# ATTACHMENT 5

## Excerpts from NARUC Rate Case and Audit Manual (2003) Pages 7, 14, 35 & 38

**Focusing the Audit**

The auditor may want to prepare an analysis, in order to better focus one's time and resources on portions of the expenses, revenues, and investment that are most likely to impact customers' rates. For instance, it would be easy to get lost in the political sensitivities of trying to eliminate donations and political expenditures that regulators may consider to be offensive, but in doing so, one could overlook the larger expense of special pensions for the Board of Directors that may also be inappropriate. By identifying the big ticket items – those that really matter to the overall level of rates – one can determine the issues about which to inquire first, and those that can wait or move to the bottom of the list.

The spreadsheets of historical data and trends can be very useful in identifying the more significant items. One may want to focus on those costs that have changed the most from historical levels. Regardless of the change from historical levels, the auditor may want to focus on those few items that make up the most significant portion of the operating costs (e.g., salaries, depreciation, and purchased power costs).

Another approach to focusing the audit is to compute ranges of change that would have to be incurred to impact rates. What percentage change in rate base would have to occur in order to change the earned return by one percentage point (or 100 basis points)? In another instance, a utility could be asking for less than its fully authorized return in order to mitigate rate impacts on customers. If so, what dollar level of expense or rate base adjustment would be required in order to exceed the requested authorized return level? These boundaries can assist the auditor in deciding whether to pursue a more difficult or questionable adjustment.

There is another area related to focusing the audit of which the auditor will want to be aware: What limitations or constraints exist regarding the areas to review? If the auditor believes that it is important to review affiliate transactions, it is useful to know early in the process whether one might be overstepping the Commission's authority to review such transactions, or whether the Commission has broad powers of review in this area. Similarly, if the auditor wants to review not only the minutes of the Board of Directors' meetings for the utility, but also for the Board of the parent company, may he/she do so? When looking at these sensitive areas, the auditor should have thought through answers to questions of relevance to the utility operations and Commission authority.

**Reviewing Federal Regulatory Reports, Shareholder Reports, and SEC Filings**

Reports filed by the utility with the Securities and Exchange Commission (SEC), the FCC, the FERC, and other regulatory bodies may contain a host of information over and above the traditional financial information that becomes the mainstay of an auditor's work. This information will reveal everything from lawsuits pending against the utility to the significant accounting practices, if the auditor takes the time to read the footnotes. The perspective provided to shareholders in these reports is often significantly different than the outlook provided to regulators, and may provide the auditor insights into management's views.

## RECORDS TO BE REVIEWED

The following is a list of records that the auditor may consider obtaining or reviewing during the audit or site visit:

- Affiliate Agreements for Inter-affiliate Transactions
- Audit Committee Minutes
- Billing Records (registers, etc.)
- Board of Director Minutes
- Chart of Accounts and Accounts Manual
- Construction Work Orders
- Construction Budgets
- Continuing Property Records
- Depreciation Studies
- External Independent Audit Reports and Workpapers (looking especially at the adjustments that the company chose not to make in spite of the auditor's recommendations)
- Franchise Fee Records (collection and payment)
- General Ledger and Subsidiary Ledgers
- Income Tax Returns
- Internal Audit Reports and Workpapers
- Invoices
- Lead-Lag Studies
- List of Property Units
- Monthly or Quarterly Operating/Financial Reports
- Monthly or Quarterly Trial Balances
- Organizational Charts (one showing the corporate (parent and affiliate entities) and one showing internal reporting lines and internal departments)
- Payroll Records
- Property Tax Statements
- Risk Committee Minutes and Documentation
- Sample of Customer Bills (to verify rates and information)

# OPERATING EXPENSES OTHER THAN DEPRECIATION AND INCOME TAXES

## General Review

In reviewing operating expenses, the auditor may wish to begin by again turning to the historical analysis of expenses that was prepared during the preliminary procedures and the analysis of the month by month test year data. An examination of these spreadsheets will assist one in identifying the initial areas upon which to focus during the audit. It will assist in pinpointing anomalies in the expenses, as well as trends in the expenses. Besides the list of hot topics that might be particular to one's individual jurisdiction, one will want to focus on the oddities indicated by the data.

In looking at the numbers that stand out of the analyses, one will want to gather background on the events that occurred during the test year that may have caused unusual expense levels. Was there a major storm that would have caused the need for unusual levels of maintenance and repair? Was there a labor strike that would have impacted salaries and wage levels? Did a new switch (or power plant) come on line that will change the overall operating costs?

One of the overriding principles to remember when reviewing expense related adjustments is the concept of *known and measurable*, particularly when dealing with adjustments to historic test periods. It is widely accepted that adjustments should have a strong degree of certainty associated with them, and that there should be a reasonable ability to measure the item underlying the adjustment. For example, there might be different mindsets about including an adjustment for additional personnel in the administrative expenses if the job descriptions for the people had been prepared and a classified help wanted ad were being run, compared to simply indicating that additional people were needed but they had not yet been included in corporate budgets. Similarly, there might be a world of difference between indicating that it is the utility's general policy to grant cost of living increases to employees and the situation where one can view the Board of Directors' minutes showing that a specific percentage increase has been approved.

## Maintenance and Repair Expenses and Practices

The auditor will want to look at general maintenance practices of the utility and determine whether the expenses incurred appear reasonable based on those practices. Has there been an increasing or decreasing trend of maintenance expenses? Is there an indication that maintenance is the victim of cost cutting measures in order to maintain shareholder dividends?

One may also wish to consider whether those maintenance practices are consistent with Commission expectations as well as the provisioning of safe, adequate, and reliable service. For example, does the utility have a practice or policy relative to the testing of meters? How often is it done and how does this compare to the manufacturer recommendations? Does it test them salaries than another with fewer, higher paid employees, but it may be that if the costs are similar, the ratepayers are indifferent.

As to the actual expenses in the filing or utility submission, the auditor could assure that the filing reconciles with various payroll records, such as quarterly tax reports. Also, the auditor will want to look for supporting documentation for any payroll adjustments that are proposed. Is there a union contract denoting the increase reflected in the case? Is there a minute of the Board of Directors' authorizing salary changes? Are there payroll records verifying the number of employees during the test year? The auditor should also remember that as salaries and wages are adjusted, so are payroll taxes.

Another area often examined relates to overtime. One will want to determine if the amount of overtime included in the test year is reasonable and more importantly, typical. Therefore, the auditor may wish to look at the percentage of overtime worked during the past few years (generally three to five years) and compare it to the percentage of overtime in the test year. If there is a large difference between the historical numbers and the test year numbers, one will want to obtain an explanation. Additionally, one may wish to consider using a multiple year average percentage of overtime to use in the computation of the revenue requirement in order to normalize any test year anomalies. One may wish to look at capitalization versus expense ratios, and contract labor levels in a similar manner to that just described for overtime.

The auditor may also find it informative to look at severance costs (e.g., for recent changes of top management) and stock options in terms of the overall reasonableness of compensation packages. It is important to remember that through the audit, the auditor is not trying to manage the company, or even tell the company what the utility policies are to be. Rather, one is attempting to determine what is a reasonable level to be included in revenue requirement for inclusion in customer rates. The auditor should find out whether his/her Commission has allowed severance costs and stock options to be included in setting rates.

**<u>Pensions</u>**

A basic understanding of SFAS 87, Employers' Accounting for Pensions, will want to be held by the auditor. This accounting standard requires that pension plans be accounted for on an accrual basis rather than on a cash basis. In other words, the cost of an employee's pension is recognized over that employee's approximate service life, and the books reflect those expenses over that life, rather than basing it on the amount the employer decides to contribute to that plan for any particular period. The statement also requires immediate recognition of a liability when the accumulated benefit obligation exceeds the fair value of plan assets. This later provision of recognizing an additional liability may have ratemaking relevance with continued dramatic movements in stock values and thus, the value of pension plans. The auditor will want to see what has transpired with the pension plan relative to recent changes in the stock market.