

Concerns as to the Accuracy of Independent Audits of Major Investor-Owned Utilities in the Context of Public Company Accounting Oversight Board Reports: Request for Commission to Issue Order Instituting a Rulemaking (OIR)

Dear President Peevey and Commissioners Ferron, Florio, Sandoval and Simon,

The Black Economic Council, the National Asian American Coalition, and the Latino Business Chamber of Greater Los Angeles hereby petition the Commission under § 1708.5 of the Public Utilities Code to adopt a regulation in the context of growing concerns about the accuracy of CPA audits. We seek an order to institute a rulemaking regarding the verification of information by outside auditors criticized by PCAOB who are used by investor-owned utilities (IOUs) as it affects the accuracy of rate increases, executive compensation and all other audits.

In the ongoing Sempra rate proceeding, the Joint Parties have previously raised the issue of the Public Company Accounting Oversight Board's (PCAOB's) determination that Deloitte & Touche's so-called independent audits of Sempra are suspect.¹ These independent audits are likely to affect future rate increases, executive bonuses and diversions of ratepayer funding from intended purposes. The auditors for the big three utilities have all been determined to be suspect by the PCAOB. (See, Wall Street Journal, December 21, 2011, "Accounting Board Finds Faults in Deloitte Audits", New York Times, 10/17/11, "Accounting Board Criticizes Deloitte's Auditing System" and Wall Street Journal, 10/18/11, "Audit Watchdog Criticized Deloitte Quality Controls in '08.")

However, based upon the ruling in the Sempra case discussed below, it appears that this Commission believes that there are better avenues for the exploration of this issue. If this issue cannot be raised in ongoing general rate cases, then it should instead be raised within another forum within the CPUC. With this in mind, we urge an expedited Order Instituting a Rulemaking (OIR) to ascertain the impact, if any, of faulty independent audits by Deloitte & Touche, PricewaterhouseCoopers, Ernst & Young, and KMPH (known as the Big Four CPA firms) on utilities with one billion dollars or more in revenue.

¹ Please see A.10-12-005 and A.10-12-006, *Motion of the Joint Parties to Compel Testimony of Auditing Partner of Deloitte & Touche, Mr. K. Alan Lombom*.

This rulemaking request is also consistent with the January 18th, 2012 pledges by Commissioners Florio and Sandoval at their Senate Rule Committee confirmation hearings. Both committed to “making more information available regarding the Commission’s oversight of Pacific Gas and Electric and other utilities.” (San Francisco Chronicle, 1/19/12, “Regulators Pledge to Be More Open.”) It is also consistent with all of the Commissioners’ position that we need “to step up [our] safety auditing....” (Commissioner Sandoval comments, San Francisco Chronicle, *id.*)

The Financial Audits Relied Upon by the CPUC Face Serious Concerns as to Independence and Impartiality

The San Francisco Chronicle front-page article of January 13th, “State Calls PG&E Lawbreaker: Utility Diverted Safety Funds Into Profit,” is a stark reminder of the importance of this Commission receiving reliable and accurate independent audits, not just for Pacific Gas & Electric (PG&E), but for all utilities.² (Both PG&E and Sempra use Deloitte & Touche for data submitted to the CPUC. Deloitte & Touche has been singled out by the PCAOB for unreliable data, not following generally accepted accounting principles and being a pawn of management.³)

There may be numerous problems relating to data that this Commission has relied on. This may one day haunt and damage this Commission’s reputation and cost the ratepayers billions of dollars. This will be unfair to this Commission, especially because the Joint Parties recognize that all the commissioners are highly dedicated and have impeccable integrity.

² In the PG&E case, for example, the audits failed to uncover or note the diversion of 100 million dollars in gas, safety and operations money over a 15-year period to shareholders and for executive bonuses. There is every reason to assume similar problems exist at the other major utilities. The online version of this article can be found at: <http://www.sfgate.com/cgi-bin/article.cgi?f=/c/a/2012/01/13/MNUS1MOSUC.DTL>

³ PG&E’s financial data that this Commission relies upon for rate increases and executive bonuses, is audited by its long-term auditor, Deloitte & Touche. Deloitte & Touche has been the auditor for Sempra for more than fifty years and its audit may affect the proposed 2.4 billion dollar Sempra rate increase. Deloitte & Touche, more than any other CPA firm, has been consistently and recently criticized by the PCAOB for the inaccuracy of its data, its cozy relationship with its management and its lack of independence. See, Wall Street Journal, December 21, 2011, “Accounting Board Finds Faults in Deloitte Audits,” New York Times, 10/17/11, “Accounting Board Criticizes Deloitte’s Auditing System” and Wall Street Journal, 10/18/11, “Audit Watchdog Criticized Deloitte Quality Controls in '08.”

For far too long, this Commission and other commissions across the country have unduly relied on the accuracy of so -called independent audits of financial data prepared by the Big Four CPA firms. We are unaware of any major California utility that has not been audited by the Big Four; Deloitte & Touche alone is estimated to be the auditor of 40 percent of all major utility and energy companies, including the auditor for both PG&E and Sempra Energy, which includes San Diego Gas & Electric and Southern California Gas.

The evidence that the three minority business and community organizations have as to the utilities and their suspect CPA firms is as follows:

- a. Sempra has used the same auditor, Deloitte & Touche, for more than fifty consecutive years.⁴ As to PG&E, the Joint Parties do not yet have the information as to how long PG&E has used Deloitte & Touche , but the relationship goes back to at least 2006 or for the last five years.⁵ The Joint Parties have no information at this point as to Southern California Edison's (SCE's) timeframe in using PricewaterhouseCoopers. However, contemporaneous to this filing, the Joint Parties will inquire of all the utilities, to secure information and other pertinent information that may be helpful in this considering this proposed OIR.
- b. The Joint Parties know for a certainty, because of their involvement in the present pending general rate cases, that the auditors used by SCE and Sempra (PricewaterhouseCoopers and Deloitte & Touche, respectively), provide cozy management type consultant services. These cozy relationships are of concern to the PCAOB because they affect the independence and accuracy of the audits. It is therefore likely that Deloitte & Touche provides a similar cozy type management services for PG&E. However, we will be seeking further information.

⁴ Please see "Annual Report to Security Holders, page 138, located at:
<http://www.sec.gov/Archives/edgar/vprr/08/9999999997-08-017859>

⁵ Southern California Edison, which is seeking a 4.6 billion dollar rate increase, is also audited by PricewaterhouseCoopers, which was criticized by the PCAOB in its report on 2010 audits. See Wall Street Journal, December 21, 2011, "Accounting Board Finds Faults in Deloitte Audits, New York Times, 10/17/11, "Accounting Board Criticizes Deloitte's Auditing System" and Wall Street Journal, 10/18/11, "Audit Watchdog Criticized Deloitte Quality Controls in '08.

Deloitte & Touche receives an average of seven million dollars a year in audit and other service fees from Sempra.⁶ The Joint Parties will soon secure the amounts paid by PG&E and SCE for its auditors. However, these amounts may be insignificant if they produce independent and accurate audits, particularly since some of these costs may be covered by the shareholders. The key issue, however, is not cost, but independence and accuracy.

These Concerns Are Not Isolated to the California Utility Industry, As Evidenced by the Public Company Accounting Oversight Board (PCAOB)

The PCAOB report for the year 2010 demonstrates very substantial concerns as to three of the four Big Four firms, PricewaterhouseCoopers, Deloitte & Touche, and KPMG (the report for Ernst & Young should be available by the beginning of February and it is likely that similar concerns will exist as to Ernst & Young). Most importantly, the big three California utilities, Sempra, Southern California Edison and PG&E, have had long term and cozy relationships with their Big Four CPA firms that are unlikely to have been independent. Further, according to the PCAOB, many have failed to use generally accepted accounting principles (GAAP). It should be noted that Deloitte & Touche has been singled out for the harshest criticism the PCAOB has ever expressed as to any large CPA firm.⁷

The PCAOB, in its pending Docket No. 37 on independence of audits, expressed concerns and offered suggestions about this lack of independence and apparent “partnerships” between a so-called independent CPA firm and the management of the company they are auditing. As part of this docket, the PCAOB has raised questions⁸ as to:

⁶ This information was provided to the Joint Parties through a data response to the Joint Parties that is currently on file in the Sempra general rate case (A.10-12-005 and A.10-12-006) as Exhibit 282.

⁷ See, Wall Street Journal, December 21, 2011, “Accounting Board Finds Faults in Deloitte Audits,” New York Times, 10/17/11, “Accounting Board Criticizes Deloitte’s Auditing System” and Wall Street Journal, 10/18/11, “Audit Watchdog Criticized Deloitte Quality Controls in '08.”

⁸ The Black Economic Council, the Latino Business Chamber of Greater Los Angeles and the National Asian American Coalition have all intervened in this docket before the PCAOB, as of January 13, 2011, and have filed the attached PCAOB comments, which may be of assistance to this Commission and DRA.

- a. The rotation of CPA firms on a regular basis to prevent cozy management relationships and promote independence;
- b. Whether a CPA firm can be independent when it does consulting work for management, while at the same time performing its independent audit work;⁹ and
- c. Creating greater competition among independent auditors that may include more diverse CPA firms.¹⁰

The Joint Parties Previously Raised These Issues in A.10-12-005 and A.10-12-006

Pursuant to Rule 6.3 of the Rules of Practice and Procedure of the CPUC, the Joint Parties hereby set forth the history of these issues before the CPUC in A.10-12-005 and A.10-12-006. The Joint Parties attempted, despite the general opposition of Sempra's counsel, to raise these issues in the Sempra rate case once the PCAOB's report denouncing Deloitte & Touche was publicly exposed on October 17, 2011. ¹¹ We subsequently alerted CPUC Assigned Commissioner Ferron, President Peevey and Executive Director Paul Clanon as to this matter, and invited Executive Director Clanon to participate in any conversations we had with the PCAOB, including our conversation of January 5th with one of its board members and its general counsel. We also invited the Division of Ratepayer Advocates (DRA) to participate, but DRA, given its huge witness list and extraordinary responsibilities in this case, understandably declined to participate at this point. However, we believe, based on other evidence in the rate cases, that DRA and other ratepayer advocates may share our concerns.

⁹ See PCAOB Docket No. 37, "Concept Release on Auditor Independence and Audit Firm Rotation," for full information.

¹⁰ The Big Four have never been willing to provide their ethnic/racial data and are believed to be far less diverse than most smaller competitors. In 2010, as part of the OIR on diversity, the Black Economic Council, the Latino Business Chamber of Greater Los Angeles and the National Asian American Coalition initiated an unsuccessful effort to directly gather data from the Big Four for the then ongoing OIR on diversity. All four firms declined to respond, much less cooperate.

¹¹ Please see A.10-12-005 and A.10-12-006, *Motion of the Joint Parties to Compel Testimony of Auditing Partner of Deloitte & Touche, Mr. K. Alan Lonbom*.

In the Sempra general rate case, it was also determined (and similar findings may exist for the other affected utilities) that management is not actively involved in ascertaining the validity of the audits. For example, in the Sempra case, the COOs of both SDG&E and SoCal Gas stated that they knew nothing of the PCAOB October 17th findings and were not involved in the impact of PCAOB findings on Sempra's proposed rate increase. Similarly, the acting controller of Sempra, when cross-examined by the Joint Parties, admitted that he too was not knowledgeable regarding the impact and like the CEOs, did not know whether Deloitte & Touche's audit of Sempra was a suspect audit. Further, none of these three top Sempra officials could definitively state whether Deloitte & Touche had informed them of the PCAOB investigation and findings and/or whether Sempra was among the more than two-dozen suspect corporate audits by Deloitte & Touche.

Although we do not concur with the ALJ's ruling of January 12th denying the Joint Parties' motion to further inquire as to the legitimacy of the data relied on by Sempra, we do not appeal. (The Joint Parties' motion, which was denied, was to cross-examine Deloitte & Touche's principal auditor for Sempra who works out of their San Diego office near Sempra's headquarters.) We do not appeal the ruling because it appears that the ALJ ruling in its present form has the full support of the Assigned Commissioner, the President of the CPUC and perhaps of other commissioners.¹²

We hope that the ALJ will allow us to make an offer of proof as to the information we would have secured from the principal auditor of Sempra as to further illuminate the rate increase and assist in evaluating this request for an OIR.

Recommendations and Next Steps

The Wall Street Journal of January 14, 2012, "One Cure for Accounting Shenanigans," sets forth one simple cure for this problem: limit the terms of these auditors. As the chairman of the PCAOB stated, "Without independence, it's unlikely you are going to get skepticism or a healthy look for disconfirming evidence."

¹² Both the Assigned Commissioner and the President were alerted by the Joint Parties after the cross examination of COOs Niggli and Smith as to our concerns as to the accuracy of the proposed 2.4 billion dollar rate increase.

Although the Wall Street Journal's emphasis is on protecting investors, it is even more important to protect ratepayers who are far more vulnerable and lack the resources to demand independent audits when facing rate increases.¹³

Another issue that should be covered by the OIR relates to the potential of an inaccurate or suspect CPA audit on proposed rate increases. As set forth in the Sempra case in particular, the limitations of the rate proceeding as interpreted by the ALJ prevented us from fully exploring this matter in the context of the 2.4 billion dollar rate increase.¹⁴ Nor was the matter properly explored in regards to the 4.6 billion dollar proposed SCE rate increase. This was largely because all evidentiary hearings and briefs were completed before the PCAOB report was made publicly available.

However, the Joint Parties recognize that this request for an OIR may not directly affect the pending rate cases of SCE and Sempra. However, it is our hope that an expeditious OIR will enable this Commission, particularly if it works with the DRA, to develop appropriate ground rules for future engagements of independent auditor CPA firms. This could include, for example, issues raised by the Black Economic Council, the Latino Business Chamber of Greater Los Angeles and the National Asian American Coalition, in our attached January 13th PCAOB filing, such as:

- (a) CPA firms that are engaged in an audit be barred from providing any other paid services, such as management consulting;
- (b) CPA firm engagements be limited to six consecutive years for companies with one billion dollars or more in revenue;
- (c) What portions of a CPA audit are used to bolster proposed rate increases and/or executive compensation bonuses and incentives; and

¹³ The Wall Street Journal of January 14, 2012 states, "for the sake of investors, we should phase out auditors - for-life too."

¹⁴ See A.10-12-005 and A.10-12-006, January 20, 2012 "Administrative Law Judge's Ruling Regarding Joint Parties' Motion to Compel Testimony of Deloitte & Touche"

(d) How this Commission can secure greater certainty as to the reliability of the data upon which rate increases are predicated or executive bonuses are determined.¹⁵

To the best of our knowledge, no other utility regulatory commission has yet looked into these issues. However, as set forth in our PCAOB comments, Enron -type scandals could be avoided if there were truly independent audits. See for example comments of John Biggs, the former chairman and CEO of TIAA-CREF, quoted in our PCAOB remarks. He testified that:

“Had Arthur Andersen in 1996 known that Peat Marwick was going to come in 1997, there would have been a very different kind of relationship between them and Enron....There is a very high probability that had rotation been in place at Enron with Arthur Andersen you would not have had the accounting scandal that I think we now have....”

Proposed Language to Include in an OIR

The proposed language is similar to what the Joint Parties are urging in their comments filed January 13th before the PCAOB (PCAOB on January 5th urged the parties to file such comments).

- “All CPA firms hired to do an annual audit shall be barred from providing any other paid services with particular reference to management and consulting services. This will help ensure that the CPA audit firm and the utility it audits are free from any appearance of and/or actuality of conflicts of interest and/or partnerships.”
- “No utility shall maintain the same CPA auditing firm for more than six consecutive years. This rotation of auditors is likely to maximize the independence of the auditors and prevent the type of lifetime ‘partnerships’ that appear at many companies who use their auditors for long periods of time.”

¹⁵ This could perhaps include ascertaining the feasibility of allowing the CPUC to do an independent audit of the figures provided by the IOUs, as was recently suggested by CPUC staff in a straw proposal on how to incorporate safety issues into the regulatory structure.

- “No CPA firm may be hired to perform an independent audit after its six year term until at least twelve years thereafter. This will further promote independence of auditing firms and promote more competition.”
- “This Commission recognizes the importance of competition in promoting cost reductions, independence and diversity efforts to encourage use of firms other than the Big Four are likely to create far greater competition and long term cost reductions among independent auditors. It is also likely given the lack of diversity among partners at the Big Four firms to also promote another goal of this Commission diversity pursuant to GO 156.”
- The matter could cover all utilities with one billion dollars in revenue or more, or as little as fifty million in revenue or more.

Conclusion

In conclusion, this Commission has a well -deserved reputation and a great responsibility to the ratepayers of California. We therefore urge, in the context of the PCAOB’s findings as to the lack of independence and integrity of CPA firms used by the three largest California utilities, that it would be appropriate to open an OIR on this matter as soon as possible . This will not only ensure the accuracy and reliability of the figures provided by the IOUs, but will also have a major impact on utility safety and transparency before the CPUC.

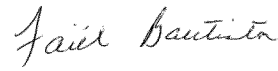
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