City of Austin

A Report to the Austin City Council

Mayor
Lee Leffingwell

Mayor Pro Tem
Sheryl Cole

Council Members
Chris Riley
Mike Martinez
Kathie Tovo
Laura Morrison
Bill Spelman

Office of the City Auditor

City Auditor
Kenneth J. Mory
CPA, CIA, CISA

Deputy City Auditor
Corrie E. Stokes
CIA, CGAP

AUDIT REPORT

Audit of Austin Energy's Proposed Revenue Requirement

May 2012

REPORT SUMMARY

The FY 09 figures that AE used to develop its test year are supported by the City's audited financial statements, with one exception, which does not impact the revenue requirement.

We tested 17 adjustments and verified that 10 of the adjustments are reasonable, and 2 are not reasonable when compared to actual budgets and expenditures documented subsequent to FY 09. We are unable to verify whether 5 of the adjustments are reasonable.

AUDIT NUMBER: AU12116

TABLE OF CONTENTS

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.

AUDIT TEAM

Walton Persons, CPA, CICA, Assistant City Auditor
Henry Katumwa, CGAP, CICA, Auditor-in-Charge
Charles Holder, CPA, Auditor
Neha Sharma, CPA, Chartered Accountant, CIA, CISA, Auditor
JoJo Cruz, CICA, Auditor
Olga Ovcharenko, CGAP, CICA, Auditor

Office of the City Auditor
Austin City Hall
phone: (512)974-2805
email: oca_auditor@austintexas.gov
website: http://www.austintexas.gov/auditor

Copies of our audit reports are available at http://www.austintexas.gov/auditor/reports

Printed on recycled paper
Alternate formats available upon request

AUDIT OF AUSTIN ENERGY'S PROPOSED REVENUE REQUIREMENT

May 2012

Audit Report Highlights

Why We Did This Audit

At a special called meeting on February 22, 2012, the Austin City Council directed the Office of the City Auditor (OCA) to conduct a review of Austin Energy's revenue requirement. OCA performed this audit in response to Council's directive.

What We Recommend

We did not issue any recommendations in this audit.

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 of Austin Energy's proposed revenue requirement.

BACKGROUND

On February 22, 2012, the City Council directed the City Auditor to complete a review of Austin Energy's (AE) Revenue Requirement Adjustments included in the *AE Rate Analysis and Recommendations Report* as presented to Council on December 19, 2011.

OBJECTIVE AND SCOPE

The objective of this audit was to provide Council with an assessment of the reasonableness of amounts and adjustments used to determine revenue requirements in the *AE Rate Analysis and Recommendations Report*.

The audit focused specifically on the revenue requirement included in the *AE Rate Analysis and Recommendations Report* including the assumptions, methodologies, and revenue requirement amounts.

WHAT WE FOUND

AE made 33 revenue requirement adjustments to both revenue and expense items in the *AE Rate Analysis and Recommendations Report*. OCA selected 17 adjustments, which account for 92% of the total value of the adjustments, for testing. We found that:

- The Fiscal Year 2009 (FY 09) numbers that form the basis for calculating the revenue requirement are materially accurate based on the City of Austin's FY 09 Audited Comprehensive Annual Financial Report, with one exception relating to Capital from Current Revenue that does not impact the revenue requirement.
- Ten of the adjustments we tested are reasonable.
- Two of the tested adjustments are not reasonable when compared to actual budgets and expenditures documented subsequent to FY 09.
- We are unable to verify whether five of the adjustments are reasonable. Each of these adjustments relied on estimates derived from specialized software applications that we have not tested for reliability. For that reason, we cannot verify whether these adjustments are reasonable.

We appreciate the cooperation and assistance we received from Austin Energy staff during this audit.

Kenneth J. Mory, City Auditor

BACKGROUND

On December 19, 2011, Austin Energy (AE) presented its *Rate Analysis and Recommendations Report* (Report) to the Austin City Council. The Report included recommendations on the redesign of AE's rate structures and a proposal for new electric rates. To develop the proposed rates, AE determined its revenue requirement, prepared a cost of service study, and used the results to create a rate design. The revenue requirement presented by AE indicates the utility needs a revenue increase of $126.8 million, representing an 11 percent increase in revenues over Fiscal Year 2009.

At a special called meeting on February 22, 2012, the Austin City Council directed the Office of the City Auditor (OCA) to conduct a review of Austin Energy's revenue requirement. OCA conducted this audit in response to Council's directive.

The revenue requirement is the amount of revenue that AE asserts it must recover through rates and other income sources to pay all the costs of running the utility during a representative Test Year. AE calculated its revenue requirement based on actual figures from Fiscal Year 2009 (FY09) and made "known and measurable" adjustments to normalize the figures so they represent the costs to operate AE during a typical year. This "normalized" year is the Test Year (TY 09).

OBJECTIVES, SCOPE, AND METHODOLOGY

Objectives

The objective of this audit was to provide Council with an assessment of the reasonableness of amounts and adjustments used to determine revenue requirements in the *AE Rate Analysis and Recommendations Report*.

Scope

The audit focused specifically on the revenue requirement included in the *AE Rate Analysis and Recommendations Report* as presented to Council on December 19, 2011 and amended on February 2, 2012, including the assumptions, methodologies, and revenue requirement amounts. The audit focused on AE's calculation of its revenue requirement and did not address AE's cost of service study or rate design.

Methodology

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

- Interviewed AE staff and citizens regarding the revenue requirement adjustments
- Verified the FY 09 numbers that form the basis for calculating the revenue requirement
- Reviewed the Revenue Requirement section of the *AE Rate Analysis and Recommendations Report*, including the known and measurable adjustments made to normalize the test year
- Reviewed work papers prepared by AE and other supporting documentation for the revenue requirement
- Conducted analytical procedures to evaluate report assumptions, methodologies, and revenue requirement amounts

AUDIT RESULTS

OCA verified that FY 09 numbers that form the base for calculating the revenue requirement are supported by the City's audited financial statements, with one exception that does not impact the revenue requirement. In addition, we reviewed the reasonableness, including accuracy, of the adjustments used to develop the Test Year 2009 (TY 09) revenue requirement and conducted trend analysis to verify the appropriateness of the amounts.

AE made 33 revenue requirement adjustments to both revenue and expense items in the *AE Rate Analysis and Recommendations Report*. Our review was limited in scope to 17 of the 33 adjustments. Selection of the 17 adjustments was based on materiality[1] and observed Council and citizen interest. The adjustments selected accounted for $11.6 million of $12.7 million (92%) net total revenue requirement adjustments. A summary of the Test Year Revenue Requirement Adjustments is provided in Appendix A of this report.

Of the 17 adjustments selected for review, we verified that 10 were reasonable, 2 were not reasonable, and we could not verify reasonableness for 5 adjustments. Exhibit 1 shows our overall conclusions for each adjustment.

EXHIBIT 1
OCA Conclusions on the 17 Selected Revenue Requirement Adjustments

Adj. # [2]	Description	Amount ($)	Conclusion
1	Off-System Sales Revenue	43,871,182	Reasonable
2	Normalized Capital Improvement Program	-41,579,109	Reasonable
4	Non-Electric Expense	-14,870,321	Reasonable
5	Non-Electric Revenue	13,799,872	Reasonable
8	Transmission Cost of Service Off-Set	-11,046,676	Reasonable
9	Interest and Dividend Income	9,804,953	Reasonable
12	Service Area Street Lighting Revenue	5,767,940	Reasonable
13	Debt Service	-4,897,654	Reasonable
14	South Texas Project and Fayette Power Plant O&M[3] Expenses	4,868,817	Reasonable
22	City Services	1,640,177	Reasonable
10	Labor Costs	-8,552,604	Not reasonable
16	Sand Hill Energy Center O&M Expenses	4,147,447	Not reasonable
3	Reserve and Contributions	30,093,139	Could not verify
6	Transmission Services Adjustment Rider	-12,509,975	Could not verify
7	Normalization of Load and Resources	-11,751,191	Could not verify
11	Transmission Expenses	7,437,633	Could not verify
15	Re-Aggregated Customer Classes	-4,593,438	Could not verify

SOURCE: OCA analysis of the revenue requirement adjustments.

---

1 Materiality level was established at a level of adjustments equal to or greater than $4 million.
2 This refers to the adjustment number as stated in the *AE Rate Analysis and Recommendations Report*
3 Operations & Maintenance

The adjustments that we were unable to verify as reasonable may, in fact, be fair and appropriate adjustments. However, we were unable to obtain sufficient evidence to verify the adjustments. See Finding 3 for more information on why we were unable to verify those adjustments. See Finding 4 for more information on why we conclude two adjustments are not reasonable, including our estimation of what are reasonable adjustment amounts.

Exhibit 2 provides the positive, negative, and net adjustments categorized as reasonable, not reasonable, unable to verify, and not tested.

EXHIBIT 2
Overall Conclusions Regarding Adjustments ($ thousands)

Conclusion	Additions	Reductions	Totals	Related Finding
Verified as Reasonable	79,753	–72,394	7,359	Finding 2
Verified as Not Reasonable	4,147	–8,553	–4,405	Finding 3
Unable to Verify Reasonableness	37,531	–28,855	8,676	Finding 4
Totals Tested	**121,431**	**–109,802**	**11,630**	
Adjustments Not Tested	8,316	–7,270	1,046	-
Total Adjustments	**129,747**	**–117,071**	**12,676**	-

SOURCE: OCA analysis of the revenue requirement adjustments.

Finding 1: The FY 2009 figures AE used to develop its Test Year are supported by the City's audited financial statements, with one exception that does not affect the revenue requirement.

The FY 09 figures that form the basis for calculating AE's revenue requirement, as presented in *AE's Rate Analysis and Recommendations Report* (Rate Report), reconcile to the City of Austin's Audited *Comprehensive Annual Financial Report* (CAFR) for the year ended September 30, 2009. The figures are materially accurate with one exception, which has no impact on the revenue requirement.

The audited financial statements did not support the FY 09 figure AE used when preparing the Normalized Capitalized Improvement Program adjustment. As shown in Exhibit 3, AE used a Capital from Current Revenue amount of $152.7 million. However, the Statement of Cash Flows in the FY 09 CAFR presents cash used for construction of capital assets of $249.9 million and proceeds from the issuance of commercial paper of $105.8 million. The difference between those two, which amounts to $144.1 million, is the amount of capital from current revenue AE actually used to finance the remaining capital construction in FY 09. However, as described in Finding 2 – Normalized Capital Improvement Program section, AE understated the adjustment amount by an amount equal to the overstatement, offsetting the error. As a result, the difference described here did not impact the calculated revenue requirement.

EXHIBIT 3
Cash Uses: Capital from Current Revenue

	FY 2009 ($)
As reported by AE in the *Rate Analysis and Recommendations Report*, Table 3.5	152.7 million
Correct amount calculated from the FY 09 Audited CAFR, Statement of Cash Flows	144.1 million
Difference	**8.5 million**[4]

SOURCE: Austin Energy Rate Analysis and Recommendations Report (Table 3.5); OCA analysis of the revenue requirement adjustments

Finding 2: Most of the adjustments used by AE to determine its revenue requirement are reasonable.

OCA reviewed AE's data and assumptions for reasonableness. We considered the revenue requirement adjustment to be reasonable if:

- AE's methodology is logical
- Data is verified to supporting documentation and to the City Financial System and was found to be materially correct

Based on our review, 10 of the 17 tested adjustments, accounting for $7,359,182, appear to be reasonable. For these revenue requirements, listed in Exhibit 4, we were able to confirm the validity of the key assumptions; verify the methodology used by AE; and ascertain the mathematical accuracy of the adjustments.

EXHIBIT 4
Reasonable Adjustments

Adj #	Description	Amount ($)
1	Off-System Sales Revenue	43,871,182
2	Normalized Capital Improvement Program	–41,579,109
4	Non-Electric Expense	–14,870,321
5	Non-Electric Revenue	13,799,872
8	Transmission Cost of Service Offset	–11,046,676
9	Interest and Dividend Income	9,804,953
12	Service Area Street Lighting Revenue	5,767,940
13	Debt Service	–4,897,654
14	South Texas Project and Fayette Power Plant O&M Expenses	4,868,818
17	City Services	1,640,177
	Total	**7,359,182**

SOURCE: OCA analysis of the revenue requirement adjustments

Because there has been public discussion and interest on some of these adjustments, we want to explain our work further for the following adjustments:

[4] The difference is due to rounding.

Off-System Sales

The removal of $43.9 million in off-systems sales revenue from the revenue requirement is reasonable.

Prior to December 2010, AE recorded off-system sales revenue from sales of power to other utilities in the wholesale power market. In December 2010, the Electric Reliability Council of Texas (ERCOT) implemented the nodal system structure. Under the nodal system, all entities with generating capacity are required to sell their power to ERCOT and subsequently purchase it back from ERCOT.

According to AE, the transition to the "Nodal Market" changed the way that AE calculated off-system sales, and the financial transactions associated with both sales and purchases of power are difficult to ascertain. The difference between the sales and purchase of power in the nodal market is the "Net ERCOT Settlement" and AE made a decision to record it as part of the fuel cost. This change in effect moved off-system sales from AE's base rate revenue to the fuel recovery component of a customer's bill.

To compensate for this loss in base revenue, AE increased its revenue requirement by $43.9 million. However, AE management asserted that the total customer's bill would not change because the amount charged in the base rate of the bill will increase while the amount charged for fuel will decrease by equal amounts. That is why AE removed off-system sales as a source of funds in the 2009 test year.

Normalized Capital Improvement Program

AE made a $41.6 million adjustment to reduce Normalized Capital Improvement Program (CIP) included in the revenue requirement. The reduction was overstated by $8.5 million. However, the net effect on AE's revenue requirement is zero, as described in Finding 1.

AE calculated the Normalized CIP adjustment based on an assumption that the utility would finance capital projects with 50 percent debt. If AE financed construction with 60 percent debt, as Council and AE have discussed, it would reduce the revenue requirement by approximately $22 million, net of increases in the debt service requirement.

AE used the FY 09 audited financial statements as the basis for developing their revenue requirement. As described in Finding 1, the Capital from Current Revenue AE presented in the *Rate Analysis and Recommendations Report* for FY 09 was $152.7 million. However, the correct amount calculated from the FY 09 Audited CAFR, Statement of Cash Flows, is $144.1 million, which is the difference between cash used for construction of capital assets of $249.9 million and proceeds from the issuance of commercial paper of $105.8 million. As a result, the balance AE adjusted was overstated by $8.5 million. The overstated balance and the overstated reduction in the adjustment produce a net effect of zero on the Test Year balance. For this reason, we conclude that the Normalized Capital Improvement Program included in the revenue requirement is reasonable.

Debt Service

AE's adjustment for debt service of $4.9 million appears to be reasonable. The Test Year debt service savings is calculated by taking the difference in the combined FY 09 actual debt service (principal and interest) from the FY 11 debt service figures. The difference matches the balance presented in AE's adjustment.

City Services

The City Services revenue requirement adjustment of $1.64 million appears reasonable. AE is required to make certain contributions and transfers to the City to support certain City programs. We selected a judgment sample of 7 of the 26 transfers and contributions to the City, which account for $139 million (98%) out of the $142 million of the Test Year amount. We verified that AE is obligated to make those transfers and contributions, and that the amounts reflected in the Test Year are materially accurate based on supporting documentation.

Finding 3: Two adjustments used by AE to determine its revenue requirement are not reasonable.

Based on our review, 2 of the 17 adjustments we tested, totaling $4.41 million, are not reasonable. The adjustments shown in Exhibit 5 below do not reflect AE's current practices and operating costs.

EXHIBIT 5
Adjustments That Are Not Reasonable

Adj #	Description	Amount($)	Reasonable Adjustment ($)	Difference ($)
10	Labor Costs	–8,552,604	–6.5 to –4.4 million	2.0 to 4.1 million
16	Sand Hill Energy Center O&M Expenses	4,147,447	1.2 to 1.9 million	–2.9 to –2.2 million
Total		**–4,405,157**	**–5.3 to –2.5 million**	**-0.9 to 1.9 million**

SOURCE: OCA analysis of the revenue requirement adjustments.

Labor Costs

AE's projected labor savings are not reasonable. AE based its Labor Costs adjustment on two factors. First, it forecast an increase in labor costs. Second, it removed from the FY 09 amounts a one-time adjustment related to post-employment benefits and net pension obligations. The net effect of these two factors reduced the revenue requirement by approximately $8.6 million. However, we found that the increase in labor costs from FY 09 through FY 11 was higher than AE estimated. Rather than reducing the revenue requirement by $8.6 million, a reasonable adjustment would be for AE to reduce the revenue requirement by $6.5 million to $4.4 million.

Sand Hill Energy Center (SHEC) Operations & Maintenance (O&M) Expenses

AE's adjustment to increase the revenue requirement for SHEC O&M expenses is not reasonable. SHEC expenditures have increased from FY 09 to FY 11 and budgeted expenditures for FY 12 also increased, but are still less than the $4.1 million adjustment made by AE. Rather than increasing the revenue requirement by $4.1 million, a reasonable adjustment would be for AE to increase the revenue requirement by $1.2 million to $1.9 million.

Finding 4: We were unable to verify whether five adjustments to AE's revenue requirement were reasonable.

Based on our review, we were unable to verify whether 5 of the 17 tested adjustments were reasonable. As shown in Exhibit 6, these adjustments total $8.68 million.

EXHIBIT 6
Revenue Requirement Adjustments for Which We Could Not Verify Reasonableness

Adj #	Description	Amount ($)
3	Reserve and Contributions[5]	30,093,139
6	Transmission Services Adjustment Rider[6]	–12,509,975
7	Normalization of Load and Resources[6]	–11,751,191
11	Transmission Expenses[7]	7,437,633
15	Re-Aggregated Customer Classes[7]	–4,593,438
	Total	**8,676,168**

SOURCE: OCA analysis of the revenue requirement adjustments.

Each of these adjustments relied on estimates derived from specialized software applications used by AE and its consultants. Although AE states these programs are widely used in the industry, we were unable to test these applications to verify the reliability of the forecasts they produce.

The applications these adjustments rely upon include the following:

- UPLAN, which is software employed by AE to forecast fuel, purchased power, and sales in the ERCOT market
- Matrix ND, which is software AE uses to normalize the Test Year based on historical weather trends and projected future demand. According to AE, this data is required to update UPLAN with the normalized Test Year amounts.
- Software used by Science Applications International Corporation (SAIC), an international firm hired by AE that compiled the data used for the re-aggregation of customer classes with their own software.

Reserves and Contributions

In OCA's January 2012 audit of AE's Rate Proposal, we established that AE used the appropriate methodology to calculate the reserve contributions target levels. These targeted levels comply with AE's council-approved financial policies. However, as we reported in the Austin Energy Rate Proposal Audit issued on January 25, 2012:

- AE did not perform a site study to establish the target level for the Non-nuclear Decommissioning Fund.
- AE proposed replenishing the Repair and Replacement Fund and the Rate Stabilization Fund over a period of three years. AE's financial policies do not prescribe the length of time for replenishing these funds; a longer replenishment period could reduce the rate increase.

---

5 Adjustments that used outputs from UPLAN

6 Adjustments that used outputs from the Matrix ND

7 Underlying data compiled by SAIC

These findings from the prior audit contributed to our conclusion that we cannot verify whether the adjustment for Reserves and Contributions is reasonable.

TEST YEAR 2009 REVENUE REQUIREMENT TABLE FROM AE'S RATE ANALYSIS AND RECOMMENDATIONS REPORT

Table 3.4
TY 2009 Revenue Requirement

Item	FY 2009 ($)	Adjustments ($)	TY 2009 ($)
Operation & Maintenance Expenses			
Production ($)	547.333.150	(3.576.125)	543.757.025
Transmission ($)	66.913.260	10.906.673	77.819.933
Distribution ($)	39.157.987	9.884.532	49.042.519
Customer ($)	67.341.767	(21.798.795)	45.542.972
A&G ($)	135.795.362	(31.107.024)	104.688.338
Total Expenses ($)	856.541.526	(35.690.739)	820.850.787
Depreciation & Amortization of CIAC ($)	108.990.890	8.223.622	117.214.512
Debt Service ($)	176.919.813	(8.849.523)	168.070.290
General Fund Transfer ($)	95.000.000	10.000.000	105.000.000
Margin ($)	26.277.668	(9.904.639)	16.373.029
Other Expenses ($)	16.358.459	(12.829.761)	3.528.698
Other Non-Rate Revenue ($)	(132.427.698)	46.461.546	(85.966.153)
Total Revenue Requirement ($)	**1,147,660,657**	**(2,589,494)**	**1,145,071,163**
$/MWh	95.03	1.90	96.93
Test Year Rate Revenue ($)	1.033.507.095	(15.265.606)	1.018.241.490
Deficiency ($)	114.153.562	12.676.112	126.829.674
Deficiency (%)	11.0	1.5	12.5

SOURCE: Austin Energy Rate Analysis and Recommendations Report

APPENDIX B

ADJUSTMENTS TABLE FROM AE'S RATE ANALYSIS AND RECOMMENDATIONS REPORT

Test Year Adjustments by Major Revenue Requirement Category, TY 2009

	Revenue Requirement Category									
Adjustments(1)	Total Operations & Maintenance Expenses	Depreciation & Amortization of CIAC	Debt Service	General Fund Transfer	Margin	Other Expenses	Other (Non-Rate) Revenue	Non-FAC(2) Rate Revenue	FAC(2) Revenue	Total Adjustment
Off-system sales revenue							43,871,182			43,871,182
Normalized capital Improvement Program					-41,579,109					-41,579,109
Reserve and Contributions					30,093,139					30,093,139
Non-electric Expense	-840,234	-3,619,223	-3,951,869		3,619,223	-10,078,218				-14,870,321
Non-Electric Revenue							13,799,872			13,799,872
Transmission Service Adjustment Rider Revenue								-12,509,975		-12,509,975
Normalization of load and Resources	-41,336,665							18,087,012	11,498,462	-11,751,191
Transmission COS Off-Set							-11,046,676			-11,046,676
Interest & Dividend Income					9,804,953					9,804,953
Labor Costs	-8,552,604									-8,552,604
Transmission Expense	7,437,633									7,437,633
Service Area Street Lighting Revenue								5,767,940		5,767,940
Debt Service			-4,897,654							-4,897,654
STP & FPP O&M	4,865,713					3,105				4,868,817
Re-aggregated Customer Classes								-4,593,438		-4,593,438
SHEC O&M	4,147,447									4,147,447
FPP Scrubber O&M Expense	2,433,504									2,433,504
Power Factor Revenue								-2,305,760		-2,305,760
Metering Expense	2,047,526									2,047,526
Reversal of Holly Inventory Write Off	-1,756,428									-1,756,428
STP Regulatory Asset Deferral	-1,748,752									-1,748,752
City Services	-4,488,138			10,000,000		-3,871,685				1,640,177
Rate Review Expenses	1,292,907									1,292,907
Franchise Fees						1,117,037				1,117,037

APPENDIX B

Adjustments(1)	Total Operations & Maintenance Expenses	Depreciation & Amortization of CIAC	Debt Service	General Fund Transfer	Margin	Other Expenses	Other (Non-Rate) Revenue	Non-FAC(2) Rate Revenue	FAC(2) Revenue	Total Adjustment
	Revenue Requirement Category									
Uncollectible Accounts	907,555									907,555
Incremental Revenue from Solar Gross Metering								-678,635		-678,635
New Building Lease	517,778									517,778
Legislative Advocacy	-314,242									-314,242
Removal of Holly Non-Labor O&M	-178,063									-178,063
Other Revenue							-162,832			-162,832
Removal of Non-Electric Indirect						-125,676				-125,676
Net Additional Depreciation		11,842,844			-11,842,844					0
Overhead Redistribution	-125,676					125,676				0
Category Total	-35,690,739	8,223,621	8,223,621	10,000,000	-9,904,638	-12,829,761	46,461,546	3,767,144	11,498,462	12,676,112

SOURCE: Austin Energy Rate Analysis and Recommendations Report, December 19, 2011.

	Adjustment reviewed by OCA