

# City of Vernon

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

### REPORT NUMBER 2011-131, ISSUED JUNE 2012

This report concludes that although the City of Vernon (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.

In the report, the California State Auditor (state auditor) made the following recommendations to the city. The city did not submit a six-month response to the audit when it was due to the state auditor in December 2012. Therefore, the state auditor's determination regarding the current status of recommendations is based on the city's August 27, 2012, 60-day response to the state auditor.

#### **Recommendation 1.1.a—See pages 22—24 of the audit report for information on the related finding.**

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.

***City's Action: Pending.***

The city indicated that its human resources director and city attorney, who were both recently appointed, will review and recommend civil service procedures, but it has not provided detail on the steps it intends to take to develop these procedures.

**Recommendation 1.1.b—See pages 25 and 26 of the audit report for information on the related finding.**

To increase accountability and transparency in its governance, the city should 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.

***City's Action: No action taken.***

➡ The city did not address this recommendation in its August 2012 response.

**Recommendation 1.1.c—See pages 25 and 26 of the audit report for information on the related finding.**

To increase accountability and transparency in its governance, the city should continue the effort to develop a comprehensive plan to construct additional housing in the city.

***City's Action: Partially implemented.***

The city, with input from the Housing Commission counsel and a legislative member's office, has selected a housing developer and is in the process of developing the necessary agreements for city council approval that will result in a comprehensive housing plan for the construction of additional city housing.

**Recommendation 1.1.d—See page 24 of the audit report for information on the related finding.**

To increase accountability and transparency in its governance, 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 Action: No action taken.***

➡ The city did not address this recommendation in its August 2012 response.

**Recommendation 1.2.a—See pages 27 and 28 of the audit report for information on the related finding.**

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.

***City's Action: Fully implemented.***

The city appointed a human resources director to start in September 2012.

**Recommendation 1.2.b—See pages 27 and 28 of the audit report for information on the related finding.**

To ensure that it develops complete and appropriate personnel policies and procedures, the new human resources director should ensure that the city's policies and procedures include, at a minimum, requirements for performing and documenting the analyses and justifications for appointments, including promotions, to management positions.

***City's Action: Pending.***

Although the city indicated that its recently appointed human resources director will review and recommend improvements to personnel policies and procedures, the city did not specifically respond to our recommendations, elaborate on any plans to improve its policies and procedures, or give a time frame for completion.

**Recommendation 1.2.c—See pages 27 and 28 of the audit report for information on the related finding.**

To ensure that it develops complete and appropriate personnel policies and procedures, the new human resources director should ensure that the city's policies and procedures include, at a minimum, requirements for minimum qualifications, desirable qualifications, and job duties for all city executive positions.

***City's Action: Pending.***

Although the city indicated that its recently appointed human resources director will review and recommend improvements to personnel policies and procedures, the city did not specifically respond to our recommendations, elaborate on any plans to improve its policies and procedures, or give a time frame for completion.

**Recommendation 1.2.d—See pages 27 and 28 of the audit report for information on the related finding.**

To ensure that it develops complete and appropriate personnel policies and procedures, the new human resources director should ensure that the city's policies and procedures include, at a minimum, a periodic appraisal process for executives.

***City's Action: Pending.***

Although the city indicated that its recently appointed human resources director will review and recommend improvements to personnel policies and procedures, the city did not specifically respond to our recommendations, elaborate on any plans to improve its policies and procedures, or give a time frame for completion.

**Recommendation 1.2.e—See pages 28—34 of the audit report for information on the related finding.**

To ensure that it develops complete and appropriate personnel policies and procedures, the new human resources director should ensure that the city's policies and procedures include, at a minimum, 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.

***City's Action: Pending.***

Although the city indicated that its recently appointed human resources director will review and recommend improvements to personnel policies and procedures, the city did not specifically respond to our recommendations, elaborate on any plans to improve its policies and procedures, or give a time frame for completion.

**Recommendation 1.3—See pages 34 and 35 of the audit report for information on the related finding.**

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 Action: No action taken.*

- ➔ The city did not address this recommendation in its August 2012 response.

**Recommendation 1.4—See pages 36—38 of the audit report for information on the related finding.**

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

*City's Action: Partially implemented.*

The city has begun reporting its attorney contributions under the miscellaneous classification and is working with CalPERS to remove the safety classification for attorneys from its contract.

**Recommendation 2.1.a—See pages 42 and 43 of the audit report for information on the related finding.**

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 enterprise resource planning (ERP) system so that the contract managers and the city can more efficiently and effectively track the city's contract expenditures.

*City's Action: Pending.*

The city states that a top priority for its recently appointed city attorney will be to develop a comprehensive contracting policy resolution for city council approval, but it did not give a time frame for completion.

**Recommendation 2.1.b—See pages 42 and 43 of the audit report for information on the related finding.**

To better control contract expenditures and ensure that it receives the best value for the services it purchases, the city should also begin using the ERP system's uniquely assigned contract numbers for tracking and generating a list of contracts.

*City's Action: No action taken.*

- ➔ The city did not address this recommendation in its August 2012 response.

**Recommendation 2.1.c—See pages 43—47 of the audit report for information on the related finding.**

To better control contract expenditures and ensure that it receives the best value for the services it purchases, the city should require all contracts to have expenditure limits and starting and ending dates for services performed.

*City's Action: Pending.*

The city states that a top priority for its recently appointed city attorney will be to develop a comprehensive contracting policy resolution for city council approval, but it did not give a time frame for completion.

**Recommendation 2.1.d—See pages 47—51 of the audit report for information on the related finding.**

To better control contract expenditures and ensure that it receives the best value for the services it purchases, the city should require contract managers to use logs to monitor payments and the contractor's progress toward completion of required deliverables.

***City's Action: Pending.***

The city states that a top priority for its recently appointed city attorney will be to develop a comprehensive contracting policy resolution for city council approval, but it did not give a time frame for completion.

**Recommendation 2.1.e—See pages 47—51 of the audit report for information on the related finding.**

To better control contract expenditures and ensure that it receives the best value for the services it purchases, 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 Action: Pending.***

The city states that a top priority for its recently appointed city attorney will be to develop a comprehensive contracting policy resolution for city council approval, but it did not give a time frame for completion.

**Recommendation 2.1.f—See pages 47—51 of the audit report for information on the related finding.**

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

***City's Action: Pending.***

The city states that a top priority for its recently appointed city attorney will be to develop a comprehensive contracting policy resolution for city council approval, but it did not give a time frame for completion.

**Recommendation 2.1.g—See pages 47—51 of the audit report for information on the related finding.**

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

***City's Action: Pending.***

The city states that a top priority for its recently appointed city attorney will be to develop a comprehensive contracting policy resolution for city council approval, but it did not give a time frame for completion.

**Recommendation 2.1.h—See pages 51—53 of the audit report for information on the related finding.**

To better control contract expenditures and ensure that it receives the best value for the services it purchases, 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 Action: Pending.***

The city states that a top priority for its recently appointed city attorney will be to finalize the proposed comprehensive contract and purchasing ordinance that establishes an open and competitive bidding process for service contracts as required by the city charter, but it did not give a timeframe for completion.

**Recommendation 2.2—See page 53 of the audit report for information on the related finding.**

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.

***City's Action: Pending.***

The city states that a top priority for its recently appointed city attorney will be to develop a comprehensive contracting policy resolution for city council approval, but it did not give a time frame for completion.

**Recommendation 2.3.a—See pages 53 and 54 of the audit report for information on the related finding.**

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.

***City's Action: No action taken.***

➔ The city did not address this recommendation in its August 2012 response.

**Recommendation 2.3.b—See page 54 of the audit report for information on the related finding.**

To improve its internal controls, better control costs, and prevent abuse from occurring, the city should revise its travel and expense reimbursement policy to be clear about the expenditure limits for meals, and add a limit for lodging accommodations.

***City's Action: No action taken.***

➔ The city did not address this recommendation in its August 2012 response.

**Recommendation 2.4.a—See pages 55 and 56 of the audit report for information on the related finding.**

To comply with the Political Reform Act (reform act), the city should ensure that the city administrator and city clerk are appropriately trained to administer its conflict-of-interest code (conflict code).

***City's Action: No action taken.***

➔ The city did not address this recommendation in its August 2012 response.

**Recommendation 2.4.b—See pages 55 and 56 of the audit report for information on the related finding.**

To comply with the reform act, the city should continue to ensure that all city executives file statements of economic interests, as its conflict code requires.

***City's Action: No action taken.***

The city did not address this recommendation in its August 2012 response.



**Recommendation 2.4.c—See pages 55 and 56 of the audit report for information on the related finding.**

To comply with the reform act, 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.

***City's Action: No action taken.***

The city did not address this recommendation in its August 2012 response.



**Recommendation 2.4.d—See pages 55 and 56 of the audit report for information on the related finding.**

To comply with the reform act, the city should ensure that any consultants identified by the city administrator as needing to file statements of economic interests submit the forms as soon as possible.

***City's Action: No action taken.***

The city did not address this recommendation in its August 2012 response.



**Recommendation 3.1.a—See pages 60—68 of the audit report for information on the related finding.**

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.

***City's Action: Partially implemented.***

The city states that in addition to the 20 percent reduction in its general fund expenditures reflected in the 2012–13 fiscal year budget, a subsequent budget amendment further reduced general fund spending by 6 percent. Additionally, the city indicates considering other actions, including working with key stakeholders in the business community to develop a comprehensive long-term revenue plan for the city's general fund and expects to present a proposal to city council by December 2012.

**Recommendation 3.1.b—See pages 68—70 of the audit report for information on the related finding.**

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 Government Finance Officers Association (GFOA).



*City's Action: No action taken.*

- ➡ The city did not address this recommendation in its August 2012 response.

**Recommendation 3.2.a—See pages 71—73 of the audit report for information on the related finding.**

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.

*City's Action: No action taken.*

- ➡ The city did not address this recommendation in its August 2012 response.

**Recommendation 3.2.b—See pages 68 and 69 of the audit report for information on the related finding.**

The city should ensure that its budgets include the information required in the city code.

*City's Action: No action taken.*

- ➡ The city did not address this recommendation in its August 2012 response.

**Recommendation 3.2.c—See pages 72 and 73 of the audit report for information on the related finding.**

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.

*City's Action: Partially implemented.*

The city instituted quarterly budget reports to the city council beginning in May 2012. The city states that the budget presentation to city council outlined the budget requirements, process, and contents and reported the status of revenues and expenditures for the first quarter. The next quarterly budget report was scheduled for a September 2012 city council meeting. However, the city did not address whether it has developed a process for city executives to regularly report the budget status of their departments to the city administrator.

**Recommendation 4.1—See pages 76—80 of the audit report for information on the related finding.**

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.

*City's Action: No action taken.*

- ➡ The city did not address this recommendation in its August 2012 response.

**Recommendation 4.2—See pages 76—80 of the audit report for information on the related finding.**

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.



*City's Action: No action taken.*

The city did not address this recommendation in its August 2012 response.



**Recommendation 4.3.a—See pages 98 and 99 of the audit report for information on the related finding.**

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.

*City's Action: No action taken.*

The city did not address this recommendation in its August 2012 response.



**Recommendation 4.3.b—See pages 98 and 99 of the audit report for information on the related finding.**

To ensure that it can demonstrate sufficient analysis and provide justification for its decisions on significant energy-related transactions, 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, and documenting and communicating the findings of the evaluation process to the city council.

*City's Action: No action taken.*

The city did not address this recommendation in its August 2012 response.



**Recommendation 4.4—See page 95 of the audit report for information on the related finding.**

If the city plans to continue to rely on the advice of its consultants when entering significant energy-related transactions, it should develop a process for the consultants to provide written documentation that would enable the city to satisfy the process and guidelines outlined in 4.3.a and 4.3.b above.

*City's Action: No action taken.*

The city did not address this recommendation in its August 2012 response.



**Recommendation 4.5—See pages 104—106 of the audit report for information on the related finding.**

To minimize the continuing financial losses on the two currently outstanding interest rate 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.

*City's Action: No action taken.*

The city did not address this recommendation in its August 2012 response.



**Recommendation 4.6.a—See pages 99—104 of the audit report for information on the related finding.**

To ensure that any future decisions to enter into interest rate swaps are carefully considered, the city should develop and follow a process that thoroughly analyzes the risks and benefits of the potential swap transaction.

*City's Action: No action taken.*

- ➔ The city did not address this recommendation in its August 2012 response.

**Recommendation 4.6.b—See pages 99—104 of the audit report for information on the related finding.**

To ensure that any future decisions to enter into interest rate swaps are carefully considered, 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.

*City's Action: No action taken.*

- ➔ The city did not address this recommendation in its August 2012 response.