



May 6, 2024

To: Executive Committee
From: Darrell E. Johnson, Chief Executive Officer
Subject: Measure M2 Eligibility for the City of Orange

A handwritten signature in blue ink, appearing to read "Darrell E. Johnson", is written over the "From:" line of the header.

Overview

The Orange County Transportation Authority's Internal Auditor has released the results of an independent auditor's report of the City of Orange's compliance with the Measure M2 eligibility requirements for fiscal year 2022-23. The independent auditor's report found the City of Orange lacked adequate documentation to support whether it had spent sufficient discretionary funds on streets and road purposes to meet the maintenance of effort requirement prescribed in the Measure M2 Ordinance. Based on this information, recommendations related the City of Orange eligibility and compliance with the Measure M2 Ordinance are presented.

Recommendations

- A. Find the City of Orange an ineligible jurisdiction to receive or apply for net Measure M2 revenues.
- B. Suspend net Measure M2 revenue payments to the City of Orange until the City of Orange can demonstrate compliance with Measure M2 eligibility requirements and the Board of Directors acts to find the City of Orange an eligible jurisdiction.
- C. Require the City of Orange to demonstrate supplemental investment of discretionary transportation funds equal to the amount of discretionary investment that was short of the maintenance of effort benchmark in the fiscal year 2022-23 (approximately \$1.12 million) as a condition of accessing suspended funds.
- D. Authorize the Internal Auditor to engage independent auditing services to apply agreed-upon procedures to assess the City of Orange's compliance with maintenance of effort expenditures and authorize staff to deduct

audit costs from any future net Measure M2 payments to the City of Orange.

- E. Authorize the Chief Executive Officer to negotiate and execute a settlement agreement with the City of Orange to correct and remedy the fiscal year 2022-23 audit issues and formalize required actions to become an eligible jurisdiction.

Background

The Measure M2 (M2) Ordinance outlines eligibility requirements that each local jurisdiction must continually satisfy to receive net revenues from the M2 Program, including local fair share, Senior Mobility Program, and awards through competitive programs. One of the requirements is that a local jurisdiction must continue to invest a certain level of discretionary revenues, such as general funds that support street and road activities, to be deemed eligible for any M2 funding. This requirement originates from the California Public Utilities Code (PUC) 180001, which enables local transportation authorities to seek voter approval for sales tax measures. The PUC states the intent of the legislature is that funds generated through a sales tax ordinance “shall supplement existing local revenues used for public transportation purposes and that local governments maintain their existing commitment of local funds for transportation purposes” (PUC 180200).

The local jurisdiction demonstrates its commitment to comply with the required maintenance of effort (MOE) by budgeting the appropriate level of discretionary funding as part of the local jurisdiction budget process. The local jurisdiction must also provide the Orange County Transportation Authority (OCTA) with an annual expenditure report to validate that the local jurisdiction has met the MOE commitment for each fiscal year (FY).

The OCTA Board of Directors (Board) determines eligibility based on the information provided by each jurisdiction and with support from the Taxpayer Oversight Committee (TOC), which is also charged with reviewing certain submittals. Following the annual eligibility cycle, the TOC directs the internal auditor to review local agencies’ compliance with M2 requirements through agreed-upon procedures for MOE. The review is designed to confirm that funds have been spent in accordance with the M2 Ordinance and that the jurisdiction had sufficient expenditures to meet the MOE requirement, which is consistent with OCTA’s established MOE benchmark.

Every year, for the last 13 years, OCTA’s Finance and Administration, Internal Audit, and Planning staff, as well as the TOC, have provided training on the MOE

process and cautioned local agencies that budgeting at or just above the required MOE amount may put the jurisdiction's M2 funds at risk if they end up not meeting the requirement due to disallowed costs.

At the direction of the TOC, the OCTA Internal Auditor utilizes OCTA's independent financial audit firm to conduct agreed-upon procedures reviews of selected cities. Results of reviews for the FY 2022-23 were presented to the Finance and Administration Committee on April 24, 2024, and will be presented to the Board on May 13, 2024. The review of the City of Orange (City) indicated that the City lacked adequate documentation to support whether it had spent sufficient discretionary funds on streets and roads purposes to meet the MOE requirement for the M2 Ordinance. The result of the review impacts the City's eligibility determination and the disbursement of net M2 revenues to the City.

Discussion

In June 2022, the City provided MOE certification that stated it had budgeted sufficient expenditures for FY 2022-23, consistent with the following requirement:

“The Authority shall not allocate any net revenues to any jurisdiction for any fiscal year until that jurisdiction has certified to the Authority that it has included in its budget for that fiscal year an amount of local discretionary funds for streets and roads purposes, at least equal to the level of its maintenance of effort requirement.”

The City met the initial MOE requirement through the submittal of the self-certification of intent to meet the MOE based on their FY 2022-23 budget. The City's MOE benchmark for FY 2022-23 was \$3,392,885. The next submittal related to MOE was the expenditure report to verify that the City had actually spent sufficient discretionary funding on streets and roads expenditures to meet the MOE benchmark. The city council approved the expenditure report through a resolution on December 12, 2023, and submitted it to OCTA on December 18, 2023. According to the expenditure report that was submitted, the City spent \$3,852,679 in discretionary revenues on streets and roads-related improvements to meet the MOE requirement.

However, an independent review of the City's expenditures identified costs, which were reported as direct costs, should have been classified as indirect costs. In order for OCTA to allow indirect costs to be used to meet the MOE requirement, the local jurisdiction must have a documented, reasonable cost allocation methodology. The City could not provide documentation to confirm that any of the indirect costs allocated to MOE were allocated based on a

reasonable methodology. After the removal of unsupported indirect costs, the City's shortfall from the MOE benchmark is \$1,116,649. The City, in its response to the audit, acknowledges the findings and indicated that it would ensure indirect charges are supported, documented, and based on a reasonable allocation methodology going forward. After deducting these unverifiable expenditures, the City cannot demonstrate that it has met the MOE requirement for FY 2022-23.

This is not the first city to be recommended to be found ineligible for net M2 revenues due to the lack of a reasonable methodology for determining indirect costs for MOE. OCTA continues to provide reminders and guidance through guidelines, eligibility workshops, and annual M2 Finance Director Workshops, stating that indirect costs must have a reasonable basis or methodology for cost allocation. Despite these efforts, there have been past circumstances that have led to ineligibility determinations under similar circumstances.

The formal process for a determination of ineligibility is specified in the M2 Ordinance as follows:

“A determination of non-eligibility of a jurisdiction shall be made only after a hearing has been conducted and a determination has been made by the Authority's Board of Directors that the jurisdiction is not an eligible jurisdiction.”

Staff is recommending that the Board find the City ineligible to receive M2 revenues to be consistent with the requirements of the M2 Ordinance and to comply with the intent of the authorizing state statute. Specific actions include:

- Find the City ineligible to receive or apply for net M2 revenues;
- Suspend payments to the City of net M2 revenues until the City is deemed eligible;
- Require the City to demonstrate supplemental investment of discretionary transportation funds (above the required MOE benchmark), equal to the amount of discretionary investment that was short of the MOE benchmark in FY 2022-23 (approximately \$1.12 million) as an additional condition of accessing suspended funds;
- Deduct future review or audit costs related to verification of MOE and supplemental investment of discretionary funds from any future net M2 payments to the City;
- Authorize the Chief Executive Officer to negotiate and execute an agreement with the City outlining the process to re-establish eligibility and,
- Direct staff to return to the Board and seek further direction if the City has not re-established eligibility within two years.

Based on these recommendations, subject to Board approval, net M2 payments would be suspended until the City can re-establish eligibility. The funds will be held in reserve, consistent with past practice, until such a time that the City has re-established eligibility, as determined through a future MOE-related review. Costs incurred for the review will be paid for by the City through a reduction in M2 revenues. The M2 Ordinance and eligibility guidelines do not include precise time frames and terms related to re-establishing eligibility. Therefore, OCTA will work with the City to enter into an agreement that details specific requirements and time frames for submittals to support timely re-establishment of the City's eligibility.

Summary

A recent report conducted by an independent auditing firm indicated that the City of Orange did not meet Measure M2 eligibility requirements. Recommendations are presented to find the City of Orange ineligible to receive net Measure M2 funds, consistent with the Measure M2 Ordinance.

Attachment

- A. Crowe, Independent Accountants' Report on Applying Agreed-Upon Procedures, City of Orange

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