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December 9, 2013

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Subject: **Comments of the Office of Ratepayer Advocates on Draft Resolution E-4633 (Southern California Edison (SCE) requests approval of program year 2011 energy efficiency awards, in compliance with Ordering Paragraph 8 of D.12-12-032).**

Pursuant to the November 19, 2013 Comment Letter for Draft Resolution E-4633 (Draft Resolution), the Office of Ratepayer Advocates (ORA) submits these Comments on the Draft Resolution, addressing Southern California Edison's (SCE) Advice Letter 2946-E. In AL 2946-E, SCE requests approval of program year 2011 energy efficiency awards, in compliance with Ordering Paragraph 8 of D.12-12-032. The Draft Resolution reduces SCE's 2011 award amount from the $18,605,138 requested in AL 2946-E to an initial award of $13,554,619 and the potential to earn an additional $5,005,528 (for a total of $18,560,138) after a second audit is conducted.

SUMMARY OF ORA'S RECOMMENDATIONS

ORA supports the Draft Resolution with ORA's recommended modifications. Shareholder incentives are meant to award the IOUs for superior performance, which includes compliance with Commission policy. Given the findings of the initial audit conducted by the Commission's Utility, Audit, Finance, and Compliance Branch (UAFCB) on only a portion of total expenditures, ORA is not confident that the remaining expenditures reported by SCE are reliable. ORA supports the Draft Resolution's proposal to conduct an additional audit before awarding SCE with their full incentive earnings.

However, the Draft Resolution's initial payment does not fully protect ratepayers from the risk of awarding incentives on misreported expenditures. The Draft Resolution estimates the potential total value of misreporting based on the audit sample size and determines SCE's initial award based on that figure. There is a possibility that a second audit will find a greater amount of misreporting than estimated. In this event, the initial award could be higher than the final calculated award. Instead, ORA recommends that the Draft Resolution be modified to award SCE $6,261,821 at present based on the portion of total expenditures examined in the initial audit. SCE will then have the potential to earn an additional $12,298,317 (for a total of $18,560,138) pending a more exhaustive audit of the remaining expenditures. This prudent approach assures ratepayers that the entire award is based only on reliable expenditures. Notably, ORA's recommendations could result in the same maximum award amount as the Draft Resolution, $18,560,138, but ORA simply recommends a larger 'hold back' amount until the results of the second audit are determined. A comparison of our recommendation with that of the Draft Resolution and SCE's request is summarized in Table 1 below.

In the event the Commission maintains the initial incentive reward proposed by the Draft Resolution, the Commission should add language to the Draft Resolution clarifying that in the event that the second audit finds a higher error rate than was originally estimated by the Draft Resolution and the resulting SCE 2011 incentive award falls below the $13,554,610 initially awarded, SCE will be required to refund ratepayers the difference with interest

Table 1: Comparison of SCE's request, the Draft Resolution, and ORA's proposal

	Initial Award Earnings	Potential Earnings Following Additional Audit; 'hold back'	Maximum Award
SCE's Request in AL	$18,605,138	none	**$18,605,138**; excluding disallowance
Draft Resolution	$13,554,619; award based on total expenditures less potential misrecorded funds	$5,005,528; assumes comprehensive audit finds no additional discrepancies	**$18,560,138**; including disallowance ($818,092)
ORA's proposal	$6,261,821; award based only on expenditures examined in initial audit	$12,298,317	**$18,560,138**; including disallowance ($818,092)

BACKGROUND

In D.12-12-032, the Commission adopted an energy efficiency shareholder incentive mechanism for the 2010-2012 cycle consisting of a management fee (5% of qualifying expenditures[1]) and an ex ante performance review (capped at 1% of qualifying expenditures). The IOUs' ex ante

[1] Qualifying expenditures are total annual programmatic expenditures less those associated with EM&V (D.12-12-032, Findings of Fact 23).

performance review scores were determined in the Decision. The final awards were to be based on annual audits conducted by UAFCB and each IOU was ordered to file a Tier 3 advice letter claiming the final award amount once the audit became public.[2]

D.12-12-032 determined SCE's ex ante review score to be 56/100. Therefore, the Decision awarded SCE an annual incentive award of 5.56% of qualifying expenditures for program years 2010-2012.[3]

The *Energy Efficiency Financial Compliance Examination Report of Southern California Edison (SCE) for the Period January through December 31, 2011* (Final Audit Report) conducted by UAFCB was published on September 30, 2013. Unfortunately, it reported a number of material errors by SCE. UAFCB deemed SCE's 2011 reports less than accurate and reliable.[4] Of the expenditures audited, SCE had $30,796,647 of recording and reporting discrepancies in their 2011 reports.[5] This equates to 27% of the total expenditures sampled. Further, the Final Audit Report found that SCE did not demonstrate compliance with Public Utilities Code Sections 314(a), 581, and 584, the Uniform System of Accounts (USOA), General Order 28, the Commissions directives on administrative costs, the terms of SCE's contracts, and SCE's own policies and procedures.[6] Specifically, the Final Audit Report outlined the following findings:

- **SCE's quarterly reports do not tie with SCE's recorded data.** The gross errors totaled $15.3 million and the net errors totaled $2.7 million.

- **SCE potentially misclassified nearly $24.7 million of its reported costs in the areas that UAFCB examined.** Misclassifications included, but were not limited to: recording costs in a different program area than it should, using estimated allocation factors, and permitting its direct implementation contractors to allocate their total costs between direct implementation, administrative and marketing costs instead of directly charging costs from those areas.

- **SCE did not provide adequate supporting source documentation for $4,447,179 of the expenditures UAFCB examined.**

- **SCE did not accrue $741,866 of its 2010 expenditures in 2010.**

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[2] D.12-12-032, OP 8.

[3] D.12-12-032, OP 2.

[4] Final Report, p. 1.

[5] Draft Resolution, p. 4.

[6] Final Report, p. 2.

- **UAFCB was not able to evaluate SCE's process for estimating labor costs and therefore was unable to verify $343,267 of labor charges.** SCE should have policies that allow UAFCB to verify each amount listed as a labor cost.

- **SCE overstated OBF committed funds and customer overbillings.** Total errors amounted to $471,147.

- **SCE is not vigorously enforcing its internal controls** (or SCE's controls are too lax).[7]

Further, the Draft Resolution states that SCE did not demonstrate good faith effort to comply with the audit and UAFCB.[8] The Resolution outlines the difficulty experienced by UAFCB staff in getting reliable and timely responses from SCE. Specifically:

- **SCE frequently missed deadlines for data requests.**

- **SCE's responses to data requests were often incomplete or inaccurate.**

- **SCE was inconsistent in its answers to discrepancies (often provided more than one answer when the first was unsuccessful at removing the discrepancy).**[9]

Ultimately the Final Audit Report recommended that SCE be disallowed the amount of $818,092 when calculating its 2011 shareholder incentive award. This is a small portion of the $30.7 million in errors found because most did not change the overall amount spent during the 2011 program year.

On October 4, 2013, SCE filed Advice Letter 2946-E requesting a 2011 shareholder incentive award of $18,605,624. In the Advice Letter, SCE states that it does not support the disallowance recommended in the Final Audit Report. Therefore, SCE does not subtract the $818,092 recommended in the report before calculating their incentive claim of $18,605,624.[10]

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[7] Final Report, pp. 2-5.

[8] Draft Resolution, p. 8.

[9] Draft Resolution, pp. 7-8.

[10] AL 2946-E, p. 3.

THE DRAFT RESOLUTION

The Draft Resolution explains that SCE had numerous opportunities but was unable to provide any documentation to support its reasoning for rejecting UAFCB's recommended adjustments. Therefore, Energy Division finds that the incentive award calculated by SCE in AL 2946-E is not appropriate because it does not include the disallowances recommended in the Final Audit Report.[11]

When taking the $818,092 of disallowances into consideration, SCE's total incentive award would be $18,560,138.[12] However, the Draft Resolution does not award SCE this total amount at the present. The UAFCB audit was limited in scope and only included a sample of costs and reporting in four portfolio areas; administrative costs, Energy Efficiency Contracts, On-Bill Financing, and Multifamily Energy Efficiency Rebates. These sampled areas represent approximately 34% of SCE's total 2011 portfolio expenditures.[13] Since the sample was limited and because UAFCB found SCE's 2011 reports to be less than accurate and reliable, the Draft Resolution states, "Staff is concerned about the potential of awarding shareholder incentives for reporting practices that limit the Commission's ability to fully understand SCE's expenditures." (p. 9). Therefore, the Draft Resolution awards SCE an initial payment of $13,554,610 and holds back $5,005,528 until a more exhaustive audit is completed.[14] The Draft Resolution states that Staff will oversee the scoping and implementation of an additional audit of SCE's 2011 expenditures. The remainder of SCE's 2011 incentive award will be determined once this follow-up audit is made public.

ORA'S PROPOSED MODIFICATIONS TO THE RESOLUTION

ORA supports the recommendation of the Final Audit Report to disallow $818,092 from SCE's total expenditures before calculating SCE's 2011 incentive award. Therefore, ORA supports the Draft Resolution's proposed maximum award for SCE of $18,560,138. However, it is important to highlight that the $818,092 disallowance could have been much higher. For example, the Final Audit Report found that $4,447,179 of the expenditures examined did not have adequate supporting source documentation. However, UAFCB still allowed these under-supported

[11] Draft Resolution, p. 4 & 7.

[12] (Total expenditures ($334,633,524) –disallowance ($818,092))* 5.56% = $18,560,138.

[13] UAFCB was also not able to examine 100% of the costs in these four areas, so the total sample was less than the 34% figure. Draft Resolution, p. 4.

[14] This hold back amount is calculated by extrapolating the $30,796,647 of misreported expenditures identified in the Final Audit Report over the remainder of SCE's expenditures not examined in the audit. This extrapolation totals nearly $90.8 million and is considered to be the 'full value of potential reporting errors.' The corresponding award for this amount is $5,005,528 ($90.8 * 0.0556 = $5,005,528). Draft Resolution, p. 9.

expenditures and only states that, in *future* examinations, they may disallow costs that are not properly supported.[15]

ORA also supports the Draft Resolution in its recommendation to conduct further audits of SCE's 2011 expenditures. ORA agrees that the sample examined in the Final Audit Report is not robust enough to represent SCE's entire 2011 energy efficiency portfolio and that the magnitude of errors found during the audit warrant a second look at the numbers. The Final Audit Report states, "Due to the error rates in UAFCB's samples, UAFCB cannot provide full assurance to the reasonableness of all the amounts that SCE reported in its EEGA reports" (p. 2).

ORA is concerned with the risk of awarding incentives based on inaccurate reporting. The shareholder incentive mechanism is designed to award the IOUs for implementing successful energy efficiency portfolios. However, the errors found during the audit and the lack of good faith effort put forth by SCE during the audit process does not give the impression of a well-managed energy efficiency portfolio. The Draft Resolution states, "If SCE cannot effectively track and report its expenditures, then ratepayer money invested in energy efficiency programs is at risk of being misspent and lost" (p. 8).

SCE should not receive awards for expenditures that have not yet been verified, as UAFCB is not confident in the reasonableness of SCE's reports given the large magnitude of errors in the small sample audited. It is not good practice to award such behavior and SCE should be encouraged to improve the practices outlined by UAFCB. ORA supports the Draft Resolution's directive to withhold the award amount corresponding to the full value of potential misreporting's. However, the Draft Resolution does not fully protect against the risk of awarding incentives based on unreliable expenditures. Therefore ORA proposes the following alternative recommendation to the Draft Resolution, specifically;

1. SCE's initial 2011 award earnings should be based on the portion of total expenditures examined in the Final Audit Report. UAFCB examined $113,440,765 and found $818,092 of disallowances. Therefore the initial award payment should be ($113,440,765 - $818,092)* the D.12-12-032 authorized award percentage (5.56%) = $6,261,821.

2. Following an additional audit of SCE's 2011 expenditures, SCE will have the potential to earn an additional $12,298,317, for a total of $18,560,138. This $18,560,138 is exactly the same maximum reward as proposed by the Draft Resolution.

[15] Final Audit Report, p. 3.

Table 2: Comparison of the Draft Resolution and ORA's Proposal

	Initial Award	Hold back until additional audit	Maximum Award
Draft Resolution	$13,554,610 (Total expenditures – extrapolation of misreported funds[16])*5.56% This approach holds back the award corresponding to the value of *potential* reporting errors, estimated by extrapolating misreported error rates.	$5,005,528	$18,560,138
ORA's Proposal	$6,261,821 (Expenditures examined in the Final Audit Report – disallowance) *5.56% This approach awards SCE for the incentive amount corresponding to expenditures examined in the audit (including the disallowance). It holds back the award corresponding to expenditures that have not been audited and are not assured to be reasonable by UAFCB.	$12,298,317	$18,560,138

ORA finds these modifications justified due to the magnitude of errors found in the Final Audit Report. UAFCB found $30.7 million in misreported funds equating to 27% of the expenditures sampled. It is not clear whether an additional audit of the remaining expenditures would result in similar error rates. The total value of misreported funds examined during the second audit could be larger than the extrapolated $90.8 million estimate calculated in the Draft Resolution. SCE should only receive awards for the expenditures examined in the audit report because UAFCB cannot assure the reasonableness of the expenditures that are yet to be audited. The extrapolation used in the Draft Resolution is only an estimate; therefore the Draft Resolution could result in the undesired outcome of awarding SCE a higher incentive amount than warranted before fully examining its 2011 expenditures. Instead, a more prudent approach would be to withhold all awards corresponding to the remaining expenditures that have yet to be audited.

[16] Extrapolation of misreported funds= percentage of misreported funds in sample ($30,796,647/$113,440,765=**27%**)* total expenditures ($334,633,524) = $90,845,566.

Again, under ORA's recommendations, SCE can still earn the same maximum reward as proposed by the Draft Resolution, the only difference being that under ORA's recommendations, a greater portion of the initial reward is withheld to guard against an outcome where the second audit finds a higher error rate than the first audit.

In the event the Commission maintains the initial incentive reward proposed by the Draft Resolution, the Commission should add language to the Draft Resolution clarifying that in the event that the second audit finds a higher error rate than was originally estimated by the Draft Resolution and the resulting SCE 2011 incentive award falls below the $13,554,610 initially awarded, SCE will be required to refund ratepayers the difference with interest. Since issuing a refund would ultimately be more costly to implement than simply withholding the reward, awarding SCE in the present for only verified expenditures would be the most prudent approach to take.

CONCLUSION

ORA agrees with the Draft Resolution that the incentive amount claimed by SCE in AL 2946-E is not appropriate because it does not include the disallowances recommended in the Final Audit Report. Given the limited scope of the audit sample and the amount of discrepancies found, ORA supports the Draft Resolution directive to conduct an additional audit of SCE's 2011 expenditures. However, ORA does not believe that SCE should receive any awards for expenditures not yet verified. It is not clear that SCE's remaining and unaudited expenditures were accurately reported. As such, ratepayers should only fund shareholder incentives are based

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on verified and allowable expenditures. Therefore, ORA recommends that the Draft Resolution be modified to award SCE with an initial payment of $6,261,821 with the potential to earn an additional $12,298,317 (for a total of $18,560,138) pending the results of the second audit required by the Draft Resolution.

Very truly yours

/s/ MICHAEL CAMPBELL

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Service List R.12-01-005