City Council's Office of the City Auditor
Colorado Springs

OFFICE OF THE CITY AUDITOR
COLORADO SPRINGS, COLORADO

11-06
ELECTRIC COST ADJUSTMENT, GAS COST ADJUSTMENT , AND ELECTRIC CAPACITY CHARGE ADJUSTMENT REVIEWS

March 2011

OFFICE OF THE CITY AUDITOR
PUBLIC REPORT

Date: March 3, 2011

To: Honorable Mayor and Members of City Council

Re: 11-06 Electric Cost Adjustment (ECA), Gas Cost Adjustment (GCA), and Electric Capacity Cost (ECC) Adjustment Reviews

We conducted audits of the proposed ECA, GCA, and ECC adjustments. The purpose of these audits was to evaluate whether CSU prepared the Electric Cost Adjustment (ECA), Gas Cost Adjustment (GCA), and Electric Capacity Charge (ECC) in accordance with the approved tariffs. The methodology to calculate the ECA and GCA was compared to prior filings for consistency and calculations were tested for accuracy.

The ECC charge adjustment represents a reduction in the ECC to return $3.5 million, or 50% of the 2011 estimated savings to electric customers related to the purchase of the Front Range Power plant in December, 2010. We reviewed the methodology for calculating estimated savings for reasonableness and agreement with the ECC tariff

We concluded that the ECC adjustment with the purchase of Front Range Power will produce a lower Debt Service Coverage Ratio than that used in the financial metrics described in the 2011 Electric Rate Case. However, CSU management has indicated that rating agencies support a lower debt service ratio for power generators and integrated utilities. Therefore, the lower debt service coverage should not be a problem. We have recommended CSU communicate these changes to the City Council.

We conclude that the ECA and GCA calculations are accurate and in accordance with the related tariffs.

These adjustments will impact the typical residential bill as follows:

$2.82 increase related to the ECA
$5.69 increase related to GCA
($1.32) decrease related to the ECC
$7.19 increase

As always, feel free to contact me if you have any questions.

Sincerely,

Denny Nester
Interim City Auditor
MBA, CPA, CIA, CGFM, CFE, CGAP

Cc: Jerry Forte, Chief Executive Officer
Bill Cherrier, Chief Financial Officer
Stella Chan, Manager, Financial Planning and Pricing
Dave Maier, Manager, Enterprise Risk Management

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OFFICE OF THE CITY AUDITOR
COLORADO SPRINGS, COLORADO

Electric Cost and Gas Cost Adjustment Reviews

March 2011

Purpose

The purpose of this audit was to evaluate whether CSU prepared the Electric Cost Adjustment (ECA) and Gas Cost Adjustment (GCA) in accordance with the approved tariff. The methodology was compared to prior filings for consistency and calculations were tested for accuracy.

Highlights

Based on our review of the calculations and related background information, both the ECA and GCA were calculated in accordance with the approved tariffs. The model being used indicates the current overcollected balances will be returned to customers by the end of March 2011.

ECA

The last ECA adjustment was effective January 2009 authorizing a refund of $.0067 per kWh unit. The overcollected balance was approximately $33 million at the time of the last adjustment.

The actual overcollected balance at January 2011 per this review was $3.6 million. Colorado Springs Utilities proposes in this filing to decrease the refund from $.0067 to $.0020.

Also, note that the ECA has been impacted by the purchase of Front Range Power by removal of management agreements with associated revenue and expense. These changes were implemented January 1, 2011.

GCA

The last GCA adjustment was effective November 2010 resulting in a refund of $.1499 per unit. The overcollected balance was approximately $21 million at the time of the last adjustment.

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Management Response

Recommendations

Electric Cost and Gas Cost Adjustment Reviews

March 2011

(Highlights continued from page 1)

The actual overcollected balance at January 2011 per this review was $7.5 million. Colorado Springs Utilities proposes in this filing to decrease the refund from $0.1499 to $0.055.

OBSERVATIONS:

Colorado Springs Utilities includes the Office of the City Auditor in monthly meetings to review changes in ECA and GCA balances. Accordingly, our Office has observed a commitment to reach and maintain minimal over and under collected balances for ECA and GCA. Colorado Springs Utilities reviews the forecasted balances and anticipates timely changes while attempting to minimize the impact to customers. We recognize the unpredictability of weather and volatility in prices as uncontrollable variables in this analysis. Accordingly, while ECA and GCA balances are overcollected, as noted above, Colorado Springs Utilities has indicated that they are recommending the proposed changes to smooth the impact to customers based on the forecast information available.

OFFICE OF THE CITY AUDITOR
COLORADO SPRINGS, COLORADO

Electric Capacity Charge Rate Filing

March 2011

Purpose

The purpose of this audit was to evaluate whether Colorado Springs Utilities (CSU) prepared the Electric Capacity Charge (ECC) in accordance with the approved tariff. The methodology was compared to prior filings to ensure consistency and to determine whether it met the intended objective as stated on the tariff sheet. Calculations were tested for accuracy and verified to the appropriate source documentation.

Highlights

We conclude that Colorado Springs Utilities has prepared the ECC in a manner that considers the factors listed in the approved tariff. However, the resulting financial metrics are not consistent with those described in the prior Electric Rate Filing , which were the basis for the current rates.

According to the memorandum accompanying the proposed rate change, the proposed rate reduction is based on returning to customers $3.5 million, 50% of the estimated first year net firm savings of $7 million from the purchase of Front Range Power, LLC (FRP). The reduction was not based on the revenue requirements stated below.

According to the Electric Capacity/Front Range Charge—ECC Tariff Sheet, the revenue requirements supporting rates in this tariff will be calculated as follows:

1. Capacity Payments to Western Area Power Authority (WAPA)
2. Principal and interest costs associated with Utilities purchase of FRP….
3. Incremental operating and maintenance costs incurred by Utilities as a result of the FRP purchase, and
4. Revenues necessary to support financial metrics of a “AA” (Aa2 Moody’s) bond-rated utility as a result of the additional bond issue….

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Recommendations

While we support the implementation of the proposed rate adjustment, we recommend changes in targeted financial metrics be communicated to the City Council with rate filings.

Management Response

The improvement to cash flow resulting from the purchase of Front Range Power is sufficient to reduce the need for the higher debt service coverage that would have been required without the purchase. The 2010 ratio, after including the purchase, is in line with the actual ratio achieved in 2009 and also that forecasted for 2011.

Electric Capacity Charge Rate Filing

March 2011

(Highlights continued from page 1)

We verified that the revenue generated by the proposed rate was adequate to cover the costs associated with #1-#3 above and also contribute approximately $3.5 million to #4—the financial metrics. However, the resulting financial metrics are not consistent with the financial metrics cited in the prior Electric Rate Case.

The 2011 Electric Rate Case stated, "*A 'AA' bond rated utility should maintain at least a 2.25 debt service coverage ratio and a debt leverage ratio of 60% or less. Due to the expected increase in capital requirements, the debt ratio will be increasing up to 63% in 2011. To manage the debt ratio during this period, debt service coverage will need to exceed 2.25 in 2011 to generate sufficient funds to keep the debt ratio within the expected AA range.*"

The purchase of FRP has impacted CSU's financial metrics. Specifically, we have noted a shift in the Debt Service Coverage Ratio from 2.25 to 2.13. CSU issued $274 million in debt, which replaced a non-debt Power Purchase Agreement. Consequently, the debt service coverage ratio has declined, but the fixed cost coverage ratio has increased along with cash. We believe CSU has adequately explained the benefits of the purchase. However, we could not recalculate the proposed revenue requirements listed in the tariff based on the financial metrics from the last rate case.

CSU management has indicated that rating agencies support a lower debt service ratio for power generators and integrated utilities. Therefore, the lower debt service coverage should not be a problem. In recent years, CSU has maintained the following debt service coverage ratios while maintaining a "AA" bond rating.

Year	2007	2008	2009	2010
Debt Service Ratio	2.18	2.03	2.15	2.13

If the current rate reduction is approved, the resulting debt service ratio will be approximately 2.13—compared to the 2.25, which CSU indicated they would need to exceed in 2011. If a debt service ratio of 2.25 was required in 2011, with adjustments for FRP, CSU would be asking for an increase, instead of the reduction.

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City Council's Office Of The City Auditor

Colorado Springs, Colorado

About our Office

The mission of the Office of the City Auditor is to provide City Council with an independent, objective and comprehensive auditing program for operations of the City. Our auditing program includes:

- Evaluating the adequacy of financial controls, records and operations
- Evaluating the effectiveness and efficiency of organizational operations
- Providing Council, management and employees objective analysis, appraisals, and recommendations for improving systems and activities

The Office of the City Auditor is responsible for auditing the systems used by the City of Colorado Springs and its enterprises, including Colorado Springs Utilities and Memorial Health System. We perform a variety of audits for these entities, including financial audits, performance audits, contract audits, construction audits, and information system audits. We also perform follow-up on a periodic basis to monitor and ensure management actions have been effectively implemented.

Authorization and Organizational Placement

Our audits are conducted under the authority of Chapter 1, Article 2, Part 7 of the Colorado Springs City Code, and more specifically parts 703, 705 and 706 of the Code. The Office of the City Auditor is structured in a manner to provide organizational independence from the entities it audits. This independence is accomplished by the City Auditor being appointed by and reporting directly to the City Council.

Audit Standards

This audit was conducted in accordance with the *International Standards for the Professional Practice of Internal Auditing*, a part of the Professional Practices Framework promulgated by the Institute of Internal Auditors. The audit included interviews with appropriate personnel and included such tests of records and other supporting documentation as deemed necessary in the circumstances. We reviewed the internal control structure and compliance tests were performed. Sufficient competent evidential matter was gathered to support our conclusions.

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