OFFICE OF THE CITY AUDITOR
PUBLIC REPORT

Date: November 17, 2011

To: President of Council Hente, President Pro-Tem Martin, and Members of City Council

Re: 2012 Rate Case Filing Report

We have reviewed the 2012 Rate Case filing including base rate cases, cost of service studies, and tariffs submitted by Colorado Springs Utilities. The filings included the Electric Service Cost of Service Study, and Gas Service Cost of Service Study, as well as changes to tariffs such as a change to the wastewater rate methodology. The filings are scheduled to be heard during a Public Hearing on November 22, 2011.

Conclusion

We conclude that overall the 2012 Rate Case filing was properly supported by the cost of service study, and the methodology used to prepare the cost of service study was consistently and accurately applied. The filing meets the requirements in place through the Executive Limitations.

We did identify three observations during the course of our review which we believe will improve processes that provide key inputs to the cost of service study.

Background and Scope

The City Auditor's Office performed a review of Colorado Springs Utilities' submitted cost of service studies which supported the proposed rate changes requested by Colorado Springs Utilities. Our review focuses on the accuracy and consistency of the methodology used to develop the cost of service studies and proposed rate changes.

The cost of service studies are based on expected revenues, expenses, and financial needs for the coming year. Consistent with prior years, the cost study is based on a forecast for the following year and did not include a true-up of forecasted sales and costs to actual financial results. Operations and maintenance expenses per the cost of service study were agreed to the budget submitted to Council for the coming year. The scope of our review does not extend to analysis of such costs or review of budget assumptions.

Colorado Springs Utilities 2011-2015 Strategic Plan includes a Strategic Destination Goal that non-fuel base rate adjustments will not result in more than a 6% increase on the typical residential customer bill. The total typical non-ECA/GCA residential bill that includes all services increased 5.81% with this filing, including the second annual 12% adjustment to water approved by City Council in May, 2010 scheduled to take effect January 1, 2012.

For the Electric and Gas Services, Colorado Springs Utilities performs a cost of service study for each service to determine how revenue requirements will be allocated to various customer classes. Because of differences in how customer classes utilize the system, their costs will vary. For example, customer classes that are interruptible typically have lower costs and lower rates. Schedule S10 of the Cost of

Service Studies filed with the rate request indicates the overall increase in revenue and also indicates the percentage increase for each customer class.

Significant over collected balances were refunded to customers through the Electric Cost Adjustment (ECA) in 2010 and 2011 (approximately $26.4 and $10 million respectively). This refunding is now complete and the ECA currently has an under collected balance. Significant refunds were also made through the Gas Cost Adjustment (GCA) in 2010-2011 (approximately $5.2 and $17.9 million respectively). GCA Refunds are not anticipated in 2012. The ECA and GCA are tracked separately, but as refunds are recorded as reductions to revenue at the time of refund, they impact cash balances and metrics such as actual debt service coverage. Forecasted metric requirements are a driver for base rates.

Per Resolution 131-10, effective January 1, 2010, City Council fixed electric and gas Surplus rates at $.006173 and $.391539 per unit delivered within the City, respectively. The Surplus rates are no longer automatically adjusted when base rates increase.

Observations and Recommendations

Observation 1 – Load Studies Had Not Been Performed Regularly

As noted in the Electric Service Report, Colorado Springs Utilities performed a load study in 2011 based on 2009 through 2010 data to determine peak and off-peak load patterns for various classes. The prior study was done in 2006. Load data is used to allocate generation, transmission, and distribution costs to customer classes (e.g. residential versus commercial). The 2011 study showed a significant shift in peak load requirements from residential to commercial customers as compared to the study using 2006 data.

Shifts in load patterns impact the cost development of rates between customer classes. Due to the large changes in the current load study over prior 2006 study and surrounding uncertainties in the load trends, Colorado Springs Utilities elected to mitigate this impact in their 2012 rate design. See the electric service report page 4-6 for more information.

Recommendation

Colorado Springs Utilities should conduct load studies on a regular basis, at least every two years. If data shows a consistent change in load patterns from residential to commercial customers, appropriate rate changes should be considered and incorporated into rate design.

Colorado Springs Utilities Response

We agree with this recommendation. Colorado Springs Utilities has begun conducting continuous electric load research. Annual studies will be used to assist in the evaluation of load pattern trends between rate classes. Colorado Springs Utilities will also adjust rates when appropriate to reflect sustained load shifts identified through the studies.

Observation 2 –Financial Forecast Model Review and Approval Process

The Financial Forecast Model was prepared by Colorado Springs Utilities Financial Forecasting, Reporting and Budgeting Group and was the basis for revenue requirements that were allocated to customer classes in the cost of service studies. The Financial Forecast Model included both actual balances and assumptions obtained from various groups within the organization, including debt service and planned financing activities. We noted that update and approval processes by these functional groups providing key input for data were not formalized. Detailed verification of the Financial Forecast Model by someone other than the analyst did not appear to be performed or documented although management level reviews were in place. Without formalized update, review, and approval processes, a significant error in the Financial Forecast Model used in rate development might not be detected.

Recommendation
Colorado Springs Utilities should review the process in place to update and maintain the Financial Forecast Model to ensure updates are accurate and timely. Appropriate reviews and approvals should be documented.

Colorado Springs Utilities Response
We agree with this recommendation and have begun to review several processes in place to ensure not only accurate and timely updates, but also to document appropriate reviews and approvals. Our expected completion date is no later than September 30, 2012.

Observation 3 – Review of Statement by Utility Service
Financial data by service (electric, gas, water, wastewater and streetlights) such as cash balances, were utilized by the Financial Forecasting, Reporting and Budgeting Group and by Pricing in rate development. Financial Statement line items such as costs and revenues were directly assigned to accounts by service. Colorado Springs Utilities has indicated that other line items were estimated using generally accepted allocation methods.

Initial cost of service studies based on financial statements by service included an error that Colorado Springs Utilities identified and promptly corrected. In obtaining an understanding of this correction, we observed that statements by service are key inputs to the cost of service studies. Assumptions, allocations, and controls supporting monthly statements by service should be reviewed regularly. This review will ensure methods and assumptions used in monthly statements by service are accurate and up to date, and that appropriate controls and review processes are in place. It is our understanding that the methodology for some of the allocations (for example, Administrative and General expense allocations) had not changed for several years.

Recommendation
We recommend that Colorado Springs Utilities review their controls and review processes in place to estimate monthly account balances by service. Key assumptions and allocations should be reviewed to ensure they align with current business operations.

Colorado Springs Utilities Response
We agree with this recommendation to evaluate the controls and processes related to certain accounts which are estimated by service. Though we have not had to, and do not expect to, significantly change key assumptions and allocation methodologies based on business operations, we agree to review. Our expected completion date is no later than September 30, 2012.

Other Noteworthy Items Related to 2012 Rate Cases
(See Colorado Springs Utilities Rate Reports for More Detailed Information)

Electric Base Rates

- Costs related to the Front Range Power Plant that were previously recovered through the Capacity Charge will be recovered through base rates and the ECA. This is noted in the Electric Service report, page 1. (ECA rates may adjust throughout the year as approved separately by City Council.)
- The purchase of Front Range Power increased Electric Debt Service for 2012 by $19.5 million and has impacted the debt related metrics. Please refer to the Electric Service Report page 3 for more information.

Gas Base Rates

- Increases to gas base rates this year were primarily related to increases in the Capital Improvement fund (Cash) to: 1) increase cash balances to improve metrics and 2) fund a portion of the capital budget. As stated in the Gas Service report, page 2, additions to cash represent $8.2 million of the increased $9.5 million base rate revenue requirement for this service.
- A factor in the Capital Improvement Fund increase this year was significant liquidity needs in the Gas Service. A negative unrestricted cash balance in the Gas Service existed of ($12.4M) at 9/30/11 which was forecasted by Colorado Springs Utilities to increase to negative $36 million as of 12/31/11. Factors underlying the negative unrestricted cash balance in this service that have resulted in a need for additional cash balances were:
    a. Colorado Springs Utilities indicates that rate increases in this service have been held to minimum levels in past years to moderate customer impacts
    b. $5.2 million was refunded in 2010 and $17.9 million was refunded in 2011 through the GCA.
- A G4T Commercial Transportation rate became effective with the current heating season in November, 2011. Colorado Springs Utilities determined that the cost to serve this customer class is significantly different than originally thought. Colorado Springs Utilities elected to phase in this updated cost of service to avoid rate shock for this customer group. As a result, Colorado Springs Utilities may under-collect on the revenue requirement for 2012.

Methodology Changes

As our review checks for changes in consistency, we noted the following changes in methodology. We concur with these changes for creating the most accurate cost recovery. A methodology change is proposed to simplify the wastewater average daily usage calculation. Revenue collected and customer costs should be approximately the same under the new wastewater methodology. Also, the methodology used to allocate surplus requirements to customer classes was revised to be consistent with the authorizing ordinance. This change was phased in to avoid rate shock for certain customer classes.

Please contact me if you have any questions regarding this report.

Sincerely,

Denny L. Nester, MBA CPA CIA CFE CGFM CGAP
City Auditor

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