OFFICE OF THE CITY AUDITOR PUBLIC REPORT

Date: April 11, 2012

To: Colorado Springs Utilities Board

Re: Monitoring Report on parts of EL 4—Asset Protection, and EL 7—Financial Condition and Activities

We have completed the external monitoring as directed by City Council acting in its capacity as the Utilities Board under the Utilities Board Policy Governance. The purpose of this review was to determine whether Colorado Springs Utilities (CSU) and the Utilities Chief Executive Officer (CEO) complied with the existing Executive Limitations of EL 4, Asset Protection Policy Prohibitions 1, 4, 6, 7 & 9 and all of EL 7 Financial Condition and Activities Policy Prohibitions. Our work included review of source documentation, detail tests of calculations, and other auditing procedures as we considered necessary to verify the accuracy and reliability of the statements made in the EL 4 & 7 reports prepared by Colorado Springs Utilities for the Utility Board.

We concluded that CSU and the CEO were in compliance with most of the Policy Prohibitions listed in the ELs. This report provides details related to three observations and recommendations made during our review. These observations primarily relate to the low level of unrestricted cash and investments at year end 2011 and changes in the information provided to the Utilities Board as part of the EL 7 Report from the CEO.

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

Sincerely,

Denny L. Nester, MBA CPA CIA CGFM CFE CGAP

City Auditor

Cc: Jerry Forte, CEO
Bill Cherrier, Chief Planning and Finance Officer
Sherri Newell, Chief Public Affairs Officer
Dede Jones, General Manager, Financial Services
Steven Berman, Manager, Financial Forecasting and Reporting

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OFFICE OF THE CITY AUDITOR
COLORADO SPRINGS, COLORADO

12-06: Annual External Report on Executive Limitation (EL) 4 and 7—Asset Protection and Financial Conditions and Activities

April 2012

Purpose

The purpose of this review was to determine whether Colorado Springs Utilities (CSU) and the Utilities Chief Executive Officer (CEO) complied with the existing Executive Limitations of EL 4 , Asset Protection Policy Prohibitions 1,4,6,7 & 9 and all EL 7 Financial Condition and Activities Policy Prohibitions. Our work included review of source documentation, detail tests of calculations, and other auditing procedures as we considered necessary to verify the accuracy and reliability of the statements made in the EL 4 & 7 reports prepared by Colorado Springs Utilities for the Utility Board.

Highlights

We completed the external monitoring as directed by City Council acting in its capacity as the Utilities Board under the Utilities Board Policy Governance. While we conclude that CSU and the CEO were in compliance with most of the areas we audited in both EL 4 and EL 7, this report provides details related to three observations and recommendations made during our review. These observations relate to the low level of unrestricted cash and investments at year end 2011 and changes in the information provided to the Utilities Board as part of the EL-7 reports from the CEO.

Observations:

1) As noted in management's Quarterly Report on EL 7—Policy Prohibition 5 dated March 14, 2012, Working Capital fell below the minimum required 45 days of operating and maintenance expenses at 39.8 days. Colorado Springs Utilities' comments indicated this situation was due to lower balances in unrestricted cash and investments. Further comments indicated sufficient compensating liquidity was readily available—referring primarily to the available line of credit. As communicated in the 4th quarter report from management, CSU and the CEO were not in compliance with Policy Prohibition 5.

Management Response

CSU Management's Responses related to each observation have been incorporated into this document after each observation.

Recommendations

1) The days of Working Capital should be increased to comply with the Executive Limitation. Alternatively, if the Utilities Board believes the available lines of credit adequately address liquidity and any other concern related to Working Capital, the Board may choose to modify the Executive Limitation.

2) CSU management should ascertain the level of reporting desired by the Utilities Board. Consistent information should be provided to the Board to allow the Board to compare information over time.

3) CSU management should continue to monitor unrestricted cash and investments to ensure that each service maintains adequate amounts of unrestricted cash and investments to support the service.

12-06: Annual External Report on Executive Limitation (EL) 4 and 7—Asset Protection and Financial Conditions and Activities

April 2012

Recommendation
The days of Working Capital should be increased to comply with the Executive Limitation. Alternatively, if the Utilities Board believes the available lines of credit adequately address liquidity and any other concern related to Working Capital, the Board may choose to modify the Executive Limitation.

CSU Management's Response
Lower balances in unrestricted cash and investments at the end of 2011 were driven by increased collateral postings, which are directly influenced by interest rates and Treasury security yields. CSU is currently in the process of exploring options to address this increase, including the novation of two swap agreements, which will significantly decrease collateral postings. While working capital fell below the executive limitation at December 31, 2011, CSU maintains sufficient liquidity through lines of credit which are readily available.

2) This is the first audit by the Office of the City Auditor since CSU management reduced the amount of "Supplemental Information" provided with their compliance report to the Utilities Board. CSU made this change beginning first quarter 2011. Some of the change was noted in an April 1, 2010 communication with the Utilities Board which stated, "By-Service and component unit reports are not available as of the date of this report and are pending following external audit of Front Range Power Company LLC acquisition entries and reporting." This explanation appeared reasonable in 2011. A similar notation (without the mention of Front Range Power) is again included in 2012. The following areas are not included in the 2012 Supplemental Information:

- Segment Reporting by Service
- Operating Revenue and Expense Variances by Service
- Unrestricted Cash and Investments by Service
- Detailed Capital Expenditure Report for Capital Projects Budgeted Over $2M
- Selected Financial Ratios and Graphs

While the Supplemental Information is not required, it may provide information supporting compliance with executive limitations to the Utilities Board. For example, Policy Prohibition 6 prohibits "Transfer (of) unrestricted cash and investments between services without prior Board approval. Such balances are accounted separately for electric, gas, water, wastewater, and streetlight services." The March 14, 2012 Report from the CEO states, "The CEO reports that these conditions have not occurred as of the date of this monitoring report." However, the report does not provide detailed information, which might support the statement of the CEO. The Supplemental Information previously provided clearly identified unrestricted cash and investments by service as mentioned in the second sentence of Prohibition 6.

Recommendation
CSU management should ascertain the level of reporting desired by the Utilities Board. Consistent information should be provided to the Board to allow the Board to compare information over time.

CSU Management's Response
The amount of supplemental information included in all executive limitation reporting was reduced in an effort to provide the Utilities Board with useful information in support of compliance with policy prohibitions while not

including excessive information. Segment reporting is still provided in the supplemental information, however was not available at the time of distribution for the Q4 EL 7 Report. This information will be provided to the Utilities Board with communications the week of April 9, 2012. The segment reporting will support the CEO statement on Policy Prohibition 6.

3) Concerning Policy Prohibition 6 quoted above, the unrestricted cash and investments for the Gas service at year end was approximately negative $20 million according to a report provided to my office. It is important to understand that this number is an approximation because CSU does not maintain separate cash and investment accounts for each service. CSU allocates cash and investments to each service when they prepare Segment Reporting by Service. As the City Auditor has noted in prior reports, an allocated negative cash balance within a service might be perceived as a transfer between services or a defacto loan from the other services. We noted that approximately $22 million in over-collected Gas Cost Adjustments (GCA) had been refunded to customers in 2010 and 2011. We also noted that Gas rates were adjusted for 2012 to address the negative cash balance in the Gas service.

Recommendation

CSU management should continue to monitor unrestricted cash and investments to ensure that each service maintains adequate amounts of unrestricted cash and investments to support the service.

CSU Management's Response

CSU monitors and manages enterprise and by service cash balances routinely. As a four service utility within one enterprise, CSU customers derive financial benefit from the many functions that support each service without redundancy. Examples include centralized customer service, cohesive strategic planning, consolidated treasury and financing activities, and procurement and contracting, among many more. While CSU does prepare Segment Reporting by Service for rate-making or cost of service analysis, as well as Service Line Business Planning efforts, the allocation of certain account balances such as unrestricted cash and investments does not equate to a transfer between services. The Gas service, in this case, is afforded the opportunity to more gradually improve its stand-alone financial metrics, including its approximate cash balance, while minimizing the base rate impacts to its customers and still returning over collection in the GCA. CSU management believes this levelized approach to rates is appropriate for each of its services.

The audit was conducted in a manner that meets or exceeds the International Standards for the Professional Practice of Internal Auditing, a part of the Professional Practices Framework promulgated by the Institute of Internal Auditors, with the exception of the requirements under standards 1312 and 1321 to obtain an external quality assurance review once every five years. We do not believe this non-compliance impacted the quality of our audit.