

City of Austin



**A Report to the
Austin City Council**

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Kathie Tovo
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AUDIT REPORT

Austin Energy Rate Proposal Audit

January 2012



REPORT SUMMARY

Proposed fixed and variable residential rates, when combined, are comparable to a sample of other utilities while proposed rate structure is not. The cost allocation methodology is acceptable by the industry. We did not identify any instances where reserve funds were used inappropriately. AE did not follow policy when establishing the level for one reserve fund, but the other 5 unrestricted reserve funds are in compliance with policies. AE's Proposed Debt Service Coverage and the Debt Ratio comply with its financial policies and are consistent with guidance for achieving the desired credit ratings.

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GOVERNMENT AUDITING STANDARDS COMPLIANCE

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 that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

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AUSTIN ENERGY RATE PROPOSAL AUDIT

January 2012



Audit Report Highlights

Why We Did This Audit

This audit was conducted as part of the Office of City Auditor's (OCA) FY2012 Strategic Audit Plan.

Audit and Finance Committee members asked the OCA to present the audit results in time for a January 2012 decision on Austin Energy's proposed rate increase.



For more information on this or any of our reports, email
oca_auditor@austintexas.gov

Mayor and Council,

I am pleased to present this audit on the Austin Energy Rate Proposal.

BACKGROUND

- On December 14, 2011, Austin Energy (AE) presented a rate proposal to the Austin City Council.
- AE last raised base electric rates (non-fuel) in 1994.
- AE estimates that a revenue increase of 12.5%, or \$126.8 million, is required to protect the utility's long-term financial stability.

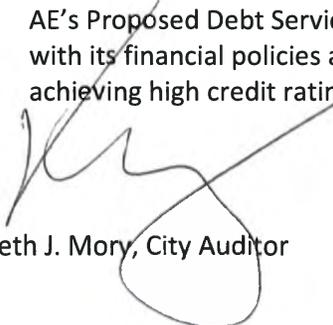
OBJECTIVE AND SCOPE

The objective of the audit was to conduct a limited review, necessary to meet a January 2012 decision, of key portions of AE's proposed revenue requirement and rate design, and compare them to accepted industry practices.

The audit scope included AE's pending rate proposal as well as the work performed by AE and its consultants to complete the proposal.

WHAT WE FOUND

- The combined fixed and variable residential rates proposed by AE produce monthly bills that are comparable to other Texas electrical utilities.
- The *Average and Excess Demand* cost allocation methodology that AE selected for the Cost of Service study is an acceptable method in the industry and has been accepted by the Public Utility Commission of Texas (PUCT).
- Based on a limited review, we did not identify any instances where reserve funds were spent inappropriately in the last five years.
- AE did not prepare a site study to establish levels for the Non-Nuclear Decommissioning Reserve Fund, as required by financial policies. The surrogate study used may not be indicative of expected costs.
- Funding levels AE proposed for six other reserve funds comply with financial policies. AE's proposed reserves are higher than the reserves of other utilities surveyed.
- AE's Proposed Debt Service Coverage and the Debt Ratio comply with its financial policies and are consistent with guidance for achieving high credit ratings.


Kenneth J. Mory, City Auditor

BACKGROUND

On December 14, 2011, Austin Energy (AE) presented a rate proposal to the Austin City Council. AE has not raised its base rates (non-fuel) since 1994. According to AE management, the utility has experienced a significant decline in net income and cash, and determined that a rate increase is necessary to conduct operations and address contingencies. AE selected the Cash Flow Method of cost recovery in determining its revenue requirement because it aligns with their financial policies, and it is acceptable to the Public Utility Commission of Texas (PUCT). AE management estimates that a revenue increase of 12.5%, or \$126.8 million, is required to protect the utility's long-term financial stability.

Audit and Finance Committee members asked the OCA to review AE's rate proposal and present the audit results in time for a January 2012 decision on Austin Energy's proposed rate increase. As such, OCA limited this audit to a review of the AE's pending rate proposal to determine whether residential rates, certain methodologies employed by AE, proposals for reserve funds, and certain debt measures appear reasonable and follow acceptable industry practices. OCA has not performed a comprehensive audit of the revenue requirement, cost of service study, or rate design that are part of AE's proposal.

OBJECTIVES, SCOPE, AND METHODOLOGY

The AE Rate Proposal Audit was conducted as part of the Office of City Auditor's (OCA) Fiscal Year (FY) 2012 Strategic Audit Plan, as presented to the City Council Audit and Finance Committee.

Objective

The objective of the audit was to conduct a limited review, necessary to meet a January 2012 decision, of key portions of AE's proposed revenue requirement and rate design, and compare them to accepted industry practices.

Scope

The audit scope included AE's rate proposal, presented to Council on December 14, 2011, as well as the work performed by AE and its consultants to complete the proposal.

Methodology

To accomplish our audit objectives, we performed the following steps:

- Interviewed AE Finance & Corporate Services Division personnel and other key staff
- Interviewed representatives of interested of citizen organizations and other stakeholders
- Analyzed the pending rate proposal and supporting documents
- Evaluated applicable laws, policies, and industry standards
- Evaluated rate cases brought before the PUCT
- Selected a judgment sample of electric utilities for comparison with AE
- Researched production demand allocation methods and evaluated the methodology AE used to select a cost allocation method
- Reviewed various provisions of the rate proposal for compliance with AE and City financial policies
- Reviewed how AE used reserve funds during fiscal years 2006 through 2010
- Reviewed credit rating guidelines provided by bond rating agencies
- Reviewed and analyzed historic financial information for AE

AUDIT RESULTS

The combined fixed and variable residential rates proposed by Austin Energy (AE) are comparable to amounts charged by a sample of other Texas electric utilities and cooperatives. However, AE's proposed fixed rates exceed those charged by the electric utilities in our sample. None of the sampled utilities have a five-tier progressive residential rate structure as AE has proposed. We are unable to determine the reasonableness of AE's rate structure for residential customers because other utilities are not using AE's planned approach.

The cost allocation methodology that AE used in its Cost of Service study is considered an acceptable methodology in the industry and has been accepted by the Public Utility Commission of Texas (PUCT).

A limited review of transfers from these funds did not identify instances where funds were used inappropriately in the last five years. The targeted funding levels in the rate proposal are within the range prescribed in the financial policies for six of the seven reserve funds. However, AE did not follow its financial policy when establishing the target level for the proposed Non-nuclear Decommissioning Fund.

When compared to a sample of other electric utilities, AE has proposed more reserve funds and the total dollars reserved is higher relative to revenues. (See Exhibit 4.) We also noted that if AE were to replenish two of the funds over a longer period of time it would reduce AE's proposed revenue requirement.

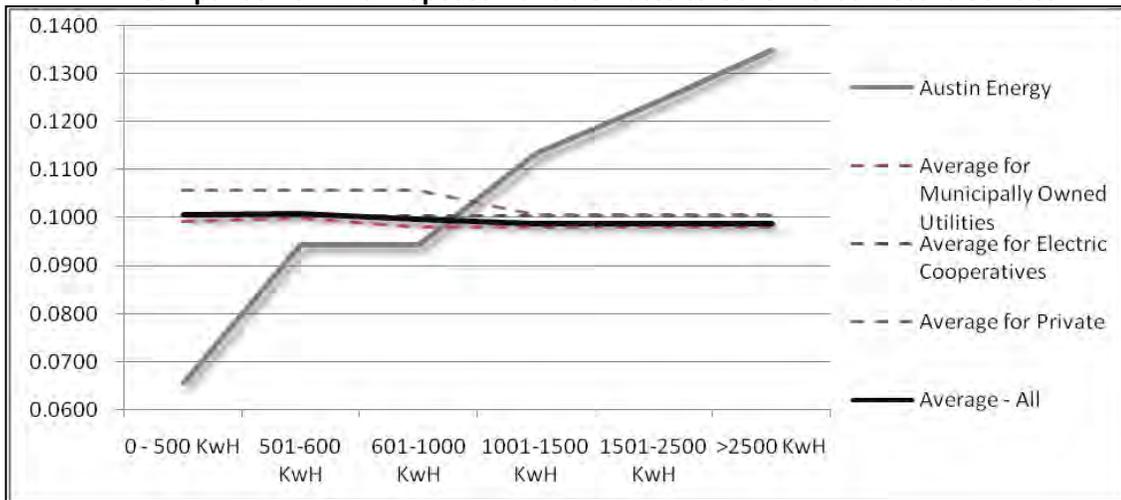
AE has proposed a rate structure that would produce a debt service coverage (DSC) of 2.42x, a level higher than seven of nine other AA-rated electric utilities that we surveyed. In addition, AE's proposal would have AE maintain a Debt Ratio of fifty percent (50%) which is lower than all the other electric utilities that we surveyed.

Finding 1: For an average residential customer, the combined fixed and variable residential rates proposed by AE produce monthly bills that are comparable to other Texas electrical utilities, while the proposed rate structure is not.

For a residential monthly utility bill of 1000 kWh, which is close to the amount used by an average Austin customer, the combined fixed and variable rates proposed by AE are lower than the combined amounts charged by six of eleven Texas electric utilities and cooperatives we surveyed. The fixed amounts charged by the sample utilities varied from only \$3.53 to \$8.88. AE proposes a fixed charge of \$22 with an additional \$1 Customer Benefit Charge. AE's proposed fixed charge is close to the fixed amounts of \$22.50 charged by two electric cooperatives in our sample. As shown in Exhibits 1 and 2, AE's proposed variable rates for less than 1000 kWh are lower than the average for competitors in the sample size, while higher than the average for usage exceeding 1000 kWh.

AE's proposed progressive rate structure includes five tiers with the largest users of energy paying the highest marginal rates. None of the utilities in our sample have a progressive rate structure like AE's. The sample utilities use single rate, progressive two-tier, and regressive two-tier rate structures. We are unable to determine the reasonableness of AE's rate structure for residential customers because other utilities are not using AE's planned approach.

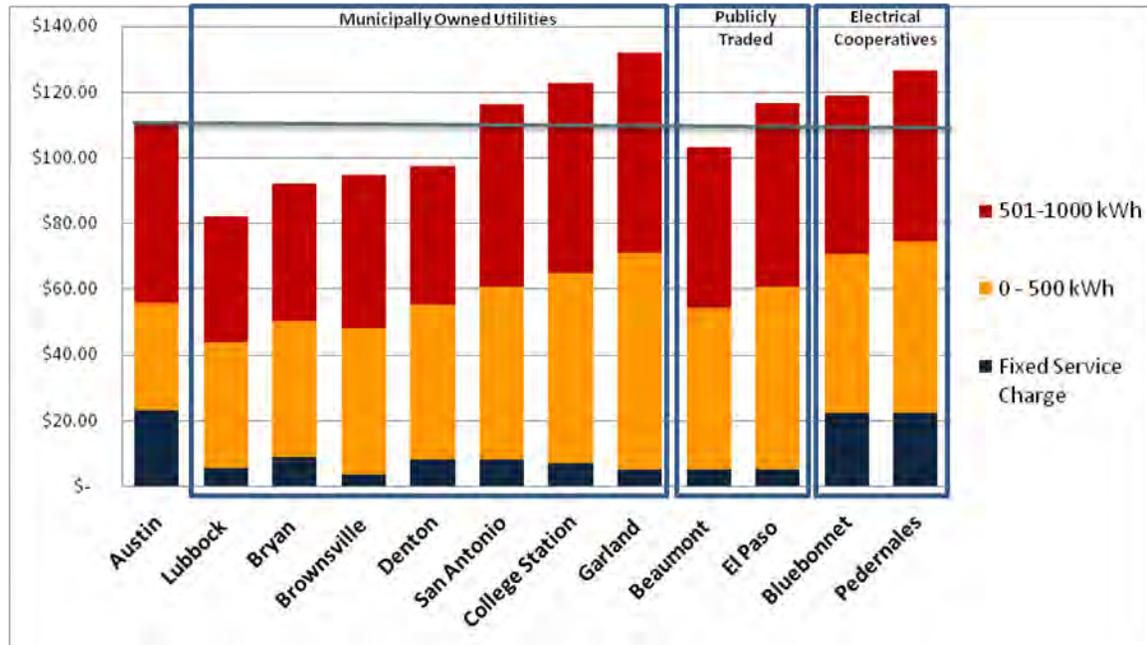
EXHIBIT 1
Comparison of AE's Proposed Variable Rates to Other Texas Electric Utilities



SOURCE: OCA analysis of data collected from utilities sampled

We estimated and compared a total residential bill based on 1000 kWh usage using seven municipally owned Texas utilities, two publicly traded utilities and two cooperatives that serve the greater Austin area. We integrated all known fixed and variable costs including fuel costs and Austin Energy's customer benefit charges. From our analysis, we found that Austin Energy's total bill would be lower than six of the eleven utilities sampled.

EXHIBIT 2
Comparison of 1000 kWh Residential Bills to Other Texas Electric Utilities



SOURCE: OCA Analysis of data collected from utilities sampled

Finding 2: AE’s use of the *Average and Excess Demand (AED)* cost allocation methodology and consideration of elasticity are reasonable.

The AED demand-related production cost allocation methodology that AE used in its Cost of Service study is considered an acceptable method in the industry and has been accepted by the Public Utility Commission of Texas (PUCT). AE selected AED after considering the *Baseload, Intermediate, Peak (BIP)* and *4 Coincidental Peak (4CP)* methods.

The Residential Rate Advisor hired by AE to represent residential customers recommended using the BIP method. In addition, the BIP method produces results that are more favorable for residential customers. However, by applying only 95%¹ of the cost of service to residential customers, AE reduced the impact on residential users despite using AED instead of BIP. Both the BIP and 4CP methods are also acceptable in the industry. However, BIP has not yet been accepted by the PUCT.

AE management did not perform a formal elasticity study for the rate proposal. However, industry standards and the PUCT do not require elasticity studies as part of a rate design. AE’s rate proposal states that they estimated the impact of prices on demand. As a result, AE made minor adjustments to demand and energy charges. AE management states that unbundling of the costs by collecting more fixed costs through fixed charges, along with AE’s strategic goal of conservation, mitigates the risk of reduced demand due to increased prices.

Price elasticity measures the rate of response of demand due to a price change.

Finding 3: Based on a limited review, we did not identify any instances where reserve funds were used inappropriately in the last five years.

AE has financial policies that require it to maintain several reserve funds. See Exhibit 3 for a complete list of AE’s reserve funds. A limited review of transfers and payments from these funds did not identify instances where funds were used inappropriately in the last five years. Only the Rate Stabilization Reserve², Repair and Replacement Fund, and Non-Nuclear Decommissioning Fund had money transferred or paid out during the last five years.

- From FY 2006 through FY 2010, AE transferred \$30.4 million from the Rate Stabilization Reserve to pay for capital projects that included automated meter infrastructure, ERCOT Statewide nodal market systems, and clean energy initiatives. These transfers were made according to AE’s annual approved budgets.
- The Repair and Replacement Fund has been used for providing extensions, additions, and improvements to the Electric System. In FY 2008, \$30.0 million was transferred and an additional \$35.0 million was transferred in FY 2009 to pay for additional generating capacity at the Sand Hill Energy Center. In FY 2010, an additional \$2.0 million was transferred for the Sand Hill Energy Center. These transfers were made according to AE’s annual approved budgets.

¹ For this rate proposal, AE management decided that each customer class would pay no less than 95% and no more than 105% of the cost of service applicable to that class. We are unable to verify the reasonableness of applying 95% of cost of service to residential customers because we were unable to validate the basis for using the 95% since it was based on a management decision and not on a verifiable analysis.

² The Rate Stabilization Reserve is part of the Strategic Reserve Fund.

- From FY 2006 through FY 2010, \$24.5 million has been transferred into the Non-Nuclear Decommissioning Fund, which was established to fund plant retirements. From FY 2006 through 2010, \$4.2 million in payments were made for decommissioning the Holly Power Plant. These transfers and payments were made according to AE's approved budgets.

Finding 4: AE's proposed unrestricted reserve fund levels generally comply with AE financial policies and are higher than the levels found at other utilities.

AE's rate proposal recommends reserving \$404.4 million in six unrestricted reserve funds. The revenue requirement included in the rate proposal includes approximately \$30 million for replenishing the reserve funds to AE's target levels. This accounts for approximately twenty four percent (24%) of AE's requested revenue increase. AE's financial policies prescribe the targeted level of funding for each of the reserves. For some reserves, the policies set a minimum and maximum level; for others the policies establish specific targets. See Exhibit 3 for the targeted amount compared to financial policies.

The targeted funding levels in the rate proposal are within the range prescribed in the financial policies for five of the six unrestricted reserve funds. For two reserve funds AE management targets the maximum funding amount although those reserves do not have a minimum requirement. AE management states that they do not anticipate actually reaching the targeted levels they proposed.

AE did not follow its financial policy when establishing the target level for the Non-Nuclear Decommissioning Fund. Instead, AE based the target level on a study to calculate closure costs for only the Holly Power Plant. Reserves set aside in the fund will pay for decommissioning Fayette and Decker power plants. The financial policy creating the fund requires the utility to perform a decommissioning study to establish target levels. The surrogate study (Holly Power Plant) used may not be indicative of expected costs.

AE proposes replenishing \$73.6 million into the Repair and Replacement Reserve Fund and the Rate Stabilization Reserve Fund over three years. Financial policies do not prescribe the length of time for replenishing these reserve funds, nor do they prescribe when unrestricted cash should be transferred to replenish the reserves. The period of time selected for replenishment of funds will impact AE's proposed revenue requirement. In addition, extending the period beyond three years would allow AE's special contract customers, whose rates are fixed until June 2015, to participate in the replenishment.

EXHIBIT 3

Target Levels for Unrestricted Reserve Funds Proposed by AE

Reserve Fund³	Minimum Required by Policy (\$ millions)	Maximum Required by Policy (\$ millions)	AE Target Level Proposed (\$ millions)	Reserves per Rate Proposal (\$ millions)	Amount Needed to Replenish Fund/ timeline (\$ millions)
Working Capital	51.7	51.7	51.7	51.7	0.0
Repair and Replacement	0.0	61.2	61.2	0.0	61.2/ 3 years
Emergency Reserve	68.9	68.9	68.9	68.9	0.0
Contingency Reserve	68.9	68.9	68.9	68.9	0.0
Rate Stabilization Reserve	0.0	98.2	98.2	85.8	12.4/ 3 years
Non-Nuclear Decommissioning	55.6	55.6	55.6	0.0	55.6/ 10 years
Total	245.0	404.4	404.4	275.2	129.2

SOURCE: OCA analysis of AE financial policies and financial data presented by AE management

AE's current and targeted funding levels for the reserve funds, when measured as a percent of revenues, is higher than the levels maintained by electric utilities we surveyed. AE now has reserve levels equal to twenty percent (20%) of revenues and is proposing increasing the level to thirty one percent (31%) of revenues. The utilities we surveyed maintain reserve funds at four (4%) to seventeen percent (17%) of revenues. Although the measure of reserves to revenues is not common in the industry, we selected the measure to level the field among various sizes of utilities while comparing reserve levels.

Days Cash on Hand shows unrestricted cash and investments that utilities have in addition to the reserves. See Exhibit 4. According to *FitchRatings* report⁴, AE's cash on hand is lower than other utilities'.

³ The Nuclear Decommissioning Reserve Fund is excluded from comparison because it has an offsetting liability and its assets are managed by an external third party.

⁴ *FitchRatings*, US Public Power Peer Study, June 2011

EXHIBIT 4
Comparison of Unrestricted Reserve Funds proposed by AE to Other Utilities⁵

Utility	Total Reserved (\$ millions)	Ratio of Reserves to Revenues	Reserve Fund Balances (\$ millions)					Days Cash On Hand
			Contingency	Emergency	Repair & Replacement	Rate/Fuel Stabilization	Non-nuclear Decommissioning	
Austin Energy (Proposed)	353	31%	69	69	61	98	56	55
Austin Energy (Current)	224	20%	69	69		86		55
San Antonio-CPS	332	17%			332			121
Anaheim Electric	15	4%			15			115
Jacksonville Electric Authority	90	5%			90			77
Orlando Utilities	59	7%			51	7		182
MEAG Power	47	6%	41	6				107
Sacramento Mun. Utility	42	3%				42		158
Lincoln Electric System	10	4%				10		152
Pedernales Cooperative	48	9%	35	13				29

SOURCE: OCA analysis of utilities' financial statement; *FitchRatings*

Finding 5: AE's Proposed Debt Service Coverage and the Debt Ratio comply with its financial policies and are consistent with guidance for achieving high credit ratings.

AE has proposed a rate structure that would produce a Debt Service Coverage (DSC) of 2.42x, a level

Debt Service Coverage (DSC) is a measure of the utility's ability to service its debt, computed by dividing net revenues by total debt service costs (principal and interest on outstanding debt).

Debt Ratio, or Debt to Capital Ratio, is a measure of leverage showing what proportion of debt the utility has relative to its capital assets.

higher than seven of nine other AA-rated electric utilities that we surveyed. In addition, AE's proposal would have the utility maintain a Debt Ratio of 50 percent (50%). This would require AE to fund future plant expansions with equal amounts of debt and cash. AE's Debt Ratio is lower than all the other electric utilities that we surveyed, meaning the other utilities rely more on debt to finance capital assets rather than using cash from operations. See Exhibit 5 below for the comparison of AE's DSC and Debt Ratio to the other utilities. The average DSC among those utilities is 2.12x.

⁵ Working Capital Reserve is excluded from comparison because all utilities maintain working capital, and the Nuclear Decommissioning Reserve Fund is excluded from comparison because it has an offsetting liability and its assets are managed by an external third party.

EXHIBIT 5

Austin Energy Debt Service Coverage and Debt Ratio Comparisons (AA-rated utilities)

Utilities	Debt Service Coverage	Debt Ratio (%)
Austin Energy - Proposed	2.42	50.0
Austin Energy – Actual	1.62	46.8
Anaheim Electric Utilities	1.44	66.8
JEA Electric System	3.34	86.2
Los Angeles Dept. of Water and Power	2.45	55.0
Orlando Utilities Commission	1.83	68.0
CPS Energy (San Antonio)	2.28	58.6
Chattanooga Electric Power	1.98	51.1
Colorado Springs Utilities	1.43	63.4
Nashville Electric Services	2.05	63.4
Pedernales Electric Cooperative	2.27	58.6
Average (excluding AE’s proposal)	2.12	63.5

SOURCE: OCA analysis of U.S. Public Power Peer Study published by FitchRatings, dated June 30, 2011 (unaudited)

City of Austin financial policy establishes a minimum DSC of 2.00x for electric utility bonds. The policy, which was last revised in 2002, does not establish a maximum DSC. The DSC that AE proposes would be a substantial increase for the utility. According to a *Standard & Poor’s* (S&P) report issued on January 6, 2012⁶, AE’s DSC for the past two years has been 1.80x, which is below the minimum established by City policy. The DSC for AE’s 2009 Test Year, which represents actual DSC normalized to reflect a standard year, was 1.66x.

AE reports its Debt Ratio for FY 2010 was forty nine and a half percent (49.5%). The utility’s financial policy establishes a desirable range of forty and sixty five percent (40-65%) for the utility’s debt ratio. According to *Moody’s Investors Services*⁷, utilities that own their generation capacity have a median debt ratio of about sixty percent (60%).

Bond rating agencies look at both of these measures, among other factors, to assign credit ratings. For example, guidelines established by one rating agency suggests that entities maintain a DSC of 2.0 to 2.5 and Debt Ratio of 26% to 50% to achieve an AA rating. While the rating agencies consider other factors, such as cash available for operations, the mix of generation resources, and market stability, AE’s proposed measures would provide support for maintaining its current high credit ratings. See exhibit 6 for comparison of debt measures.

⁶ *Standard & Poor’s*; Austin, Texas; Combined Utility; Retail Electric; January 2012

⁷ *Moody’s Investors Service*; U.S. Public Power Electric Utilities with Generation Ownership Exposure; November 2011

**EXHIBIT 6
Comparison of Debt Measures**

Measure	Proposed	Policy	Moody's Criteria for AA Rating
DSC	2.42x	>2.0x	2.0-2.5
Debt Ratio	50%	40% to 65%	26% to 50%

SOURCE: AE and *Moody's* Investors Service, Inc.

In a January 6, 2012 Report, *Standard & Poor's*³ affirmed their A+ long-term rating for AE's separate-lien electric utility system revenue bonds. The report indicates that S&P has a positive outlook on AE in part due to an expected positive outcome for AE's current rate proposal.