AGENDA

Assembly Budget Subcommittee No. 3 on Resources and Transportation

Assemblyman Richard Bloom, Chair

March 6, 2013

9:00 a.m. - State Capitol Room 447

California Public Utilities Commission (CPUC) Performance Audit

The purpose of this hearing is to discuss the Office of State Audits and Evaluations' (OSAE) audit to evaluate whether CPUC's budget process for developing the 2012-13 and the 2013-14 Governor's Budgets provided reliable and accurate information to Finance, the Governor, the Legislature, and other stakeholder.

9:00 – 9:15	**Welcome & Introductions**
9:15 - 9:45	**Overview of CPUC Audit** David Botelho, CPA Chief, OSAE Department of Finance (DOF)
9:45 – 10:15	**Legislative Analyst's Office (LAO)** Tiffany Roberts, Senior Fiscal & Policy Analyst - Energy and Climate Change
10:15 – 10:45	**California Public Utilities Commission** Paul Clanon, Executive Director Edward Randolph, Director, Energy Division Michelle Cooke, Director, Administrative Services
10:45 – 11:15	**Division of Ratepayer Advocates (DRA)** Joseph P. Como, Acting Director
11:15 – 11:30	**Public Comments**

Overview of Audit

As a result of the special fund discrepancies found at the Department of Parks and Recreation in July 2012, the Governor directed the Department of Finance (DOF) to conduct a review of all the state's over 500 special funds. This review revealed variances greater than $1 million for seven of the funds the CPUC administers. The CPUC oversees 14 special funds, which collect surcharges that exist on gas, electric and telephone bills. This money is used for such things as subsidies for low-income natural gas customers and telephone services for deaf and disabled individuals. While some of the variances were attributable to methodology, timing, and human error, a significant portion were unexplainable. As a result, DOF launched an audit of CPUC's budgeting practices and procedures.

DOF's audit objectives were to evaluate whether CPUC's budget process for developing the 2012-13 and the 2013-14 Governor's Budgets provided reliable and accurate information to DOF, the Governor, the Legislature, and other stakeholder. The audit also evaluated the adequacy of the CPUC's fund condition statement reconciliation process of the seven funds with variances (between State Controller's Office and DOF records) greater than $1 million, to ensure accurate fund balances as of June 30, 2011.

DOF's audit found "widespread weaknesses within CPUC's budget operations which compromise its ability to prepare and present reliable and accurate budget information." The audit found:

- Ineffective management over budgeting functions;
- Budget forecasting methodologies and monitoring need improvement;
- Fiscal management practices need improvement; and,
- Non-compliance with statutory requirements specified to the Division of Ratepayer Advocates.

CPUC Background

The CPUC, headquartered in San Francisco, regulates privately owned electric, natural gas, telecommunications, water, railroad transit, and passenger companies. It was established by Constitutional Amendment as the Railroad Commission in 1911. The CPUC is made up of 11 divisions and administers 14 special funds. It is governed by five Governor-appointed Commissioners. According to CPUC's 2012 Annual Report, Californians spend more than $50 billion annually for services from industries regulated by the CPUC.

The Division of Ratepayer Advocates (DRA) is a division within the CPUC established to advocate on behalf public utility customers and to ensure the lowest possible rates for service. Monies from the Public Utilities Commission Reimbursement Account are transferred to the Ratepayer Advocate Account in the annual Budget Act. The Ratepayer Advocate Account is authorized to be used only by DRA in the performance of its duties.

Summary of Audit Findings

- Ineffective Management Practices over Budgeting Functions

  OSAE observed inadequate internal controls over CPUC's budget process, insufficient staffing levels in the budget office and limited to no guidance or oversight for these tasks.

  Since 2001-02, CPUC's administration of special funds has grown from 4 to 14. However, management did not adequately respond to the related administrative challenges of the increased complexity and workload. The Budget Office consists of one employee who is responsible for managing the budget responsibilities for 14 funds. This has led to tasks being farmed out to part-time annuitants, members of the executive management and program staff who receive limited to no guidance or oversight. Who ultimately is responsible for CPUC's budget operations is unclear.

  The audit also found that CPUC does not provide comprehensive training to staff responsible for developing, monitoring, and reporting budget information. This includes basic understanding of budget processes and procedures. Non-Budget Office staff lacked an understanding of how tasks performed contributed to the information reported in the Governor's Budget. Further, program staff are not trained regarding the reporting of encumbrance and accrual information to the Fiscal Office, which increases the risk that incorrect and inaccurate information may be communicated to and relied on during budget preparation by decision makers.

- Forecasting Methodologies Need Improvement

  OSAE observed that over the past seven budget cycles, CPUC's forecasting models have produced results that significantly differ from the actual revenues, reimbursements, and expenditures as published in the Governor's Budget.

  Because of deficiencies in its forecasting models, CPUC is not always able to reliably project the revenues, reimbursements, or expenditures for the funds it administers. OSAE identified variances were as much as 73 percent and $189 million in revenues and as much as 99 percent and $212 million in expenditures. Most variances were found to be unexplainable.

  Further, the audit found CPUC was not performing year-to-year trend analysis, considering overall fund condition including budgeted revenues/expenditures, cash reserves, or fund balances, nor performing reviews of previously budgeted amounts to actual revenues or expenditures and investigating significant variances.

  Forecasting deficiencies have impacted CPUC's budgeting processes by causing projected or actual negative fund balances, or conversely, excessive fund balance reserves. The Legislature relies on this information to make budgeting decisions. Inaccurate forecasts make it impossible for the Legislature to know the actual performance of CPUC's funds and programs.

- *Fiscal Management Practices Need Improvement*

  OSAE found that lack of recording transactions caused CPUC's accounting records to misrepresent the true financial condition of the funds and did not support the amounts reported in the Governor's Budget. OSAE identified accounting records for four funds (Funds 0462, 0483, 0493, and 3015) that did not include deposits in Surplus Money Investment Fund (SMIF) transactions. As a result, the funds' accounting records were materially misstated. For example, as of June 30, 2011, unrecorded SMIF transactions ranged from approximately $40,000 to $275 million.

- Non-Compliance with Statutory Requirements

  Current law requires the director of the Division of Ratepayer Advocates (DRA) to develop the DRA budget and submit it the commission for final approval. OSAE found that DRA does not prepare its own budget, nor is it reviewed and approved by the CPUC. Rather, the CPUC Budget Office prepares and approves the DRA budget. The process lacks transparency, and has led to DRA being unable to adequately explain, or defend its own budget.

- Inadequate Fund Balance Reconciliation

  As a result of DOF identification of variances between the June 30, 2011 fund balances reported in the Governor's Budget and SCO's records, CPUC initiated reconciliations to identify reasons and/or explanations for the identified variances. As mentioned previously, CPUC reconciled its accounting records with the SCO records and its accounting records with the Governor's Budget for the seven funds identified with $1 million or greater variances.

  However, OSAE found CPUC's reconciliations lacked sufficient instructions from CPUC management resulting in inadequately prepared reconciliations for five of the seven funds reviewed. OSAE identified inconsistencies in the methodologies used to perform the reconciliations, mathematical errors, and transfer errors.

  Because of the incorrect calculations, OSAE re-performed the reconciliations. OSAE's analysis found many factors contributed to the variances. The following table details the results of the five funds' reconciliations.

CPUC Fund Balance Reconciliation	
Fund	**Explanation**
0462 - Public Utilities Commission Utilities Reimbursement Account	Variance due to a combination of not recording SMIF or General Fund loan transactions, and unsupported prior year adjustments in the Governor's Budget.
0470 - California High-Cost Fund-B Administrative Committee Fund	Variance due to timing differences in recording of General Fund loan transactions and unsupported prior year adjustments in the Governor's Budget.
0483 - Deaf and Disabled Telecommunications Program Administrative Committee Fund	Variance due to not recording SMIF or General Fund loan transactions, and unsupported prior year adjustments in the Governor's Budget.
0493 - California Teleconnect Fund Administrative Committee Fund	Variances due to not recording SMIF transactions and unsupported prior year adjustments in the Governor's Budget.
3015 - Gas Consumption Surcharge Fund	Variance unable to be determined.

To prevent future variances between the Governor's Budget and SCO fund balances, on September 6, 2012, DOF issued Budget Letter 12-22 to remind and inform state departments of existing and new requirements for reporting past/prior year financial data when submitting budget documents during development of the Governor's Budget. The letter also requires that information provided to DOF be accurate and reconciled between accounting and budget records.

Audit Recommendations

The audit recommends CPUC take a series of actions, including the following:

- Strengthen its fiscal controls over its budget process and fund administration:
  - Increase staffing in the Budget Office;
  - Establish and clearly define roles and responsibilities of those performing budgeting tasks;
  - Ensure that the Budget Office is the sole unit within CPUC responsible for all budget functions (with the exception of the preparation of DRA's budget);
  - Develop comprehensive training program for staff; and,
  - Document and regularly update key budget and fiscal policies and procedures.

- Improve forecasting processes:
    - Develop and document key policies and procedures for forecasting all funds; revenue and expenditure activity.
    - Ensure forecasting models include:
        - Assessing the viability of assumptions;
        - Performing year-to-year trend analysis of budgeted and actual revenues and expenditures; and,
        - Compare previously budgeted revenues and expenditures to actual amounts and investigate variances.
- Strengthen its fiscal management practices to ensure the accuracy and reliability of its accounting data by developing procedures to record deposits in SMIF transactions in its accounting records.
- DRA should assume responsibility for the development of its budget, develop processes to facilitate transparency, and submit its budget to the commission for approval.

CPUC's Response
The CPUC has formally stated that it agrees with nearly all of the findings and has communicated to auditors that it is working on correcting problems. According to the CPUC, the "audit correctly identifies the primary issue the CPUC must address is that its management practices over the budget functions were ineffective. All subsequent observations stem from this shortcoming." The CPUC must submit a corrective action plan to OSAE by April 10, 2013. The Governor has submitted a budget proposal to fund three new budget positions at the CPUC.

The one finding that the CPUC disagreed with the audit involves the observation that it has not complied with current law regarding its preparation of DRA's budget. According to the CPUC, it believes that statute appears to support the existing and longstanding practice of having DRA's budget approved by the Executive Director. "The fact that the Legislature has not objected to this existing practice would seem to add legitimacy to this conclusion."

LAO Analysis. *Audit Raises Concerns Regarding CPUC's External Auditing Functions*. LAO finds that the OSAE audit raises several issues that merit legislative oversight, in order to ensure that CPUC's budget process becomes more transparent and accurate. It also notes that the audit's findings regarding problems with the commission's internal budgeting and accounting practices raise questions about CPUC's ability to effectively audit the records and accounts of the utilities that it regulates. Under current law, CPUC is required to audit at least once every three years utility "balancing accounts." (Balancing accounts are authorized by the CPUC for specific projects, programs, or other requirements that the utility must implement in accordance with CPUC decisions). These accounts are established by the utilities and used to track revenues and expenditures for such activities as electricity procurement, energy efficiency programs, and the EPIC program. Balancing accounts help to ensure that ratepayers only pay CPUC–authorized amounts and that utilities will be able to recover the amounts needed to support their revenue requirements or costs. If a utility receives more revenue than is needed from ratepayers, then ratepayers receive a credit. Alternatively, if the utility has not received enough revenue, then ratepayers will be required to pay more to make up the difference.

LAO recommends that the Legislature request the Joint Legislative Audit Committee to direct the Bureau of State Audits to conduct an audit of the CPUC’s processes for auditing the accounts of those entities that it regulates for regulatory and tax purposes. In particular, the requested audit should examine the process that CPUC uses to review utility balancing accounts.

Staff Comments.
The magnitude and scope of the mismanagement of CPUC's internal budgeting, forecasting and accounting practices is alarming. The most noteworthy findings are as follow:

- ✓ "Inaccurate forecasts make it impossible for the Legislature to know the actual performance of CPUC's funds and programs."

- ✓ "Who ultimately is responsible for CPUC's budget operations is unclear."

- ✓ CPUC staff responsible for developing, monitoring, and reporting budget information lack "basic understanding of budget processes and procedures."

- ✓ "Forecasting deficiencies have impacted CPUC's budgeting processes by causing projected or actual negative fund balances, or conversely, excessive fund balance reserves."

- ✓ Unrecorded transactions, ranging from $40,000 up to $275 million, caused CPUC’s accounting records to be "materially misstated."

The Legislature relies on this information to make budgeting decisions. Staff concurs with the audit's assessment that inaccurate and incomplete information "make it impossible for the Legislature to know the actual performance of CPUC's funds and programs." Given the breakdown of fiscal controls revealed in OSAE's audit of the budget processes at the CPUC, the Subcommittee should consider requesting OSAE conduct a fiscal audit, which would be a critical analysis of the CPUC's financial records and documentations.

The Subcommittee may also wish to explore the impact these budgeting issues have had on rate payers. A review of the special funds the CPUC oversees revealed that four funds had fee increases and one fund had a structural deficit (California Teleconnect Fund). The Universal Lifeline Telephone Service Fund showed a fee increase of $171,907,000 – nearly doubling the size of the fund. The Subcommittee may wish to ask the CPUC to explain the reasons for these rate increases and what caused the Teleconnect Fund structural deficit.

The LAO makes a persuasive argument that the problems with the CPUC's internal budgeting and accounting practices raises concerns about the Commission's ability to effectively audit the records and accounts of the utilities that it regulates. CPUC is responsible for auditing special purpose accounts, known as “balancing accounts,” set up by California's major power companies (i.e., PG&E, Southern Cal Edison, San Diego Gas & Electric, and Southern California Gas Company) to pay for activities required by the CPUC. These accounts hold billions of ratepayer dollars and are used for projects such as procuring electricity, as well as energy efficiency and smart meters.

The Public Utilities Code Section 314.5 states:

> The commission shall inspect and audit the books and records for regulatory and tax purposes (a) at least once in every three years in the case of every electrical, gas, heat, telegraph, telephone, and water corporation serving over 1,000 customers, and (b) at least once in every five years in the case of every electrical, gas, heat, telegraph, telephone, and water corporation serving 1,000 or fewer customers. An audit conducted in connection with a rate proceeding shall be deemed to fulfill the requirements of this section. Reports of such inspections and audits and other pertinent information shall be furnished to the State Board of Equalization (BOE) for use in the assessment of public utilities.

The BOE has not received any CPUC audit reports since 1977. Staff discovered that the CPUC does not maintain a comprehensive list of the utility accounts it is statutorily required to audit or the authorized amounts for such accounts. After admitting publically that it didn't know the precise number of balancing accounts it oversees, the CPUC stated that "it oversees approximately 170 utility balancing accounts" totaling $29.4 billion. However, staff has not been able to verify this claim. In January 2013, the LAO requested the CPUC provide a list of all the balancing accounts that CPUC has authorized, including the name of each account, as well as the amount the CPUC had authorized to be collected from rate payers for each account. The information submitted to LAO by the CPUC contained gross errors and inaccuracies. Further, the CPUC failed to provide staff with a requested list of these accounts and audits the CPUC performed on these accounts prior to this hearing.

The CPUC has stated that it agrees with nearly all of the findings in the audit. However, it disagreed with OSAE's finding that it has not complied with current law regarding its preparation of DRA's budget. Current law requires the director of the DRA to develop the DRA budget and submit it the commission for final approval. However, OSAE found that DRA does not prepare its own budget, nor is it reviewed and approved by the commission. Rather, the CPUC Budget Office prepares and approves the DRA budget. Staff concurs with the audit's assessment that this process does not follow the law and lacks transparency.

Further, while DRA generally has full knowledge and control over its personal services budget and direct Other Operating Equipment and Expense (approximately $20.3 million), it has no control or information about the administrative and legal support services costs provided by the Commission (just over $7 million). As a result, it has been unable to specifically budget or track these costs.

Staff Recommendation:

1. Request OSAE conducts a fiscal audit of the CPUC.

2. Request the Joint Legislative Audit Committee to direct the Bureau of State Audits to conduct an audit of CPUC's processes for auditing the accounts of those entities it regulates for regulatory and tax purposes. In particular, the audit should examine the process that CPUC uses to inspect and audit utility balancing accounts.

3. Direct staff to work with the Department of Finance on drafting provisional budget language that stipulates that any funds authorized from the Public Utilities Commission Ratepayer Advocate Account shall be utilized exclusively by the DRA in the performance of its duties as determined by the director.

4. Request that the CPUC submit a copy of its Corrective Action Plan to the Subcommittee on April 10, 2013.

5. Request that the CPUC submit a comprehensive list of all of the accounts of those entities it regulates for regulatory, and tax purposes, including all utility balancing accounts, and provide a record of the audits performed on these accounts.

6. Request the CPUC report back to the Subcommittee on its Corrective Action Plan at its budget hearing on April 24, 2013.