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Monitoring Utility Financial Performance: Conducting An Audit

**Presented By:
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BACKGROUND & DEFINITIONS

- What is the regulatory definition of the term “AUDIT”?

A regulatory review; a field investigation; appropriateness of financial presentation for regulatory purposes (NARUC Rate Case & Audit Manual)

- PUCO’s regulatory authority:
 - “Under the Laws of the State of Ohio, a PUCO employee holding this card may enter in, or upon, and inspect any property and all associated equipment, and may also examine, and copy as required, books, records, documents, and associated materials of any company regulated by the Public Utilities Commission of Ohio.”



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BACKGROUND

Purpose & Scope of Audits:

- Purpose:
 - Verification of sufficiency of finances (not over-sufficiency) and fairness to consumers
 - Management proficiency – restrict utility's ability to pass cost of inefficiencies to the consumer (Prudence reviews)
 - Proper application of financial & regulatory standards
 - Improve operational efficiency
 - One of the major tools to assist regulators in carrying out their monitoring function and assuring financial viability of utilities
- Scope:
 - Narrowed focus (often specific financial applications)
 - Broader focus (management performance and/or operational efficiency)



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OVERVIEW

1. Types of audits
2. Reasons to audit
3. Sources of information
4. Analysis of operating and financing activities:
Conducting an audit



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TYPES OF AUDITS



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TYPES OF AUDITS

- Financial
- Annual adjustment clause
- Management
- Compliance
- Special reviews





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TYPES OF AUDITS

- Financial
 - Mainly confined to tariff/rate process; verification of costs and asset values
- Fuel adjustment clause
- Management
 - Broader in nature; generally done after at least 3-5 years;
 - Assess effectiveness of management and efficiency of operations
- Compliance
- Special reviews



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AUDIT MODELS

- Dedicated audit teams
 - Regulatory body has established specialized audit team that conducts various audits as part of their regularly-assigned duties
- Ad Hoc audit teams
 - Regulatory body establishes various audit teams from time-to-time to conduct an individual specific audit, or a series of a specific type of audit
 - Comprised of individuals with specific and various types of expertise that perform the audit role in addition to other roles in the agency (rate/tariff setting, accounting, finance, engineering compliance, safety)



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REASONS TO AUDIT

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SPECIFIC REASONS TO AUDIT

- Sufficiency
- Sustainability
- Benchmarking



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SPECIFIC REASONS TO AUDIT

Sufficiency

- Profit levels, shareholder earnings
- Return on Equity
- Capital expenditure trends



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SPECIFIC REASONS TO AUDIT

Sustainability

- Debt/equity ratio & trends
- Uncollectible revenues



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SPECIFIC REASONS TO AUDIT

Benchmarking

- Intra-company comparisons – multi-year comparisons of that utility (costs/customer or employee, consultants, etc.)
- Inter-company comparisons – per unit comparisons
- BUT, significant differences may exist due to individual company costs, investments, taxes, different growth rates or levels of saturation



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SPECIFIC REASONS TO AUDIT

- Verification of sufficiency of finances
 - But not over-sufficiency
 - Fairness to consumers while balancing utility/shareholder interests
 - Track outcomes or efforts
- Management proficiency
 - Restrict utility's ability to pass cost of inefficiencies to the consumer
 - Prudence reviews
- Proper application of financial & regulatory standards
- Improve operational efficiency



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SOURCES OF INFORMATION



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SOURCES OF INFORMATION: Historical Data Analysis

- **EXTERNAL**
 - Investment community analyses & reports
 - Governmental filings
 - Independent evaluations
 - Other regulatory bodies
 - Same jurisdiction
 - Adjacent/neighboring jurisdictions
- **INTERNAL**
 - Various company filings
 - Other company documentation



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SOURCES OF INFORMATION – EXTERNAL: Examples

- Investment community analyses & reports
 - Debt Analysts
 - Standard & Poor's
 - Equity Analysts
 - Salomon Brothers
- Governmental filings
 - SEC 10-K, 10-Q
 - FERC Form 2
- Independent evaluations
 - Examination of financial health of publicly traded public utilities
 - Annual Reports



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SOURCES OF INFORMATION - INTERNAL

- Company filings
 - Rate case
 - Fuel cost
 - Forecasts
 - Short-term
 - Long-term
 - Annual Reports filed with PUCO (different from Annual Reports to Shareholders)
 - Intra-company documentation and/or correspondence (PUCO statutory authority re: examination of utility's books & records)
- **Anecdotal information not sufficient for adjudicatory proceedings and hearing record purposes; documentation required**



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ANALYSIS OF OPERATING AND FINANCING ACTIVITIES: CONDUCTING AN AUDIT





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FINANCIAL AUDITS

- Most commonly used by PUCO for fuel procurement activities
 - Natural Gas 
 - Electricity (prior to 2001 & Electricity Deregulation)
- Also for specific riders – 
 - e.g., CG&E Accelerated Main Replacement Program
- To ensure accurate financial representation by utility
 - In its fuel procurement filings
 - Veracity of rates calculated and applied to customer bills



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FUEL ADJUSTMENT CLAUSE AUDITS

- PUCO conducts “periodic” audits of annual adjustment clause or GCR
- Billed subject to refund/adjustment
- 1988 and prior: annual audits
- Since 1989: biennial audits
- Large LDC audits
- Small LDC audits



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FUEL ADJUSTMENT CLAUSE AUDITS

- Small LDC audits
- Large LDC audits





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FUEL ADJUSTMENT CLAUSE (GCR) AUDITS SMALL LDCs

- Small LDC = fewer than 50,000 customers
- Biennial
- Approximately 6 small LDC audits/year
- Staff-conducted; 3 staff members; teams of 2-3
 - Pre-audit preparation
 - Conduct detailed examination
 - Post-audit procedures



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SMALL LDCs: CONDUCTING AN AUDIT

Pre-Audit Preparation

- Previous audit report & recommendations
- Previous Commission orders
 - Previous audit
 - Special GCR dockets
 - Recent rate case
- Company filings at PUCO
 - Annual Reports ~200 pages of forms
 - ownership, board of directors, officers, throughput detail, sales detail, customer counts by class, income, expenses, plant, depreciation, revenues recovered (by class), etc
 - Short-term Forecasts (twice/year filings of company's monthly throughput history for prior 12 months & 6 month projections)



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SMALL LDCs: CONDUCTING AN AUDIT

Pre-Audit Preparation

- Coordinating the audit:
 - Resource allocation
 - Limited Staff resources
 - Limited financial ability to examine
 - 1 mile wide, 1" deep vs. 100' across and 1,000' deep in some areas?
 - Mixed time for interviews & document review
 - Appropriate utility officials available
 - Appropriate utility documents locationally situated for review



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SMALL LDCs: CONDUCTING AN AUDIT

Detailed Examination:

- On-site
- Interview officers
- Review source documentation
- Issue additional/follow-up data requests
- Conduct standard analyses and draft findings
- Compile draft audit report for internal review and utility comment (only to extent of reporting factual errors, not context)
- Revise & finalize report before filing



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SMALL LDCs: CONDUCTING AN AUDIT

Detailed Examination

- Examining for:
 - Supporting DOCUMENTATION
 - Arithmetic ERRORS
 - INAPPROPRIATE charges
 - TIMING issues whether for charges or refunds
 - UNUSUAL costs
 - AFFILIATE TRANSACTIONS
 - ANYTHING OMMITTED



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SMALL LDCs: CONDUCTING AN AUDIT

Detailed Examination: On-site visit:

- Entrance interviews
 - LDC president, billing supervisor, treasurer/accountant, customer service, operations, marketing
 - Re: management & overall operations
 - Familiarization with utility's procedures & protocols
- Examine source documentation
 - Utilize the filed GCRs as the filed rates being audited for verification through detailed examination of on-site documentation



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SMALL LDCs: CONDUCTING AN AUDIT

Entrance Interview Topics

- Utility Practices
- Utility management structure/table of organization
- Decision-making processes
- Examine areas of corporate responsibility
- Examine utility's performance in other regulatory areas
- Familiarization with utility's procedures & protocols
- Coordinate on-site and subsequent information requests



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SMALL LDCs: CONDUCTING AN AUDIT

Review Source Documentation

- Compare filed GCR to what utility billed
- Statistically sample various customer bills to ensure billing accuracy
 - Proper application of existing tariff structure
 - Proper application of that month's effective GCR rate
- Verify actual utility gas purchases (procurement costs) as contained in GCR filings against actual pipeline and supplier invoices



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SMALL LDCs: CONDUCTING AN AUDIT

Review Source Documentation (continued)

- Examine utility's bank records to verify timing & rate of costs paid by utility
- Conduct LUFG calculation based on actual purchase & sale of natural gas
- Verify reported sales to aggregated customer billing records



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SMALL LDCs: CONDUCTING AN AUDIT

Post-audit procedures

- Formally file report
- Utility issues Legal Notice of Hearing via newspapers, as prescribed by PUCO
- Utility drafts testimony in agreement with or in opposition to any or all aspects of audit report
- Settlement or formal hearing



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FUEL ADJUSTMENT CLAUSE AUDITS

- Small LDC audits
- Large LDC audits





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ANNUAL ADJUSTMENT CLAUSE AUDITS LARGE LDC AUDITS

- Large LDC = <50,000 customers
- Biennial
- 2 parts:
 - Financial
 - Management/Performance
- Staff involvement
 - Pre-audit preparation
 - Audit conduction
 - Post-audit procedures



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BIENNIAL PROCUREMENT AUDITS LARGE LDCS

- Financial Audits
- Management/Performance Audits



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BIENNIAL PROCUREMENT AUDITS LARGE LDCS

Financial Audits

- Generally conducted by utility's independent financial auditor (e.g., PriceWaterhouse, KPMG, etc.) hired for Shareholder's Annual Report on examination of utility's books
- Financial auditor required to follow-up on and examine any financial items specifically ordered by the Commission resulting from the prior audit or ordered by the Commission to be examined in the interim



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BIENNIAL PROCUREMENT AUDITS LARGE LDCS

Management/Performance Audits

- Commission issues RFP soliciting bids for focused audits of the management/procurement functions from outside consulting firms
- Tend to be broadly-focused (?) audits
 - Broad review of utility's most recent procurement activities (past) combined with current planning/forecasting functions
 - Focused examination of any items deemed important by PUCO via
- Commission receives proposals and selects independent consultants as the client by ordering the utility to pay for the audit



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BIENNIAL PROCUREMENT AUDITS LARGE LDCS

Management/Performance Audits

- Similar audit procedures followed by auditors
- PUCO Staff oversees auditor selection process & on-going audit work by audit team
- Upon filing of independent auditors' reports (both financial & management/performance audit), Staff may:
 - Agree with auditor's findings
 - File testimony that deviates from the auditors' findings
- Conclude audit process similar to Small LDC process
- Other: intervenors; consumer advocates