Sonoma County

Auditor-Controller-Treasurer-Tax Collector

Internal Audit Report

Contract Compliance Audit: Department of Transportation and Public Works

For the Period
July 1, 2011 to June 30, 2015

Engagement No: 3370
Report Date March 15, 2016

Donna M. Dunk, CPA
Auditor-Controller-Treasurer-Tax Collector

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Executive Summary

Managing solid waste and recyclables services is common among many communities. To deliver these services for the County's unincorporated area, in October 2009 the County entered into a Solid Waste Collection and Franchise Fee Agreement (Agreement) with a local Waste Management Operator (Operator). The Agreement was amended and restated in October 2010. In exchange for the right to provide solid and green waste collections, recycling, and other services to the County's unincorporated area, the Operator, among other requirements, must avoid utilizing the County's landfill site for a minimum of 45 percent of the total waste it collects from area customers. The Agreement also requires the Operator to pay fees, called franchise fees, to the County that are due monthly over the life of the 20 year Agreement.

As a part of the 2015/2016 Annual Audit Plan, the Internal Audit Division of the Sonoma County Auditor-Controller-Treasurer-Tax Collector's Office (ACTTC)) completed an audit of the Agreement to determine whether the Operator (1) met key landfill diversion requirements, and (2) accurately paid franchise fees to the County. To perform this work, ACTTC reviewed key documents, such as the Agreement; County and Operator activity reports, certain financial records, and tonnage data; analyzed residential and business billing rates; observed the County's landfill operations and the Operator's recycling operations; and interviewed County and Operator officials about processes, controls, and methods for calculating diversion rates and franchise fee payments. Finally, we performed an independent calculation of diversion rates and franchisee fee payments owed to the County in accordance with the terms and conditions of the Franchise Fee Agreement. The scope of the audit covered Fiscal Year (FY) 11/12 to FY 14/15.

ACTTC determined the following:

1. The Operator Did Not Accurately Calculate and Report Diversion Rates

- The Operator did not accurately calculate and report Diversion Rates for calendar years 2011-2014. For example, for 2014 the Operator reported a 54.03% diversion rate instead of 47.18%. The Operator's errors led to slightly higher residential and commercial service rates. Our analysis found that service rate adjustments were overstated by .18 to .24 percent. As a result, the customers were over charged and the County was over paid by approximately $23,000 in franchise fees. Although our analysis identified errors in the Operator's calculations, when we corrected the errors, the adjustments did not cause the Operator to fall below the minimum diversion rate of 45%, as required by the franchise fee agreement.

2. The Operator Underpaid Some Fees Owed

- The Operator underpaid franchise fees in other areas. The Operator did not meet minimum contractual payments for FY 12/13. The fees underpaid totaled $5,400. The Operator tracked franchise fee payments based on their calendar year rather than the County's fiscal year, which led to this underpayment. Additionally, the Operator excluded revenue from the sales of some types of recyclables received by contract from area businesses, although the Franchise Agreement does not contain language to exclude this type of revenue from the franchise fee. The additional franchise fees paid to the County for fiscal year 2011/12 through December 2014 would have been $27,000 if such revenue was included in the franchise fee calculation.

3. Correcting Service Rates Will Enhance Franchise Fee Revenue

- The County could enhance franchise fee revenue by correcting inadvertent errors made by the Department of Transportation and Public Works (DTPW) in computing service rates for residential and commercial customers. These errors resulted in generally lower service rates for commercial customers and for the use of debris boxes while slightly higher service rates for residential customers. Although the Operator reviewed and approved the service rates calculated by the County, the errors were not identified.

  DTPW management explained that there is no practical remedy for collecting up to an estimated $165,000 in franchise fees due to the service rate errors that occurred between FY 11/12 and FY 14/15. After accounting for all under and over payments of franchise fees that our audit identified, we estimate the County missed an opportunity to receive approximately $170,000 in fees during the period FY 11/12 to FY 14/15. By correcting the identified exceptions, we estimate that the County would receive approximately $230,000 in additional franchise fees between FY 15/16 and FY 19/20.

- In other areas, the County potentially lost an estimated $65,000 in tipping fees when, without an authorization from the County, the Operator paid another non-affiliated Company to move already processed materials outside of the County service area.

Other concerns were identified related to the monitoring of compliance with the terms and conditions of the franchise fee agreement. For example, the Operator did not provide the reports, as required by the agreement, for DTPW to adequately perform its oversight responsibilities. Also, DTPW did not verify the accuracy of the Waste Characterization studies performed by the Operator as required by the Agreement. The results of these affect the customer billing rates as well the franchise fee.

To mitigate the risk of errors in diversion rate calculation and loss of franchise fee, DTPW should improve its oversight by strengthening monitoring controls over the Operator. The Agreement should be amended to clarify roles and responsibilities, requirements for information systems, controls, and the type of reports required to support compliance with the Agreement terms.

Recommendations

We recommend that the Director of the DTPW take the following actions to improve compliance with the contract:

Recommendation No 1 (Risk Classification B): Require the Waste Operator to recalculate fees owed to the County from FY 2011 through FY 2015 based on reporting periods required by the Agreement.

Recommendation No 2 (Risk Classification B): Require the Waste Operator to correct the diversion rates reported to the County for FY 2011 through FY 2015 and to resubmit the corrected diversion rate reports. Going forward, the diversion rate calculation should exclude materials obtained from the transfer stations unless the origin of the materials can be determined.

Recommendation No 3 (Risk Classification A): Adjust the service rates based on the corrected diversion rates as specified by the Agreement for FY 2012 through FY 2015.

Recommendation No 4 (Risk Classification B): Clarify Section 1.28 of the Agreement to better define the treatment of revenue from the sale of recyclable materials purchased from unincorporated County area businesses.

Recommendation No 5 (Risk Classification C): Add to Section 7.1 of the Agreement that pay cycle reports are to be submitted to the County on a monthly basis.

Recommendation No 6 (Risk Classification C): Enforce Paragraph 5.9 of the Agreement to ensure that the Operator conducts a waste characterization study annually.

Recommendation No 7: (Risk Classification C): Add to Paragraph 5.9 of the Agreement that the DTPW shall verify that the results of the Operator's waste characterization study are accurately reflected in the Operator's Recycling Revenue Allocation Model.

Recommendation No 8: (Risk Classification C) Add to Paragraph 5.9 of the Agreement that the Operator is required to submit documentation showing the cost of services and the amount of materials actually recycled by a non-affiliated company. Based on the results of the documentation provided by the Operator, the County should determine whether to allow the diversion of the already processed material from the County landfill. The County should also determine whether the materials that were transported outside of the County service area could not be further processed and must be disposed of at the County landfill.

Recommendation No 9: (Risk Classification C): DPTW should ensure that the sources of recyclable materials indicated in the reports provided by the Operator are in accordance with the contract and all tonnage used in the diversion calculation is accurate. A potential option for consideration by DTPW includes requiring an independent audit of the diversion rate.

Recommendation No 10: (Risk Classification C) Revise Section 7.3.2 of the Agreement from "By April 1 of each year, Company shall deliver to the County two (2) copies of the audited franchise fee statements of franchise fees for the Company's preceding fiscal year" To "By October 1 of each year, Company shall deliver to the County two (2) copies of the audited franchise fee statements of franchise for the County's preceding fiscal year."

Recommendations

Recommendation 11 (Risk Classification C): DPTW should consult the County Counsel and consider appropriate actions including retroactively billing customers and adjusting service rates to recover prior underpayments. DPTW should seek relief of accountability in accordance with the County's established polices, if the decision is to forego collection.

Introduction & Background

Introduction

We have completed the audit of the Sonoma County's (County) Waste Operator's compliance with the terms of the contract covering the calculation of diversion rates and remittance of franchise fees earned by the County. We conducted the audit in accordance with the International Standards for the Professional Practice of Internal Auditing (Standards). These Standards require that we identify, analyze, evaluate, and document sufficient information and evidence to achieve audit objectives. We believe that the evidence obtained provides a reasonable basis for the results, observations, and recommendations contained in our audit report.

The purpose of this audit report is to furnish management independent and objective analyses, recommendations, and other information concerning the activities reviewed. The audit report is a tool to help management identify and implement improvements.

We would like to thank management and staff for their time, information, and cooperation throughout the audit.

Background

The California Integrated Waste Management Act of 1989 (the "Act") established a statewide solid waste management system. Under the Act, counties, cities and other local jurisdictions must develop integrated solid waste management strategy and implement plans for waste source reduction, diversion, re-use and recycling. Public Resources Code section 40059 gives local jurisdictions the authority to provide certain aspects of solid waste services under partially exclusive or wholly exclusive franchise, contract, or licensing agreements.

In September 2009, the Sonoma County Board of Supervisors (Board) entered into an original Franchise Fee Agreement (Agreement) with a locally owned waste disposal and recycling company, to be referred to as Waste Management Operator, or Operator. The Agreement, amended in 2010 for delivery of additional services, expires in October 2029 unless otherwise terminated under the terms of the Agreement.

The Agreement requires the Operator to provide specific types of services for eight zones[1] within the County's unincorporated area, such as:

- Solid waste, green waste, and recycling collection;
- General street sweeping;
- Roadside pick- up and clean-up programs;
- Emergency service;
- Dead animal pick-ups;
- Waste characterization services and audits;
- Education and public awareness; and
- Customer services.

The Agreement requires the Operator to divert a minimum of 45 percent of the waste generated within the County unincorporated area from landfill disposal. The Agreement is designed to allow the County to

[1] Eastern Sonoma County/Petaluma Zone, Southwest/Santa Rosa Zone, Larkfield Zone, Sebastopol/South Sonoma Zone, Cloverdale Zone, Pacific Coast Zone, Sunrise Zone, and West Sonoma County Zone.

determine service levels and implement programs that will support the County's higher diversion goals and to provide all residents and businesses with a consistent level of service.

To date, the Operator has paid $8,245,249 in franchise fees. Minimum amounts owed to the County throughout the life of the franchise fee agreement are shown in Table 1.0 below. If the amount of fees paid by the Operator for the fiscal year is less than the applicable base amount, the Operator must remit the difference to the County.

The County uses the franchise fee revenues to pay for: (1) the County's costs (e.g. staff) associated with management of the Agreement, (2) other refuse enterprise-related expenses, such as maintenance of closed landfills, road repair costs related to the impact of garbage trucks on County roads, and (3) other similar programs as determined by the Board.

Table 1.0: Minimum Franchise Fees Owed to the County by Fiscal Year

Fiscal Year	Minimum Franchise Fees Owed to the County
October 1, 2009 to June 30, 2011	$2 million
FY 11/12	Greater of, 5% of Gross Revenue or Base Franchise fee of $1,331,280
FY 12/13	Greater of, 7.5% of Gross Revenue or Base Franchise Fee of $2,060,821
FY 13/14	Greater of, 10% of Gross Revenue or Base Franchise Fee of $2,835,690,
FY 14/15	Greater of, 11% of Gross Revenue or Adjusted Base Franchise Fee of $3,154,871
FY 15 to October 20, 2029	Greater of, 11% of Gross Revenue or Adjusted Base Franchise Fee

Objectives, Scope & Methodology

Objectives

DTPW, the agency responsible for oversight of the Agreement, requested ACTTC to assess the Operator's compliance with certain terms of the Agreement and determine if the Operator accurately calculated and reported (1) the diversion rates, and (2) the franchise fees earned by the County.

Scope

The scope of the audit covered FY 11/12 to FY 14/15. We examined activities related to account set up for collection services, bill payment, financial reporting, diversion rate computation, and franchise fee calculation.

Methodology

To assess the accuracy of the Operator's diversions rates we performed the following procedures:

1) Obtained and tested the accuracy of information maintained by the County, and the Operator, needed to calculate the diversion rates including the total tonnage disposed at the landfill, total tonnage obtained from recycling activities, as well as certain quarterly and annual reports.
2) Calculated the diversion rate and compared it to the rate reported by the Operator, which utilized the information above and used the methodology established in the Agreement.
3) Met with the Operator to analyze the variances between the calculated and Operator reported diversion rates.
4) Observed the Operator's processing of refuse to separate recycling material.

To analyze the accuracy and remittance of franchise fees paid to the County, we performed the following procedures:

1) Obtained and tested the accuracy of residential and commercial customer billing rates, customer billing and payment records, other financial records and documents, such as reconciliations, reports, and bank statements.
2) Obtained and tested the accuracy of the billing rate computations, payment records and other reports.
3) Reviewed the relevant Agreement terms and conditions.
4) Reviewed the Operator as well as DTPW's processes relevant to the calculation of franchise fees.
5) Conducted variance and trend analysis on the average amount of revenue received for residential and commercial accounts.
6) Compared the Operator's bank statement information to revenue actually remitted to the County.
7) Determined whether revenue remitted to the County was in accordance with the Agreement provisions and agreed with the Operator's revenue reports.

Internal audit standards require the assessment of the County's controls to ensure the accuracy and reliability of data used by the DTPW and the Operator. To assess the reliability of franchise fee data, we compared bank statement information to revenue actually remitted to the County. If the difference between the two amounts was more than five percent, we conducted further analysis by selecting over 65 percent of transactions for one year and examined them for accuracy.

Objectives, Scope & Methodology

We then compared monthly bank statements among four subsidiary accounts maintained by the Operator to monthly revenue reports submitted to the County. The analysis led to a variance of $9.7 million between bank deposit information among the subsidiary accounts and total gross revenue reported to the County. We attribute the difference to intercompany transfers between different bank accounts for business purposes and California Redemption Value payments.

For both the Operator and DTPW, we identified weaknesses in internal controls over data accuracy that required us to re-compute diversion rates and franchise fee calculations that led to expansion of this review. Our analysis identified discrepancies in the service rates computed by the County for commercial and residential customers and for the use of debris boxes, which led to the correction of some rates for FY 11/12. We subsequently revised numerous other rates for our analysis for each Fiscal Year from 2012 through 2015. The FY 15/16 service rates were subsequently adjusted by the County. We relied on the adjusted rates to estimate the fees owed to the County. It is important to note that the franchise fees due to the County and described in this report are estimates only. To have precise calculations on the fees owed would have required us to examine the accuracy of the diversion rates reported for FY 2009-2010, which would have delayed the issuance of the audit report.

We assessed whether the Operator charged all customers for services. We met with Operator management and staff to discuss controls for establishing and managing accounts and for controlling leakage. Leakage refers to the number of accounts that did not receive bills for services, or the number of household or commercial locations receiving services without setting up an account. We determined that the Operator performs routine monitoring of accounts to control for leakage. We supplemented the Operator's efforts by conducting a trend analysis on the average amount of revenue received for residential and commercial accounts. We did not find exceptions to the results that would warrant further review.

During the course of our audit, the Operator raised an issue concerning the exclusivity of the franchise fee agreement and the limited and/or no enforcement by the County that could deter County customers from renting debris boxes from other companies. Although the Operator did not provide sufficient information regarding the magnitude of the concern that would inform subsequent decision-making about expanding the scope of the audit, we notified DTPW. DTPW management explained a compliance officer was hired to assist with enforcement and that Chapter 22 of the Sonoma County Code of Ordinances was presently under review by County Counsel.

Finally, County Counsel assisted us throughout the review and provided clarification on franchise fee terms and conditions.

Results

Finding 1: The Operator did not Accurately Calculate and Report Diversion Rates (Risk Classification B)

The Operator did not accurately calculate and report diversion rates for calendar years 2011-2014. For example, for 2014 the Operator reported a 54.03% diversion rate instead of 47.18%. The Operator's errors led to slightly higher residential and commercial rates.

Section 4.5 of the Agreement requires the Operator to divert, annually, at least 45 percent of total waste material collected in the service area from the County landfill. Diverted material represents waste material collected within the service area that is sold or delivered to a recycler or re-user.

The Operator reported diversion rates, adjusted for computational errors identified by the audit that meet or exceed the 45 percent diversion rate goal established in the Agreement for the periods that we examined. As shown in Table 2, the diversion rates reported by the Operator to the County were 1.36 percent to 6.85 percent higher in comparison to those based on our calculation.

Table 2: Diversion Rates Reported

Diversion Rate (Calendar Year)	2011	2012	2013	2014
Franchise Fee Requirement	45%	45%	45%	45%
Waste Operator	55.28%	55.17%	57.15%	54.03% [a]
Internal Audit Office	53.92%	52.66%	52.20%	47.18%
Difference	1.36	2.51	4.95	6.85

[a] Source: Waste Management Operator Annual Report.

The key reasons for not accurately calculating diversion rates were the following:

- In September 2012 the Operator started improperly including materials obtained at the transfer stations which led to the errors in the diversion rate calculation. County Counsel explained that because the Operator cannot determine the geographical source of these materials they should not be included as diversion attributed to the County. While the total impact of the transfer station weight had no impact on customer service rates for the audit period, continuing to include materials obtained from transfer stations in the future could lead to unallowable customer rate increases in future periods.

- Data entry errors by the Operator led to the differences between the rates computed by ACTTC and those by the Operator. For example, in July 2012, the Operator keyed in 1,166.66 instead of 1,666.66 – a difference of 500 tons. As a result, the tonnage data included in the Operator's computation of diversion rate did not match the tonnage data that we received from the County. A strong system of internal controls would include evidence that the Operator performed procedures reviewing the accuracy of data entered into Excel spreadsheets, ensuring the use of the correct formula and verifying the accuracy of the results (detective controls). At the time of our review, the Operator had not implemented such procedures.

The Agreement allows the Operator to apply for service rate adjustments based upon the changes in diversion rates it reports for the County's review and acceptance.

In other words, the annual diversion rate reported by the Operator is tied to service rate adjustments. Higher diversion rates translate to increases in billing rates charged to residential and commercial customers. Rate adjustments generally include adjustments for fuel, disposal and for inflation.

Results

Had the Operator computed its diversion rates correctly, the subsequent service rate adjustments would have been slightly lower for County customers, as shown in Table 3 below, and the franchise fee to the County would have been lower by approximately $23,000.

Table 3: Impact of Computed Diversion Rates on Service Rate Adjustments

	Total Rate Adjustments Per ACTTC Diversion Rate Adjustment (110%)			**Total Rate Adjustment Per Operator Diversion Rate Adjustment (120%)**			**Difference between ACTTC & Operator Rate Adjustments**		
	Res.	**Comm.**	**Misc.***	**Res.**	**Comm.**	**Misc.**	**Res.**	**Comm.**	**Misc.**
FY 11/12	6.58%	9.35%	3.66 %	6.58%	9.35%	3.66%	0%	0%	0%
FY 12/13	5.46%	7.44%	3.2%	5.63%	7.69%	3.2%	-0.17%	-0.25%	0%
FY 13/14	2.69%	2.61%	3.2%	2.86%	2.85%	3.84%	-0.17%	-0.24%	-0.64%
FY 14/15	1.46%	1.97%	3.2%	1.64%	2.21%	3.84%	-0.18%	-0.24%	-0.64%

*Examples of miscellaneous services fees include return trip charge, additional bin collections, pick up a contaminated green waste bin. These fees are not affected by the diversion rate calculation.

Finding 2: The Operator Underpaid Some Fees Owed (Risk Classification B)

The Agreement requires the Operator to pay minimum fees to the County, as previously shown in Table 1 of this report. The Operator computes the amounts owed to the County based on gross revenues, defined as total payments collected from customers for a specified period of time. Outstanding customer charges are not included in the calculation until collected.

Based on our analysis, we estimate that the Operator underpaid the County by approximately $5,400 between FY 11/12 and FY 14/15, as shown in Table 4.

The net under payment was the result of the following:

- **The Operator used calendar year instead of fiscal years for minimum annual franchise fee calculation** - Although the Operator applied the correct formula for determining the annual minimum franchise fee due, the calculation was based on calendar year and not fiscal year as required by the Agreement. This resulted in underpayment of fees of about $5,400 for the period covered by our audit. Our analysis supports that the underpayment would not have been made up in future periods since the formula to determine the minimum franchise fee was based on the calendar year and the minimum payment required under the Agreement varied from year to year.
- Additionally, the Operator excluded revenue from the sales of some types of recyclables received by contract from area businesses, although the Franchise Agreement does not contain language to exclude this type of revenue from the franchise fee. The additional franchise fees paid to the County for fiscal year 2011/12 through December 2014 would have been $27,000 if such revenue was included in the franchise fee calculation

Finding 3: Correcting Service Rates Will Enhance Franchise Fee Revenue (Risk Classification A)

DTPW is responsible for computing the service rates for solid waste, recycling, green waste and other services that are used by the Operator to bill commercial and residential customers.

Results

The fees collected are then used to calculate franchise fees owed to the County. The Operator, overall, under-charged County customers because of DTPW's inadvertent errors in service rate calculation. Multiple errors affected commercial, debris boxes and residential rates for the period covered by our audit.

Generally, commercial and debris box service rates across the eight service zones were understated and a few residential rates were overstated. The service rate errors went undetected because there were no detective controls in place over the service rate calculation process. Examples of detective controls include a detailed secondary review or a second person independently re-performing the process. Based on the complexity of the calculation and the high dollar impact we recommended that the department assign a second person to independently re-perform the annual service rate calculation. Subsequent to issues raised during this audit, management took prompt corrective actions, they corrected the service rates and assigned a division manager to re-perform the rate calculation process.

As required by the Agreement, the Operator reviewed and approved the service rate calculations performed by DTPW. The Operator's staff however did not identify errors in the service rates calculation performed by the County.

DTPW management explained that there is no practical remedy to recoup the fees lost. When fees are set, government agencies generally have an obligation to recover underpayments, but the decision to collect or to waive the fees may depend on mitigating factors, such as if the cost of the collection effort would exceed the nominal benefit[2]. The County can potentially collect approximately $165,000 without factoring in collection costs, if underpayments can be recovered.

By making the corrections we note in this report, the franchise fee earned by the County will increase by approximately $230,000 over the next five years. We were not able to estimate the increase over the remaining nine years of the contract.

Table 4. Estimated Net Franchise Fee Enhancement, FY 15/16 to FY 19/20

Cause of underpayment	*FY 11/12 to FY14/15*	*FY 15/16 to FY 19/20 (projected)*
Use of incorrect reporting period.	$5,400	$6,700
Errors in diversion and service rates (see finding 3 above)	$165,000*	$223,000
Estimated/Projected loss	$170,400	
Estimated revenue enhancement		$229,700

*Amount included $23,000 overpayment, which resulted from incorrect diversion rates reported by the Operator.

[2]*Protecting Against the Harms of the Mistaken Utility Undercharge,* Roger Colton, 1991. Urban Law Annual; Journal of Urban and Contemporary Law.

Other Matters

A. Transportation of material outside the County is not in compliance with the agreement. (Risk Classification C)

Although the Agreement prohibits the transport of materials to a non-affiliated company outside of the service area, the Operator transported approximately 5,500 tons since January 2012 outside of the service area. Further, the Agreement stipulates that the processing of recyclable materials shall occur at the company facilities.

The approximately 5,500 tons of material transferred contained mainly glass, plastic, and paper that, according to the Operator, could not be further separated and marketed for sale. Operator management asserted the material was previously sold to an unrelated entity who had the capability to further separate the material, but beginning in July 2014, the Operator began paying the entity to take possession of this material.

The Agreement allows for the transport of materials outside of the County for further processing provided that County authorization is obtained. However, the County was unaware that the Operator was transporting materials outside of the County facilities. The County was also unaware that waste residual, after the materials have been further processed, were not transported back to the County run landfill as required by the franchise agreement.

Based on the information available to us, the Operator paid approximately $11,000 since July 2014 (avoiding paying approximately $65,000 in tipping fees to the County) for another party to assume possession of the material. Although, the Operator included the weight of these materials in the diversion rate calculation, we could not verify whether the material was ultimately recycled or disposed of.

B. The Agreement does not require the Operator to provide the reports DTPW needs to adequately perform its oversight responsibilities. (Risk Classification C)

The multi-million dollar Agreement contains a framework for transparency and accountability; controls for recordkeeping, reporting, and information requirements; and mechanisms for addressing breaches in contractual requirements. While the framework requires the Operator to provide supporting information to the County for its remittance of diversion rates and franchise fee payments, the Agreement does not provide the specificity needed to ensure that the County has what it needs to ensure payment and reporting accuracy. Some of the reports, such as quarterly reports, show the fees and materials collected, including the amount of material diverted, but this data is not sufficient for monitoring and verifying the accuracy of diversion rate and franchise fee payments. Other information, such as Pay Cycle reports, are needed because these reports provide the details needed to support the estimate of gross revenues used to compute franchise fee payments owed to the County. While DTPW and the Operator took steps recently to share this information voluntarily, the Agreement could benefit from additional detail on the types of financial information needed to verify the Operator's franchise fee payment calculation.

Other Matters

Waste Characterization Study Used to Allocate County Revenue May Need Updating (Risk Classification C)

Section 5.9 of the County's Agreement requires the Operator to conduct waste characterization studies annually. However, the last study conducted by the Operator was completed in 2010.

The Operator's waste characterization study estimates the content and amount of unprocessed materials collected from up to 22 commercial and residential programs among 16 jurisdictions, including the County of Sonoma. Each jurisdiction is then assigned a percentage for each type of material that was actually recovered from the processing of the material. Generally, the amount of recyclable materials assigned to each collection program should not exceed the amount of unprocessed materials collected from that program and the percentage allocated among the 22 programs should equal 100 percent. We determined that the allocations of recyclable materials assigned to the majority of jurisdictions do not exceed the amount of unprocessed materials, but for four jurisdictions, assigned allocations exceeded the actual amount of unprocessed materials for an extended period of time, approximately 2 ½ years. In one instance, the assigned allocation exceeded the unprocessed materials collected in that jurisdiction by 812 tons for the period from calendar year 2011 through 2014**.**

The Operator's allocation of weight assigned to the County of Sonoma was lower than expected. We determined that the Operator's waste characterization study included six commodities of recyclables that were excluded from the model used by the Operator to assign revenue allocations from the sale of recyclables. This led to lower than expected revenue allocations for the County, which in turn, effected the amount of franchise fee remitted. The Operator executive management and senior staff acknowledged the inaccuracy of the model and agreed that the accuracy of the model could improve by performing additional waste characterization studies for all collection programs represented in the model.

Conclusions

The Agreement is a significant source of revenue for the County, representing over $8,245,249 million in payments. Because of the need for waste management and recycling services, it is important that the County find ways to prevent inaccurate diversion rates and errors in service rates; otherwise it could jeopardize the County's ability to collect on a key source of revenue in the future. Although the terms and conditions of the Agreement demonstrate that the County took steps to keep up with the demand for services and to try to ensure accuracy in payment and diversion rate reporting, the discrepancies that we noted throughout this report show that oversight activities need improvement by both the Operator and DTPW. In addition, as part of the ongoing endeavor to deliver services in an accountable and transparent manner between DTPW and the Operator, other efforts can be expanded through improved reporting and validation of service rate calculations.

Integrated Waste
Northern Sonoma County Air Pollution Control District
Road & Bridge Operations
Sonoma County Airport
Sonoma County Transit

Susan R. Klassen, Director

Deputy Director, Road Operations: John McCarthy

Date: May 10, 2016

To: Olga Gray, Accountant Auditor II

Copy: Kanchan Charan, Audit Manager

From: Susan Klassen, Director

Subject: DTPW Contract Compliance Audit Report

Attached are the management responses to the recommendations detailed in the Contract Compliance Audit for the Solid Waste Collection Franchise Agreement between the County of Sonoma and Redwood Empire Disposal of Sonoma County, Inc.

Thank you.

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Recommendations & Management Responses

We recommend that the Director of the DTPW take the following actions to improve compliance with the contract:

Recommendation No 1 (Risk Classification B): Require the Waste Operator to recalculate fees owed to the County from FY 2011 through FY 2015 based on reporting periods required by the Agreement.

Management Response: *The Department of Transportation and Public Works ("DTPW) concurs with Recommendation No. 1. DTPW will direct RED recalculate the franchise fees for each fiscal year from FY 11-12 through Fiscal Year 14-15 as stipulated in Section 3.1 – Franchise Fee, subsection 3.1.3.*

Recommendation No 2 (Risk Classification B): Require the Waste Operator to correct the diversion rates reported to the County for FY 2011 through FY 2015 and to resubmit the corrected diversion rate reports. Going forward, the diversion rate calculation should exclude materials obtained from the transfer stations unless the origin of the materials can be determined.

Management Response: *The DTPW concurs with Recommendation No. 2. Revised Annual Reports have been requested by the Department of Transportation and Public Works (TPW) and submitted by RED. Diverted materials obtained from the transfer stations shall be excluded from April 1, 2015 forward to coincide with the effectuation of the Master Operations Agreement (MOA). Since the Ratto Group now has an agreement with Republic Services to operate the transfer stations, the diversion from the transfer stations will be counted towards the diversion Republic Services is required to achieve through the MOA and not through the Franchise Agreement.*

Recommendation No 3 (Risk Classification A): Adjust the service rates based on the corrected diversion rates as specified by the Agreement for FY 2012 through FY 2015.

Management Response: *The DTPW concurs with Recommendation No. 3. Exhibit E – Service Rates has been revised to reflect corrections to the Annual Diversion Reports as submitted by RED according to the Exhibit G – Annual Rate Adjustment Methodology for Solid Waste Collection Rates for rates effective July 1, 2012, July 1, 2013, July 1, 2014, and April 1, 2015.*

Recommendation No 4 (Risk Classification B): Clarify Section 1.28 of the Agreement to better define the treatment of revenue from the sale of recyclable materials purchased from unincorporated County area businesses.

Management Response: *The DTPW concurs with Recommendation No. 4. Section 1.28 of the Franchise Agreement has been amended to add the following language: "Gross Revenues shall not include revenue from Non-Franchised Recycling as defined in Section 1.36A below."*

Section 1.36A (Non-Franchise Recycling) has been added as a new section: "The term non-Franchise Recycling means recycled materials that a commercial business generator within the Service area sells to the Company or its Affiliates for their market value based on an arm's length transaction, Non-Franchise Recycling materials are outside the Franchise Fees to the extent such materials were purchased by Company or its Affiliates for material consideration." The Third Amendment to the Agreement was approved by the Board on November 3, 2015.

Recommendation No 5 (Risk Classification C): Add to Section 7.1 of the Agreement that pay cycle reports are to be submitted to the County on a monthly basis.

Management Response: *The DTPW concurs with Recommendation No. 5. Section 7.1 sets forth the requirements for maintaining records. Since the summary pay cycle reports are submitted as part of the backup for payment of the franchise fees, the appropriate place to include the requirement to submit summary pay cycle reports is Section 3.2 (Payment of Franchise Fee). Clarification regarding this recommendation has been completed by adding Section 1.49 (Summary Pay Cycle Reports) and amending Section 3.2 in the Amendment No. 3 to the Franchise Agreement, which was approved by the Board of Supervisors on November 3, 2015.*

Recommendation No 6 (Risk Classification C): Enforce Paragraph 5.9 of the Agreement to ensure that the Operator conduct waste characterization study annually.

Management Response: *The DTPW concurs with Recommendation No. 6. Section 5.9 has been amended in the Amendment No. 3 to the Franchise Agreement, approved by the Board on November 3, 2015. The new Refuse Enforcement Specialist spends 40% of staff time working on Solid Waste Franchise Issues, including verifying required waste characterization studies.*

Recommendation No 7 (Risk Classification C): Add to Paragraph 5.9 of the Agreement that the DTPW shall verify that the results of the Operator's waste characterization study are accurately reflected in the Operator's Recycling Revenue Allocation Model.

Management Response: *The DTPW concurs with Recommendation No. 7. Section 3.2 (Payment of Franchise Fees) and Section 5.9 (Waste Characterization Services and Audits) have been amended to include a self-certification that the Company's Recycling Revenue Allocation Model reflects any changes resulting from the Company's waste characterization study as part of Amendment No. 3 to the Franchise Agreement, approved by the Board on November 3, 2015. The new Refuse Enforcement Specialist spends 40% of staff time working on Solid Waste Franchise Issues, including verifying the accuracy and/or observing the changes applicable to the County's allocation in the Company's Recycling Revenue Allocation Model.*

Recommendation No 8 (Risk Classification C) Add to Paragraph 5.9 of the Agreement that the Operator is required to submit documentation showing the cost of services and the amount of materials actually recycled by a non-affiliated company. Based on the results of the documentation provided by the Operator, the County should determine whether to allow the diversion of the already processed material from the County landfill. The County should also determine whether the materials that were transported outside of the County service area could not be further processed and must be disposed of at the County landfill.

Management Response: *The DTPW concurs with Recommendation No. 8. Section 4.2.6 (Notification of Delivery of Source Separated Recyclable Materials to a Non-Affiliated Company) has been added to the Agreement through Amendment No. 3 of the Franchise Agreement to ensure timely notification by RED to TPW when Source Separated Recyclable Materials are diverted to a non-affiliated company. In addition, the section requires submittal of documentation showing the cost of services and the amount of materials actually recycled (versus landfilled) for all materials processed by a non-affiliated company. Finally, a section has been added to Exhibit J – Liquidated Damages for not complying with Section 4.2.6. The Third Amendment to the Agreement was approved by the Board on November 3, 2015.*

Recommendation No 9 (Risk Classification C): DPTW should ensure that the sources of recyclable materials indicated in the reports provided by the Operator are in accordance with the contract and all tonnage used in the diversion calculation is accurate. A potential option for consideration by DTPW includes requiring an independent audit of the diversion rate.

Management Response: *The DTPW concurs with Recommendation No. 9. RED has been directed in writing to include a statement of self-certification of the accuracy of all reports to each report required under Section 3.2 and Section 7.2 of the Agreement. The Third Amendment to the Agreement was approved by the Board on November 3, 2015. The new Refuse Enforcement Specialist spends 40% of staff time working on Solid Waste Franchise Issues, including verifying the accuracy of all required reports.*

Recommendation No 10 (Risk Classification C): Revise Section 7.3.2 of the Agreement from "By April 1 of each year, Company shall deliver to the County two (2) copies of the audited franchise fee statements of franchise fees for the Company's preceding fiscal year" To "By October 1 of each year, Company shall deliver to the County two (2) copies of the audited franchise fee statements of franchise for the County's preceding fiscal year."

Management Response: *The DTPW concurs with Recommendation No. 10. As part of realigning the rate adjustments to match the Master Operations Agreement with Republic Services, the dates for submitting the audited franchise fee statement has also been realigned by amending Section 7.3.2 of the Franchise Agreement. The Third Amendment to the Agreement was approved by the Board on November 3, 2015.*

Recommendation No 11 (Risk Classification C): DTPW should consult the County Counsel and consider appropriate actions including retroactively billing customers, adjusting service rates to recover prior underpayments. DTPW should seek relief of accountability in accordance with the County's established policies, if the decision is to forego collection.

Management Response: *The DTPW concurs with Recommendation No. 11. DTPW will seek relief of accountability in accordance with the County's established policies.*

Appendix B: Report Item Risk Classification

For purposes of reporting our audit findings and recommendations, we classify audit report items into three distinct categories to identify the perceived risk exposure:

- **Risk Classification A: Critical Control Weakness:**
  Serious audit findings or a combination of Significant Control Weaknesses that represent critical exceptions to the audit objective(s), policies, and/or business goals of a department/agency or the County as a whole. Management is expected to address Critical Control Weaknesses brought to their attention immediately.

- **Risk Classification B: Significant Control Weakness:**
  Audit findings or a combination of Control Findings that represent a significant deficiency in the design or operation of internal controls. Significant Control Weaknesses generally will require prompt corrective actions.

- **Risk Classification C: Control Findings:**
  Audit findings concerning internal controls, compliance issues, or efficiency/effectiveness issues that require management's corrective action to implement or enhance processes and internal controls. Control Findings are expected to be addressed within our follow-up process of six months, but no later than twelve months.