

# **Audit**

## **Follow-Up**

**As of April 30, 2012**



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City Auditor

## **Electric Utility Reserves**

**(Report #1201 issued October 28, 2011)**

**Report #1212**

**July 6, 2012**

### **Summary**

*Two of the five action plan steps established to address issues identified in our audit of the Electric Utility Reserves have been completed and actions initiated to complete the other three steps.*

In audit report #1201, we noted current City policy provides for establishment of reasonable and appropriate reserves for electric utility operations. We reported that, in recent years, available reserves have been within (or at some points very near) the lower end of the targeted reserve levels established by City policy and levels suggested by industry guidance. As also reported, planned uses of the reserves in fiscal year 2012 will place reserves below those levels.

Increases in reserve levels over the last decade were attributable to investment earnings and transfers of operating surpluses from electric utility operations, as provided by City policy.

Uses of reserves over the last decade were found to have been authorized and in accordance with policy provisions. Those uses included:

- Temporary provision of working capital to allow the electric utility to timely pay expenses and obligations.
- Repair and related costs related to emergency events.
- Temporary funding of margin calls on hedged deals executed in connection with the acquisition of natural gas used in the

generation of electricity.

- Direct and indirect rate stabilization.

We also reported that the undesignated balance of funds in the City's electric utility repair, replacement, and improvement (RRI) fund should be considered as part of the reserves available to the electric utility.

Lastly, we found that accounting for electric utility reserve funds and related activity were generally appropriate and correct.

Only a few issues were identified for which recommendations for improvements or corrective actions were made. Five action plan steps were established by City management to address those issues. Those five steps were due to be completed by April 30, 2012. In our follow up review, we found City management has completed two of those action plan steps and initiated actions to complete the remaining three steps. Specifically:

- Accounting journal entries are now being timely recorded to reflect transfers of funds from the Electric Utility Operating Reserves to the Energy Services department for margin calls on hedged financial deals. **(Step Completed)**
- Reconciliations continue to be improved to ensure City funds paid into the City's NYMEX (New York Mercantile Exchange) margin account are properly received, used, accounted for, and reported by the City's contracted agent. **(Step In Process)**
- The City Energy Risk Management Policy and Procedures have been revised to

provide an appropriate funding source for all margin calls on financial deals maturing in subsequent fiscal years, regardless of the maturity dates on those deals. (*Step Completed*)

- Revisions to City Commission Policy 224 “Financing the Government” are being prepared for submission to the City Commission for approval. (*Step In Process*)
- The version of City Commission Policy 224 “Financing the Government” on the City’s internal and external websites are planned to be updated after City Commission approval of changes to that policy (see previous item). (*Step In Process*)

We appreciate the cooperation and assistance provided by staff in Energy Services, Accounting Services, and the Budget and Policy Office during this audit follow-up.

### ***Scope, Objectives, and Methodology***

We conducted this audit follow-up in accordance with the International Standards for the Professional Practice of Internal Auditing and Generally Accepted Government Auditing Standards. Those standards require we plan and perform the audit follow-up to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit follow-up objectives.

### ***Original Report #1201***

The overall objective of our original audit (report #1201) was to ascertain the reasonableness of the reserves maintained for City electric utility operations. Specific objectives included (1) determining whether current City policy provided for establishment of reasonable and appropriate electric utility reserves; (2) determining whether the City maintains adequate and appropriate reserves for electric utility operations; (3) determining if the sources and uses of reserve

funds for the electric utility were proper, reasonable, and in accordance with established policy; and (4) determining whether reserve funds maintained for the electric utility were properly accounted for by the City.

In connection with those objectives we reviewed applicable City policies. We also identified and considered available industry guidance on establishment and maintenance of reserves for municipal electric utility operations. Furthermore, activity pertaining to the sources and uses of electric utility operating reserves, as well as reserve levels, over the last decade were reviewed and analyzed.

### ***Report #1212***

This is our first follow-up on action plan steps identified in audit report #1201. The purpose of this follow up is to report on the progress and status of efforts to complete action plan steps due for completion as of April 30, 2012. To determine the status of the action plan steps, we interviewed staff, made observations, and reviewed relevant documentation.

### ***Background***

In accordance with sound and prudent business practices, the City maintains reserves for its electric utility operations. The primary purpose of those reserves is to ensure sufficient funds (cash) are available to maintain continuity of operations, i.e., generation and provision of electricity to City utility customers in the event of cash shortages and/or emergencies. The City also maintains reserve funds for ancillary purposes, including rate stabilization and as a source for the temporary funding of margin calls (required cash outlays) on hedged financial deals, which are executed in connection with the acquisition of natural gas to be used in the generation of electricity.

City Commission Policy 224 “Financing the Government” authorizes the establishment of electric utility operating reserves to provide security, liquidity, and flexibility. Those reserves are critical to protect the City from a financial perspective and to protect City utility customers

from a competitive rate perspective. The policy establishes four primary purposes of the reserves as well as target funding levels. The four primary purposes include:

- Working Capital - Ensure liquidity to maintain continuity of operations.
- Emergency Reserves - Pay repairs and related costs in the event of damages to the City's electric utility.
- Fuel Risk Management - Provide a funding source for margin calls on hedged financial deals (for the purchase of natural gas used in generation of electricity) that mature in future fiscal years.
- Rate Stabilization - Provide funds to stabilize rates in the event of fluctuations in revenue requirements.

In addition to the electric utility operating reserves, the undesignated balance of funds in the City's electric utility repair, replacement, and improvement (RRI) fund serves as a contingency (reserve) fund for the electric utility. The primary purpose of the electric utility RRI fund is to fund capital improvements, projects, and similar needs that are not funded from bond proceeds.

Another City policy that impacts the City's electric utility operating reserves is the "City Energy Risk Management Policy and Procedures." That policy, in conjunction with City Policy 224 as described above, prescribes the circumstances and amounts of operating reserves to be used for margin calls on hedged financial deals.

Two sources of industry guidance were identified and used in our evaluation of the adequacy of the City's electric utility operating reserves. Those sources were (1) the Government Finance Officers Association (GFOA) and (2) the American Public Power Association (APPA).

### *Previous Conditions and Current Status*

In report #1201, we noted current City policy provides for establishment of reasonable and

appropriate reserves for electric utility operations. We reported that, in recent years, available reserves have been within (or at some points very near) the lower end of the targeted reserve levels established by City policy and levels suggested by industry guidance. As also reported, planned uses of the reserves in fiscal year 2012 will place reserves below those levels.

Increases in reserve levels over the last decade were attributable to investment earnings and transfers of operating surpluses from electric utility operations, as provided by City policy.

Uses of reserves over the last decade were found to have been authorized and in accordance with policy provisions. Those uses included:

- Temporary provision of working capital to allow the electric utility to timely pay expenses and obligations.
- Repair and related costs related to emergency events.
- Temporary funding of margin calls on hedged deals executed in connection with the acquisition of natural gas used in the generation of electricity.
- Direct and indirect rate stabilization.

We also reported that the undesignated balance of funds in the City's electric utility RRI fund should be considered as part of the reserves available to the electric utility.

Lastly, we found that accounting for electric utility reserve funds and related activity were generally appropriate and correct.

Only a few issues were identified for which recommendations for improvements or corrective actions were made. Five action plan steps were established by City management to address those issues. Each of those steps was due to be completed by April 30, 2012. As shown below in Table 1, two of those five steps have been addressed and completed. Actions have been initiated to complete the remaining three steps.

**Table 1  
Action Plan Steps from Audit Report #1201  
Due as of April 30, 2012, and Current Status**

Action Plan Steps Due as of April 30, 2012	Current Status
<b>Ensure timely and appropriate accounting of operating reserve activity</b>	
<ul style="list-style-type: none"> <li>• Timely accounting journal entries will be recorded to reflect transfers of funds from the Electric Utility Operating Reserves to the Energy Services department for margin calls on hedged financial deals maturing in future fiscal years.</li> </ul>	<ul style="list-style-type: none"> <li>✓ In the initial audit, we reported that Accounting Services was not always timely recording entries showing the transfer of operating funds (designated for fuel risk management) to the Energy Services department to pay margin calls on hedged financial deals that matured in subsequent fiscal years. As reported, not timely recording those entries resulted in the City’s records incorrectly overstating the amount of the reserve funds (\$30 million designated for this purpose) available to pay additional margin calls. That circumstance, in effect, limited the usefulness of the City’s accounting system as a means to track and accurately report the status of operating reserve funds, and to determine if use of those funds were within policy limitations. During our follow up engagement, we found Accounting Services took timely action to rectify this issue. Specifically, the process has been revised such that the transfers of funds from the operating reserve fund are now recorded concurrently with the payment of the margin calls. Our review showed this revised process is being followed.</li> </ul>
<ul style="list-style-type: none"> <li>• Reconciliation processes for the City’s NYMEX account will be enhanced to adequately and properly identify and validate activity reflected in the City’s contracted agent’s monthly statements to activity reflected in the City’s general ledger.</li> </ul>	<ul style="list-style-type: none"> <li>➤ In the initial audit, we reported enhancements were needed to reconciliations performed by Accounting Services to ensure City funds paid into the City’s NYMEX (New York Mercantile Exchange) margin account were properly received, used, accounted for, and reported by the City’s contracted agent. As explained in the initial audit report, City funds are placed into that account in connection with margin calls on hedged financial deals, as a form of insurance the City will be able to meet its financial obligations when natural gas market prices fluctuate relative to the contracted prices. Additional cash is sometimes deposited into that account, such as when hedged deals are initially executed and when the contracted agent sells certain financial instruments (e.g., put options or previously purchased call options) on behalf of the City. Funds are paid from that account when hedged deals mature and the market prices are less than the contracted prices.</li> </ul>

	<p>The contracted agent sends the City monthly statements reflecting activity and balances in the City’s NYMEX account. Accounting Services reconciles activity and balances in the City’s general ledger (PeopleSoft Financials) to those monthly statements. Those reconciliations are intended to ensure City funds are properly tracked, used, and reported by the contracted agent and NYMEX. In the initial audit, we reported those reconciliations were not always adequate to provide the desired assurances. Specifically, in those months where there were purchases or sales of put and/or call options, staff performing the reconciliations did not reconcile that activity to the activity recorded in the City’s general ledger. As reported, staff instead attributed all differences between the activity recorded in the City’s general ledger and the market values reported on the contracted agent’s monthly statements as a “market value adjustment.” As a result, the reconciliations were inadequate and based on incomplete validations.</p> <p>During our follow up review, we found the reconciliations of the City’s margin account performed by Accounting Services for fiscal year (FY) 2011 to be adequate and complete. (Note: Since the initial audit there have been cash transactions involving margin calls but there have been no cash transactions resulting from purchases or sales of put or call options.) We also determined that at the beginning of FY 2012, the City changed contracted agents. At the time of our follow up audit fieldwork in April 2012, monthly reconciliations pertaining to the City’s margin account with the new agent had been completed, but not yet reviewed and approved by supervisory staff within Accounting Services. Nonetheless, we reviewed those monthly reconciliations through February 2012. Our review showed the reconciliations were inadequate and incomplete. Specifically:</p> <ul style="list-style-type: none"> <li>– Accounting Services staff did not correctly identify the account balance on the contracted agent’s monthly statements.</li> <li>– Accounting Services staff did not record in the City’s general ledger the settlements of outstanding hedged financial deals that occurred when the City changed agents.</li> </ul> <p>Accordingly, as of the date of our fieldwork in May 2012, there has been no verification that City funds had been properly received, used, and reported by the new contracted agent.</p>
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	<p>Accounting Services supervisors likely would have detected and corrected these issues upon their review and approval of those staff-prepared reconciliations. In our discussions, supervisory staff acknowledged the reconciliation deficiencies and indicated reviews of subsequent monthly reconciliations would be done timelier. We will follow up and report on this reconciliation process in our subsequent follow up engagement</p>
<p><b>Ensure proper funding of margin calls on hedged financial deals</b></p>	
<ul style="list-style-type: none"> <li>• City Energy Risk Management Policy and Procedures will be revised to identify an appropriate funding source for all margin calls on hedged financial deals maturing in subsequent fiscal years.</li> </ul>	<ul style="list-style-type: none"> <li>✓ The City Energy Risk Management Policy and Procedures was revised such that the \$30 million set aside within the City’s Electric Operating Reserves are now authorized as a funding source for all margin calls on hedged financial deals maturing in subsequent fiscal years, regardless of whether the maturity date is more or less than 12 months from the date of the applicable margin call. Those revisions were approved by the City’s Energy Risk Policy Committee (ERPC). The City Commission was notified of those revisions and the ERPC’s approval.</li> </ul>
<p><b>Ensure an appropriate and adequate policy</b></p>	
<ul style="list-style-type: none"> <li>• Appropriate revisions to City Commission Policy 224 “Financing the Government,” that accomplish the following, will be presented for City Commission approval.             <ul style="list-style-type: none"> <li>– Identify and provide “additional” specific funding sources for the Electric Operating Reserve Fund.</li> <li>– Clarify that targeted reserve funding levels are dynamic in nature and should be updated periodically (e.g., annually) based on current budgets and circumstances.</li> </ul> </li> </ul>	<ul style="list-style-type: none"> <li>➤ Management indicated draft changes to the policy have been prepared and will be presented to the City Commission for their review and approval as part of the FY 2013 budget process.</li> </ul>
<ul style="list-style-type: none"> <li>• The version of City Commission Policy 224 “Financing the Government” on the City’s internal and external websites will be updated for approved changes to that policy.</li> </ul>	<ul style="list-style-type: none"> <li>➤ Management indicated this action will be completed upon completion of the preceding action plan step.</li> </ul>

**Table Legend:**

- Issue to be addressed from the original audit.
- ✓ Issue addressed and resolved.
- Actions initiated but not completed.

## Conclusion

Table 1 above shows City management successfully completed and resolved two of the five action plan steps established to address issues identified in audit report #1201. Completed action involved (1) the timely recording of accounting entries to reflect transfers of funds from the Electric Utility Operating Reserves to the Energy Services department for margin calls on hedged financial deals and (2) revising the City Energy Risk Management Policy and Procedures to provide an appropriate funding source for all margin calls on hedged financial deals maturing in subsequent fiscal years, regardless of the date the deal matures. Table 1 also shows that actions have been initiated to resolve issues applicable to the remaining three action plan steps. Those actions and related status include:

- Completion of appropriate reconciliations to ensure City funds paid into the City's NYMEX (New York Mercantile Exchange) margin account were properly received, used, accounted for, and reported by the City's contracted agent. *(During this follow up engagement we found significant additional enhancements were necessary; Accounting Services supervisory staff is currently in the process of completing those additional enhancements.)*
- Make appropriate revisions to City Commission Policy 224 "Financing the Government" and presenting those revisions to the City Commission for their approval. *(Department of Management and Administration {DMA} staff indicated draft changes have been prepared and will be presented to the City Commission for approval.)*
- Update the version of City Commission Policy 224 "Financing the Government" on the City's internal and external websites. *(DMA management indicated this action will be completed after the City Commission approves applicable policy changes – see previous item.)*

We appreciate the cooperation and assistance provided by staff in Energy Services, Accounting Services, and the Budget and Policy Office during this audit follow-up.

## Appointed Official's Response

### City Manager:

We appreciate the work done by the City Auditor on the Electric Utility Reserves follow-up audit. We are pleased that two of the five action plans have been completed and that work has begun on the remaining three action plan items. We will continue to evaluate the recommendations contained in the original audit as it relates to the remaining action items as we work to complete the remaining items.

Copies of this audit follow-up #1212 or audit report #1201 may be obtained from the City Auditor's website (<http://talgov.com/auditing/index.cfm>) or via request by telephone (850 / 891-8397), by FAX (850 / 891-0912), by mail or in person (Office of the City Auditor, 300 S. Adams Street, Mail Box A-22, Tallahassee, FL 32301-1731), or by e-mail ([auditors@talgov.com](mailto:auditors@talgov.com)).

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