

David J. Schindler  
Direct Dial: (213)891-8415  
david.schindler@lw.com

355 South Grand Avenue  
Los Angeles, California 90071-1560  
Tel: +1.213.485.1234 Fax: +1.213.891.8763  
www.lw.com

# LATHAM & WATKINS LLP

## FIRM / AFFILIATE OFFICES

Abu Dhabi	Moscow
Barcelona	Munich
Beijing	New Jersey
Boston	New York
Brussels	Orange County
Chicago	Paris
Doha	Riyadh
Dubai	Rome
Frankfurt	San Diego
Hamburg	San Francisco
Hong Kong	Shanghai
Houston	Silicon Valley
London	Singapore
Los Angeles	Tokyo
Madrid	Washington, D.C.
Milan	

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.

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

**LATHAM & WATKINS**LLP

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.

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 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.

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.

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.

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.

**LATHAM & WATKINS**<sup>LLP</sup>

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,

/s/ 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.

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.

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.

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 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.

### **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).

---

<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/).

<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.

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).
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.**

**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.

**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:**

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

“52<sup>nd</sup> 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 52<sup>nd</sup> 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 “52<sup>nd</sup> Drive Housing Development” discussed earlier.

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

**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.**

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.

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.**

**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.

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.**

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.

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.

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.

**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 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:**

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. 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.**

**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.

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:

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.

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.

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.

**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.

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:

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.

**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.

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:

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.

**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.

**I. The Draft Report fails to acknowledge that the City is already in the process of improving the administration of conflict code.**

**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.

**J. The Draft Report inaccurately asserts that one Council member participated in several decisions in which he had a disqualifying financial interest.**

**Finding:**

One council member participated in several decisions in which he had a disqualifying financial interest, in violation of the reform act.

**Recommendation:**

The auditors will refer this matter to the Fair Political Practices Commission and the Los Angeles County District Attorney's Office for further investigation.

**City's Response:**

The Draft Report alleges that a council member violated the reform act by participating in three City Council decisions in which he had a financial interest. (Draft Report 69). The City respectfully disagrees.

An analysis of these three transactions suggests a fundamental misunderstanding of the applicable law, and further reveals a hypertechnical application of the law to a set of facts that are patently immaterial. The councilman in question was a lineman for SCE. The stock holdings at issue were shares acquired in the lineman's pensions over a lifetime of work. The transactions identified by the audit staff are immaterial on their face. For example, one transaction involved the payment of \$300 per year to rent an shed from SCE. There is no construction or rational interpretation that would suggest that a lineman who participates in a decision to rent a closet for \$300 per year violates either the Political Reform Act or California Government Code, Section 1090. Nevertheless, given the seriousness of the audit staff's allegations, the councilman in question has obtained separate counsel who is independently providing a response to these allegations. The City incorporates by reference whatever response the councilman's counsel provides.

**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.

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.

**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.

---

<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.

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 reviews all budgets. Once this is completed, the City Administrator recommends a Final Budget to the Honorable Mayor and City Council for approval.

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.

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.**

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.

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:**

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.

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.

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.

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 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.

---

<sup>5</sup> Municipal bond insurance unconditionally guaranteed the payment of all principal and interest due on the bonds.

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.

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 structure 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.

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.

**C. The Draft Report fails to acknowledge that the City is already reforming its energy policies and procedures.**

**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, 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.

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.
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.**

**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.

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.**

**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.

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.

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.

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.