yet diligent manner. To act otherwise would fail to satisfy the “due diligence” required under generally accepted government auditing standards. Contrary to the image evoked by the city’s response, we were never rude, disrespectful, or inconsiderate to city staff. We also did not invade the personal workspace of public employees and rifle through their desk drawers, nor did we “harass” city officials. Instead, we went about our work as we always do—by submitting document requests; talking with city staff to learn as much as possible about its processes and practices; and accessing this information directly, as required by generally accepted government auditing standards. In performing our audit work, we were mindful of the fact that city business must continue as usual and we attempted to be as unobtrusive as possible. We recognize that being subject to an audit takes time and that it can be inconvenient, but the city’s insistence on treating this process as an intrusion, rather than an opportunity to make much-needed improvements, is unfortunate.
- ⑭ In its response, the city makes reference to a comment that was purportedly made by a state auditor’s staff member regarding familiarity with accounting. The city makes this comment in a way that is entirely out of context and mischaracterizes the conversation.
- ⑮ The city’s claim that it provided us a contract list at the onset of the audit is false. The city’s outside legal counsel gave us two CDs at the entrance conference: one contained city ordinances and



resolutions for 2005 through 2010 and the other contained bond-related documents. Further, during initial meetings with city executives, we were told that the city did not have a centralized contract list. We were only able to discover that the city maintained a central storage area for contracts, as well as a contract list, while on a tour of the city clerk's office after one of our staff asked the city clerk what type of documents were stored in the city clerk's file room. Also, to clarify, we held our entrance conference with the city on October 3, 2011, not on September 27.

The city's assertion that we had an ongoing practice of asking individuals without relevant knowledge to provide information regarding topics outside their expertise and job duties and then report that we received incorrect information is disingenuous. The audit team is well trained in obtaining relevant information from appropriate individuals with knowledge of the specific subject area at issue. It is troubling that the city did not provide any examples that we could specifically address.

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As the city is aware, we sent a document request that included, among other items, a request for contract lists. In response to this document request, the city's outside legal counsel provided us the two CDs described in comment 15, and directed us to the assistant treasurer and the city administrator's assistant for the remaining items on the list. The city's notion that we should have known to ask the city clerk's office for all city documents is indicative of the obstacles we encountered during the day-to-day interactions with most city staff. In addition, we believe the "random City staff" the city refers to in regards to contracts is the assistant treasurer, whom the city's outside legal counsel told us at the entrance conference was responsible for providing us a list of contracts, and the finance director, who as the city's chief financial officer, should know where contracts are stored.

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The city's response is confusing and contradictory. In its response, the city asserts that it has many internal policies governing the use and transfer of light and power revenues, yet it also states on the same page that it will review other municipalities' power revenue transfer policies and develop a formal policy.

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The city's assertions that we do not dispute the methodology for its executive salary survey and that we made our own "qualitative determination as to the salary levels" are false. As we state on page 30 of our report, our review of the salary survey raised questions about the depth and thoroughness of the city's analysis and whether it chose positions in the most appropriate cities for comparison. Also, as we state on pages 30 and 31 of our report, the city did not consider the job descriptions for the positions in its survey to identify relevant compensable factors, including

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education, experience, or organization size and structure, as well as the scope of responsibilities and duties and qualifications. These are serious methodology flaws and cast considerable doubt on the salary survey results.

- ⑳ The city is wrong. We acknowledge on page 35 of our report that in June 1994, the city closed the original longevity program to new employees and adopted a more modest longevity program, with payments limited to 5 percent of base pay. However, we also note on the same page that from May through November 2011 there were 114 city employees who received payments under the original longevity program and of these, 99 employees have 20 or more years of service with the city, which qualifies them to receive a 20 percent longevity payment on top of their base salary each month. Unless the city is aware that a significant number of these 114 employees will soon retire or leave city service, there will continue to be substantial payments to employees under the original longevity program for years to come.
- ㉑ We explained the “other relevant factors” we used to select service and consulting contracts to the city during our exit conference. However, to clarify our report we added the following explanation to the Scope and Methodology table on page 15 of our report: “. . . other factors we believed were relevant, including contractors that had been mentioned in media reports, had unusual payment patterns, or had known ties to other city contractors or employees.”
- ㉒ In several places in the response, the city asserts we failed to acknowledge that it is already reforming its contracting policies and it lists new procedures that it claims to follow for contracting. The city’s response then notes in several places that it is currently developing a comprehensive contract policy that it intends to submit to the city council for approval in July 2012. However, contrary to the city’s assertion, we clearly acknowledge its reform efforts on page 53 of our report. While we recognize that certain city departments may follow their own informal contracting practices, our recommendations relate to the weak citywide contracting policies that existed during the period of time that the Legislature asked us to review, which included policies in place during fiscal year 2010–11. Notwithstanding its current practices, until the city completes and adopts its comprehensive contract policy, reform efforts in this area will not be successful.
- ㉓ The city’s response is inconsistent with guidance from the Association of Corporate Counsel and best practices. The city asserts that “it is nonsensical to include either an end date or an expenditure limit” on legal services contracts and that “it is contrary to common practice.” However, as a public entity, the city should

have expenditure limits and end dates on all of its contracts. Lacking these contract elements make it difficult, if not impossible, for the city to effectively manage and control costs.

The city describes a contracting practice for purchases of goods, and not service and consultant contracts, which the city is aware was the focus of our review. While certain city departments may have informal practices to ensure that invoices and packing slips properly reflect the *goods* purchased, the city lacks a citywide policy for sufficiently detailed invoices related to *service and consultant contracts*.

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We are concerned by the city's unwillingness to recognize the weaknesses in its control processes for its credit card purchases. Its response indicates that the finance director reviews and signs the credit card statements. However, as we state on page 54 of our report, the finance director told us that the executives are responsible for approving their own credit card statements and that the finance department is not responsible for questioning the appropriateness of credit card charges.

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We disagree with the city's assertion that it is unreasonable to set an expenditure limit on lodging accommodations. The State has such a policy, which works very well. Lacking such a policy, the city leaves itself vulnerable to past abuses, such as a former city administrator who charged the city for hotel lodging of up to \$1,100 a night.

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The city blurs the distinction between the purposes of budgets and audited financial statements. The city refers to its audited financial statements, which include a schedule that compares the budgeted and actual expenditures and revenues for the completed fiscal year. However, because the audited financial statements are prepared well after the completion of the fiscal year, they do not inform the process to develop that same fiscal year's budget. More simply, budgets are prepared *before* the fiscal year starts; audited financial statements are prepared *after* the fiscal year ends.

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As we discuss on page 66 of our report, despite the city's efforts in fiscal year 2010–11 to curtail budgeted expenditures, its actual spending in fiscal year 2010–11 exceeded budgeted expenditures by \$14.7 million, and was \$2.2 million higher than the city's general fund's actual expenditures from the previous fiscal year.

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The city's assertion that it follows recommended budget policies is baseless. Although the city charter requires that the budget contain the elements listed in the response, the city fails to ensure that its budget includes all the elements. For example, as discussed on pages 68 and 69 of our report, we noted that the budget fails to include the required element to explain reasons for proposed increases or

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decreases from prior fiscal year expenditures. Further, despite the city's claim that it already follows recommended budget practices of the Government Finance Officers Association, our review found that the city's budget policies were deficient in numerous areas as shown in Table 10 on page 72 of our report.

- ③⑩ We are confused by the city's response. Our recommendation that the city is attempting to address relates to the development of *budget* policies. However, the city's response to this recommendation relates to our concerns about its lack of a *debt* policy, which we discuss in Chapter 4.
- ③⑪ The city's response regarding our conclusion that it lacks a comprehensive debt policy is contradictory. Although the city expresses disagreement with our conclusion, it almost immediately indicates that it is currently working with multiple consultants and advisers to develop a comprehensive debt policy.
- ③⑫ To clarify, there was only one face-to-face meeting between us and the city's financial adviser. After this meeting we attempted to meet again with the city's financial adviser to obtain and review the analyses it indicated having prepared to support the energy and swap transactions. However, as noted in the Scope and Methodology on pages 18 and 19 of our report, because the city and the financial adviser did not provide us these analyses, we had to use the state auditor's authority to subpoena these records. As of June 25, 2012, this subpoena was not fully resolved.
- ③⑬ We acknowledge on pages 89 and 99 of our report the city's use of a financial adviser when entering into each energy and swap transaction we discuss. Yet, despite our repeated requests for the analyses that the city asserted the financial adviser performed related to each transaction, and which was referenced in some of the documents provided, the city failed to provide these analyses. For example, as we note on pages 90, 92, 104, and 106 of our report, our finance and energy expert concluded that the city provided little to no documentation to demonstrate that it performed expected analyses or followed its own guidelines and best practices when initiating energy and swap transactions. Moreover, despite the misleading inferences in the city's response, in the one face-to-face meeting we had with the financial adviser, its representatives recalled attending a city council meeting only once.
- ③⑭ The city disingenuously implies that the [advisory committee on electric rates (rate advisory committee)] was part of the process used to evaluate all bond and swap transactions discussed in our report, which date back to 2004 and 2003, respectively. This would not have been possible because the rate advisory committee's

first meeting was in April 2011. Therefore, the only transaction discussed in our report for which the rate advisory committee could have advised the city was the January 2012 bond issue.

Although the city asserts that it provided various bond financing information to the city council for each bond issuance, our review found that most of the information was technical and did not provide insights on the reasons for the debt. For example, as noted on page 79, in conjunction with the proposed issuance of \$419.4 million in refunding bonds in 2009 the city provided a one-page staff report from the city attorney to recommend that the city council approve the bond issuance. However, the staff report provided very little insight into the expected benefit of the refunding bonds nor did it discuss the potential fiscal impact of the refunding bonds on electric rates, which the city would use to repay the debt. The city also provided the city council with 180 pages of primarily technical information pertaining to the bond sale. In contrast, our review found that when other cities proposed issuing bonds, they provided narratives to their city councils that explained key elements of the bond issuance and the potential fiscal impact.

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The city's statement is misleading. We clearly acknowledge the city's recent activity to comply with California's new renewable energy requirements on pages 98 and 99 of our report, but we also note that this would only be one element of an integrated energy strategy. Further, our finance and energy expert observes that the city's "energy and credit risk management policy" referred to in its response is used to give guidance on energy trading, and is not a substitute for an energy strategy. Moreover, it is unclear what reforms the city intends to implement, because as shown in Appendix A beginning on page 109, none of the city's 69 reform measures relate to the energy strategy that we are recommending the city develop.

③⑥

It is unclear what relationship the city believes exists between the "creation of the California Independent System Operator," which was incorporated in 1997, and the city's decision to sell the Malburg Generating Station, which the city completed construction of in 2006 and sold in 2008.

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cc: Members of the Legislature  
Office of the Lieutenant Governor  
Little Hoover Commission  
Department of Finance  
Attorney General  
State Controller  
State Treasurer  
Legislative Analyst  
Senate Office of Research  
California Research Bureau  
Capitol Press