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Management Audits / Prudency

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Audit of Financial Statements

- Utility accounts to be maintained according to relevant Uniform System of Accounts
- Annual auditing of a utility's financial statements by and independent certified public accountant
- Audited accounts to be filed with MPUC
- Commission may inspect and copy a utility's books, accounts, papers, and records



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Audit of Utility Operations – “Management Audit”

- Ordered as needed, not routine
- Commission may require a utility to pay for an independent audit of the utility’s operations
- Has utility engaged in planning to ensure that its facilities are adequate to meet the realistic needs of customers ?
- Are its operations conducted in an effective, prudent, and efficient manner under industry standards ?
- Does utility avoid inefficiencies that could increase costs to consumers ?



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Prudence Review

- Prudence is a standard often used in management audit
- Prudence issue considered frequently in the course of a revenue requirements case (rate case)
- Should the utility be permitted to recover from customers (through rates) the cost of “unfortunate” investments or actions ?



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What is prudent ? What is not ?

- Utility must follow a course of conduct that a capably managed utility would have followed in light of existing and reasonably knowable circumstances.
- Analysis looks backwards
- Analysis “forgets” the present
- Reasonable choices that lead to bad results are not imprudent



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Factors considered in assessing prudence

- Utility executives are financial and technical experts
- Prevailing practice is relevant but not determinative
- Was the undertaking substantial ?
- Utility has legal obligation to provide safe, reasonable, and adequate service at lowest cost
- Review initial utility decision and subsequent utility response to changing circumstances
- Prudence analysis is not based on hindsight



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Misalignment of Interests

- Executives of public utility have duty of care to investors and customers
- Imprudence by competitive firms destroys investment
- Imprudence by public utility shifts costs to customers
- Imprudence most frequent where interests are misaligned (excessive rate base; favoritism)
- Regulatory structure seeks alignment of interests



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Prudency Review Arises out of Calculation of Revenue Requirement

- Rate case tests reasonableness of rate base and expenses – only reasonable costs allowed in revenue requirement
- Utility presents “test year”
- Regulators / parties scrutinize accounts accounts
 - Are accounts receivable too high ?
 - Has uncollectible account seen accelerated growth ?
 - Were capital projects necessary ?
 - Were capital projects overbuilt ?
 - Were project costs reasonably managed ?



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Utility Activities Related to Competitive Markets Can Raise Unique Concerns

- T&D utility required to purchase power from “qualified facilities” (QFs)
 - Incentive to enter into “good” contracts ?
 - Incentive to get out of “bad” contracts ?
 - Prudency review is not hindsight review
- Regulatory unbundling can help align incentives and avoid difficulty/discomfort of prudency review. More efficient approach



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Even With Unbundling, Prudency Concerns Arise:

- Maine T&D utility reads meter for itself and competitive suppliers
- T&D utility conducts bills for both itself and competitive electric provider
- Customer pays deposit
- Customer falls into arrears
- Is the deposit credited against T&D receivables or competitive supplier's receivables ?
- When misallocation of deposits affects costs to MPUC's Standard Offer Provider is it imprudent ?



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Incentive-Based, Price Cap Ratemaking

- Revenue requirement established
- Approval of long-term (5 years) rate plan
 - periodic, formulaic adjustments for inflation
 - periodic, formulaic adjustments for productivity (changes in unit cost trend of industry)
- Aligns profit incentive with efficiency; encourages prudent expenditures
 - Service quality mechanism fills in possible misalignment