



OFFICE OF THE CITY AUDITOR
Long Beach, California

R-10

LAURA L. DOUD, CPA
City Auditor

March 9, 2010

HONORABLE MAYOR AND CITY COUNCIL
City of Long Beach
California

RECOMMENDATION:

Receive and file the Proposition H Audit Report for the fiscal year ending September 30, 2009.

DISCUSSION:

Pursuant to Long Beach Municipal Code Section 3.80.227, the Office of the City Auditor is charged with conducting an annual independent financial audit of Proposition H (Prop H) funds and providing a written report to the City Council. The City Auditor conducts annual audits of Prop H funds to identify the following: the amount of special tax revenues collected during the fiscal year, the amount of special tax revenue expended on eligible costs during the fiscal year, the amount of unspent moneys on deposit that were carried over into the current fiscal year, and the status of any projects and programs funded by the special tax revenues.

We determined the following as a result of our audit:

- 1) During FY 2009, the City received \$3,534,806 of Prop H revenues. Also of interest, from June 1, 2007 through December 31, 2009, quarterly oil production in Long Beach has declined 9.5%, thereby reducing the amount of special oil tax revenues to the City;
- 2) Prop H expenditures during the fiscal year totaled \$4,593,368. Expenditures were made for eligible costs as defined in the Municipal Code;
- 3) The amount of unspent moneys carried over into FY 2010 was \$121,512. Comparatively, the amount carried over into FY 2009 was \$1,180,074; and
- 4) Both the Police Department and the Fire Department intend to use their Prop H resources to continue funding certain designated public safety positions. However, for FY 2010, budgeted expenditures pertaining to these designated personnel exceed budgeted resources by \$449,459, a difference that must be absorbed by the General Fund. This deficit may grow significantly in times of declining oil production, when actual revenues may be less than those budgeted, and when public safety labor agreements require salary increases.

Detailed information regarding the results discussed above is included in the attached report.

In conclusion, we express our appreciation to employees of the Police Department, Fire Department and Department of Financial Management for providing their time, information, and cooperation during the audit process.

TIMING CONSIDERATIONS:

Action by the City Council is not time sensitive.

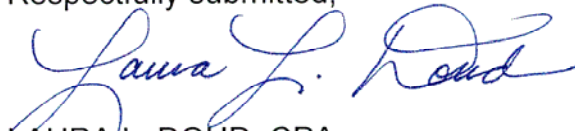
FISCAL IMPACT:

Approving this action would have no fiscal impact.

SUGGESTED ACTION:

Approve recommendation.

Respectfully submitted,

A handwritten signature in blue ink that reads "Laura L. Doud". The signature is written in a cursive style with a large initial "L" and "D".

LAURA L. DOUD, CPA
CITY AUDITOR

Dated: March 1, 2010

Attachment

Audit Report

Proposition H Police and Fire Public Safety Oil Production Act

For Fiscal Year Ending September 30, 2009

March 1, 2010



Audit Staff

City Auditor: Laura L. Doud
Assistant City Auditor: James Johnson
Deputy City Auditor: Danica D. Rogers
Senior Auditor: Sotheary Hul
Audit Staff: Kris Lopez

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BACKGROUND:

Proposition H

The citizens of Long Beach (City) approved Proposition H (Prop H), the Police and Fire Public Safety Oil Production Tax, on May 1, 2007. Prop H amended the Long Beach Municipal Code to assess an additional 25 cents per barrel special tax on oil producers in Long Beach, with the tax rate to be adjusted annually on June 1 based on the Consumer Price Index (CPI). The special tax became effective on June 1, 2007, and was increased to 26 cents per barrel on June 1, 2008 to reflect the change in CPI.

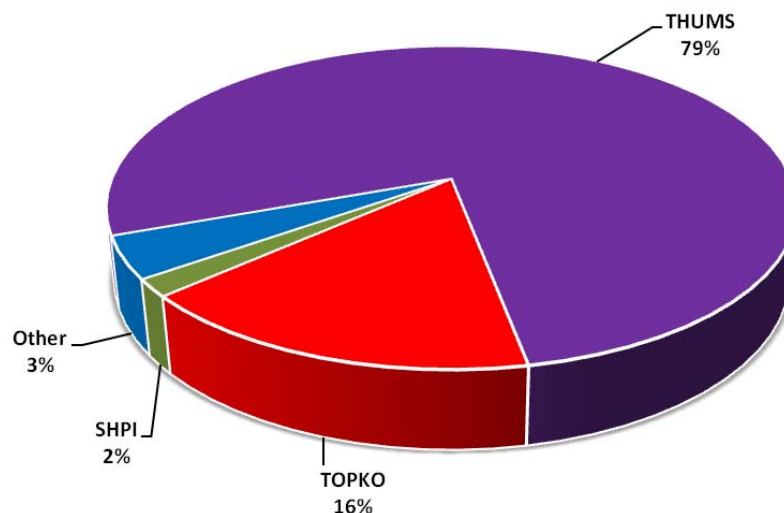
This special tax is in addition to the existing tax of 15 cents per barrel produced, and is a legally distinct tax to be used specifically to fund public safety. Specifically, these proceeds may only be used for police officers, firefighters, and related costs including, but not limited to, equipment, facilities, and training, in order to ensure timely responses for public safety needs.

This special tax is due to the City on or before the last day of the calendar quarter. The payment is based on a production quarter, which ends one month earlier than the calendar quarter. For example, the special tax payment for the production quarter ending August 31, 2009 was due to the City on or before September 30, 2009.

Oil Producers

In fiscal year (FY) 2009, oil operators in Long Beach reported a total of 13,532,174 barrels of oil produced. THUMS Long Beach Company (THUMS), Tidelands Oil Production Company (TOPKO) and Signal Hill Petroleum Inc. (SHPI) were the City's top oil producers in FY 2009. As illustrated below, these three oil operators accounted for 97% of oil produced in FY 2009.

Percentage of Barrels Produced in FY 2009 by Oil Producer

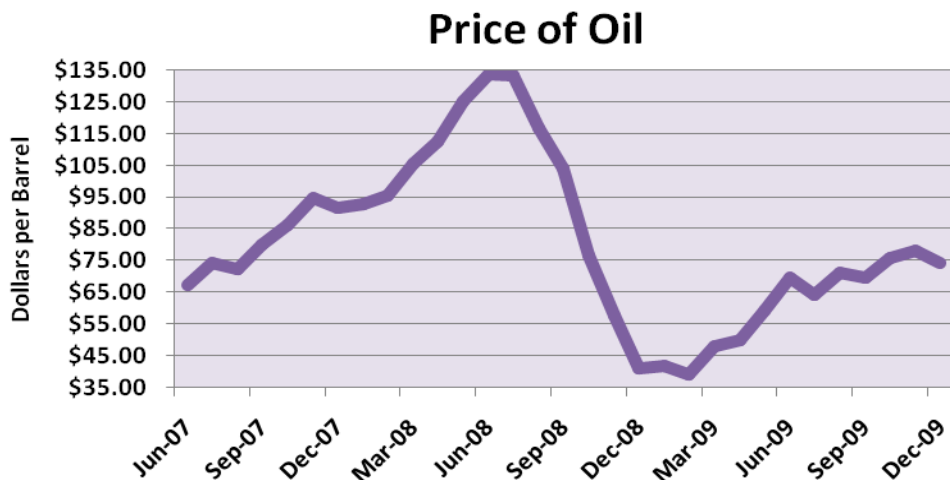


The source for the majority of the oil produced is the Wilmington Oil Field. The Wilmington Oil Field was discovered in Long Beach in 1932 and is 13 miles long, extending from San Pedro to Seal Beach. The field is divided into two sections: West and East. TOPKO serves as the field contractor for the western section of the oil field, and THUMS serves as the field contractor for the eastern section. In FY 2009, THUMS produced 10,627,092 barrels of oil, while TOPKO produced 2,225,988 barrels of oil.

SHPI, the third largest oil producer in Long Beach, is the operator for the Signal Hill West Unit and the Signal Hill East Unit Oil Fields. The oil fields are located in both Long Beach and Signal Hill. In FY 2009, SHPI produced a total of 237,969 barrels of oil in Long Beach.

Price of Oil

When the special oil tax became effective in June 2007, the monthly average price of oil based on the WTI (West Texas Intermediate) crude index was steadily rising. In June 2008, the monthly WTI average reached a high of \$133.93 per barrel, as shown in the chart below. However, oil prices began to decrease significantly shortly thereafter. In February 2009, the monthly WTI average fell to \$39.16 per barrel, a low not seen since June 2004.

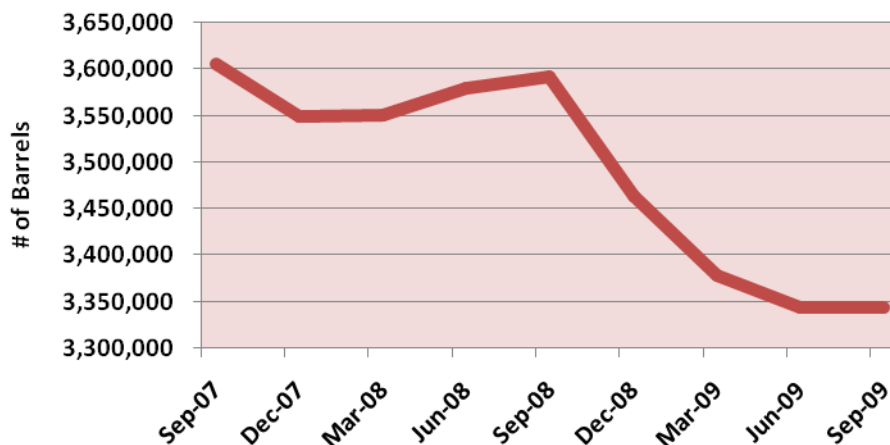


As demonstrated in the graph above, oil prices have steadily risen since February 2009. However, it is important to note that a decline in the price of oil could impact the City in the following two ways:

- 1) Prop H revenue will be suspended for any months in which the WTI average is below \$20 per barrel; and
- 2) Oil producers might decrease production in line with a decrease in oil prices, thereby reducing Prop H revenues.

Since the inception of Prop H through September 30, 2009, quarterly oil production in Long Beach has declined significantly, thereby reducing the amount of special oil tax revenues to the City. See the below chart for additional details on the decline in oil production in recent years.

Quarterly Oil Production



As depicted in the graph above, oil production in the City has notably decreased. For the fourth fiscal quarter of 2007, Long Beach oil producers reported 3,605,516 barrels of oil produced. For the fourth fiscal quarter of 2009, 3,344,247 barrels of oil were reported. Additionally, preliminary oil production figures for the first fiscal quarter of 2010 totaled 3,264,048, equating to 9.5% reduction in quarterly oil production over two and a half years. Given this trend in declining oil production, we encourage management to continue considering the above potential impacts in their fiscal planning.

AUDIT OBJECTIVES, SCOPE AND METHODOLOGY

Long Beach Municipal Code §3.80.227 requires annual independent financial audits of Prop H revenues and expenditures during each fiscal year. The four primary objectives of this audit were as follows:

- 1) Identify Prop H revenues received during FY 2009 and determine if funds remitted by the oil producers were properly calculated;
- 2) Identify FY 2009 expenditures of Prop H funds and analyze whether such expenditures complied with the approved uses set forth in the Municipal Code;
- 3) Determine the amount of unspent Prop H monies on deposit at September 30, 2009 that were carried-over into the current fiscal year; and
- 4) Determine the status of any projects and programs funded by Prop H revenue.

The scope of our audit covers the period October 1, 2008 through September 30, 2009, with additional limited procedures performed on the first fiscal quarter of 2010. We performed the following procedures during our audit:

- Calculated the annual change in the special tax rate based on the change in the annual average of CPI and compared the result to the City's calculation.
- Identified the amount of underpaid special taxes for fourth quarter 2009 and first quarter 2010 related to the tax rate.
- Obtained the Oil Production Taxes Schedule from the Department of Financial Management and recalculated FY 2009 Prop H revenues.
- Identified the largest Prop H revenue sources and traced those revenues to the checks received and supporting production reports from the oil producers, and verified that all revenues were recorded into the City's financial system.
- Independently confirmed 94% of the reported oil production amounts with the oil producers for FY 2009 and first quarter of 2010.
- Identified the Prop H expenditures during FY 2009 and determined whether the expenditures were in accordance with the Municipal Code.
- Obtained the Police and Fire Departments' plans to use Prop H monies in the future, and determined whether those plans are in accordance with §3.80.224 of the Municipal Code.
- Identified the amount of unspent Prop H monies on deposit at September 30, 2009 that were carried over into the current fiscal year.
- Reviewed certain significant payments received from the oil producers and determined whether appropriate penalties were assessed on late payments.
- Interviewed City personnel in the Police Department, Fire Department and Department of Financial Management and obtained relevant documentation to obtain an understanding of internal control procedures related to Prop H revenues and expenditures.

We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

In addition to the results below, we have communicated to management in separate correspondence certain internal control recommendations not significant to the objectives of our audit.

AUDIT FINDINGS AND RESULTS

Objective 1 - Identify Prop H revenues received during FY 2009 and determine if funds remitted by the oil producers were properly calculated.

The City received a total of \$3,534,806 of Prop H special tax revenue, including penalties and interest, during FY 2009, as depicted in the table below. However, funds remitted by the oil producers were not properly calculated, as discussed in Finding 1 below.

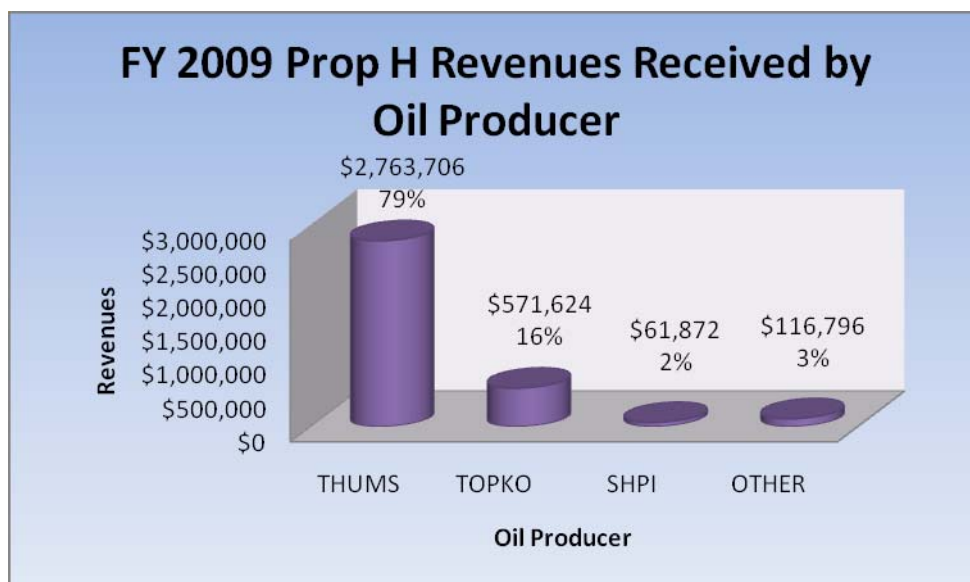
Total Revenues Received in FY 2009

Oil Tax Revenue	Penalties	Interest	Total
\$3,511,007	\$2,991	\$20,808	\$3,534,806

The special tax revenue received was based on production reports totaling 13,532,174 barrels of oil. FY 2009 revenues were slightly less than to be expected given the production level, because TOPKO reduced its tax payment in the fourth quarter of FY 2009. TOPKO decreased its fourth quarter special tax payment by approximately \$7,000 to correct tax overpayments in previous years for an oil well that it recently determined is not located in the City of Long Beach.

We substantively tested 94% or \$3,300,580 of the special tax revenues received in FY 2009 through confirmations with the oil producers. We also verified that revenues were recorded into the City's financial system. In addition, we reviewed significant revenues received to ensure that penalties were assessed on late payments, and we recalculated the interest earned on Prop H revenues for reasonableness. Both penalties and interest revenue appear reasonable.

Below is a summary of the Prop H funds received from major oil producers during FY 2009.



The special tax revenues and penalties received were deposited into Fund 121, the Police and Fire Public Safety Oil Production Act Special Revenue Fund, as required by §3.80.225 of the Municipal Code. The revenues were divided equally between two sub-funds, one for the Police Department and one for the Fire Department. Additionally, each department earned interest on its respective fund balance.

Finding 1:

The oil production tax was not increased on June 1, 2009 to reflect the change in the CPI as required by Municipal Code 3.80.222. The Municipal Code states that the basis for calculating the change in CPI will be the annual average of the consumer price index. However, the Department of Financial Management (Financial Management) used a monthly rate rather than the annual average, which resulted in no change in CPI. As a result, Financial Management notified the producers that the tax rate would remain 26 cents per barrel for the production year beginning June 1, 2009. This caused an underpayment of revenues for the production quarters ending August 30, 2009 and November 30, 2009 of approximately \$33,443 and \$32,641, respectively.

Production Quarter Ending	# of Barrels Produced	Revenues Received Based on \$0.26 per barrel	Revenues Received Based on \$0.27 per Barrel	Underpayment
08/30/09	3,344,247	\$869,504	\$902,947	(\$33,443)
11/30/09	3,264,048 *	\$848,652	\$881,293	(\$32,641)

* includes estimates based on previous quarter's production for one very small producer who had not remitted payment as of January 26, 2010.

By using the annual average, the special tax should have increased one cent per barrel, from 26 cents to 27 cents. Financial Management issued a notice to all oil producers of the correct tax rate and requested reimbursement for the underpayments. By the end of January 2010, 97% of the above underpayments had been remitted to the City.

Recommendation 1:

Ensure that the annual adjustment to the special oil production tax is calculated correctly each year in accordance with the Municipal Code. Consider enhancing the review procedures to ensure accuracy and compliance with the Municipal Code.

Finding 2:

The City Hall mailroom receives mail twice a day at approximately 8:00 a.m. and 12:00 p.m. The morning mail is delivered to the appropriate departments the morning of receipt, while the afternoon mail is combined with the next morning's mail delivery. The mailroom does not date stamp mail delivered to the City upon its receipt. Therefore, Financial Management does not know which checks the City received in the afternoon of the last day of the quarter and which checks were late, because they are commingled with the next day's mail.

Municipal Code 3.80.222 B is specific with regards to late payments. An oil producer may make its special tax payment up to one month after the end of its production quarter. For example, payments for the production quarter ending August 31 must be received by the City on or before September 30. However, on the first day of the month following the close of the calendar quarter, any producer who fails to pay the special tax in the previous month is assessed a late penalty of 25% of the tax that is owed. Given these significant penalties, it is critical that Financial Management be aware of which payments were received on time and which payments were late.

Recommendation 2:

Develop and implement procedures to ensure all special tax payments received on the last day of a calendar quarter are properly identified as such, and late penalties are assessed on payments received even one day late. Consider sending an employee to the mailroom to retrieve the mail in the late afternoon on these four critical days each year.

Objective 2 - Identify FY 2009 expenditures of Prop H funds and analyze whether such expenditures complied with the approved uses set forth in the Municipal Code.

Police Department

In FY 2009, Prop H expenditures for the Police Department totaled \$1,791,021. Salaries and benefits for the 14 Prop H-funded citywide motorcycle officers totaled \$1,584,447 and accounted for 88.5% of total expenses. The remaining Prop H police expenses consisted primarily of fleet services charges and some small additional costs for uniforms and equipment. We reviewed \$1,773,959 (99% of total expenditures), of salaries, benefits, and fleet expenses for the 14 motorcycle officers and found that they complied with the approved uses as set forth in the Municipal Code.

Fire Department

The Fire Department's FY 2009 Prop H expenditures totaled \$2,802,347. Significant expenditures included \$1,895,290 in salaries and benefits for 12 Fire Station 14 firefighters and the one-time purchase of a new \$800,919 fire truck for the same station. Additional expenses consisted of charges from other City departments and costs for materials, supplies and services. We reviewed 96%, or \$2,696,209, of the total expenditures and found that these expenditures complied with the approved uses as set forth in the Municipal Code.

Objective 3 - Determine the amount of unspent Prop H monies on deposit that were carried-over into the current fiscal year.

The chart below depicts the cash flow of Prop H funds during FY 2009.

Subfund	Amount Carried Over From FY 2008	Amount Transferred to/from Police Subfund from FY 2008	FY 2009	FY 2009	Amount Carried Over to FY 2010
			Revenues	Expenditures	
Police	\$517,221	(\$445,000)	\$1,770,294	(\$1,791,021)	\$51,494
Fire	\$662,853	\$445,000	\$1,764,512	(\$2,802,347)	\$70,018

As earmarked by the City Council during FY 2008 budget adoption, \$445,000 of the carried over amount from the FY 2008 Police subfund was transferred in FY 2009 to the Fire subfund to help pay for the new fire truck for Fire Station 14.

Objective 4 - Determine the status of any projects and programs funded by Prop H revenue.

Anticipated Activities

In FY 2010, the Police Department intends to use Prop H revenues to continue funding salaries, benefits, uniforms, and fleet maintenance expenses for the 14 Prop H-funded motorcycle officers.

In FY 2010, the Fire Department intends to use its Prop H appropriations to continue funding fleet and labor costs for the 12 Prop H-funded firefighters that staff Fire Truck 14.

FY 2010 Budgeted Revenues and Expenditures

For FY 2010, budgeted Prop H revenues and expenditures for the Police Department were \$1,834,900 and \$1,752,084, respectively, resulting in a budgeted surplus of \$82,816 for the year. That surplus combined with the amount carried over from FY 2009 results in a budgeted ending fund balance of \$134,310 for FY 2010. Approximately 99% of total expenditures were budgeted for salaries and benefits expense for the 14 citywide motorcycle officers.

For FY 2010, the Fire Department’s budgeted Prop H expenditures exceeded their budgeted available resources (including the amount carried over from FY 2009) by \$235,268, as shown below.

FY 2010 Budgeted Revenues and Expenditures

Revenues and Expenditures	Police	Fire	Total
FY 2010 Budgeted Revenues:			
Oil Production Tax	\$ 1,820,000	\$ 1,820,000	\$ 3,640,000
Interest - Pooled Cash	14,900	9,600	24,500
Total Budgeted Revenues	1,834,900	1,829,600	3,664,500
FY 2010 Budgeted Expenditures:			
Salaries and Benefits	1,731,901	1,962,909	3,694,810
Worker's Compensation	-	114,064	114,064
Furlough Savings	-	(64,054)	(64,054)
Fleet and Other Expenses	20,183	121,967	142,150
Total Budgeted Expenditures	1,752,084	2,134,886	3,886,970
Expenditures Exceeding Revenues	82,816	(305,286)	(222,470)
Beginning Fund Balance at 10/1/2009	51,494	70,018	121,512
Ending Fund Balance 9/30/2010 (Budgeted)	\$ 134,310	\$ (235,268)	\$ (100,958)

The above table represents the budgeted revenues and expenditures in the Prop H special revenue fund. However, the Fund's budget does not capture all expenses related to the 14 motor officers and 12 firefighters currently designated as Prop H personnel. With regards to the Police subfund, workers' compensation and fleet services charges related to the Prop H motor officers are budgeted in the General Fund and therefore are not included in the table above. Additionally, the furlough savings in the Fire subfund will likely remain unrealized, as the City does not currently anticipate Fire Department furloughs in FY 2010. To gain a complete picture of total anticipated costs associated with these Prop H-dedicated personnel, the following adjustments must be made.

Prop H Special Revenue Fund Adjustments

	Police	Fire	Total
Expenditures Exceeding Revenues (Budgeted)	\$ 82,816	\$ (305,286)	\$ (222,470)
Adjustments:			
Furlough Savings	-	(64,054)	(64,054)
Workers' Compensation	(84,266)	-	(84,266)
Fleet Services Charges	(200,181)	-	(200,181)
Total Adjustments	(284,447)	(64,054)	(348,501)
Expenditures Exceeding Revenues (Adjusted)	(201,631)	(369,340)	(570,971)
Beginning Fund Balance at 10/1/2009	51,494	70,018	121,512
Transfer-In From General Fund	150,137	299,322	449,459
Adjusted Budgeted Fund Balance at 9/30/2010	\$ -	\$ -	\$ -

Observation 1:

As stated above, Prop H resources have been and are budgeted to be spent on public safety costs, in compliance with the Municipal Code. However, it is important to note that the FY 2010 budgeted labor and equipment expenditures for personnel designated as Prop H-funded exceed the estimated Prop H resources by \$449,459 (12%), as depicted above. Financial Management reported that the budgeted expenses were predicated on an estimated carry-over fund balance from FY 2009. However, given the decline in oil production, the carry-over balance ended FY 2009 was \$126,342 under budgeted expectations. This dip in performance will create a negative fund balance at the end of FY 2010 if revenues do not change or mid-year budget reductions are not implemented.

Additionally, given general inflation and the future salary increases guaranteed by the police and fire union agreements, it is likely that future expenditures for the designated Prop H public safety personnel and their equipment will continue to increase. As such, in coming years, we anticipate that the deficit between revenues and expenditures for these personnel will continue to increase each year if oil production does not increase, the tax rate is not raised, or cost cutting measures are not taken.

This increasing deficit is further exacerbated in times of declining oil production, when actual revenues may be less than those budgeted. Since the inception of Prop H, oil production figures have declined approximately 1% per quarter. FY 2010 revenues were budgeted based on quarterly oil production levels of approximately 3,370,370 barrels. As mentioned above, actual oil production for the first fiscal quarter of 2010 was 3,264,048 barrels, 3% below budget.

Management of the Gas and Oil Department stated that a new source of oil production might begin in 2012 related to secondary oil drilling in the Long Beach Harbor District. Although new production estimates are difficult to pinpoint until production begins, it is currently anticipated that this new production may result in approximately 1,000 to 2,000 additional barrels produced per day. However, at the current tax rate, 2,000 additional barrels per day equates to only \$197,100 in additional annual Prop H revenue. These potential additional revenues are not sufficient to fully address the expanding deficit mentioned above without changes to planned expenditures.

Recommendation 3:

We recommend that representatives of the Fire Department and Police Department continue to work together with Financial Management to resolve this budget shortfall and develop a plan to prevent budget shortfalls in the future. The Prop H Fund cannot currently sustain the expenses associated with the designated personnel. Alternative funding sources or reductions in expenditures should be considered.

Observation 2:

The Prop H Fund does not reflect the full costs associated with the designated police and fire staffing. Without consolidating all of the expenditures related to the Prop H designated employees into the Prop H special revenue fund, the cost of providing the public safety services and the resulting fund balance will be understated and overstated, respectively. In this case, FY 2010 Prop H budgeted expenditures exceed expected resources by \$100,958, although total projected costs pertaining to the designated employees actually exceed expected revenues by \$449,459. Without corrective action, the General Fund would be required to absorb \$348,501 of expenditures related to these designated personnel in addition to the \$100,958 projected negative Prop H fund balance (as noted in the charts on page 9).

Recommendation 4:

We recommend that representatives of the Fire Department and Police Department continue to work together with Financial Management to consolidate all activities, including equipment costs, pertaining to Prop H-designated personnel into the special revenue fund, and include General Fund subsidies or other transfers within that budget.

MANAGEMENT'S COMMENTS

Fire Department

The Fire Department will continue to work with Financial Management to capture and budget all Prop H costs in the designated special revenue fund and to align budgeted expenditures with budgeted revenues. Due to increasing personnel costs and flat or declining revenue, this will require General Fund subsidies, which may need to be offset with a corresponding reduction in budgeted General Fund expenditures.

Police Department

With regard to Recommendations 3 and 4, the Police Department has met with Financial Management and discussed a process by which the issues identified in Findings 3 and 4 will be addressed in the Fiscal Year 2011 Budget planning process to ensure both continuity of expenses and transparency of funding sources.

The Police Department will continue to work with Financial Management in subsequent annual budget processes to address the adequacy of projected Proposition H revenue to match projected expenditures and, if necessary, identify alternative fund support.

Department of Financial Management

Recommendation 1

The Department of Financial Management concurs with the recommendation. In prior years, the Department of Financial Management used the annual (i.e. year-over-year) change in the December CPI after interpreting the guidance contained in the italicized portion of the passage of Municipal Code Section 3.80.222 (A):

“For the purposes of this section, the special tax shall be automatically adjusted on June 1st of each year, upward or downward, equivalent to the most recent change in the annual average of the Consumer Price Index as published by the United States Department of Labor for the Los Angeles-Riverside-Orange County, CA, area ("CPI"). For purposes of calculating the annual inflation/deflation factor under this section, the base year shall be the year ended December 31, 2006”.

For fiscal year 2008, this approach resulted in no variation from a calculation using the annual CPI rate. The Department immediately revised its procedures for calculating the rate and has received 97% of the revenue associated with this change.

Recommendation 2

The Department has a procedure to determine whether the special tax payment is considered to have been received by the last business day one month after the end of the production quarter. The following methodology is used to determine when the City recognizes the receipt of payment:

- Checks delivered to the department by the City Mailroom on the morning after the last business day of the quarter month are considered received by the City within the quarter month.

This procedure has been considered a prudent and cost effective approach to this requirement.

Recommendation 3

Financial Management staff recognized that the steep decline in oil production left FY 2009 year-end balances below expectations and that FY 2010 estimated revenues would likely fall short of budgeted expectations. Financial Management staff has been working with Police and Fire staff to address the current year shortfall to ensure the fund ends the fiscal year positively, and will ensure that the FY 2011 budget is adopted with a structural balance.

Recommendation 4

Appropriate expenditure reductions or revenue enhancements will be proposed in the FY 2011 budget to align available Prop H resources with total expenditures.