

Decision **PROPOSED DECISION OF ALJ EDMISTER** (Mailed 10/6/2015)

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

Application of Pacific Gas and Electric Company for Approval of 2013-2014 Energy Efficiency Programs and Budget (U39M)

Application 12-07-001
(Filed July 2, 2012)

And Related Matters.

Application 12-07-002
Application 12-07-003
Application 12-07-004

DECISION GRANTING SOUTHERN CALIFORNIA EDISON COMPANY'S (U-338-E) MOTION FOR CLARIFICATION PURSUANT TO ORDERING PARAGRAPH 49 OF DECISION 12-11-015

Summary

In this decision, we:

1. Determine that beginning with calendar year 2017, all energy efficiency (EE) Program Administrators (PAs) shall include in all new or amended EE third-party fixed-price contracts a provision giving the Commission the ability to obtain through PAs additional information on the finances of PA counterparties to EE third-party fixed-price contracts upon request; and,
2. Direct the Utility Audit and Financial Compliance Branch (UAFCB) to: obtain through PAs¹ financial

¹ Where there is a contractual audit right; see above.

information from an EE third-party fixed-price contract counterparty when review of the counterparty's contract(s) and invoice(s) under those contracts suggest allocation of contract amounts among 1) administrative costs; 2) marketing/outreach costs; and 3) direct implementation costs are materially inaccurate.

3. Determine that it was reasonable for Southern California Edison Company to use factors supplied by contract counterparties to allocate costs for EE third-party fixed-price contracts among:
 - 1) administrative costs; 2) marketing/outreach costs; and 3) direct implementation costs, subject to audit by Utility Audit, Finance, and Compliance Branch (UAFCB) as discussed in Paragraph 2.
4. Determine that all PAs may use factors supplied by contract counterparties to allocate costs for EE third-party fixed-price contracts among:
 - 1) administrative costs; 2) marketing/outreach costs; and 3) direct implementation costs, subject to audit by UAFCB as discussed in paragraph 2.
5. Direct Commission Staff to complete the audit of investor-owned utilities' administrative costs previously directed in Decision (D.) 09-09-047.²

These consolidated proceedings remain open to consider issues arising from a pending Petition for Modification of D.13-09-044, which approved energy efficiency (EE) financing pilots. Those issues are unrelated to the issues we address today.

² D.09-09-047, OP 13 and 14 (pp. 369-370). To clarify in response to comments, this decision directs an audit of the most current administrative cost data available, not an audit of 2009 costs.

1. Procedural Background

On May 19, 2014, Southern California Edison Company (SCE) filed a “Motion for Clarification Pursuant to Ordering Paragraph 49 of Decision (D.) 12-11-015.” In its motion, SCE took issue with aspects of a UAFCB, EE Financial Compliance Examination Report of SCE for the period January through December 31, 2011, dated September 27, 2013 (2011 Audit Report). On June 3, 2014, Pacific Gas and Electric Company (PG&E), San Diego Gas and Electric Company (SDG&E), and Southern California Gas Company (SoCal Gas) filed responses to SCE’s motion, generally supporting the motion, but diverging on the remedy they would have us select.³ We conducted an evidentiary hearing on March 30, 2015. The litigants filed opening briefs on May 22, 2015, and answering briefs on June 12, 2015. Parties moved for acceptance of transcript corrections on April 30, 2014 (SCE) and on May 1, 2015 (UAFCB). No party objected to the proposed corrections, and we grant the motions for corrections. For a fuller procedural history, see the Commission’s docket card.⁴

2. Discussion

UAFCB annually audits energy utility EE financial compliance. For the period of January 1 through December 31, 2011, one of the issues that UAFCB raised in the 2011 Audit Report,⁵ and the issue now before us, is how to allocate the costs of fixed-price third-party contracts across three accounting “buckets”

³ We will refer to PG&E, SDG&E, SoCal Gas, and SCE as the Investor-Owned Utilities (IOUs). We will refer to the IOUs and UAFCB together as “litigants.”

⁴ http://delaps1.cpuc.ca.gov/CPUCProceedingLookup/f?p=401:56:10061975687158::NO:RP,57,RIR:P5_PROCEEDING_SELECT:A1207001.

⁵ UAFCB has raised this same accounting issue in audits of SCE’s subsequent-year contracts (e.g., 2012). In addition, UAFCB has raised this same issue with respect to PG&E’s 2012 program year. Accordingly, we take the opportunity here to set rules for all IOUs.

that we require that all EE Program Administrators (PAs) use. Those “buckets” are:

- 1) Administrative Costs
- 2) Marketing/Outreach Costs
- 3) Direct Implementation Costs

These “buckets” are Commission-specific and not standard accounting categories. They are used only for Commission-jurisdictional EE expenditures, and all PA EE program expenditures have to land in one or another of these buckets.⁶ Allocation across the “buckets” is easy enough for a PA’s internal costs. It is feasible, if somewhat more difficult, to allocate costs for time-and-materials contracts a PA has with third parties, since with time-and-materials contracts, a counterparty’s own costs are generally the same as the charges to the PA. With time-and-materials contracts, invoices provide a ready reference for review of cost allocations.

However, allocations across Commission accounting categories are trickier for third-party fixed price contracts. A simple illustration of the issue is provided below.

Consider a contract under which a PA pays a counterparty a fixed price per unit of energy savings (e.g., \$0.05/per kilowatt-hour (kWh) saved).

⁶ We note that the money that PAs transfer to the Commission for Evaluation, Measurement, and Verification (EM&V) is not allocated across the buckets. EM&V is arguably not a PA expenditure at all, since EM&V is calculated to be a “grossed up” addition to PA program budgets (D.15-01-002 at 3), but we note the fact for completeness.

Figure 1: Third-party fixed price contracts hypothetical illustration

<u>Counterparty</u>	<u>PA</u>	<u>CPUC Accounting</u> <u>Categories</u>
Invoice: (X) kWh of savings	Amount Paid: \$0.05/per kWh saved	1. Admin Costs? 2. M/O Costs? 3. DI Costs?

In this hypothetical, the only thing the counterparty needs to show to the PA in order to receive payment is savings. The counterparty's invoice need not break out time spent on individual tasks to achieve the savings. In addition, the amounts invoiced to the PA will not necessarily reflect the counterparty's actual costs. How, then, to allocate the amounts PAs pay under these contracts across the three cost buckets?

SCE's approach to allocation for third-party fixed-price contracts has been to leave allocation largely to the counterparties. In its *pro forma* 2009-2011 targeted request for proposals (2009-11 Request for Proposal (RFP)), SCE provided a blank table (allocation table) into which counterparties were to enter figures for administrative costs, marketing/outreach costs, and direct implementation costs.⁷ Just below the table, the 2009-11 RFP provided prospective bidders with explanations for each category.

SCE asserts that it examines the counterparty's allocations when it evaluates the RFP response. SCE contends further that such a breakdown is in any event unnecessary and inimical to the Commission's policies favoring the use of fixed-price third-party contracts. SCE proposes either that we drop

⁷ Ex. SCE-2.

altogether any requirement for allocation of third-party contract costs, or, in the alternative, that we allow the use of predetermined allocation percentages for third-party contracts.⁸

UAFCB would have SCE take a different approach to allocation. UAFCB's principal concern is with the administrative costs bucket. In D.09-09-047, we imposed "a 10% cap on total administrative costs."⁹ The point of the cap is to have "ratepayer funds [] used to the greatest degree possible for [EE] programs themselves"¹⁰ rather than for utility internal activities.

Establishing a cap on a particular type of cost sets up a familiar dynamic. As regulated entities push up against the cap, they may seek to move costs into uncapped categories.¹¹ They may also seek to move costs "off-book" that is, transfer otherwise capped costs to third parties in order to conceal them from regulatory scrutiny. UAFCB's review of SCE's 2011 contracts and associated

⁸ PG&E supports dropping the reporting requirement altogether, while SDG&E and SoCal Gas support use of predetermined allocation percentages. PG&E, SDG&E, and SoCal Gas assert that they, like SCE, have been using predetermined allocation percentages for third-party fixed price contracts.

⁹ "Defined as overhead (General and Administrative Labor and Materials), labor (Management and Clerical), Human Resources Support and Development, Travel and Conference Fees ([collectively,] Administrative Costs)." D.09-09-047 at 49.

¹⁰ D.09-09-047 at 51.

¹¹ Various parties have alleged the IOUs have done just that in response to the 10% cap. *See, e.g.*, D.09-09-047 at 51. ("Division of Ratepayer Advocates and The Utility Reform Network believe that the utilities, instead of reducing their administrative costs in the new applications, have relabeled much of their administrative costs as direct implementation costs, as evidenced by the significant increase in direct implementation costs between the July 2008 and March 2009 filings but relatively level total budget amounts"). Without passing on whether this is actually happening or not, we have acknowledged this concern, and committed to explore it more fully, in both D.09-09-047 and in Rulemaking 13-11-005.

invoices raised the specter of third-party fixed price contracts becoming, whether by design or by inadvertence, an “off-book” shelter.¹²

A simple, if extreme, hypothetical illustrates how such a shelter might work. An IOU approaching the administrative cap could have a third-party contractor take on administrative tasks under a fixed-price contract. For purposes of this hypothetical, assume that the contract is entirely for administrative tasks. These costs would ordinarily count entirely against the administrative cap. In this hypothetical, though, the costs are tucked into a fixed-price third-party contract, which the IOU can allocate across *all three* “buckets,” provided the counterparty is willing to cooperate. This means that only a fraction of costs otherwise wholly chargeable to administration end up counting towards the administrative cap.

Figure 2: Illustration of “off-book” shelter

<u>IOU</u>	<u>Fixed-price contract</u>
Administrative Cap: \$100	
Current Administrative Costs: \$80	
<u>New Administrative Costs: \$40</u>	
New Total: \$120	
Cap Overage: (+) \$20	

¹² Ex. UAFCB-1-3, at A-15-17.

<u>IOU</u>	<u>Fixed-price contract</u>
Administrative Cap: \$100	
<u>“Off-Book” shelter solution</u>	<u>“Off-Book” allocation</u>
Fixed-price Contract : \$40	Administrative Costs: \$10
Allocate across “buckets”	Marketing/Outreach Costs: \$15
<u>New Administrative Costs: \$10</u>	<u>Direct Implementation Costs: \$15</u>
New Total: \$90	Total Fixed-price contract: \$40
Cap Overage: (-) \$10	\$10 instead of \$40 counting against Administrative Cap.

In practice, for third-party fixed-price contracts, an arrangement like the one posited in the hypothetical above would be hard to pull off. If a contract were solely for administrative services, UAFCB could see that on the face of the contract. If it were for more than administrative services – say there was a provision for installation of some energy-saving widgets in addition to a disproportionate share of administrative costs – that would be harder to detect. The contract would still likely pull focus during either the Commission’s ex ante or ex post review, because the contract cost per kWh would be very high. In other words, this hypothetical requires: (1) that the PA and its counterparty collude to conceal the extent to which a third-party fixed-price contract provides for administrative services; and (2) that the contract avoid scrutiny during Commission Staff review processes.

UAFCB’s review of SCE’s 2011 contracts, and associated invoices raised the specter of a variant of this scenario actually happening.¹³ In response to this

¹³ Ex. UAFCB-1-3 at A-15-17.

discovery, UAFCB called for arrangements to ensure “the costs reported in the three cost areas would be accurate for evaluating targets and asking actual costs for conducting marketing, administration and direct implementation.”¹⁴ The point being that accuracy is necessary to ensure compliance with the cap, beyond avoiding outright fraud. UAFCB’s specific proposal is to audit all counterparties on a rolling five-year cycle. Information from the audit would establish and/or validate allocation factors, which IOUs could then apply to their payments to the respective counterparties.

To summarize the position of the parties:

- SCE argues that for third-party fixed price contracts the “actual” costs are the contract payments to the third-party, and so allocation is impracticable and unnecessary. Alternatively, SCE argues for allocating invoiced amounts, not a counterparty’s costs, based on proportions the counterparty provides.
- UAFCB, on the other hand, contends that the relevant costs are the costs that SCE’s counterparty incurs, not what the counterparty invoices. In UAFCB’s view, SCE must determine those costs and then allocate those costs into the three “buckets.” Alternatively, if SCE can use proportions to allocate *invoiced amounts* (as opposed to counterparty costs), then SCE needs to verify those proportions against some sample of counterparties’ actual costs.

The question before us is, in essence, how accurate do the allocations really need to be? Once we answer this question, we can arrive at an appropriate allocation approach.

¹⁴ Ex. UAFCB-1-3 at A-16.

How we answer the question depends on what the Commission's goals are. If the goal is to prevent large-scale misallocations of spending across the "buckets," then the Commission does not need a high level of precision in the allocations. If the goal is to be sure that fixed-price third-party contracts do not enable PAs to avoid hitting the administrative cap where they otherwise would, then the Commission needs a higher level of precision.

We conclude that our *principal* goal is to prevent large-scale misallocations of administrative costs associated with fixed-price third-party contracts. The Commission is confident that UAFCB, in conjunction with other Commission Staff, can prevent such abuses without having to audit all counterparties. This confidence flows from UAFCB's testimony regarding the "October Invoice." This was an invoice from an unnamed contractor where, according to UAFCB, "there were no direct implementation cost activities associated with the invoice, and yet the vendor used the predetermined allocation factor to assign 91%, or \$1,358,335, of that invoice to direct implementation."¹⁵ SCE contends that there in fact were direct implementation costs associated with the invoice, as established by reference to the invoice detail, and that the counterparty was "confused" in stating otherwise on the face page of the invoice.

Regardless of who is right about the particulars of the October Invoice, the discussion surrounding it illustrates how UAFCB can identify possible large-scale misallocation without auditing *all* counterparties on a five-year cycle. If UAFCB both (1) reviews contract terms and invoices, and (2) has the ability to

¹⁵ Ex. UAFCB-1-2 at 4:9-12.

obtain counterparty financial information when that review raises its suspicions, then we have the large-scale misallocation problem adequately addressed.

We do not want UAFCB auditing third-party fixed-price contracts at the slightest provocation, but neither do we want to create a clear “safe harbor” for counterparties to misallocate across the “buckets.” UAFCB is to audit contracts and invoices to decide what, if any third-party fixed-price contracts to investigate more closely through its examinations of the PA’s records. UAFCB will have discretion to obtain, via PAs, additional information. We expect them to use that discretion wisely.

SCE argued that a more rigorous approach to allocation would greatly increase IOU and/or counterparty costs. Cross-examination demonstrated that these claims lacked any empirical analysis to support them.¹⁶ SCE also argued that it lacked access to information from its counterparties. Examination showed that the *pro forma* RFP required respondents to provide for quarterly reports: “**B. CPUC Reporting Requirements:** . . . the requisite information on the prior month’s activities . . . related to its respective Work obligations, for purposes of preparing any reports required of SCE by the CPUC including Quarterly and Annual Reports. The CPUC reporting requirements may be amended from time to time, at which time SCE will notify Consultant of the changes and issue a Change Order.” A more detailed description of the reporting requirements follows, and identifies under “**Expenditures**” an item for “Total Expenditures” with substructure for “Administrative Cost, Marketing/ Advertising/Outreach

¹⁶ RT 86:15-90:16

Costs,” and “Direct Implementation Cost”¹⁷ i.e. the three accounting “buckets” at issue here. The *pro forma* RFP and associated Appendix F provides, in essence, that counterparties have to give SCE the information we direct SCE to obtain from them to report to us. The *pro forma* RFP and associated Appendix F also provide that our reporting requirements can change at any time.

In sum, then, the evidence demonstrates that SCE can obtain from counterparties any information the Commission (and so UAFCB) requires. While there may be some additional costs to SCE and counterparties related to providing that information, we have no record what those costs will actually be, or how bearable (or not) that burden may be for counterparties.

With all that said, absent unequivocal evidence that there is a large-scale problem here, we will not impose an auditing requirement of the breadth and depth that UAFCB requests. For now, we have only one indication – and a disputed one at that – that there may be a problem with the allocations that SCE is using. That is not enough evidence to warrant requiring UAFCB, SCE, and counterparties to go through the effort of obtaining financial information from all counterparties, and parsing counterparty cost information out into our non-standard accounting categories on a regular basis.

Focusing on large-scale misallocations may allow a PA to come in under the administrative cost cap where it otherwise would not have. That is, a PA might attribute 9% at cost to adjust if using estimated allocation factors. If those factors were more accurate the PA might have attributed say, 11% to admin.

¹⁷ Ex. SCE-3.

This presents the Commission with a question of how to allocate the Commission's accounting resources. In dealing with the problem of excessive utility administration costs, it is better to devote accounting resources to auditing a PA's own administrative costs. An example of such an approach is the audits of utility administrative costs that we directed in D.09-09-047. This view is, of course, premised on the expectation that there is not a massive transfer of administrative costs "off-book." If UAFCB finds evidence of broad or deep misallocation of administrative costs under third-party fixed price contracts, we will reconsider our approach.

Accordingly, we conclude that it was reasonable for SCE to use counterparty cost allocations subject to SCE review. We further conclude that PAs may continue to use this practice going forward. PAs shall ensure that UAFCB can access counterparty financial information. It appears from the *pro forma* RFP and associated Appendix F that the requisite capability is already in place. To the extent it is not, PAs should obtain the ability to demand cost information from counterparties upon Commission (and Commission Staff) request in the next round of third-party RFPs and/or contract extensions.

If UAFCB finds evidence of large-scale shifting of administrative costs "off- book," or if PAs and counterparties fail to cooperate fully with Commission Staff and their auditors (including outside auditors), we will reconsider our approach.

In closing, we point out that this debate has material ramifications for energy corporation shareholders. As SCE stated in the motion initiating this dispute, "[a] portion of SCE's 2011 EE incentive award related to contracting expenditures [is] being withheld until additional information is obtained

regarding these reporting practices.”¹⁸ In addition, SCE states that “the EE incentive awards for 2012, 2013, and 2014 are at risk for disruption.”¹⁹

The possible “disruption” that SCE refers to results from the intersection of shareholder incentive mechanisms with Commission-defined accounting methodologies. For 2011 and 2012 EE program activities, IOUs are eligible to receive shareholder incentives pursuant to D.12-12-032. For subsequent years, IOUs are eligible for awards via the Energy Savings Performance Incentive mechanism (ESPI).²⁰ For all years, the amount of IOU incentives we award depends in part on the results of UAFCB audits of EE expenditures.²¹ This is true whether we award those incentives pursuant to D.12-12-032 or under the ESPI. For every program year, UAFCB audits portions of IOU EE expenditures and issues a report. That report feeds into the incentive calculations.

Consequently, one final issue to address here is release of the shareholder award amounts being withheld pending clarification of the accounting rules for third-party fixed price contracts. Energy Division should release funds that it had withheld in connection with this dispute over accounting for third-party fixed price contracts.

3. Comments on Proposed Decision

The proposed decision of the ALJ in this matter was mailed to the parties in accordance with Section 311 of the Public Utilities Code and comments were allowed under Rule 14.3 of the Commission’s Rules of Practice and Procedure.

¹⁸ SCE Motion, at 3 (internal citation omitted).

¹⁹ *Id.*

²⁰ The ESPI is an incentive mechanism [] designed to motivate utilities to prioritize EE goals. D.13-09-023 at 2.

Comments were filed on October 26, 2015 by PG&E and SCE. Reply comments were not filed. PG&E's recommendations are addressed in the body of the Decision. SCE's comments supported the proposed decision.

4. Assignment of Proceeding

Carla J. Peterman is the assigned Commissioner and Todd O. Edmister is the assigned ALJ in this proceeding.

Findings of Fact

1. PAs allocate the costs of fixed-price third-party contracts across three accounting "buckets:" administrative, marketing and outreach, and direct implementation. The Commission requires all PAs to use these "buckets." All PA EE program expenditures have to land in one or another of these "buckets."

2. These "buckets" are Commission-specific, and not standard accounting categories. They are used only for Commission-jurisdictional EE expenditures.

3. The amount invoiced by the counterparty does not need to break out time spent on individual tasks to achieve energy savings.

4. The amounts a counterparty invoices to a PA under a fixed-price third-party contract will not necessarily reflect the counterparty's actual costs.

5. UAFCB's review of SCE's 2011 contracts and associated invoices raised the specter of third-party fixed price contracts becoming, whether by design or by inadvertence, an "off-book" shelter for administrative costs.

6. The Commission's principal goal in auditing fixed-price third-party contracts costs is to prevent large-scale misallocations of PA administrative costs through fixed-price third-party contracts.

7. There is not enough evidence to warrant requiring UAFCB, SCE, and the counterparties to go through the effort of obtaining financial information from all

counterparties, and parsing counterparty cost information out into the Commission's non-standard accounting categories, on a routine basis.

8. If UAFCB both: (1) reviews contract terms and invoices, and (2) has the ability to obtain counterparty financial information when that review raises its suspicions, then we have the potential for large-scale misallocation adequately addressed.

9. SCE's assertion that a more rigorous approach to cost allocation than SCE proposed would greatly increase IOU and/or counterparty costs lacked empirical support.

10. The *pro forma* SCE RFP and associated Appendix F allow SCE to obtain information from contract counterparties and to provide such information to the Commission. The *pro forma* RFP and associated Appendix F expressly contemplates Commission reporting requirements changing at any time.

Conclusions of Law

1. It is reasonable for SCE to allocate *invoiced amounts* to cost "buckets" under fixed-price third-party contracts, rather than to allocate counterparty costs.

2. UAFCB may audit SCE's fixed-price third-party contracts and invoices thereunder to decide what, if any, contracts require further examination.

3. Where SCE's contract with a counterparty allows SCE to obtain third-party contract counterparty financial information sufficient to verify claimed allocation factors used to allocate invoice amounts across cost "buckets," SCE must obtain and provide that information to UAFCB upon UAFCB's request.

4. It was reasonable for SCE to use counterparty cost allocations subject to SCE review to allocate invoiced amounts under fixed-price third-party contracts to the accounting "buckets."

5. It is reasonable for PAs to continue to use counterparty cost allocations subject to SCE review to allocate invoiced amounts under fixed-price third-party contracts to the accounting “buckets.”

6. It is reasonable to require that PAs provide in third-party fixed price contract for Commission access to third-party fixed price contract counterparty financial information.

7. It is reasonable for Energy Division to release shareholder incentive award amounts that it had withheld in connection with this dispute over accounting for third-party fixed-price contracts.

O R D E R

IT IS ORDERED that:

1. Southern California Edison Company (SCE) shall recover the \$5,005,528 of shareholder incentives withheld from SCE’s 2011 shareholder incentive awards, and the \$1,239,986 of 2012 shareholder incentives withheld from SCE’s 2012 energy efficiency (EE) shareholder incentive awards pending resolution of the third-party fixed-price contract issue from Utility Audit and Financial Compliance Branch’s 2011 audit of SCE’s EE programs.

2. Beginning with calendar year 2017, program administrators (PAs) must include in new and amended energy efficiency (EE) third-party fixed-price contracts provision for the Commission to obtain through PAs financial information from counterparties to EE third-party fixed-price contracts.

3. If Utility Audit and Financial Compliance Branch (UAFCB) review of an energy efficiency (EE) third-party fixed-price contracts and invoices thereunder indicates that the allocation factors being used for such contract materially

misallocate costs among the administrative, marketing and outreach, and direct implementation “buckets,” then UAFCB may demand that the relevant EE Program Administrators obtain from the counterparty to the contract information sufficient to confirm that the allocation factors are reasonable.

4. Commission Staff shall retain an outside auditor to audit utility administrative costs using the most recent available cost information.

5. Exhibit SCE-1 is entered into evidence.

6. Applications (A.) 12-07-001; A.12-07-002; A.12-07-003; and A.12-07-004 are closed.

This order is effective today.

Dated _____, at San Francisco, California.