



Telephone:  
(916) 445-0255

Thomas W. Hayes  
Auditor General

STATE OF CALIFORNIA  
**Office of the Auditor General**  
660 J STREET, SUITE 300  
SACRAMENTO, CALIFORNIA 95814

July 11, 1983

P-314

Honorable Art Agnos  
Chairman, and Members of the  
Joint Legislative Audit Committee  
State Capitol, Room 3151  
Sacramento, California 95814

Dear Mr. Chairman and Members:

We have reviewed the California Public Utilities Commission's (commission) administration of utility management audits that are conducted for the commission by outside consulting firms. The commission uses management audits to evaluate and improve the operations of utility companies and to review utility rates.

Our review determined that the commission is slow to initiate and complete management audits. Only one of five audits that the commission ordered or proposed since 1978 has been completed; for one of the remaining four audits, only the first of two phases of the audit has been completed. Moreover, the commission has not ensured that audit reports contain adequate information on the costs and benefits of the recommendations made in the reports. In the report for the one audit completed since 1978, only 12 of 131 recommendations included estimates of costs and benefits that could result from implementing the recommendations. As a result of these delays and deficiencies, the commission does not receive full benefit from management audits when reviewing utility costs and setting rates.

In addition, the commission lacks adequate procedures and standards for selecting consultants who conduct the management audits and for ensuring that these consultants do not have conflicts of interest. Consequently, the commission cannot ensure that consultants are selected fairly and competitively and that the audit reports are impartial. In fact, the commission suspended one management audit because of public concern about the consultant's possible conflict of interest. Lack of adequate controls to ensure independence and impartiality of consultants may jeopardize the credibility of both the audits and the commission.

Honorable Art Agnos  
Chairman, and Members of the  
Joint Legislative Audit Committee  
July 11, 1983  
Page 2

## BACKGROUND

One of the primary responsibilities of the California Public Utilities Commission is to regulate the rates and services of more than 1,500 privately owned utilities and transportation companies and over 20,000 commercial highway carriers. The commission reviews utility operations and adjusts rates in two major ways: general rate cases and fuel cost adjustment cases. In a general rate case, the commission determines the total amount of revenue that will allow a utility to collect sufficient funds to meet its operating needs and also provide a reasonable profit. A fuel cost adjustment case enables a utility to adjust rates according to fluctuations in the cost of oil, natural gas, or other fuels.

The Public Utilities Code requires the commission to exclude from utility rates any costs that are found to be unjust or unreasonable or that result from inefficient utility operations. Rates must reflect the reasonable costs of a utility's operations and include a fair rate of return on the utility's investment. The commission staff reviews these costs during periodic rate reviews.

As part of its rate review process, the commission may order or propose management audits of utility company operations to identify utility inefficiencies, to achieve savings in utility operations, and to provide commission staff with information that can be used while reviewing utility rates. The commission regards a management audit as an analysis of the way a company is run: the company's supervision of construction, its internal communications, its budgeting practices, and its systems of management control. The commission selects independent management consultants to perform the audits.

The commission has not established any set procedures for administering management audits, although the commission has administered each management audit in approximately the same manner. Before selecting a consultant, the commission appoints a committee of commission staff members and a project manager who supervises the work of the committee. This committee develops the request for proposal for the management audit and specifies what should be included in the audit report. For example, the committee may determine the degree to which management audit findings must be quantified for each audit.

Honorable Art Agnos  
Chairman, and Members of the  
Joint Legislative Audit Committee  
July 11, 1983  
Page 3

The committee then reviews proposals submitted by potential consultants, interviews those consultants, and selects the consultant for the audit. The consultant and the utility then negotiate the contract for the audit. The utility pays the consultant's fee and is allowed to recover the cost through its utility rates.

Since 1978, the commission has ordered management audits of four utilities and proposed an audit of one other utility. In 1978 it ordered audits of Pacific Gas and Electric Company and Southern California Edison Company and proposed an audit of Southern California Gas Company. In 1979 it ordered an audit of San Diego Gas and Electric Company and, in 1980, a two-phase audit of Pacific Telephone and Telegraph Company.

#### SCOPE AND METHODOLOGY

The purpose of our audit was to review the procedures that the California Public Utilities Commission uses in administering management audits. We reviewed the effectiveness of the commission staff in scheduling, developing, and supervising management audits. We examined commission policies and procedures, interviewed commission staff, including project managers and a project coordinator in charge of audit committees, and analyzed commission documents such as audit requests for proposals, audit contracts, and audit reports. We also compared the commission's process of contracting for management audits with state contracting requirements.

Finally, we contacted public utility commissions in several other states to discuss their use of management audits in rate reviews, and we examined data on the use of management audits, as reported by public utility commissions in the other 49 states.

#### AUDIT RESULTS

The California Public Utilities Commission has not adequately administered its management audits. In the following sections, we discuss the commission's delay in initiating and completing management audits, the lack of quantified information on the costs and benefits of recommendations contained in audit reports, and the commission's lack of an adequate system for selecting management consultants.

Honorable Art Agnos  
Chairman, and Members of the  
Joint Legislative Audit Committee

July 11, 1983  
Page 4

The commission has been slow to initiate and complete management audits. Only two audit reports have been issued since the first management audits were ordered during 1978. These delays have resulted because the commission places a low priority on management audits and because the commission has not adequately utilized the staff position designated for supervising management audits. As a result of these delays, the commission has missed opportunities to identify utility inefficiencies.

#### Audits Could Be Initiated and Completed Sooner

The commission has been slow to initiate and complete management audits. Although the commission has ordered or proposed audits of five utilities in the past five years, only two audit reports have been issued. The delay in completing the audits has occurred in spite of the commission's stated position on the need for management audits. In its 1978 decision on the rate change requests of Pacific Gas and Electric Company, the commission, referring to an adjustment made to the utility's expenses, stated that the adjustment "illustrates the pressing need of monitoring the efficiency of the utilities we regulate." The commission further said that "If we are to be more than a rubber stamp translating cost increases into rate increases, we must scrutinize and exercise our investigatory ingenuity to ensure [that] utilities operate productively and efficiently." Then, referring to the value of management audits, the commission stated that Pacific Gas and Electric Company should "...precisely examine its efficiency and demonstrate to us that it is attempting to improve its efficiency and reduce costs. A management and operational audit by an independent consultant may accomplish this result."

#### Delayed Audits

Since the first management audits were ordered in 1978, only two audit reports have been issued. The commission has not successfully started three other audits. In June 1980, the commission received an audit report on the Pacific Gas and Electric Company audit that it ordered in 1978; in August 1982, it received a report on the Pacific Telephone and Telegraph Company audit it had ordered in 1980. However, the latter report, which presented the first phase of a two-phase audit,

Honorable Art Agnos  
Chairman, and Members of the  
Joint Legislative Audit Committee  
July 11, 1983  
Page 5

covered various issues concerning the managerial effectiveness of Pacific Telephone and Telegraph Company, including the impact of the court-ordered divestiture of American Telephone and Telegraph Company's subsidiaries. According to the audit's project coordinator (who functioned as project manager), the second phase of the audit, which will include an examination of the cost of utility inefficiencies, will not start before 1984.

The commission has not successfully initiated the audit of San Diego Gas and Electric Company that it ordered in 1979. Although the commission did begin this audit during August 1982, it suspended the audit after one month because of public concerns over the consultant's independence. In May 1983, the commission selected a second consultant to perform the audit. In addition, the commission has not scheduled the audit of Southern California Edison Company that it ordered in 1978 or the audit of Southern California Gas Company it proposed the same year.

#### Low Priority for Audits

Although the commission has publicly stated its belief in the value of management audits, it has not initiated or completed the audits sooner because the commission regards rate reviews as having higher priority than management audits. Therefore, the commission has not established firm schedules for beginning or completing the audits. For example, in 1978, the commission informed the Southern California Gas Company that it would be audited if the audit of Pacific Gas and Electric Company produced "desirable" results. However, even though commission staff informed the commissioners in 1980 that the audit of Pacific Gas and Electric Company was successful and useful, the commission has not scheduled the audit of Southern California Gas Company.

Similarly, in 1979 the commission's president stated that the audit of Southern California Edison Company should occur as soon as convenient. However, because the commission has placed low priority on management audits, more than four years have elapsed since the commission's 1978 order to audit this utility. As of April 1983, the commission still had not taken steps to begin the audit.

Honorable Art Agnos  
Chairman, and Members of the  
Joint Legislative Audit Committee  
July 11, 1983  
Page 6

#### Lack of Supervisors for Audits

According to project managers and an assistant division director, the commission has not initiated or completed more audits because it lacks sufficient managerial staff to supervise management audits. Project managers are primarily responsible for processing utilities' applications for rate changes; that is, reviewing and analyzing the requests and preparing recommendations for the commissioners to consider in setting rates that the utilities can charge. Project managers and staff are only assigned to management audit committees when time permits.

Although the commission contends that it lacks sufficient staff to supervise management audits, we found that the commission has not adequately utilized the staff position specifically designated for supervising management audits. In July 1981, the commission obtained a full-time position for a supervisor for management audits. In requesting this new position, the commission stated that an ad hoc committee had worked on previous management audits and that if management audits were to be given proper priority, the commission would need a permanent management audit supervisor.

We found, however, that the commission has not used this new supervisory position to facilitate management audits. The commission received authorization for this new position in July 1981, but did not fill the position until April 1, 1982. Further, the commission has never assigned management audit duties to the person who filled the new position. Instead, the commission has used the management audit supervisor to manage special projects and to review rate cases. Moreover, the commission still contends that it lacks staff to supervise management audits.

#### Unidentified Inefficiencies

As a result of delaying management audits, the commission has missed opportunities to identify utilities' inefficiencies and, thus, utility rates may not accurately reflect the reasonable costs of a utility's operations. Furthermore, as we reported in a previous Auditor General report on the Public Utilities Commission, the commission staff often does not perform

Honorable Art Agnos  
Chairman, and Members of the  
Joint Legislative Audit Committee  
July 11, 1983  
Page 7

thorough reviews of utilities' applications for rate changes.\* Management audits would supply important information on the efficiency of a utility's operations. This information could be used to supplement the commission staff's rate reviews.

For example, the management audit of Pacific Gas and Electric Company produced findings that the commission staff used to recommend reducing the utility's claimed annual expenses by \$10.2 million. This recommendation to reduce utility expenses illustrates the potential benefits of a completed management audit to the commission and to consumers.

Public utility commissions in other states have also found that management audits are beneficial. Our examination of data on public utility commissions in other states revealed that since 1976, commissions in at least 33 states have ordered more than 70 management audits to evaluate the efficiency and effectiveness of utility operations. Commissions in several states have reported that these audits produced information that helped them identify inefficient operations and aided them in reducing expenses claimed by utilities. In August 1982, for example, the Legislative Post Auditor of Kansas reported that two of three management audits ordered by the Kansas Corporation Commission (the Kansas equivalent of California's Public Utilities Commission) provided information on the efficiency of utility operations that was not otherwise available. In another example, in 1980 the Connecticut Department of Public Utility Control (the state utility commission) reduced a utility's proposed annual expenses by over \$5 million based upon recommendations in a management audit. Hence, when the California Public Utilities Commission delays implementing management audits, it may forgo opportunities to identify inefficiencies and other conditions that could affect its decisions on utility rates.

---

\* This report is entitled "The California Public Utilities Commission Needs to Improve Its Rate Review Systems," Report P-219, June 1983.

Honorable Art Agnos  
Chairman, and Members of the  
Joint Legislative Audit Committee  
July 11, 1983  
Page 8

Audit Recommendations  
Are Not Fully Quantified

Not only has the commission delayed beginning or completing management audits, it has also not always ensured that management audit reports fully meet the commission's needs. A commission objective in ordering management audits is to identify utility cost savings; that is, expenditures that the utility might be able to reduce by implementing recommendations made in a management audit. However, the commission's requirements for quantifying utility cost savings have varied for each audit, and the management consultants who produced the two reports issued since 1978 did not always quantify the costs and benefits that would result from implementing their recommendations. As a result, the commission is hampered in its review of utilities' operations and consumers may not adequately benefit from management audits.

The commission has not always stated specifically what must be included in the audit reports to meet the commission's needs. Additionally, the commission has not always ensured that audit requests for proposals specifically require consultants to quantify the costs and benefits of audit recommendations designed to achieve utility cost savings. As a result, for example, consultants quantified costs or benefits for only 12 of 131 recommendations (less than 10 percent) contained in the report on the audit of Pacific Gas and Electric Company. The report on the first phase of the audit of Pacific Telephone and Telegraph Company included no estimates of cost savings. According to the commission executive director, recommendations that do not quantify costs and benefits are of value to the commission. The commission can use such recommendations to improve utility management and operations. However, he also indicated that recommendations that quantify costs and benefits are more desirable.

Because management consultants have not fully quantified cost savings, the commission may be hampered in using audit recommendations in its utility rate reviews. Although commission staff reported that the management audit of Pacific Gas and Electric Company was useful, the project manager for the 1983 general rate case for Pacific Gas and Electric Company told us that his staff could have made better decisions on the reasonableness of rate requests if the management audit had

Honorable Art Agnos  
Chairman, and Members of the  
Joint Legislative Audit Committee  
July 11, 1983  
Page 9

included additional data on the costs and benefits of the recommendations. In addition, the project manager for the 1983 general rate case for Pacific Telephone and Telegraph Company said that the commission will not be able to use the first management audit report to recommend reductions in the utility's expenses because the management consultants did not quantify any cost savings in their recommendations in that audit report.

The Commission's System  
for Selecting Management  
Consultants Needs Improvement

The commission does not use adequate procedures to evaluate objectively the qualifications of management consultants. Consequently, the commission cannot ensure that it selects consultants fairly and competitively. Moreover, the commission has inadequate standards for determining if management consultants have a conflict of interest. As a result, the commission has had problems resolving conflict of interest issues and, in fact, suspended one audit because of the public concern over possible conflict of interest.

Inadequate Contracting  
Procedures

Although the commission has established contracting procedures that include objective selection criteria, it does not use these procedures when contracting for management audits. The State Administrative Manual and state law provide a number of contracting procedures that state agencies must follow in administering contracts. One of the requirements of the State Administrative Manual is that state agencies use objective evaluation procedures to select contractors. These procedures include determining in advance the criteria and the objective scoring procedures that will be used to evaluate each potential contractor. In addition, state law requires that agencies describe for potential contractors the exact basis for the evaluation; failure to disclose this basis may subject an agency to protests by unsuccessful bidders. Furthermore, proper contracting procedures dictate that agencies evaluate consultants according to consistent criteria that reflect the relative importance of each factor being considered, such as the consultant's experience or the proposed costs. Additionally, if agencies used a standard form showing the

Honorable Art Agnos  
Chairman, and Members of the  
Joint Legislative Audit Committee  
July 11, 1983  
Page 10

number of potential points or weight to be given to each factor being evaluated, all evaluators would be able to evaluate each consultant objectively against consistent criteria.

We found that the commission does not always use formal scoring procedures to evaluate the qualifications of potential consultants for management audits. Additionally, the commission does not maintain adequate records of how management consultants are selected. For the management audits of both Pacific Gas and Electric Company and San Diego Gas and Electric Company, each member of the selection committee individually determined his or her own criteria for evaluating potential consultants. The committee then composed a list of finalists consisting of each member's top choices; the committee selected a winning consultant based on the collective opinion of the committee members. Only for the audit of Pacific Telephone and Telegraph Company did the commission staff use a formal scoring system to select a management consultant. In that case, staff used formal scoring only in the preliminary review; the staff did not use formal scoring procedures in selecting the winning management audit consultant.

Because the commission did not always use formal scoring procedures to evaluate objectively the qualifications of management consultants, the commission is subject to potential protests by consultants who were not chosen. Furthermore, without formal procedures, the commission cannot demonstrate to consumers that it chooses consultants objectively and impartially.

The commission considers management audit contracts as agreements between the utility and the consultant. Therefore, the commission believes that these contracts are not subject to state or commission standards. However, because the commission uses management audits to help fulfill its statutory responsibilities to regulate public utilities, and because the commission uses information from management audits to calculate utility revenue requirements and the necessary rate changes to support those requirements, state interests are involved in management audit contracts. We believe, therefore, that to protect the public's interest, the commission's system for obtaining such contracts should follow state standards.

Honorable Art Agnos  
Chairman, and Members of the  
Joint Legislative Audit Committee  
July 11, 1983  
Page 11

Inadequate Standards  
For Determining  
Conflict of Interest

Because the commission has no clear standard for determining when a consultant may have a conflict of interest, the commission has had problems resolving questions concerning potential conflict of interest of management consultants. In fact, one audit was suspended because of public concern over the consultant's apparent conflict of interest. Until the commission can reasonably ensure the impartiality of consultants' audit reports, public confidence in the credibility of these reports will be jeopardized.

The commission's method for determining and resolving conflict of interest has been inconsistent and unclear. For example, the consultant conducting the audit of Pacific Telephone and Telegraph Company had completed prior work for and had an existing contract with American Telephone and Telegraph Company, the parent company of Pacific Telephone and Telegraph Company. In an attempt to eliminate this apparent conflict of interest, the commission allowed the management consultant to establish a two-member quality review board to assess the consultant's work independently. The commission's executive director stated that the commission expected this review board to evaluate the quality of the consultant's work and to assess the consultant's objectivity. However, one of the two members of the quality review board was also a member of the board of directors of the consulting firm that was performing the audit. Thus, he was not in a position to evaluate the consultant's objectivity in an independent manner.

The commission resolved concerns over conflict of interest differently for the audit of San Diego Gas and Electric Company. After the audit began in 1982, newspapers reported that the firm conducting the audit had performed executive search activities for San Diego Gas and Electric Company more than 12 years earlier. The firm had identified several candidates for positions with the utility. Some of these candidates were hired by the utility and currently hold executive level positions. To resolve this appearance of conflict of interest, the commission suspended the audit and allowed the management consultant to resign.

Honorable Art Agnos  
Chairman, and Members of the  
Joint Legislative Audit Committee  
July 11, 1983  
Page 12

Because the commission lacks a clear standard for determining conflict of interest, the audit of San Diego Gas and Electric Company has been delayed. At the time of our review, the commission had spent over seven months selecting a second management consultant. After requesting potential contractors to resubmit their proposals for the audit, commission staff again had to review proposals and evaluate potential contractors.

According to the executive director, the commission made certain improvements to evaluate contractors' possible conflict of interest. To select the second consultant, the commission required the potential contractors to fully disclose all prior direct and indirect associations with the utility. The commission also expanded its evaluation of these associations.

However, the duplication of effort involved in selecting a second management consultant firm is an inefficient use of staff resources and might have been avoided if the commission had developed clear standards for determining conflict of interest before it had selected the first consultant. More importantly, the lack of standards for determining conflict of interest jeopardizes the credibility of the management audit reports and consequently the credibility of the commission's decisions on utility rates that are based on the reports. With a clear standard for determining and resolving questions concerning conflict of interest, commission staff could resolve concerns before a situation becomes so serious that an audit must be terminated or before public confidence in a management audit is diminished.

#### CONCLUSION

The California Public Utilities Commission needs to improve its administration of management audits to ensure that consumers and utilities obtain greater benefits from these audits. The commission has been slow to initiate and to complete audits. Our review disclosed that only one of the five audits that the commission has ordered or proposed is complete. In addition, the commission has not always required management consultants to quantify the costs and benefits of their audit recommendations. In the one completed audit, only 12 of 131 recommendations included estimates of the costs and benefits of implementing the recommendations.

Honorable Art Agnos  
Chairman, and Members of the  
Joint Legislative Audit Committee  
July 11, 1983  
Page 13

The commission also needs to improve its system for selecting management consultants. The commission does not always use adequate procedures to evaluate potential contractors objectively nor does the commission have clear standards for determining conflict of interest. Because the commission has not established its conflict of interest standards for management consultants, one audit has been suspended and public confidence in the management audits may have been diminished.

#### RECOMMENDATION

To ensure that greater benefits are obtained from management audits and that staff resources are used efficiently, the California Public Utilities Commission needs to modify its procedures for administering management audits of public utilities. Specifically, the commission should do the following:

- Provide direction to commission staff when management audits are ordered, specifying when audits are to be initiated and completed and what the audit reports must contain to meet the commission's needs;
- Use the commission's budgeted management audit supervisor position for its designated purpose of supervising management audits; and
- Ensure that management audit requests for proposals and audit contracts require management consultants to quantify the costs and benefits of their recommendations.

To improve its system for selecting management consultants, the California Public Utilities Commission should do the following:

- Apply and consistently use objective evaluation procedures to select management consulting firms for management audits and maintain a record of this process that the public can inspect; and
- Establish and use a standard for determining conflict of interest and consistently apply this standard when evaluating potential management consultants.

Honorable Art Agnos  
Chairman, and Members of the  
Joint Legislative Audit Committee  
July 11, 1983  
Page 14

We conducted this audit under the authority vested in the Auditor General by Section 10500 et seq. of the California Government Code and according to generally accepted government auditing standards. We limited our review to those areas specifically contained in the audit request.

Respectfully submitted,

  
THOMAS W. HAYES  
Auditor General

Audit Completion Date: July 5, 1983

Staff: Richard C. Tracy, Audit Manager  
Georgene L. Bailey  
Geraldine C. Parks, CPA  
Marlene Keller

Attachment: Response to the Auditor General's Report  
California Public Utilities Commission



ADDRESS ALL COMMUNICATIONS  
TO THE COMMISSION  
CALIFORNIA STATE BUILDING  
SAN FRANCISCO, CALIFORNIA 94102  
TELEPHONE: (415) 557- 1487

## Public Utilities Commission

STATE OF CALIFORNIA

FILE NO.

June 24, 1983

Thomas W. Hayes  
Auditor General  
600 J Street, Suite 300  
Sacramento, CA 95814

Dear Mr. Hayes:

The time allowed us for response to your draft report on management audits does not permit an official Commission reply. The comments that follow are thus those of the staff.

We agree that management audits should be conducted efficiently, effectively, and without conflict of interest on the part of the consulting firms that do the work. But, as we have pointed out to your staff, management audits are by no means the important means by which we continually seek to promote management efficiency in California utilities. It is simply one tool among the many employed by the Commission.

We believe the report should give more emphasis to the reasons why we proceed carefully with management audits. First, our overall workload on utility issues--fuel cost proceedings, major power plant construction, general operations, etc.--is enormous. It's therefore difficult to find the staff time necessary to supervise management audits. We believe the audits are worthwhile only to the extent we can direct and monitor the work of consultants, so that our staff people can understand and evaluate the management techniques of the utility companies. In other words, we do not see any benefit in conducting more audits than we are capable of supervising at any one time. Second, we learn from each audit, and are able to apply what we learn to making the next one better. One audit at a time is the better way to use the tool.

Thomas W. Hayes  
June 24, 1983  
Page 2

We supervise the audits (and evaluate potential consultants) in the most effective way we know, which is to use a team of staff people--attorneys, financial examiners, engineers, economists, etc.--experienced with the utility company being studied. In this way, our staff not only directs the consultant but learns as the study proceeds and can make maximum use of the audit results.

While a management audit often yields specific recommendations that can be quantified, a certain action by a utility would save a certain amount of money, the audits are as valuable, if not more so, when specific dollar amounts cannot be determined. One of the more important nonquantifiable areas is management. Improving utility management benefits both utility shareholders and utility customers.

Obviously, the consultant firms conducting management audits should be free of any conflict of interest. We believed our initial methods to insure this were adequate, but as new issues of possible conflicts have arisen we have expanded and toughened our standards and procedures. There has been no conflict of interest in any of the audits conducted thus far, and we are concerned that there not even be an appearance of possible conflict.

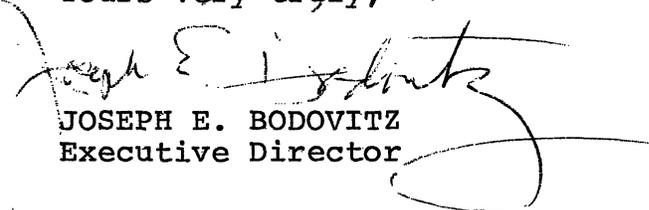
Unfortunately, the report nowhere explains what a management audit is and what it is not. A management audit is not a witch hunt, and it is not an adversarial crusade (even though some of the recommendations of a consultant may be the subject of formal hearings before the Commission). Rather, it's an effort to review the management of a utility company, from its board of directors to its field operations, and to look for improvements that would enable a company to serve its customers more efficiently and inexpensively.

For this reason, we seek consultants--through a fair, open bidding process--who can do this work competently, because of their experience in efficient management, and fairly, because of their impartiality. We too want objective means of evaluating would-be consultants, but inevitably judgments must be made about the skills and objectivity of individuals

Thomas W. Hayes  
June 24, 1983  
Page 3

and consulting firms. This is one of the reasons we both evaluate consultants and supervise projects by drawing on the talents of many of our staff people, as a project team.

Yours very truly,



JOSEPH E. BODOVITZ  
Executive Director