

Final Audit Follow-Up

**Actions Due As of
September 30, 2012**



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Electric Utility Reserves (Report #1201 issued October 28, 2011)

Report #1310

March 22, 2013

Summary

The five action plan steps established to address issues identified in our audit of the Electric Utility Reserves have been completed.

In audit report #1201, we noted current City policy provides for establishment of reasonable and appropriate reserves for electric utility operations. Specifically, City policy provided for a reserve level ranging from \$122 million to \$185.9 million, while industry guidance suggested a reserve level (based on the City budget and circumstances) ranging from \$134.1 million to \$187.5 million. We reported that, in recent years, available reserves have been at (or at some points very near) the lower end of the targeted reserve levels established by City policy and levels suggested by industry guidance. For example, as of March 31, 2011, City reserves totaled \$134.9 million (excluding reserve amounts committed to margin calls on that date). As also reported, approved uses of the reserves in fiscal year 2012 for rate stabilization (i.e., up to \$17.4 million if needed) could 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. All five steps were initially targeted by management to be completed by April 30, 2012, or earlier. Two of those steps were reported as completed in our initial follow up on this audit (see follow up report #1212, issued October 28, 2011). The three remaining steps were completed during the period covered by this follow up engagement. A detailed description of the five action steps and their completion is as follows:

- 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)*
- Adequate and appropriate reconciliations are now prepared 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 Completed)*
- 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" have been prepared and submitted to and approved by the City Commission. *(Step Completed)*
- The version of City Commission Policy 224 "Financing the Government" on the City's internal and external websites has been updated to reflect the changes approved by the City Commission (see previous item). *(Step Completed)*

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 #1310

This is our second and final 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 September 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. Specifically, City policy provided for a reserve level ranging from \$122 million to \$185.9 million, while industry guidance suggested a reserve level (based on the City budget and circumstances) ranging from \$134.1 million to \$187.5 million.

We reported that, in recent years, available reserves have been at (or at some points very near) the lower end of the range of targeted reserve levels established by City policy and levels suggested by industry guidance. For example, as of March 31, 2011, City reserves totaled \$134.9 million (excluding reserve amounts committed to margin calls on that date). That amount was within the ranges of reserve levels suggested by both City policy and industry guidance as noted in the previous paragraph.

In report #1201, we also reported that planned uses of the reserves in fiscal year 2012 could place reserves below the levels suggested by City policy and industry guidance (i.e., \$17.4 million was approved for rate stabilization purposes if needed).

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. As shown below in Table 1, those five steps have been addressed and completed.

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

Action Plan Steps Due as of September 30, 2012	Current Status
Ensure timely and appropriate accounting of operating reserve activity	
<ul style="list-style-type: none"> • 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. 	<ul style="list-style-type: none"> ✓ Completed/resolved in a prior period.
<ul style="list-style-type: none"> • 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. 	<ul style="list-style-type: none"> ✓ 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.

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.

During our initial follow up review (Report #1212 issued July 6, 2012), we found the reconciliations of the City's margin account performed by Accounting Services for fiscal year (FY) 2011 to be adequate and complete. However, as reported in that initial follow up report, we found subsequent monthly reconciliations, performed after the City changed agents in early FY 2012, to be inadequate and incomplete. Specifically:

- Accounting Services staff did not correctly identify the account balance on the contracted agent's monthly statements.
- 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.

Accordingly, we reported that, as of the date of our fieldwork in April 2012, there had been no verification City funds were properly received, used, and reported by the new contracted agent.

During our current follow up engagement, we found the Accounting Services Manager implemented appropriate corrective action, to include preparing accurate and logical tracking worksheets (separate from the PeopleSoft Financials System) for:

	<ul style="list-style-type: none"> • Reconciling balances on hand with the contracted agent as recorded in the City’s general ledger (PeopleSoft Financials System) to balances per the agent’s monthly statements (balances on the agent’s statement were correctly identified). • Identifying appropriate journal entries to record in the City’s general ledger, such that the general ledger reflects accurate and correct activity for each fiscal year. • Accounting for the settlements of outstanding hedged financial deals at the date the City changed agents. <p>As of the end of our follow up fieldwork, Accounting Services had finalized those tracking worksheets (including preparing retroactive entries) for FY 2012. Additionally, as recommended in the initial audit, the Accounting Services Manager implemented an appropriate method to properly track and account for put and call options on those worksheets and in the City’s general ledger for FY 2012. Accordingly, this relatively complex action step has been completed.</p>
<p>Ensure proper funding of margin calls on hedged financial deals</p>	
<ul style="list-style-type: none"> • 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. 	<p>✓ Completed/resolved in a prior period.</p>
<p>Ensure an appropriate and adequate policy</p>	
<ul style="list-style-type: none"> • 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"> – Identify and provide “additional” specific funding sources for the Electric Operating Reserve Fund. – Clarify that targeted reserve funding levels are dynamic in nature and should be updated periodically (e.g., annually) based on current budgets and circumstances. 	<p>✓ In the initial audit we recommended consideration be given to revising City Commission Policy 224 “Financing the Government” to (1) clarify that target funding levels established within the policy were “dynamic” amounts that will fluctuate as events occur and circumstances change and (2) provide funding sources for the electric operating reserve in addition to earnings on invested reserve funds and annual operating surpluses when they occur. In response to this recommendation, management prepared proposed revisions to the policy that clarify the dynamic nature of targeted funding levels; specifically that the targeted level for the working capital component must be adjusted annually based on the appropriated budget and that other components should be</p>

	<p>updated as circumstances change. Those proposed revisions were submitted through an agenda item to the City Commission for their review and approval. The City Commission approved the policy revisions on February 13, 2013.</p> <p>In regard to the second recommendation, management considered the circumstances and responded there is not a need to identify and provide additional specific funding (i.e., other than historical use of operating surpluses and investment earnings). Rather, management indicated there are actions available to the City Commission should a determination be made in the future that additional funding sources are needed. Accordingly, this step is considered completed and resolved.</p>
<ul style="list-style-type: none"> • 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. 	<ul style="list-style-type: none"> ✓ In the initial audit we recommended the City’s websites (internal and external) be updated to reflect the current updated version of City Commission Policy 224 “Financing the Government.” Specifically, we reported that changes to the policy approved by the City Commission in September 2010 had not been incorporated into the policy available on the City’s website. As noted in the previous action plan step, further revisions have been made to City Commission Policy 224. Subsequent to the City Commission approval of those additional revisions on February 13, 2013, the City’s websites were updated to reflect the most current version of City Commission Policy 224. Accordingly, this action plan step has been completed.

Table Legend:

- Issue to be addressed from the original audit.

- ✓ Issue addressed and resolved.

Conclusion

Table 1 above shows City management successfully completed and resolved each of the five action plan steps established to address issues identified in audit report #1201. Completed actions involved:

- 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.
- Completion of adequate and appropriate reconciliations 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.
- 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.
- Making appropriate revisions to City Commission Policy 224 "Financing the Government."
- Updating the version of City Commission Policy 224 "Financing the Government" on the City's internal and external websites.

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:

The City Auditor's Office has conducted a detailed audit of the Electric Operating Reserve Fund. The items detailed in the report demonstrate the broad scope of complexity involving our Electric Reserve Fund. I am pleased with the cooperation and professionalism demonstrated by the City Auditor's team and staff of the various audited departments. I am sure that the recommended improvements will result in measurable financial results to this government and community. The action items identified in this report will continue to ensure that our internal controls and finance policies are fiscally sound. I would like to thank the Auditor's Office as well as all departments for their outstanding work on this audit.

Copies of this final audit follow-up #1310 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).

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