

Priorities and Procedures of a Regulatory Audit

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Fundamentals of RATE BASE



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Rate Base

- The utility's Rate Base are capital investments that are used to provide service to customers.
- A fair rate of return is applied to the investments to arrive at the net operating income requirement.
- Common items included in the calculation of rate base are:
 - Plant in Service
 - Working Capital
- Michigan uses a 13 month average to arrive at Plant in Service and Working Capital balances to be included in rate base.



Plant in service

- Investors earn a return both on and of plant investment.
- Plant in Service is included net of Accumulated Depreciation in rate base.
- Plant in Service can also include the following:
 - Plant held for future use
 - Plant construction completed not classified
 - Construction work in progress
- Michigan allows the inclusion of Plant held for future use in rate base.
- Michigan also allows the inclusion of Construction work in progress in rate base.



Plant in service

- Some issues to address in auditing Plant in Service:
 - Examine major plant additions included in projections.
 - Examine current and historic plant balances looking for trends in plant investments.
 - Examine budget for capital expenditures.
 - Ask utility to identify all major plant retirements.
 - Confirm that all plant in service retirements are properly reflected as reduction in rate base.
 - Confirm that utility is using the correct historical balance as starting point.
 - Ask utility to identify all major plant retirements.



Depreciation

- The Commission sets the depreciation rates in Michigan.
- Verify the approved depreciation rates and check the accuracy of the depreciation expense calculation.
- If adjustments made to the Plant in Service balance, change the Reserve and Depreciation expense.
- Verify that plant retirements removed from Plant in Service also removed from reserve balance.



Allowance for funds used during construction

- Is defined as the net cost incurred for the period of construction of borrowed funds and a reasonable rate on other funds.
- Can be a combination of debt and equity.
- If CWIP is allowed to be included in rate base, there should not be an accrual of AFUDC.
- If CWIP is not allowed to be included in rate base, AFUDC will be accrued until property is completed and placed in service.
- The auditor should become familiar with the utility calculation of AFUDC.



Working Capital

- Measure of investor funding of daily operating expenditures and a variety of nonplant investments that are necessary to sustain ongoing operations of the utility.
- Is included in calculating the rate base.
- Three methods of calculating working capital.
 - Formula method
 - Balance sheet method
 - Lead-Lag study
- Michigan uses the balance sheet method for working capital. This method uses the 13 month average of current and accrued assets compared to current and accrued interest free liabilities.



Auditing Working Capital

- Some issues to address in auditing Working Capital:
 - Confirm that the Working Capital account balances does not include non-utility revenue.
 - Confirm that the Working Capital account balances does not include non-operating items.
 - Confirm that the Working Capital account balances does not include interest bearing items.
 - Ask utility to provide break up of Deferred debits and credits.
 - Confirm the accounting authority and Commission order for Regulatory Assets and Liabilities.



Rate Case Priorities: Operations & Maintenance Expense



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Operations & Maintenance Expense

Categories:

- Production
- Distribution
- Customer Accounts
- Customer Service
- Sales
- Administrative and General

} Typically reviewed by other Staff: Engineers

} Typically reviewed by our section: Auditors



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Administrative & General Expense

- Some of the typical adjustments to A&G Expense include:
 - Uncollectible Expense
 - Injuries & Damages
 - Political & Charitable Contributions
 - Advertising
 - Incentive Compensation
 - Non-qualified Retirement Plans
 - Expenses that the Commission excluded in the previous rate case



Administrative & General Expense

- Uncollectible Expense
 - Ask the Company for monthly write-offs, collections and sales for the past five years
 - Three or five year average percentage of write-offs less collections to sales revenue :
 - The Company may provide various methods to calculate a projected Uncollectible Expense
 - Typically Staff uses the following formula for Uncollectible Expense:
 - $(\text{Write Offs} - \text{Collections}) / \text{Sales Revenue}$



Administrative & General Expense

- Injuries & Damages Expense:
 - Staff typically prefers a three or five year average.
 - Verify Insurance recoveries for the past three or five years have been a reduction to the expense.



Administrative & General Expense

- Political & Charitable Contributions:
 - Remove all political lobbying and contributions
 - Review charitable contributions for disallowance



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Administrative & General Expense

- Advertising Expense:
 - Review advertising expense for political motives (clean air, fracking, deregulation, etc.).
 - Disallow political advertising.



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Administrative & General Expense

- Incentive Compensation:
 - Short and long-term bonuses
 - Review previous Commission orders for Employee Incentive Compensation positions.
 - Review the various metrics the Company uses for Incentives. Are they financially based? Are they related to safety? Financially based metrics are frowned upon.
 - Review Board of Director minutes and Compensation Committee minutes.
 - Threshold: Do benefits to ratepayers exceed the cost of the incentive?



Administrative & General Expense

- Non-Qualified Retirement Plans:
 - Retirement Plans offered to a select few already highly compensated employees are typically disallowed



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Administrative & General Expense

- Previously Excluded Expenses:
 - Ask the Company to provide a list of all expenses included in the current request that were excluded by the Commission in the Company's last fully contested rate case. Some of these could include:
 - Stock Options
 - Performance Shares
 - Restricted Stock
 - Rewarding Employees Plans
 - Supplemental Employee Retirement Plan
 - Executive Supplemental Retirement Plan
 - Performance Share Dividends
 - Other Executive Benefits (Leased cars, Drivers, Tickets, Security Maintenance and Allowances for Executives, (Description of Each Type with Corresponding Expense), etc.)



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Administrative & General Expense

- Additional Items to Consider:
 - Workforce Reduction
 - Review any workforce reduction plans.
 - Affiliated Transactions
 - Review affiliated transactions between the Company and its partner Companies for inflated costs
 - Significant or Unusual Accounting Items
 - Ask the Company to provide any intercompany memos regarding significant or unusual accounting items that had occurred during the historical period through the projected test year



Administrative & General Expense

Questions?



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