Audit Report

Austin Energy Fayette Power Project Contract Compliance

October 26, 2010

Office of the City Auditor
Austin, Texas

Audit Team

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City of Austin

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Date: October 26, 2010

To: Mayor and Council

From: Kenneth J. Mory, City Auditor

Subject: Performance Audit of Austin Energy Fayette Power Project (FPP) Contract Compliance

I am pleased to present this audit report on the Austin Energy FPP Contract Compliance. Our objective was to determine whether AE's approval of the FY 2010 Fayette Power Project administrative and general (AG) expense budget complied with the terms of the Participation Agreement between AE and the Lower Colorado River Authority (LCRA).

We found that because the Participation Agreement contains conflicting language, it is not clear whether approval of the FY 2010 AG expense budget complied with the Agreement. In addition, we found that the changes in methodology for determining AG expenses approved by the FPP Management Committee have increased risk for Austin Energy. Finally, we found that composition of the AE membership of the FPP Management Committee is not consistent with best practices.

Based on our work, we recommend that AE standardize the method for determining AG expense and include it in the Participation Agreement, that AE address the need to protect its interests in negotiating changes in Participation Agreement terms, and that AE review the AE Management Committee membership to ensure that no to ensure that appropriate expertise is present and no situations exist for potential undue influence. AE Management concurs with each of these recommendations.

We appreciate the cooperation and assistance we received from AE during this audit.

Cc: Marc Ott, City Manager
Robert Goode, Assistant City Manager
Larry Weis, AE General Manager
Cheryl Mele, AE Deputy General Manager
Elaine Hart, Senior Vice President of AE Finance and Corporate Services
Keith Warren, Director of AE Financial Compliance

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COUNCIL SUMMARY

This report presents the results of the Austin Energy (AE) Fayette Power Project (FPP) Contract Compliance audit. The objective was to determine whether AE's approval of the FY 2010 FPP administrative and general (AG) expense budget complied with the FPP Participation Agreement.

AE and the Lower Colorado River Authority (LCRA) own equal shares of Units 1 and 2 of FPP, located in La Grange, Texas. LCRA and AE executed a Participation Agreement (PA) setting forth the ownership and operational terms for the units. The FPP Management Committee is responsible for governance of the project. It consists of two voting members each for AE and LCRA.

We found that because the Participation Agreement contains conflicting language, it is not clear whether approval of the FY 2010 AG expense budget complied with the Agreement. In addition, we found that the changes in methodology for determining AG expenses approved by the FPP Management Committee have increased risk for Austin Energy. Finally, we found that composition of the AE membership of the FPP Management Committee is not consistent with best practices.

Based on our work, we have made three recommendations:

- AE should standardize the AG expense calculation method and include the method in the Participation Agreement
- AE should act independent of LCRA to address AE's interests in negotiating changes in Participation Agreement terms
- AE should review the AE Management Committee membership to ensure that appropriate expertise is present and no situations exist for potential undue influence

Management has concurred with each of the recommendations.

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ACTION SUMMARY
AUSTIN ENERGY FPP CONTRACT COMPLIANCE

	Recommendation Text	Management Concurrence	Proposed Implementation Date
01.	We recommend that AE's General Manager address the need to standardize the AG expense practices within the Participation Agreement, up to and including amending the Participation Agreement or creating a Project Agreement.	Concur	May 2011
02.	We recommend that AE's General Manager, independent of LCRA, address the need to protect AE's interests in negotiating changes in Participation Agreement terms. This includes an appropriate AG expense method that assures AE clear, stable costs, assurance of the appropriateness of costs and a cap to mitigate the risk to the City.	Concur	May 2011
03.	We recommend that AE's General Manager review the AE Management Committee membership to ensure that appropriate expertise is present and no situations exist for potential undue influence. Changes could include ensuring financial expertise on the committee and independent voting representatives (i.e., not in a reporting relationship).	Concur	January 2011

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BACKGROUND

This audit of Austin Energy (AE) Fayette Power Project (FPP)Contract Compliance was conducted as part of the Office of the City Auditor's FY 2010 Service Plan, as accepted by the City Council Audit and Finance Committee. We chose this project based on communication with AE wherein management expressed concerns about the Fayette Power Project administrative and general (AG) expense being charged to Austin Energy by the Lower Colorado River Authority.

FPP, located in La Grange, Texas, consists of three coal-fired generating units with an output of approximately 1,760 megawatts (MW). AE and the Lower Colorado River Authority (LCRA) own equal shares of Units 1 and 2, with a combined output of 1,290 MW. LCRA owns one-hundred percent of Unit 3, with an output of 470 MW. LCRA and AE (The Participants) executed a Participation Agreement in September 1974, amended in 1980 and 1984, setting forth the ownership and operational terms for Units 1 and 2.

While LCRA, designated as the Project Manager[1], manages and operates the plant, AE maintains a resident engineer onsite and fully participates as a member of the FPP Management Committee that provides governance to the project. Decision-making resides in the FPP Management Committee with two voting members for each Participant. Within the FPP governance structure, AE faces risks because of LCRA's dual roles as a Participant and as the Project Manager. The PA serves to limit AE's exposure to risk, including exposure to risks from AG expense, by specifying policies and procedures for determining costs.

[1] The Project Manager is the Participant responsible for the planning, construction and operation of the Project in accordance with the Participation Agreement and the Project Agreements.

OBJECTIVE, SCOPE, AND METHODOLOGY

Objective

The objective of the audit was to determine whether Austin Energy's approval of their share of the FY 2010 FPP AG expense budget complied with the Participation Agreement.

Scope

The scope of work included the FY 2010 FPP AG expense budget approval process.

Methodology

We used the following methods to conduct the audit:

- Analysis of the relevant portions of the FPP Participation Agreement
- Analysis of controls over and allocation methods for FPP general and administrative expense
- Review of AE and LCRA documents
- Interviews with AE and LCRA staff
- Review of AE internal and external communications
- Review of business practices related to AG expense
- Review of industry partnership management practices

We obtained an understanding of internal controls significant to the audit objective, and considered whether specific internal control procedures had been properly designed and placed in operation.

We conducted this audit in accordance with Generally Accepted Government Auditing Standards (GAGAS). Those standards require that we plan and perform the audit to obtain sufficient appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions.

AUDIT RESULTS

It is not clear whether approval of the FY 2010 AG expense budget complied with the Participation Agreement. However, we believe that Austin Energy's risks have increased due to the changes in methodology for determining AG expenses, and because composition of the AE membership of the FPP Management Committee is not consistent with best practices.

FINDING 1: Because the Participation Agreement contains conflicting language, it is not clear whether approval of the FY 2010 AG expense budget complied with the Agreement.

The method for calculating AG expense is stated in the Participation Agreement. The expense is to be calculated as a percentage of the cost of Station Work performed by the Project Manager.[2] The AG expense percentage is to be determined annually by an internal cost study. The study is subject to review and approval by independent certified public accountants, and adjustments to AG expense based on the study are to be made prior to the end of the fiscal year.

The method for changing the AG expense methodology is also stated in the Participation Agreement. Either Participant is entitled to request a review of the method used to determine the AG expense if the Participant believes that the method resulted in an unreasonable cost burden. The Management Committee would then review the existing method, and if it determined that an unreasonable burden existed, it could recommend a modified method to the Project Manager. These reviews could only take place after a method had been in place at least two years.

The Management Committee approved a change in the method for determining AG expense for FY 2010. Under the new method each LCRA corporate function charges FPP directly on a monthly basis for FPP's share of the function's cost rather than a percentage of station work costs. The share is based on the three-year historical average of the function's charges to FPP.

In March 1997, the FPP Management Committee recommended a new activity-based method for allocating AG expenses for FPP. The new method was adopted by the Project Manager. The Management Committee approved subsequent changes to the AG expense methodology after 1997, including a change for FY 2010. However, according to the Management Committee meeting minutes from July 2009 and our discussion with AE management, the Committee did not make a determination that the method for calculating AG expense set out in the Participation Agreement resulted in an unreasonable cost burden to either Participant prior to making the changes.

[2] Station Work is defined as the activities necessary to carry out operation and maintenance of FPP

Austin Energy management stated that they have interpreted the Agreement differently. The Participation Agreement states that the Management Committee does not have authority to modify the terms, covenants or conditions of the Participation Agreement. However, the Agreement also states that all decisions reached by the Management Committee on matters properly before the Committee for decision shall be binding upon all Participants.

Austin Energy believes that the AG expense method change process has been in compliance with the terms of the Participation Agreement. AE management, in consultation with AE legal, cited that the Participation Agreement contains a reference to "Any modified method approved by the Management Committee". In addition, the stated duties of the Management Committee contained in the Participation Agreement include:

> Review and act upon the Project Manager's recommendations concerning the annual capital expenditures budget, annual manpower table and budget, and **annual operation and maintenance budget**, including guidelines for the utilization of Project Manager's employees (emphasis added)

Austin Energy therefore concluded that a change to the AG expense method was properly decided by the Management Committee.

OCA believes that while this interpretation may be legally valid, it is in direct conflict with other sections of the Participation Agreement, highlighting the lack of clarity in the Agreement.[3] Further, this interpretation would allow contract amendments without the additional oversight provided by the Project Agreement process which is called for in the Participation Agreement.

FINDING 2: The changes in methodology for determining AG expenses have increased risk for Austin Energy.

The method for determining AG expense stated in the Participation Agreement helped limit AE's risk. The expense was tied to Station Work costs, allowing AE to control AG expense through controlling Station Work costs, thereby maintaining a reasonable relationship between the costs. In addition, the review of the annual cost study by an outside party provided assurance that costs were reasonable.

However, over time changes to Participation Agreement terms have occurred through FPP Management Committee consensus that increased AE's risks related to AG expenses. Vantage Consulting completed a cost study in March 2010 and concluded that the allocation methods currently used by LCRA to determine AG expenses are complex, and could potentially be a cause of misunderstandings and errors in the calculation of costs.

[3] OCA is not qualified to render a legal opinion, but rather addresses the issues from a process and control perspective.

In addition, AE has been incurring costs to complete annual audits of AG expense to determine if AE is being charged only its fair share of costs. AE consistently protests a portion of these costs based on the annual audit and has been successful in recovering some of the charges based on the protests.

AE's share of FY 2010 proposed corporate expenses was higher than FY 2009 by about $1 million. In 2010, the FPP Management Committee commissioned two outside consultant studies (the Vantage cost study and a benchmarking study by the Hackett Group completed in June) related to AG expense.

The cost study determined that LCRA total corporate expenses increased from $33 million to $80 million for the period 2000-2010, a nine percent compounded annual growth rate. The consultant cited a recent Energy Information Administration study that showed that AG expense for generating plants had decreased by an average of 1.8% annually over the last twenty years. The benchmarking study concluded that LCRA administrative and general costs were higher than the peer average in four of the five categories tested.

As a result of its findings, Vantage recommended that the Participants determine a reasonable method for allocating corporate overhead expense, amend the Participation Agreement to reflect the changes made to the allocation method and clearly state the policy and methodology used for decisions. OCA concurs with these recommendations and additionally recommends that the method should provide for a reasonable allocation of costs with a cap to mitigate the risk to the City.

FINDING 3: Composition of the AE membership of the FPP Management Committee is not consistent with best practices.

Best practice guidance, particularly for the non-managing Participant, recommends that representation on the governing body at least equal the other Participant's in terms of skill and authority.[4] In addition, members of the governing body should be free of impairments to independence, both in actuality and in appearance.

AE Management Committee members include the Senior Vice President of Power Supply and Market Operations and the Director of Nuclear and Coal Generation. Both positions are focused on power production. In addition, the Director reports directly to the Senior Vice President. The LCRA Committee members include the Manager of Generation Services and the Treasurer. Neither member reports to the other in the LCRA organizational structure. Therefore, the membership of the Committee is unequal in that AE does not have a person with financial expertise on the Committee, and one AE committee member is a subordinate of the other.

[4] Contract Management Guidelines, the United Kingdom Office of Government Commerce, 2002, p. 13.

Recommendations

The recommendations listed below are a result of our audit effort and subject to the limitation of our scope of work. We believe that these recommendations provide reasonable approaches to help resolve the issues identified. We also believe that operational management is in a unique position to best understand their operations and may be able to identify more efficient and effective approaches and we encourage them to do so when providing their response to our recommendations. As such, we recommend the following:

01. AE's General Manager should address the need to standardize the administrative and general (AG) expense practices within the Participation Agreement, up to and including amending the Participation Agreement or creating a Project Agreement.

MANAGEMENT RESPONSE: Concur

AE's General Manager will review the Participation Agreement language and make a recommendation to appropriately amend the PA or create a Project Agreement to assure consistency in AG practices.

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02. AE's General Manager, independent of LCRA, should address the need to protect AE's interests in negotiating changes in Participation Agreement terms. This includes an appropriate AG expense method that assures AE clear, stable costs, assurance of the appropriateness of costs and a cap to mitigate the risk to the City.

MANAGEMENT RESPONSE: Concur

AE's General Manager will review AG expense and methodology history and recommend adoption of an appropriate method that mitigates AE's risk. Adoption would be accomplished through inclusion in a Project Agreement or by amending the PA.

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03. AE's General Manager should review the AE Management Committee membership to ensure that appropriate expertise is present and no situations exist for potential undue influence. Changes could include ensuring financial expertise on the committee and independent voting representatives (i.e., not in a reporting relationship).

MANAGEMENT RESPONSE: Concur

AE's General Manager will review the membership of the FPP Management Committee considering the needs for independence and areas of expertise. The General Manager will make any changes deemed prudent to assure the City and Austin Energy's interests are protected.

APPENDIX A

MANAGEMENT RESPONSE

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MEMORANDUM

TO: Kenneth J. Mory, City Auditor

FROM: Larry Weis, General Manager

DATE: October 22, 2010

SUBJECT: **Response to Performance Audit of Austin Energy Fayette Power Project (FPP) Contract Compliance**

Attached please find Austin Energy's response to the **Performance Audit of Austin Energy Fayette Power Project (FPP) Contract Compliance.** Austin Energy concurs with the three recommendations provided in the audit report. Work is currently underway to review the FPP Participation Agreement as well as the FPP administrative and general expense allocation methodology. Based upon this work, Austin Energy will propose either changes to the FPP Participation Agreement or a Project Agreement to mitigate risks to the City and Austin Energy.

Austin Energy appreciates the work of the City Auditor's Office on this audit.

Larry Weis
General Manager
Austin Energy

Cc: Marc Ott, City Manager
Cheryl Mele, AE Deputy General Manager
Elaine Hart, Senior Vice President of AE Finance and Corporate Services
Keith Warren, Director of AE Financial Compliance

ACTION PLAN
Austin Energy FPP Contract Compliance Audit

Rec #	Recommendation Text	Concurrence	Proposed Strategies for Implementation	Status of Strategies	Responsible Person/ Phone Number	Proposed Implementation Date
01	We recommend that AE's General Manager address the need to standardize the AG expense practices within the Participation Agreement, up to and including amending the Participation Agreement or creating a Project Agreement.	Concur	AE General Manager will review the Participation Agreement language and make a recommendation to appropriately amend the PA or create a Project Agreement to assure consistency in AG practices.	UNDERWAY. AE staff is reviewing the Participation Agreement (PA) at present to identify areas where conflicts exist within the document itself, where existing Project Agreements need to be incorporated or where updates are needed to reflect current operating requirements of the Electric Reliability Council of Texas (ERCOT). Any proposed changes will be presented to the Austin Energy General Manager prior to proposing the recommended changes to LCRA. Any amendment to the PA will be brought forward by the Austin Energy General Manager for approval.	Jackie Sargent, AE Senior Vice President of Power Supply and Market Operations 322-6491	May 2011

Rec #	Recommendation Text	Concurrence	Proposed Strategies for Implementation	Status of Strategies	Responsible Person/ Phone Number	Proposed Implementation Date
02	We recommend that AE's General Manager, independent of LCRA, address the need to protect AE's interests in negotiating changes in Participation Agreement terms. This includes an appropriate AG expense method that assures AE clear, stable costs, assurance of the appropriateness of costs and a cap to mitigate the risk to the City.	Concur	Austin Energy's General Manager will review AG expense and methodology history and recommend adoption of an appropriate method that mitigates AE's risk. Adoption would be accomplished through inclusion in a Project Agreement or by amending the PA.	PLANNED. Review FPP AG expense history, Austin Energy audit findings history and appropriate industry benchmarking standards to establish Austin Energy's expectations for AG expense and methodology. Provide recommendation to Austin Energy's General Manager and Senior Vice President, Finance and Corporate Services. Recommend methodology and controls for inclusion in PA amendment or Project Agreement, as appropriate.	Jackie Sargent, AE Senior Vice President of Power Supply and Market Operations Ann Little, AE Vice President Finance and Corporate Services 322-6148	May 2011

Rec #	Recommendation Text	Concurrence	Proposed Strategies for Implementation	Status of Strategies	Responsible Person/ Phone Number	Proposed Implementation Date
03	We recommend that AE's General Manager review the AE Management Committee membership to ensure that appropriate expertise is present and no situations exist for potential undue influence. Changes could include ensuring financial expertise on the committee and independent voting representatives (i.e., not in a reporting relationship).	Concur	AE General Manager will review the membership of the FPP Management Committee considering the needs for independence and areas of expertise. The General Manager will make any changes deemed prudent to assure the City and Austin Energy's interests are protected.	PLANNED.	Larry Weis, General Manager 322-6002	January 2011