

**Landfill Lease Agreement Audit
May 2007**

Patrice Randle, City Auditor
Craig Terrell, Assistant City Auditor



City Auditor's Office

May 4, 2007

Honorable Mayor and City Council,

I am pleased to present the City Auditor's Office's report on the Landfill Lease Agreement Audit at the City of Arlington. The purpose of the audit was to evaluate the adequacy of the lease administration.

Management concurs with our audit finding and related recommendations. Management's responses to our audit finding and recommendations, as well as target implementation dates and responsibilities, are included in the following report. Within twelve months, the City Auditor's Office will conduct a follow-up audit and comment on management's implementation of these audit recommendations.

We would like to thank City staff for their cooperation and assistance during this project and we look forward to continuing our efforts to further enhance the administration of the Landfill Lease Agreement.

Patrice Randle, CPA
City Auditor

- c: Jim Holgersson, City Manager
- Fiona Allen, Deputy City Manager
- Ron Olson, Deputy City Manager
- Gilbert Perales, Deputy City Manager
- Trey Yelverton, Deputy City Manager

Landfill Lease Agreement

Table of Contents

	<u>Page</u>
Executive Summary	1
Audit Scope and Methodology	2
Background	2
Detailed Audit Finding	4

LANDFILL LEASE AGREEMENT



Office of the City Auditor

Patrice Randle, CPA
City Auditor

Project #06-07

May 4, 2007

Executive Summary

The Lessee is in compliance with material administrative and operating requirements of the Lease Agreement

One-time revenue was received as required

Opportunity for Improvement

Calculation of royalties in accordance with the Lease Agreement

In accordance with the 2006 Annual Audit Plan, the City Auditor's Office has completed an audit of the administration of the Landfill Lease Agreement. The audit was conducted in accordance with generally accepted government auditing standards. The audit objectives were to determine whether:

- Internal controls were adequate to ensure that the lessee met administrative and site operating requirements of the Lease Agreement;
- Adequate internal controls have been established to ensure that recurring revenue (royalties) is received in accordance with the Lease Agreement; and,
- One-time revenue promised under the Lease Agreement was received by the City and used for its intended purpose.

The City Auditor's Office reviewed the most significant administrative requirements (annual price adjustment, annual report of soil used as cover requirements, and annual determination of closure reserve amount) and verified that the lessee was in compliance with the Lease Agreement. Internal audit results indicated that the City's Landfill Lease Administrator verified that the lessee provided required reports in a timely manner and that the lessee (or consultants hired by the lessee) conducted tests or inspections in accordance with state-mandated schedules.

The City Auditor's Office noted that the City accepted a decreased City Collector Disposal Royalty payment of \$140,690, although the Lease Agreement restricts royalty reductions.

The issue is discussed fully in the Detailed Audit Finding section of this report.

Audit Scope and Methodology

Internal Audit reviewed compliance with the Landfill Lease Agreement for the period May 2005 through September 2006. The following methodology was used in completing the audit:

- Interviewed Environmental Services Department employees responsible for administering the Lease Agreement
- Identified and reviewed the most critical administrative and site operating requirements
- Reviewed the calculation of the annual adjustment factor to verify that it was computed in accordance with the Lease Agreement
- Reviewed and assessed internal controls over the receipt of royalty payments

Background

In February, 2005, the Mayor and City Council approved Resolution 05-095, authorizing the lease of the City Landfill. As a result, the City entered into an agreement with Republic Waste Services of Texas, Ltd. effective May 1, 2005 to lease the landfill. Under the 20-year Lease Agreement, (with one 20-year renewal), the City received a one-time payment of \$15 million and will receive annual usage fees and royalties that approach \$4 million.

The Landfill Lease Agreement requires that the lessee pay the City a one-time Development Period Usage Fee of \$500,000, and an initial payment of \$15,053,000. The City Auditor's Office noted that these payments were received as required. Since no usage restrictions have been posed upon these funds, the funds are part of the City's current working capital and may be used for general operating purposes. In fiscal years 2005 and 2006, these funds were reported as unreserved, designated for landfill lease proceeds in the City's financial statements.

The City Auditor's Office identified and reviewed all sources of lease revenue, as summarized in the following schedule:

Landfill Lease Agreement FY '06 Revenue	
Landfill Usage Fees	\$ 2,183,942
City Collector Disposal Royalty	1,126,319
Non-City Waste Royalty	656,072
Brush Waste Royalty	<u>30,000</u>
Total FY '06 Revenue	\$ 3,996,333

Source: Lawson financial system

The Lease Agreement also required that the lessee make donations to support the construction of a new animal services center, a park to recognize the service and sacrifice of fallen public safety workers, and the design and construction of a facility to support continued environmental education. The City Auditor’s Office noted that donations were received as required. The following chart documents the amount donated, expenditures to date and remaining balances of the donated funds as of the end of FY '06.

Expenditures on Landfill Donation Projects Through FY '06			
	Landfill Donations	Expenditures	Remaining Balance
PAWS 2005 Campaign	\$ 140,000	\$ -	\$ 140,000 *
Hero's Park	260,000	27,107	232,893
River Legacy Park	400,000	-	400,000

* \$338,380 spent on animal shelter from other sources through 09/30/06

Detailed Audit Finding

The City Collector Disposal Royalty Fee was reduced through application of an adjustment factor.

Article IV of the Lease Agreement outlines payments due the City for various categories of services provided by the lessee. Each year on the anniversary of the operation commencement date (May 1), the lease stipulates that an adjustment factor be applied to these payment categories. The annual adjustment factor, tied to the Producer Price Index and the Employment Cost Index, is not finalized by the lessee until the information becomes available from the U.S. Bureau of Labor Statistics. As a result, for several months after the anniversary of the operation commencement date, payments are processed using indexes established in the previous year. The lease requires that adjustments made to the monthly payments be applied retroactively to May 1.

The City Auditor's Office determined that all revenue was received in accordance with stipulations in the Lease Agreement, except for the City Collector Disposal Royalty Fee. The Lease Agreement defines the City Collector Disposal Royalty Fee as the net difference between the City Collector Disposal Fee (currently set by the City at \$21.25 per ton) and the City Waste Disposal Fee (initially set at \$18.00 per ton). For the period May through September 2006, the lessee paid the City Collector Disposal Royalty Fee of \$3.25 per ton on 146,552 tons of waste for a total of \$476,294.

Section 4.14 of the agreement provides for the City Waste Disposal Fee to be adjusted annually by the Adjustment Factor, "...provided, however, that in no case shall royalty fees be decreased for any operating year through application of the adjustment factor." In a staff report presented to City Council on January 23, 2007, the Environmental Services Department correctly noted that the lease does not provide for an automatic adjustment of the City Collector Disposal Fee (\$21.25). However, the department allowed an adjustment to the City Waste Disposal Fee (which increased from \$18.00 per ton to \$18.96 per ton), resulting in a reduction of the \$3.25 per ton royalty to \$2.29 per ton. The result was a decrease in the City Collector Disposal Royalty Fee of \$140,690, as shown in the chart below.

Calculation of Royalty Fee Before and After Application of Adjustment Factor						
	City Collector Disposal Fee	City Waste Disposal Fee	Difference	Tons	Total	
As Submitted by Lessee	\$ 21.25	\$ 18.00	\$ 3.25	146,552	\$	476,294
After Adjustment Factor	\$ 21.25	\$ 18.96	\$ 2.29	146,552		<u>335,604</u>
Difference					\$	140,690

The Environment Services Department requested and received permission to allow the lessee to reduce amounts otherwise payable to the City for February, March and April of 2007. Although the City Auditor's Office believes that "royalty fees" as written in Section 4.14 of the Lease Agreement, would include the City Collector Disposal Royalty Fee, the Environmental Services Director provided a different opinion. The Director believes that "royalty fees" in Section 4.14 refers only to the Minimum Annual Guaranteed Royalty Payment for all Non-City Waste that is detailed in Section 4.05 of the Lease Agreement. Clarification of such ambiguous language would facilitate effective administration of the Lease Agreement.

Additionally, Section 8.03 of the Lease Agreement states that, from time to time, the City may change the City Collector Disposal Fee. This would allow the City to increase the \$21.25 City Collector Disposal Fee, resulting in a corresponding increase in the City Collector Disposal Royalty Fee. According to the Environmental Services Director, the City will present a proposal to City Council that will address how to avoid the timing issue related to the automatic increase in the City Waste Disposal Fee.

Recommendation:

The Environmental Services Director should request that the City Council approve a resolution that modifies the Lease Agreement to clarify Section 4.14 of the Lease Agreement.

Management's Response:

A significant change to the lease document is scheduled for consideration by the Mayor and City Council on May 22, 2007. Part of the recommended change includes annually adjusting the City Collector Royalty Fee. While the language in 4.14 is preserved as written, modifications to Section 4.03 and 4.07 are responsive to this recommendation.

Target Date: June 1, 2007

Responsibility: Robert S. Byrd

Recommendation:

The Environmental Services Director should recommend a methodology to increase the City Collector Disposal Fee that preserves the City Collector Disposal Royalty Fee.

Management's Response:

Changes being considered by the Mayor and City Council on May 22, 2007 incorporate a methodology that preserves the City Collector Disposal Royalty Fee which will satisfy this recommendation.

Target Date: June 1, 2007

Responsibility: Robert S. Byrd