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Audit Report

GAS FRANCHISE FEE

April 25, 2007

Office of the City Auditor
Austin, Texas

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City of Austin



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Date: April 25, 2007
To: Mayor and Council
From: Stephen L. Morgan, City Auditor
Subject: Gas Franchise Fee Audit

I am pleased to present this audit report on gas franchise fee revenues. The City of Austin has two gas franchise fee agreements with two companies that operate a gas distribution system within the City. According to the agreements, the gas companies are required to pay to the City a total aggregate sum of five percent (5%) of the companies total gross revenues. This franchise fee is for use of City infrastructure including streets, alleys, and easements.

The gas franchise agreement with Texas Gas Service was recently reviewed by an outside consultant, and we performed the work necessary to be able to rely upon the results of the consultant's work. As a result, we were able to focus most of our audit resources on a second gas franchise with Atmos Energy. We found that while Atmos Energy collected franchise fee revenue in accordance with the franchise fee agreement and reported this revenue to the City, 481 properties within Austin were not coded as Austin customers by the gas company. As a result, we estimate that approximately \$50,000 in gas franchise fee is due the City.

We have issued five recommendations meant to strengthen the franchise agreement and address the need for the City to collaborate with the gas company to correct discrepancies found during the audit.

We appreciate the cooperation and assistance we received from staff in the Telecommunications and Regulatory Affairs division of Financial and Administrative Services Department and from Atmos Energy during this audit.

Stephen L. Morgan, CIA, CGAP, CFE, CGFM
City Auditor



ACTION SUMMARY GAS FRANCHISE FEE



Recommendation Text	Management Concurrence	Proposed Implementation Date
01. To recover gas franchise fees due the City, the Manager of Telecommunications and Regulatory Affairs should work with the gas company to finalize a total amount due the City for the service addresses not attributed to Austin.	Concur	June 2007
02. To ensure that Austin receives franchise fee revenue for all customers in the Austin jurisdiction, the Manager of Telecommunications and Regulatory Affairs should request a revised list of Austin customers from the gas company and should verify that the revised list contains the service addresses previously missing from the Austin customer list.	Concur	June 2007
03. To allow the City to recoup its costs associated with this audit, the Manager of Telecommunications and Regulatory Affairs, in accordance with the gas franchise ordinance, should bill the gas company for the cost of this audit.	Concur	June 2007
04. To prevent any potential delays in franchise fee payments to the City, the Manager of Telecommunication and Regulatory Affairs should, as part of the Atmos franchise agreement renewal process, include a provision that would allow the City to charge penalty and interest on late payments.	Concur	November 2007

Recommendation Text	Management Concurrence	Proposed Implementation Date
<p>05. To ensure that Atmos charges and collects a gas franchise fee on newly annexed properties on a timely basis, the Manager of Telecommunication and Regulatory Affairs should, as part of the Atmos franchise agreement renewal process, include a provision whereby upon receipt of notice of annexation from the City, the gas company has sixty (60) days to begin collecting and paying the franchise fee for any revenues received from the gas company's customers. In the event of untimely collection and payment, a penalty should be assessed (see Rec. # 4).</p>	Concur	November 2007

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BACKGROUND

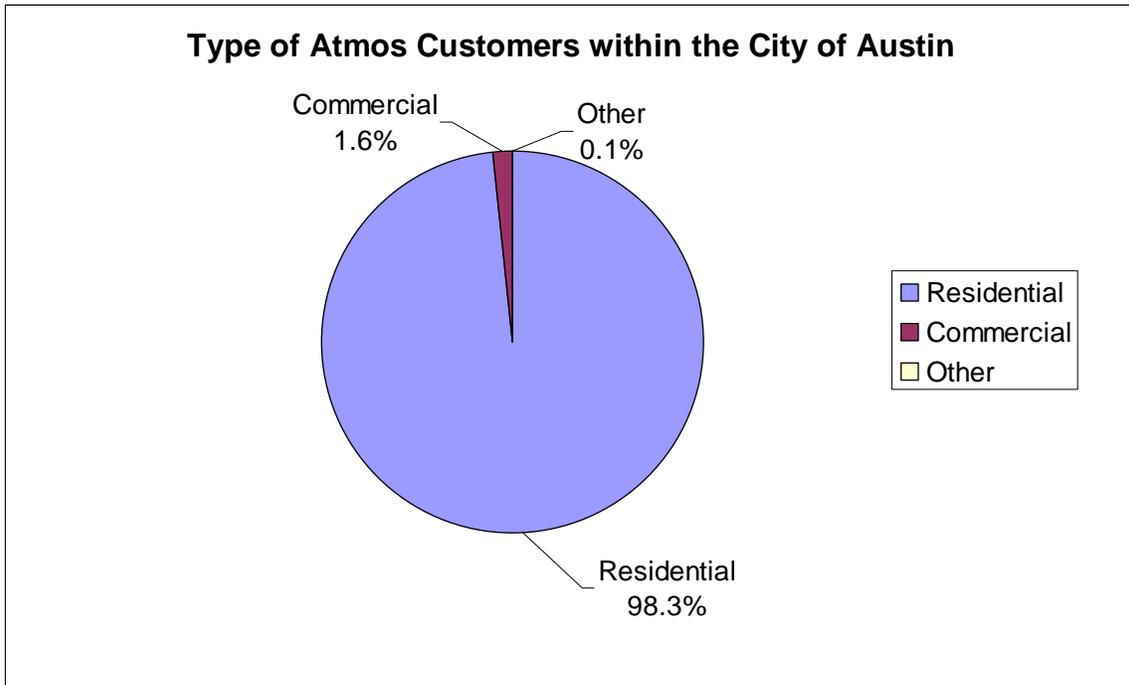
Atmos Energy, Inc. and ONEOK, Inc. dba Texas Gas Service (TGS) Company each have a franchise granted by the City of Austin to operate a natural gas distribution system within the City. The streets, right-of-way, and public easements used by the gas companies within the boundaries of the City are valuable public properties acquired and maintained by the City. The City collects a five percent (5%) franchise fee on the companies' total reported gross revenues each calendar quarter as rental payments for use of the public rights-of-way and to recover costs incurred by the City for regulating and administering the gas franchise agreements. The City's Office of Telecommunications and Regulatory Affairs regulates and administers these franchise agreements. Customers are charged 5.376%, which includes the City's franchise fee plus a state tax imposed on the franchise fee.

In 2006, the TGS gas franchise was audited by an outside consultant. The consultant reviewed gas franchise fee payments between 1997 and 2004. Gas franchise fee payments from TGS, which provides service to the majority of customers within the Austin city limits, average about \$6 million each year. The consultant identified nearly \$50,000 due the City, and this amount was remitted to the City by the gas company in August 2006.

Because there was a recent audit by a consultant of TGS, we took steps to determine that the consultant work was reliable and focused the rest of our audit resources on the Atmos Energy gas franchise. Gas franchise fee payments from Atmos Energy average about \$400,000 each year. The Atmos Energy service area only overlaps the Austin city limits in portions of north Austin.

The Atmos Energy gas franchise agreement is up for renewal in 2007. The Atmos Energy franchise agreement originally belonged to Lone Star Gas Company and became effective September 17, 1987. Since the original agreement, Lone Star Gas merged with Texas Utilities Gas, which in turn merged with Atmos Energy three years ago. In the City of Austin, Atmos Energy serves 5,357 customers. Of these, 5,265 or 98% make up residential accounts, 86 or 1.6% make up commercial accounts and six or less than 1% make up other types of customers such as industrial and transportation customers. Exhibit 1 shows the customer make up in the City of Austin.

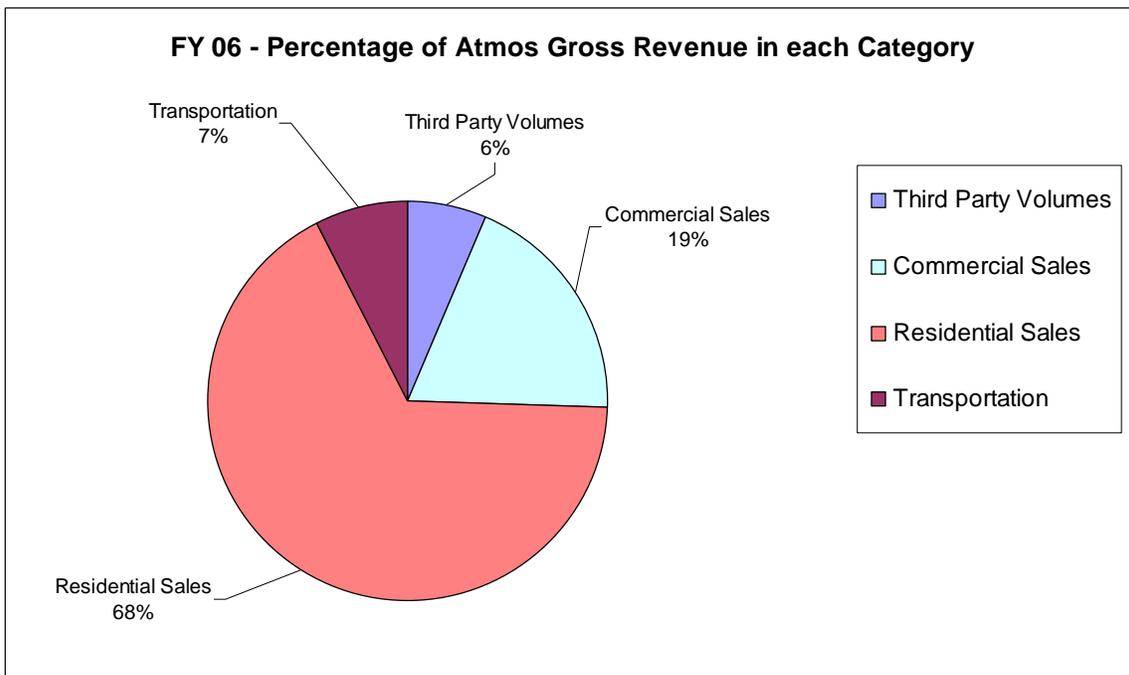
EXHIBIT 1



SOURCE: Atmos Energy Customer Information System, Feb 2007.

The total gross revenue reported to the City of Austin falls into the categories shown in Exhibit 2, below.

EXHIBIT 2



SOURCE: Atmos Energy FY 2006 Quarterly Franchise Fee Report.

Commercial and residential sales make up most (87%) of the gross revenue reported to the City, while transportation accounts for 7% of the reported revenue and third party volumes account for 6% of the reported revenue. Transportation customers use Atmos Energy's pipeline system to transport volumes of gas purchased from a third party. Atmos Energy charges the customer for the value of the service and a fee on the value of the gas purchased by that customer. Atmos Energy pays all franchise fees collected on third party value of gas to the City.

OBJECTIVES, SCOPE, AND METHODOLOGY

Objectives

The objective for this audit was to determine whether gas franchise fee revenue paid to the City by Atmos Energy is correct.

Scope

The scope of work includes gas franchise fee revenue paid to the City by Atmos Energy within the past two years (FY2005-FY2006). Where we identified properties that were not attributed to Austin, we extended our scope back to the estimated service initiation date in order to estimate franchise fee deficiencies.

Methodology

To accomplish our work, we:

1. Interviewed management and staff in the Telecommunications and Regulatory Affairs division of Financial and Administrative Services Department (FASD), and gained an understanding of their roles and responsibilities as it relates to gas franchise fee revenues;
2. Examined applicable laws, regulations, or ordinances pertaining to gas franchise fee revenues;
3. Identified and analyzed previous studies or audits related to gas franchise fee revenues. This included evaluating a consultant audit of TGS to determine whether the consultant work could be relied upon for our audit.
4. Tested billing addresses from Atmos Energy's billing system and plotted these addresses using GIS to determine whether customer records within the Austin city limits were correctly coded as Austin customers; and
5. Reconciled reported information to Atmos Energy financial records and performed detailed transaction testing on a judgmental sample of customer bills. Where we found any discrepancies, we followed up or if necessary expanded our sample size.

This audit was conducted in accordance with generally accepted government auditing standards.

AUDIT RESULTS

In our audit of the gas franchise agreement between the City of Austin and Atmos Energy, we found that, for the most part, franchise fee revenue was collected in accordance with the franchise fee agreement and accurately reported to the City. However, we did find 481 service addresses that were incorrectly coded as outside the Austin city limits. We also identified, based on a 2006 consultant audit of TGS, areas where the franchise agreement with Atmos Energy can be strengthened.

Atmos Energy collected franchise fee revenue in accordance with the franchise fee agreement and accurately reported this revenue to the City.

In this audit we determined that overall Atmos Energy collected franchise fee revenue in accordance with the terms of the franchise agreement. In addition, through several tests of Atmos Energy records, we found that customers appear to be charged the correct franchise fee rate and the amount of franchise fee revenue remitted to the City reconciles to Atmos Energy's financial records.

Atmos Energy is complying with the terms of the franchise fee agreement. For example Atmos Energy remits franchise fee payments on time. The franchise fee is due to be paid quarterly to the City on or before the 15th day of the second month following the end of the quarterly period for which said payment is due. OCA analysis indicates that all quarterly payments to the City of Austin were timely.

Atmos Energy is also appropriately excluding City facilities from the franchise fee. A review of gas bills for select City of Austin facilities reveals that the City was not charged a gas franchise fee. According to the gas franchise ordinance, the gross receipts of gas sold to the City for its own use are not subject to the 5% gas franchise fee.

Adjustments and exclusions used to compute gross revenues were reasonable and in line with the franchise agreement. These exclusions include bad debt, customer deposits, state sales taxes, etc.

In addition, Atmos Energy customers appear to be charged the correct franchise fee. A selected sample of 45 bills made up of residential and commercial customers accurately reflected the 5% gas franchise fee rate. Also, each component of the sample bills we reviewed was reasonable.

The amount of franchise fee revenue remitted to the City reconciles to Atmos Energy's financial records and appears reasonable. Amounts reported to the City in the quarterly franchise payments matched the detail data sent to us by Atmos Energy. We reviewed data supporting franchise payments for FY04, FY05, and FY06 and were able to reconcile this to information reported by Atmos Energy.

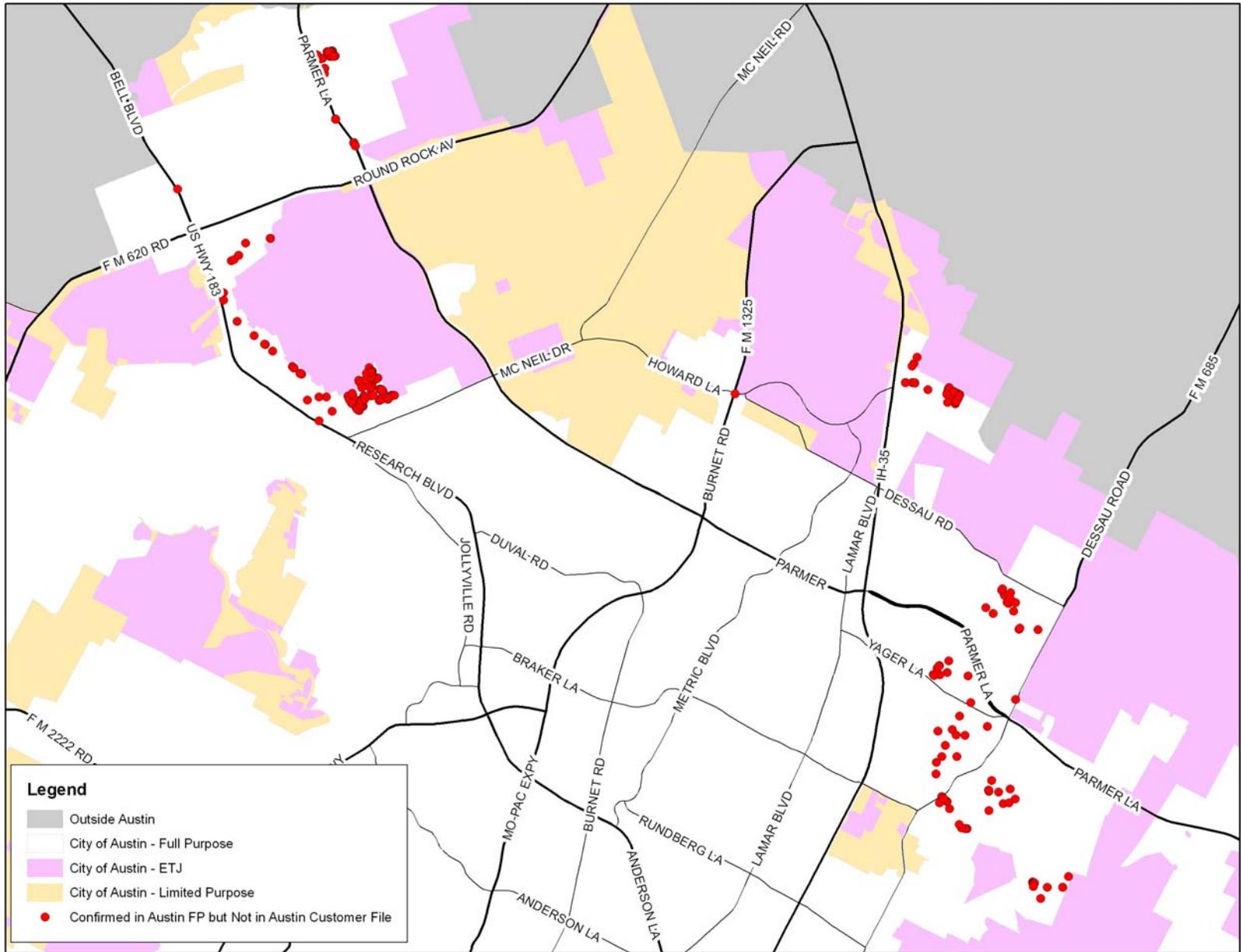
Based on the number of customers and average annual bills, Atmos Energy is reporting a reasonable amount of gross revenue to the City. We estimate the annual average residential gas bill in Austin and surrounding areas in 2006 is about \$412. This estimate is based on a study by the Texas Railroad Commission of 25 Texas cities in 2004. We projected the 2004 annual average residential gas bill to 2006 using the Consumer Price Index. According to Atmos Energy, the 2006 average residential gas bill in Austin is \$405. The 5,265 residential premises multiplied by an average annual bill of \$412 equals \$2.1 million in gross revenue subject to the City's gas franchise fee. Atmos Energy reported \$2.4 million in gross revenues from residential customers to the City of Austin in FY 2006. Therefore, the gas company is reporting a reasonable amount of gross revenues to the City of Austin in their quarterly gas franchise fee computation.

We were able to conduct several tests of the completeness of the data and can provide reasonable assurance that data provided by the gas company reflects revenue due the City. For completeness testing, we reviewed published information on revenues and analyzed data from Atmos Energy's customer information system. We also conducted geographic testing as described in the following section of this report.

Almost 500 customers within Austin were not attributed to Austin in Atmos Energy's billing system resulting in approximately \$50,000 due the City.

Some customers within Austin were not coded as Austin customers by Atmos Energy, and therefore Atmos Energy did not remit franchise fee revenue for these customers to Austin. We used Geographical Information Systems (GIS) software to plot customer addresses received from Atmos Energy to determine whether franchise fee payments for customers within the Austin city limits are remitted to the City of Austin. We found there are 5,357 customers being charged the City of Austin gas franchise fee. Most of these customers (5,265) are residential customers. We identified 481 additional customers not coded as within the Austin city limits that are in fact inside the Austin city limits and should be coded as City of Austin customers. As a result, the gas franchise fee revenue collected from these customers was not remitted to the City of Austin. Using the annexation date or City of Austin building permit date (whichever occurred later) for each omitted address and the average residential gas bill for each year we estimate a total of \$50,433 due the City. This estimate does not include those premises that were recently developed. For a GIS map of the 481 customers, see Exhibit 3.

EXHIBIT 3
GIS Map of Atmos Customers Not Attributed to the City of Austin



Recommendations

- 01. To recover gas franchise fees due the City, the Manager of Telecommunications and Regulatory Affairs should work with the gas company to finalize a total amount due the City for the service addresses not attributed to Austin.

MANAGEMENT RESPONSE: Agree. The Office of Telecommunications & Regulatory Affairs plans to recover gas franchise fees due the City immediately after adoption of the report by the Audit and Finance Committee.

- 02. To ensure that Austin receives franchise fee revenue for all customers in the Austin jurisdiction, the Manager of Telecommunications and Regulatory Affairs should request a revised list of Austin customers from the gas company and should verify that the revised list contains the service addresses previously missing from the Austin customer list.

MANAGEMENT RESPONSE: Agree. The Office of Telecommunications & Regulatory Affairs plans to implement this recommendation within the next two weeks after adoption of the report by the Audit and Finance Committee.

There are several opportunities to improve the gas franchise agreement with Atmos Energy.

The 2006 audit of Texas Gas Service (TGS) recommended improvements to the franchise agreement that should also be applied to the Atmos Energy agreement when the agreement is renewed later this year.

According to the gas franchise ordinances, audit costs shall be borne by the gas companies. The 2007 audit of Atmos Energy is currently being borne by the City, but Atmos Energy should be invoiced for the audit costs.

The 2006 consultant audit recommended that the Texas Gas Service franchise ordinance be revised to include a provision for late payments. This recommendation was implemented for the Texas Gas Service agreement and should also be implemented for the Atmos Energy agreement.

The consultant recommended that the Texas Gas Service franchise ordinance be revised to include a provision whereby upon receipt of notice of annexation from the City, the gas company shall have sixty (60) days to begin collecting and paying the franchise fee for any revenues received from the gas company’s customers. This recommendation was also implemented for the Texas Gas Service agreement and should be implemented for the Atmos Energy agreement.

Recommendations

- 03. To allow the City to recoup its costs associated with this audit, the Manager of Telecommunications and Regulatory Affairs, in accordance with the gas franchise ordinance, should bill the gas company for the cost of this audit.

MANAGEMENT RESPONSE: Agree. The gas company will be billed for the associated costs upon receipt of detailed cost information from the Office of the City Auditor. The gas company shall have net 30 days to make payment to the Office of Telecommunications & Regulatory Affairs.

- 04. To prevent any potential delays in franchise fee payments to the City, the Manager of Telecommunication and Regulatory Affairs should, as part of the Atmos franchise agreement renewal process, include a provision that would allow the City to charge penalty and interest on late payments.

MANAGEMENT RESPONSE: Agree. Franchise renewal negotiations between the Office of Telecommunications & Regulatory Affairs (TARA) and Atmos are currently underway on the gas franchise that expires on November 15, 2007. TARA will negotiate this provision as part of the new franchise to be approved by City Council.

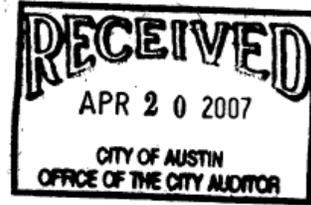
- 05. To ensure that Atmos charges and collects a gas franchise fee on newly annexed properties on a timely basis, the Manager of Telecommunication and Regulatory Affairs should, as part of the Atmos franchise agreement renewal process, include a provision whereby upon receipt of notice of annexation from the City, the gas company has sixty (60) days to begin collecting and paying the franchise fee for any revenues received from the gas company’s customers. In the event of untimely collection and payment, a penalty should be assessed (see Rec. # 4).

MANAGEMENT RESPONSE: Agree. Franchise renewal negotiations between the Office of Telecommunications & Regulatory Affairs and Atmos are currently underway on the gas franchise that expires on November 15, 2007. TARA will negotiate this provision as part of the new franchise to be approved by City Council.

ISSUE FOR FURTHER STUDY

As part of the consultant audit of TGS, only areas annexed since 1997 were tested to determine whether the franchise fee was attributed to Austin. Since our findings in this audit indicate that coding errors occurred for records that were not part of recently annexed areas, there may be an opportunity to conduct similar analysis on TGS customer premises in the future.

APPENDIX A
MANAGEMENT RESPONSE



TO: Stephen L. Morgan, City Auditor

FROM: John Stephens, CPA, Chief Financial Officer

DATE: April 20, 2007

SUBJECT: Management Response to ATMOS Energy Gas Franchise Fee Audit

Thank you for the opportunity to provide management's response to the audit report recommendations. We concur with the five (5) recommendations provided below. Rondella Hawkins, Manager of the Office of Telecommunications & Regulatory Affairs, has the primary responsibility to ensure action is taken and that all of the recommendations are implemented.

01. To recover gas franchise fees due the City, the Manager of Telecommunications and Regulatory Affairs should work with the gas company to finalize a total amount due the City for the service addresses not attributed to Austin.

The Office of Telecommunications & Regulatory Affairs plans to recover gas franchise fees due the City immediately after adoption of the report by the Audit and Finance Committee.

02. To ensure that Austin receives franchise fee revenue for all customers in the Austin jurisdiction, the Manager of Telecommunications and Regulatory Affairs should request a revised list of Austin customers from the gas company and should verify that the revised list contains the service addresses previously missing from the Austin customer list.

The Office of Telecommunications & Regulatory Affairs plans to implement this recommendation within the next two weeks after adoption of the report by the Audit and Finance Committee.

03. To allow the City to recoup its costs associated with this audit, the Manager of Telecommunications and Regulatory Affairs, in accordance with the gas franchise ordinance, should bill the gas company for the cost of this audit.

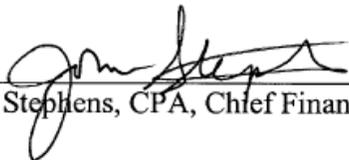
The gas company will be billed for the associated costs upon receipt of detailed cost information from the Office of the City Auditor. The gas company shall have net 30 days to make payment to the Office of Telecommunications & Regulatory Affairs.

04. To prevent any potential delays in franchise fee payments to the City, the Manager of Telecommunication and Regulatory Affairs should, as part of the ATMOS franchise agreement renewal process, include a provision that would allow the City to charge penalty and interest on late payments.

Franchise renewal negotiations between the Office of Telecommunications & Regulatory Affairs (TARA) and ATMOS are currently underway on the gas franchise that expires on November 15, 2007. TARA will negotiate this provision as part of the new franchise to be approved by City Council.

05. To ensure that ATMOS charges and collects a gas franchise fee on newly annexed properties on a timely basis, the Manager of Telecommunications and Regulatory Affairs should, as part of the ATMOS franchise agreement renewal process, include a provision whereby upon receipt of notice of annexation from the City, the gas company has sixty (60) days to begin collecting and paying the franchise fee for any revenues received from the gas company's customers. In the event of untimely collection and payment, a penalty should be assessed (see Rec. # 4).

Franchise renewal negotiations between the Office of Telecommunications & Regulatory Affairs and ATMOS are currently underway on the gas franchise that expires on November 15, 2007. TARA will negotiate this provision as part of the new franchise to be approved by City Council.



John Stephens, CPA, Chief Financial Officer



Date