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**Office of the City Auditor**

**Audit Report**

**AUDIT OF ATMOS ENERGY and ONCOR ELECTRIC  
DELIVERY FRANCHISE FEES**

(Report No. A08-004)

**November 16, 2007**

**City Auditor**

Craig D. Kinton

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## Executive Summary

The \$125.5 million in franchise fee revenue collected from ATMOS Energy (ATMOS) and ONCOR Electric Delivery (ONCOR) for the period of October 2004 through September 2006 is materially correct and paid timely. The Office of Financial Services (OFS) monitors the reasonableness and timeliness of ATMOS and ONCOR franchise fee revenue; however, OFS personnel do not perform on-going activities to verify completeness of franchise fee revenue and there are opportunities to improve documentation of oversight processes.

### Background Summary

The City of Dallas (City) received \$125.5 million in franchise fee revenue from ATMOS and ONCOR for the period of October 2004 through September 2006. The majority of revenue for this period was received from the ONCOR franchise which generated \$98,195,316 (or 78 percent) of the total franchise fee revenue.

The Office of Financial Services (OFS) regulates and administers the franchise agreements with ATMOS and ONCOR. The City grants franchises to these companies to operate a natural gas distribution system and electricity delivery system with the City, respectively.

The City Auditor's Office periodically audits the franchise fee revenue; however, ATMOS and ONCOR consider much of the information the City Auditor needs to verify revenue completeness proprietary or confidential, such as customer names and addresses. As a result, obtaining sufficient information for audit verification purposes is costly in terms of effort and time for both the City and the companies. The most efficient way for the City to verify that all franchise fee revenue due to the City is remitted is to amend the franchise fee agreements to require ATMOS and ONCOR to provide the City with an annual independent audit of revenue subject to the franchise fee.

The OFS also does not have written policies and procedures documenting the activities its personnel perform to monitor the validity and accuracy of ATMOS and ONCOR franchise fee revenue. Documenting these procedures would assist OFS in understanding whether the activities performed are sufficient and, when necessary, provide a smooth transition of duties and responsibilities.

## Summary of Recommendations

The Director of OFS should work with the City Attorney to determine the feasibility of amending the ATMOS and ONCOR franchise agreements to require an annual audit of City franchise fee revenue, at the franchise holders' expense.

The Director of OFS should also ensure that there is adequate documentation of policies and procedures performed for franchise fee activities.

## **Summary of Management's Response**

The Director of OFS agrees with both recommendations and intends to take corrective actions to timely address the issues identified in this report. The complete response is included as Appendix III to this report.

## **Summary of Objectives, Scope and Methodology**

The objectives of the audit were to determine whether: (1) ATMOS and ONCOR gas and electric franchise fee revenue to the City during the period of October 2004 through September 2006 was materially correct and paid timely; and, (2) OFS provides appropriate management oversight and monitoring of the franchise fee agreements.

The scope of the audit covered the processes and procedures the City uses to monitor franchise fee revenue, applicable laws, regulations, and ordinances pertaining to gas and electric franchise fees, and relevant ATMOS and ONCOR controls over franchise fee revenue. The audit methodology included: (1) interviewing OFS personnel and reviewing the processes and procedures used to monitor franchise fee revenue; (2) gaining an understanding of ATMOS and ONCOR Sarbanes-Oxley internal control documentation; (3) reviewing independent audit opinions on internal controls over financial reporting and financial statements; and, (4) testing the appropriate inclusion and exclusion of gas and electric users in the franchise fee revenue calculation.

## Audit Results

### Overall Conclusions

The \$125.5 million in franchise fee revenue collected from ATMOS Energy (ATMOS) and ONCOR Electric Delivery (ONCOR) for the period of October 2004 through September 2006 is materially correct and paid timely. The majority of revenue for this period was received from the ONCOR franchise which generated \$98,195,316 (or 78 percent) of the total franchise fee revenue as noted below:

Franchisee	Revenue for Period 10/2004 to 09/2005	Revenue for Period 10/2005 to 09/2006	Total Revenue for the Period 10/2004 to 09/2006
ATMOS	\$ 12,332,028	\$ 14,968,413	\$ 27,300,441
ONCOR	48,334,846	49,860,470	98,195,316
<b>Total Revenue</b>	<b>\$ 60,666,874</b>	<b>\$ 64,828,883</b>	<b>\$ 125,495,757</b>

#### I. Franchise agreements do not require annual independent audits.

OFS personnel do not currently perform activities to verify completeness of franchise fee revenue received from ATMOS or ONCOR. In order to validate revenue completeness, OFS personnel would need an understanding of the flow of data through the ATMOS and ONCOR information technology systems that capture, calculate, process, and pay the franchise fees, as well as the internal controls over the franchise fee process. Due to the time involved to gain this understanding on an on-going basis and the extent of the information needed, this is not a realistic objective or an efficient use of OFS personnel time.

The City Auditor's Office periodically audits the annual franchise fee revenue; however, ATMOS and ONCOR consider much of the information the City Auditor needs to verify revenue completeness proprietary or confidential, such as customer names and addresses. As a result, obtaining sufficient information for audit verification purposes is costly in terms of effort and time for both the City and the companies. For example, the information gathering phase for the current audit took several months to complete, as the data requested from the franchisees was not readily provided. The City had to execute a Non-Disclosure Agreement to obtain some of the documentation requested.

The most efficient way for the City to verify that all franchise fee revenue due to the City is remitted is to amend the franchise fee agreements to

require ATMOS and ONCOR to provide the City with annual independent audits of City franchise fee revenue.

Currently, ATMOS and ONCOR independent auditors are required, by the Sarbanes-Oxley Act of 2002, to perform steps to provide an opinion on the effectiveness of internal controls over financial reporting, which includes franchise fee revenue. Since the franchisee's independent auditor already has access to the franchisee's records and information technology systems, the independent auditor would only need to extend their current procedures to verify completeness of the City's franchise fee revenue.

**Recommendation I:**

The Director of OFS should work with the City Attorney to determine the feasibility of amending the ATMOS and ONCOR franchise fee agreements to require an annual audit of City franchise fee revenue, at the franchisees' expense.

**Management's Response**

Concur. The ONCOR and ATMOS franchises will expire in 10 months and 24 months, respectively. Due to the short time remaining on these contracts, it is not feasible to modify the existing franchises. OFS staff will negotiate with both companies to include such language in future franchise agreements. Because these are negotiated contracts, it will depend on the concessions demanded by the franchisee as whether or not the language will be included in the franchise.

Nick Fehrenbach with OFS will be responsible for working through the negotiations with these companies. IF OFS is able to get these changes into the individual contracts, OFS sets a time for accomplishing these at 13 months and 27 months from November 2007.

**II. The Office of Financial Services has not documented policies and procedures relating to franchise fee revenue.**

The OFS has not documented policies and procedures for the activities performed to oversee City franchise fee revenue. OFS currently performs several activities surrounding quarterly franchise fee revenue, including: a regression analysis to forecast and budget annual revenue, monitoring timeliness of payment submission, verifying the mathematical accuracy of payments, comparing payments to supporting documentation, actual bank receipts, and to budget forecasts. In addition, OFS investigates and reports on significant variances to budget.

The absence of documented policies and procedures for the oversight of franchise fee revenue makes understanding whether the activities performed are sufficient more difficult and does not provide for a smooth transition of duties and responsibilities when necessary.

**Recommendation II:**

The Director of OFS should ensure that there is adequate documentation of policies and procedures for the franchise fee activities including: annual budgeting and forecasting techniques and the on-going monitoring of franchise fee agreements, such as: (1) verifying the mathematical accuracy and timeliness of franchise fee payments; (2) comparing payments to budget forecasts; (3) investigating and reporting variances; and, (4) processing payments.

**Management's Response**

Concur. The Director of OFS will review the policies and procedures for the franchise activities and see that those policies and procedures are appropriately documented and followed.

Nick Fehrenbach with OFS will be responsible for reviewing the policies and procedures and set measures to assure that they are mathematically accurate, timely, and investigate any variances. This process will be implemented by the end of January 2008.

Appendix I

**Background, Objectives, Scope and Methodology**

**Background**

The Office of Financial Services (OFS) regulates and administers the franchise agreements with ATMOS Energy, Inc. (ATMOS) and ONCOR Electric Delivery (ONCOR). These companies have a franchise, granted by the City of Dallas, to operate a natural gas distribution system and electricity delivery system, respectively. The streets, right-of-way, and public easements used by the gas and electric companies within the boundaries of the City are valuable public properties acquired and maintained by the City. The franchise agreements with ATMOS and ONCOR expire December 3, 2009 and September 2008, respectively.

**ATMOS**

The City collects a four percent (4%) franchise fee on the total reported gross revenue each calendar quarter as rental payments for use of the public right-of-way and to recover costs incurred by the City for regulating and administering the gas franchise agreements.

ATMOS franchise fees are grouped in the following three categories: CIS Revenue, Transport Revenue, and Third-Party Fees. The Franchise Payment Reports submitted by ATMOS to the City show additional revenue detail by category as noted below:

<b>CIS Revenue</b>	<ul style="list-style-type: none"><li>- Commercial Governmental Sales</li><li>- Commercial Sales</li><li>- Industrial Governmental Sales</li><li>- Industrial Sales</li><li>- Miscellaneous Service Charges</li><li>- Residential Governmental Sales</li><li>- Residential Sales</li></ul>
<b>Transport Revenue</b>	<ul style="list-style-type: none"><li>- Transportation Governmental Sales</li><li>- Transportation Sales</li></ul>
<b>Third Party Fees</b>	<ul style="list-style-type: none"><li>- Third Party Value of Gas (pass through)</li></ul>

For the period of October 2004 through September 2006, CIS Revenue accounted for approximately 97 percent, Transportation Revenue accounted for approximately two percent and Third-Party Fees accounted for approximately one percent of total franchise fee revenue paid to the City.

## **ONCOR**

The City collects a franchise fee each calendar quarter, equal to the total number of kilowatt hours (kWh) multiplied by the approved rate, as rental payments for use of the public right-of-way and to recover costs incurred by the City for regulating and administering the electricity franchise agreement. For the period of January 2006 to March 2006, the rate per kWh was \$0.02622 and for the period of April 2006 through September 2006, the rate per kWh was \$0.02674.

| ONCOR's four rate classes are noted below:

- Residential;
- General Services (small);
- General Services (large); and
- Other

As of November 2006, the total ONCOR premise service locations for the City of Dallas were 473,223. Of this total, 412,178 (or 87 percent) were classified as Residential accounts, 29,161 (or six percent) were General Services (small) accounts, 28,678 (or six percent) were General Services (large) accounts and 3,206 (less than one percent) were Other accounts.

## **Objectives, Scope and Methodology**

This audit was conducted under authority of the City Charter, Chapter IX, Section 3 and in accordance with generally accepted government auditing standards. The audit covered the period from October 1, 2004 through September 30, 2006.

The objectives of the audit were to determine whether: (1) ATMOS and ONCOR gas and electric franchise fee revenue to the City during the period of October 2004 through September 2006 were materially correct; and, (2) OFS provides appropriate management oversight and monitoring of the franchise fee agreements.

To develop an understanding of relevant internal controls for ATMOS and ONCOR the following steps were performed:

1. Interviewed personnel with ATMOS and ONCOR personnel;
2. Interviewed personnel with OFS to obtain an understanding of the processes and procedures used to monitor franchise revenue to identify methodologies used to forecast franchise fee revenue;

3. Examined applicable laws, regulations, and ordinances pertaining to gas and electric franchise fees;
4. Reviewed procedures performed by OFS personnel to reconcile franchise revenue received to supporting documentation. Examined ATMOS's reconciliation of franchise revenue for the audit period;
5. Examined ONCOR's supporting documentation showing the calculation of franchise fee revenue for the period of October 2004 through September 2006;
6. Reviewed ATMOS's treatment of adjustments for uncollectible accounts and related exclusion of uncollectible accounts from franchise revenue;
7. Inquired about ATMOS's practice(s) to account for subsequent recoveries of previously uncollectible accounts;
8. Reviewed ATMOS's miscellaneous adjustments and exclusion from franchise revenue to ascertain the validity of such adjustments;
9. Reviewed ATMOS's revenue recognition policy for franchise revenue during the audit period;
10. Reviewed ATMOS's and ONCOR's Sarbanes-Oxley 404 (SOX) control documentation;
11. Reviewed ATMOS's independent auditor's opinion from Ernst & Young, LLP on internal controls over financial reporting as of September 30, 2005 and 2006;
12. Reviewed ONCOR's independent auditor's opinion from Deloitte and Touche, LLP on internal controls over financial reporting for calendar years 2004, 2005, and 2006;
13. Examined ATMOS's and ONCOR's audited financial statements for the years 2005 and 2006 to identify issues related to our audit;
14. Obtained information from the Dallas County Appraisal District on parcels that border the City limits. Selected a sample and tested whether each address was appropriately included or excluded from the franchise fee revenue calculation for both ATMOS and ONCOR;
15. Obtained from the Dallas Water Utilities a listing of the top 50 Water users for all zip codes within the City on a sample basis. Tested whether

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ATMOS Energy and ONCOR Electric Delivery Franchise Fees**

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each address was appropriately included or excluded from franchise fee calculation for both ATMOS and ONCOR; and,

- 16.** Requested, but were denied access to Statement on Auditing Standards No. 70: Service Organizations (SAS 70) reports from ATMOS and ONCOR.

## Appendix II

### Major Contributors to This Report

Carol A. Smith, CPA, CIA, CFE, Audit Manager  
R. Kent Henderson, CIA, CGAP, Project Manager  
Kevin Hannigan, CIA, Project Manager  
James Ryan, Auditor  
Chris Aquino, CPA, Auditor  
Theresa Hampden, CPA, Quality Control Manager

Management's Response

Memorandum

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CITY AUDITOR'S OFFICE



CITY OF DALLAS

DATE November 13, 2007 (second submittal)

TO Craig Kinton, CPA, Internal Auditor

SUBJECT Audit Response for Atmos Energy

We have reviewed your audit findings for Atmos Energy. The results of the review are detailed with our responses below.

Atmos Energy

Recommendation I

The Director of OFS should work with the City Attorney to determine the feasibility of amending the Atmos and Oncor franchise fee agreements to require an annual audit of City franchise fee revenue, at the franchisees' expense.

Management's Response

We concur, however, the Oncor and Atmos franchises will expire in 10 months and 24 months respectively. Due to the short time remaining on these contracts, it is not feasible to modify the existing franchises. OFS staff will negotiate with both companies to include such language in future franchise agreements. Because these are negotiated contracts it will depend on the concessions demanded by the franchisee as whether or not the language will be included in the franchise. Nick Fehrenbach is responsible for working through the negotiations with these companies. If we are able to get these changes into the individual contracts, we set a time for accomplishing these at 13 months and 27 months from this date.

Recommendation II

The Director of OFS should ensure that there is adequate documentation of policies and procedures for the franchise fee activities including: annual budgeting and forecasting techniques and the on-going monitoring of franchise fee agreements, such as: (1) verifying the mathematical accuracy and timeliness of franchise fee payments; (2) comparing payments to budget forecasts; (3) investigating and reporting variances; and, (4) processing payments.

Management's Response

We concur. The Director of OFS will review the policies and procedures for the franchise fee activities and see that those policies and procedures are appropriately documented and followed.

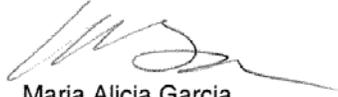
"Dallas, The City That Works: Diverse, Vibrant and Progressive."

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Nick Fehrenbach will be responsible for reviewing the policies and procedures and set measures to assure to assure that they are mathematically accurate, timely and investigate any variances. This process will be implemented by the end of January 2008.

If you have any questions, please contact me.



Maria Alicia Garcia  
Director  
Office of Financial Services

cc: David K. Cook, Chief Financial Officer  
Nick Fehrenbach, Utilities Manager