KPMG

Yano Accountancy Corporation

SAN FRANCISCO WATER ENTERPRISE AND HETCH HETCHY WATER AND POWER

Statement of Changes in the Balancing Account

June 30, 2018

(With Independent Auditors' Report Thereon)

KPMG

Yano Accountancy Corporation

KPMG LLP
Suite 1400
55 Second Street
San Francisco, CA 94105

Independent Auditors' Report

To the City and County of San Francisco
and the Wholesale Customers:

Report on the Financial Statement

KPMG LLP and Yano Accountancy Corporation have audited the Statement of Changes in the Balancing Account (the statement) of the San Francisco Water Enterprise (Water Enterprise) and Hetch Hetchy Water and Power (Hetch Hetchy), under the jurisdiction of the San Francisco Public Utilities Commission (SFPUC), for the year ended June 30, 2018, prepared pursuant to Article VII, Section 7.02 of the Water Supply Agreement (WSA), between the City and County of San Francisco (City) and certain Wholesale Customers in the counties of San Mateo, Santa Clara, and Alameda (Wholesale Customers) effective July 1, 2009.

Management's Responsibility for the Financial Statement

Management of the SFPUC is responsible for the preparation and fair presentation of the statement in accordance with Article VII, Section 7.02 of the WSA. Management of the SFPUC is also responsible for the design, implementation, and maintenance of internal controls relevant to the preparation and fair presentation of the statement that are free from material misstatement, whether due to fraud or error.

Auditors' Responsibility

Our responsibility is to express an opinion on the statement based on our audit. We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the statement is free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the statement. The procedures selected depend on the auditors' judgment, including the assessment of the risks of material misstatement of the statement, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the statement in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the statement.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the Statement of Changes in the Balancing Account, referred to above, presents fairly, in all material respects, changes in the Balancing Account for the year ended June 30, 2018 in accordance with Article VII, Section 7.02 of the WSA.

Basis of Accounting

We draw attention to note 1(b) to the statement, which describes the basis of accounting. The statement was prepared by the SFPUC on the basis of the financial reporting provisions of Article VII, Section 7.02 of the WSA, which is a basis of accounting other than accounting principles generally accepted in the United States of America, to comply with the financial reporting provisions of the WSA. Our opinion is not modified with respect to this matter.

Other Matter

KPMG LLP has audited, in accordance with auditing standards generally accepted in the United States of America, the financial statements of the San Francisco Water Enterprise and of Hetch Hetchy Water and Power as of and for the year ended June 30, 2018, and our report thereon, dated February 22, 2019, expressed an unmodified opinion on those financial statements.

Restriction on Use

This report is intended solely for the information and use of the Mayor, Board of Supervisors, San Francisco Public Utilities Commission, City management, and the Wholesale Customers, and is not intended to be and should not be used by anyone other than these specified parties.

KPMG LLP

Yano Accountancy Corporation

San Francisco, California
January 15, 2020

SAN FRANCISCO WATER ENTERPRISE AND
HETCH HETCHY WATER AND POWER

Statement of Changes in the Balancing Account

Year ended June 30, 2018

		Total	Amount allocated to the wholesale customers
Wholesale revenue requirement:			
Operating and maintenance expenses:			
San Francisco Water Enterprise (Water Enterprise):			
Source of supply	$	22,846,200	9,371,456
Pumping		2,305,854	—
Treatment		41,487,855	26,860,111
Transmission and distribution		66,003,140	19,321,094
Customer accounts		9,554,682	185,228
Total Water Enterprise operating and maintenance expenses	$	142,197,731	55,737,889
Hetch Hetchy Water and Power (Hetch Hetchy):			
Operations and maintenance expenses	$	83,881,484	14,576,461
Total Hetch Hetchy operating and maintenance expenses	$	83,881,484	14,576,461
Administrative and general (A&G) expenses:			
Countywide cost allocation plan:			
Water Enterprise	$	4,315,176	1,691,549
Hetch Hetchy		2,179,549	646,443
San Francisco Public Utilities Commission (Bureaus) :			
Water Enterprise		29,012,004	12,770,321
Hetch Hetchy		13,194,257	2,340,672
Other A&G – Water Enterprise		20,113,283	6,292,759
Other A&G – Hetch Hetchy		29,712,367	3,926,335
Compliance audit		175,700	87,850
Total administrative and general expenses	$	98,702,336	27,755,929
Property taxes (outside City only):			
Water Enterprise	$	1,831,991	1,209,847
Hetch Hetchy		547,955	162,521
Total property taxes	$	2,379,946	1,372,368
Capital cost recovery – existing regional assets (K-5):			
Water Enterprise (note 4)			804,106
Hetch Hetchy (note 4)			355,152
Capital cost contribution – new regional assets:			
Debt-funded capital projects:			
Water Enterprise (note 5a)			136,491,840
Revenue-funded capital projects:			
Water Enterprise (note 5d)			18,378,933
Total capital cost recovery and contribution			156,030,031
Revenue Credit Federal BABs Interest Subsidy			(14,099,683)
Total wholesale revenue requirement			$ 241,372,995
Balance due to wholesale customers, July 1, 2017			$ (40,417,741)
Adjustments to July 1, 2017 balance (note 2b)			(1,015,258)
Adjusted balance due to wholesale customers, July 1, 2017			(41,432,999)
Interest on adjusted beginning balance			(675,358)
Net Wholesale revenue billed (note 6)			(258,777,686)
Calculated wholesale revenue requirement			241,372,995
Interest on wholesale revenue coverage reserve (net of working capital requirement)			(268,764)
Revenue Coverage Shortfall			
Balance due to wholesale customers, June 30, 2018			$ (59,781,812)

See accompanying notes to the statement of changes in the balancing account.

(1) Summary of Significant Accounting Policies

(a) Water Supply Agreement

The City and County of San Francisco (City), acting by and through its Public Utilities Commission (SFPUC), and the Wholesale Customers, represented by the Bay Area Water Supply and Conservation Agency (BAWSCA), entered into the Water Supply Agreement (WSA) on July 1, 2009. Amendments to the WSA by all BAWSCA member agencies and the SFPUC were completed in April 2019 (note 10). The WSA has a twenty-five year term with two options for five-year extensions, and contains provisions on rate-setting, accounting, and dispute resolution, including emergency and drought-pricing adjustment. The WSA has a 184 millions of gallons per day (mgd) Supply Assurance. During the period from 2009 to 2028 the WSA limits the quantity of water delivered to the Retail Customers and Wholesale Customers from the watersheds to 81 mgd and 184 mgd, respectively, or a total of 265 mgd.

(b) Basis of Accounting

Pursuant to the terms of the WSA, the accounts of the San Francisco Water Enterprise (Water Enterprise) and Hetch Hetchy Water and Power (Hetch Hetchy), are maintained in conformity with accounting principles generally accepted in the United States of America. The financial activities of the Water Enterprise and Hetch Hetchy Funds are accounted for on a flow of economic resource measurement focus, using the accrual basis of accounting. Under this method, all assets and liabilities associated with its operations are included on the statements of net assets; revenues are recognized when earned, and expenses are recognized when liabilities are incurred. The SFPUC applies all applicable Governmental Accounting Standards Board pronouncements. For copies of the Water Enterprise and Hetch Hetchy audited financial statements for the year ended June 30, 2018, please contact the Chief Financial Officer, San Francisco Public Utilities Commission, 525 Golden Gate Avenue, 13th Floor, San Francisco, California 94102.

Under the WSA, current operating expenditures, including regional revenue-funded capital projects and debt service on bonds sold to finance regional water system improvements, are allocated between Retail Customers and the Wholesale Customers on the basis of Proportional Annual Use. The Balancing Account is maintained pursuant to the WSA, and by other provisions that may result from a settlement agreement prescribed in Article VII, Section 7.06 of the WSA.

(c) Balancing Account under the WSA

Pursuant to the terms of the WSA, the SFPUC is required to establish water rates applicable to the Wholesale Customers at the beginning of each fiscal year. The wholesale water rates are based on an estimate of revenues necessary to recover the cost of distributing water to the Wholesale Customers in accordance with the methodology outlined in Articles V and VI of the WSA.

Pursuant to Article VII, Section 7.02 of the WSA, the City is required to prepare the Wholesale Revenue Requirement (WRR) of the Water Enterprise and Hetch Hetchy after the close of each fiscal year based on the actual costs incurred in the delivery of water to the Wholesale Customers. The difference between the wholesale revenue billed to the Wholesale Customers during the year and the "actual" WRR is recorded in a separate account (the Balancing Account) and represents the cumulative amount that is either owed to the Wholesale Customers (if wholesale revenue billed exceed the WRR) or owed to the SFPUC (if the WRR exceeds wholesale revenues billed). The Balancing Account is reflected on the Water Enterprise's financial statements as either an asset or a liability depending on the amount due from or owed to the Wholesale Customers.

In accordance with Article VI, Section 6.05B of the WSA, the amount recorded in the Balancing Account will earn interest at a rate equal to the average rate earned on the invested pooled funds of the City Treasurer, and is taken into consideration in the determination of subsequent wholesale water rates.

(d) Proportional Annual Use and Adjusted Proportional Annual Use

The WSA states that the Wholesale Customers will pay their share of expenses incurred by the SFPUC in delivering water on the basis of Proportional Annual Use unless otherwise indicated in the WSA. WSA Attachment J prescribes the calculation methodology to determine Proportional Annual Use. At the end of each fiscal year, as specified in WSA Attachment J, the SFPUC and BAWSCA sign off on Table J-1, which memorializes the annual water deliveries to Retail and Wholesale Customers. The information in the Table J-1 is the basis for the Proportional Annual Use calculation.

The Proportional Annual Use is defined as the share of deliveries from the Regional Water System used by City Retail Customers and by the Wholesale Customers in a fiscal year, expressed as a percentage. The Adjusted Proportional Annual Use is defined as the respective percentages of annual water use, as adjusted to reflect deliveries of water by Hetch Hetchy to Retail Customers outside of the city limits of the City and County of San Francisco.

(e) Minimum Annual Purchases

Alameda County Water District and the cities of Milpitas, Mountain View, and Sunnyvale have agreed to a minimum annual purchases requirement, which requires each to purchase a minimum annual quantity of water from the SFPUC. These minimum quantities are included in the Individual Water Sales Contracts between SFPUC and each of these four Wholesale Customers reference to Article III, Section 3.07.C of the WSA, and WSA Attachment E.

These Wholesale Customers are billed for minimum quantities only if minimum annual purchase quantities have not been met in any fiscal year. Minimum annual purchase payments are considered wholesale water revenues. Additionally, the Proportional Annual Use is based on minimum quantities for each of these four customers if minimum annual purchase quantities are not met. Any differences between minimum quantities and below-minimum actuals are referred to as imputed water sales.

During the year ended June 30, 2018, the cities of Mountain View and Milpitas did not meet their minimum purchase requirements. Revenues associated with the shortfall in the amount of $3,208,116 are included as wholesale water revenues, and 1.60 mgd of imputed water sales was added to the wholesale usage used to calculate Proportional Annual Use.

(f) Basis of Allocating Operating Expenses

Pursuant to the terms of the WSA, direct Water Enterprise and specific Hetch Hetchy expenses are allocated to the applicable user. Regional Water Enterprise operating and maintenance expenses related to source of supply, treatment, transmission and distribution are allocated based on Proportional Annual Use.

Two percent of Water Enterprise customer service expenses are allocated to the Wholesale Customers. Water Enterprise administrative and general expenses, including the assigned costs under the City's Countywide Cost Allocation Plan, services provided by other City departments and water administration, are allocated based on the ratio of total allocated wholesale operating and maintenance expenses to total Water Enterprise operating and maintenance expenses. Certain SFPUC bureau expenses are identified as regional operations and maintenance expenses and allocated to the Wholesale Customers on Proportional Annual Use basis. Remaining SFPUC bureau expenses are allocated to the Water Enterprise on the basis of labor costs incurred by the various SFPUC enterprises, and then allocated to the Wholesale Customers on the basis of Proportional Annual Use.

Water Enterprise property taxes are levied against properties owned by the City in Alameda, San Mateo, and Santa Clara counties, and operated and managed by the SFPUC. Hetch Hetchy property taxes are levied against properties owned by the City in Tuolumne, Stanislaus, San Joaquin, and Alameda counties, and operated and managed by the SFPUC. All property taxes paid, net of (1) reimbursements received from lessees and permit holders and (2) refunds from taxing authorities, are considered Water Enterprise regional expenses or joint Hetch Hetchy expenses. The Wholesale Customers are allocated a share of Water Enterprise and Hetch Hetchy property tax expenses on the basis of Proportional Annual Use and Adjusted Proportional Annual Use, respectively.

Forty-five percent of joint Hetch Hetchy expenses are water-related expenses. The water-related share of joint Hetch Hetchy operating, maintenance, and administrative and general expenses is allocated based upon on Adjusted Proportional Annual Use.

Fifty percent of the cost of the compliance audit described in Article VII, Section 7.04 of the WSA is allocated to the Wholesale Customers.

(g) Wholesale Customers Review

Article VII, Section 7.06 of the WSA provides the Wholesale Customers the right to conduct a review of the SFPUC's calculation of the annual Wholesale Revenue Requirement and changes in the Balancing Account. The review shall be completed within 60 days after the date of the compliance auditor's report is issued. At the conclusion of the review, representatives of SFPUC and BAWSCA meet to discuss any differences noted. Adjustments agreed by both parties are adjusted to the Balancing Account. If differences cannot be resolved, the dispute shall be submitted to the arbitration in accordance with Article VIII, Section 8.01 of the WSA.

(Continued)

(h) Capital Cost Recovery – Existing Regional Assets

The SFPUC previously appropriated funds, advanced through rates charged to Retail Customers, for construction of capital projects. The unexpended balances of these appropriated funds were not included in construction work in progress as listed on WSA Attachment K-1 and K-2 as of June 30, 2009. These projects, and their associated balances, are shown on WSA Attachment K-5. Expenditures of funds from these balances from July 1, 2009 to June 30, 2014 are allocated to the Wholesale Customers based on Proportional Annual Use and amortized over ten years at an interest rate of 4%. Fiscal year 2017–18 is the fourth year for capital cost recovery through Schedule K-5.

(i) Capital Cost Contribution – New Regional Assets

The wholesale share of Water Enterprise and Hetch Hetchy capital expenditures incurred during the term of the WSA are allocated on the basis of Proportional Annual Use and Adjusted Proportional Annual Use, respectively. These costs include net annual debt service and appropriations for revenue-funded regional capital additions.

Capital expenditures financed by debt are allocated to bond proceeds on a first-in, first-out basis to the extent allowable by law and the terms of the applicable indenture. In accordance with Article V, Section 5.04A of the WSA, the SFPUC issues a certificate on the expected use of bond proceeds within 15 days of issuance (WSA Attachment L-2), and a report on actual expenditures of and earnings on bond proceeds after the proceeds are considered substantially expended (WSA Attachment L-3). The Wholesale Customers' proportionate share of net annual debt service is based on the expected use of bond proceeds on regional projects. Any differences between expected and actual expenditures on regional projects are applied in the year the proceeds are substantially expended. For copies of WSA Attachments L-2 or L-3 previously issued for each indenture, please contact the Chief Financial Officer, San Francisco Public Utilities Commission, 525 Golden Gate Avenue, 13th Floor, San Francisco, California 94102.

SFPUC and the Wholesale Customers clarified certain procedures relating to the administration of the accounting, debt administration, and capital cost contribution components of Article V, Section 5.04A as part of the Settlement Agreement (Article VII, Section 7.06 of the WSA) for the year ended June 30, 2010. For copies of the Settlement Agreement (Article VII, Section 7.06 of the WSA) for the year ended June 30, 2010, please contact the Chief Financial Officer, San Francisco Public Utilities Commission, 525 Golden Gate Avenue, 13th Floor, San Francisco, California 94102.

The regional share of appropriations for revenue-funded regional asset expenditures are allocated to the Water Enterprise and Hetch Hetchy on the basis of Proportional Annual Use and Adjusted Proportional Annual Use, respectively. Adjustments to reflect actual vs. appropriated expenditures are made in accordance with Article VI, Section 6.08 of the WSA. The adjustment for the years ended June 30, 2010-2014 was reflected as of June 30, 2015.

(Continued)

(j) Allocation of 525 Golden Gate Avenue Expenses

525 Golden Gate Avenue is the headquarters of the SFPUC as of July 2012. This building consolidated divisions of the SFPUC that were renting space at multiple locations in the Civic Center area, and consists of a new 277,500 square-foot Class A office building that spans 13 floors plus a basement level. In allocating 525 Golden Gate Avenue costs, building tenants occupy 10,709 square feet (3.9% of total building square footage), which reduces the costs allocated to the Wholesale Customers.

Certificates of Participation, 2009 Series C and D, were issued by the City in October 2009 to fund the SFPUC headquarters building at 525 Golden Gate Avenue.

SFPUC estimated that rental savings will be realized as compared to rented spaces over the lifetime of the building.

Operating, maintenance, capital expenses, and debt service payments pertaining to 525 Golden Gate Avenue are classified as Administrative and General expenses and are allocated to the three enterprises (Water, Hetch Hetchy, and Wastewater) based on square footage occupied by each enterprise based at 525 Golden Gate Avenue.

(k) Interest Earnings on Debt Reserve Funds and Capital Projects Funds from Bond Issuance

All interest earnings on Debt Reserve Funds are accounted for as credits against gross debt service in determining the net debt service amounts.

Interest earnings from unexpended bond proceeds in the Capital Projects Funds are treated as additional funds available for project expenditures.

(l) Grants

The Wholesale Customers are allocated a proportional benefit from funds received by the SFPUC from (a) governmental grants, rebates, reimbursements, or other subventions or (b) private-sector grants for Regional capital or operating purposes. The Wholesale Customers' allocated benefit is based on any excess of grant revenues over expenses. Beginning in FY 2016-17, per the advice of the SFPUC's bond counsel, interest rebates from the taxable federal Build America Bonds are no longer credited against gross debt service due to federal sequestration. Instead, they are reflected as a governmental revenue credit; the impact on the Balancing Account from both treatments is the same.

(m) Wholesale Revenue Coverage Reserve and Working Capital Requirements

Under Article VI, Section 6.06 of the WSA, the SFPUC may require periodic deposits by the Wholesale Customers to fund a debt service coverage reserve account (the Wholesale Revenue Coverage Reserve) established and maintained by the SFPUC to meet debt service and minimum working capital requirements. The WSA sets the formula to calculate the debt service coverage and the working capital requirement. The ceiling of the Wholesale Revenue Coverage Reserve is the greater amount between the required debt service coverage and the working capital. Under Article VI, Section 6.06B of the WSA, any balance in the Wholesale Revenue Coverage Reserve in excess of the actual wholesale coverage requirement may be applied as a credit against wholesale rates in the following fiscal year, unless otherwise instructed by BAWSCA.

(Continued)

The Debt Service Coverage is calculated as the lesser of: (i) 25% of the Wholesale Customers' share of net annual debt service for the applicable fiscal year or (ii) the amount necessary to meet the Wholesale Customers' proportionate share of debt service coverage, less any credits for previous deposits and interest accruing to the Wholesale Revenue Coverage Reserve.

The working capital requirement prescribed in Article VI, Section 6.07 of the WSA is one-sixth (two months) of the annual wholesale allocation of operation and maintenance, administrative and general, and property tax expenses for the Water Enterprise and Hetch Hetchy. If the Wholesale Revenue Coverage Reserve is less than the calculated working capital requirement, the Wholesale Customers are charged interest on the difference. This amount is shown as an adjustment to the Balancing Account in the subsequent fiscal year.

(2) Balancing Account under the WSA

(a) Balancing Account Activity

The following summarizes activity in the Balancing Account under the WSA for the year ended June 30, 2018:

	As previously reported	Adjustments	Adjusted balance
Balancing account under the WSA, June 30, 2017	$ (40,417,741)	—	(40,417,741)
Fiscal Year 2016-17 settlement agreement on operating expenses (note 2b)	—	(1,005,903)	(1,005,903)
Interest on Fiscal Year 2016-17 settlement agreement (note 2b)	—	(9,355)	(9,355)
Balancing account under the WSA, as adjusted, June 30, 2017	$ (40,417,741)	(1,015,258)	(41,432,999)
Interest on adjusted beginning balance at 1.63%			(675,358)
Net wholesale revenue billed (note 6)			(258,777,686)
Calculated wholesale revenue requirement			241,372,995
Interest on wholesale revenue coverage reserve (net of working capital requirement not met) (note 2b)	(268,822)	58	(268,764)
Balancing account under the WSA, June 30, 2018			$ (59,781,812)

(b) Article VII, 7.06 Settlement Agreement – Fiscal Year 2016-17

In accordance with Article VII, Section 7.06 of the WSA, the SFPUC and the Wholesale Customers reached a settlement agreement on March 29, 2019 relating to costs attributable to the year ended June 30, 2017. The following are adjustments to the fiscal year 2016–17 Balancing Account agreed to by both parties to the WSA.

		Amount
Fiscal Year 2016-17 settlement adjustments:		
Adjustments to June 30, 2017 beginning balance:		
Settlement agreement – operating expenses	$	33,483
Settlement agreement – coverage reserve		(75,336)
Settlement agreement – revenue funded capital projects		(964,050)
Subtotal Fiscal Year 2016-17 settlement adjustments – due (to)/from wholesale customers		(1,005,903)
Interest on adjustments		(9,355)
Total Fiscal Year 2016-17 settlement adjustments – due (to)/from wholesale customers	$	(1,015,258)

In addition to the above adjustment to the Balancing Account, the settlement agreement item on deposits to the wholesale coverage reserve changed the FY 2016-17 beginning coverage reserve balance, which reduced the interest on the coverage reserve for FY 2016-17 by $58. This adjustment is shown in note 2a.

(Continued)

(3) Proportional Annual Use and Adjusted Proportional Annual Use

The Proportional Annual Use and the Adjusted Proportional Annual Use for the Wholesale and Retail Customers since the inception of the WSA in FY 2009–10 are summarized below:

	Proportional annual use		Adjusted proportional annual use	
Fiscal year	Wholesale	Retail	Wholesale	Retail
FY 2009-10	66.67%	33.33%	66.48%	33.52%
FY 2010-11*	65.86	34.14	65.70	34.30
FY 2011-12*	65.83	34.17	65.72	34.28
FY 2012-13	66.56	33.44	66.43	33.57
FY 2013-14	67.63	35.37	67.52	32.48
FY 2014-15	65.67	34.33	65.56	34.44
FY 2015-16	63.28	36.72	63.15	36.85
FY 2016-17	64.27	35.73	64.12	35.88
FY 2017-18*	66.04	33.96	65.91	34.09

*adjusted for imputed water sales

(4) Capital Cost Contribution – Existing Regional Assets (WSA Attachment K-5)

WSA Attachment K-5 represents projects of previously appropriated funds, which are summarized on the following table, advanced through rates charged to Retail Customers, for construction of capital projects. From July 1, 2009 to June 30, 2015, the Water Enterprise incurred total expenditures of $9,599,442 including interest through June 30, 2015, of which $6,618,478 is the Wholesale share and $12,385,482 for Hetch Hetchy including interest through June 30, 2015, of which $2,923,204 is the Wholesale share. Based on the WSA Section 5.03, these expenditures were amortized over ten years at an interest rate at 4%. The wholesale share is based on Proportional Annual Use for Water Enterprise and Adjusted Proportional Annual Use for Hetch Hetchy. Fiscal year 2017-18 is the fourth of ten annual cost recoveries for WSA Attachment K-5 capital projects.

	Water Enterprise	Hetch Hetchy	Total
Total expenditures of previously appropriated funds – July 1, 2009 to June 30, 2015	$ 9,599,442	12,385,482	21,984,924
Wholesale share of expenditures	$ 6,393,692	2,812,954	9,206,646
Interest on wholesale share of expenditures	224,786	110,250	335,036
Total amount due from Wholesale Customers	$ 6,618,478	2,923,204	9,541,682
Interest rate	4%	4%	
Term (years)	10	10	
Annual payment due from Wholesale Customers	$ 804,106	355,152	1,159,258

The activity in the liability account for K-5 projects for the fiscal year ended June 30, 2018 is summarized below.

	Water Enterprise	Hetch Hetchy	Total
Principal balance as of June 30, 2017	$ 4,902,321	2,165,223	7,067,544
Principal payment	(619,285)	(273,522)	(892,807)
Principal balance as of June 30, 2018	$ 4,283,035	1,891,701	6,174,737
Number of annual payments remaining	6	6	
Cumulative payments received through June 30, 2018:			
Applied to principal	$ 2,335,443	1,031,502	3,366,945
Applied to interest	880,983	389,107	1,270,090
Total	$ 3,216,426	1,420,609	4,637,035

(5) Capital Cost Contribution – New Regional Assets

(a) Debt-Funded Capital Projects – Water Enterprise

The Water Enterprise has previously issued revenue bonds to fund the construction of new regional capital assets. As of June 30, 2018, outstanding debt related to the construction of new regional capital assets included Water Revenue Bonds, 2009 Series A, 2009 Series B, 2010 Series B, 2010 Series D, 2010 Series E, 2010 Series F, 2010 Series G, 2011 Series A, 2011 Series B, 2012 Series A, 2015 Series A (which refunded all of 2006 Series A and a portion of 2009 Series A), 2016 Series A (which refunded portions of 2009 Series A, 2009 Series B and 2010 Series F), 2016 Series C, 2017 Series A, 2017 Series B, 2017 Series C, 2017 Series D (which refunded a portion of 2011 Series A and a portion of 2012 Series A), 2017 Series F (which refunded a portion of 2011 Series B), and 2017 Series G (which refunded a portion of 2011 Series A). Bond 2017 Series A, 2017 Series B, and 2017 Series C had no net debt service payments during FY 2017-18, as they were in the capitalized interest period.

The Water Enterprise paid $242,260,276 in gross debt service during the year ended June 30, 2018. The net debt service is reduced to $242,208,691 when other interest earnings of $51,682 are applied against the gross debt service payments. The following tables summarize the net debt service expenditures on outstanding debt related to the construction of new regional assets that was determined to be allocable to the Retail and Wholesale Customers:

Table 1 – Debt Service Expenditures – New Regional Assets

	Principal	Net interest	Total
2009 Series A	$ 8,715,000	925,950	9,640,950
2009 Series B	8,720,000	1,157,778	9,877,778
2010 Series B	10,905,000	23,192,541	34,097,541
2010 Series D	10,340,000	2,197,819	12,537,819
2010 Series E	—	20,041,826	20,041,826
2010 Series F	4,910,000	1,356,056	6,266,056
2010 Series G	—	24,414,807	24,414,807
2011 Series A	—	22,576,485	22,576,485
2011 Series B	655,000	1,121,219	1,776,219
2012 Series A	—	24,110,988	24,110,988
2015 Series A/2006 Series A Refunding	—	18,298,730	18,298,730
2015 Series A/2009 Series A Refunding	—	1,844,208	1,844,208
2016 Series A/2009 Series A Refunding	—	13,619,657	13,619,657
2016 Series A/2009 Series B Refunding	—	15,294,146	15,294,146
2016 Series A/2010 Series F Refunding	—	6,844,953	6,844,953
2016 Series C	5,465,000	9,107,053	14,572,053
2017 Series A	—	—	—
2017 Series B	—	—	—
2017 Series C	—	—	—
2017 Series D/2011 Series A Refunding	—	3,838,762	3,838,762
2017 Series D/2012 Series A Refunding	—	2,089,206	2,089,206
2017 Series F/2011 Series B Refunding	—	148,710	148,710
2017 Series G/2011 Series A Refunding	—	317,797	317,797
	$ 49,710,000	192,498,691	242,208,691

Table 2 – Wholesale Customers Debt Service Allocation (%)

	Costs prior to July 1, 2009	Retail projects	Regional projects	Total	Substantially expended date
2009 Series A	31.65	10.43	57.92	100.00	FY 09-10 7.06
2009 Series B	—	12.63	87.37	100.00	FY 09-10 7.06
2010 Series B	—	7.10	92.90	100.00	FY 10-11
2010 Series D	—	2.76	97.24	100.00	FY 11-12
2010 Series E	—	3.15	96.85	100.00	FY 15-16
2010 Series F	—	—	100.00	100.00	FY 14-15
2010 Series G	—	—	100.00	100.00	FY 14-15
2011 Series A	—	6.47	93.53	100.00	FY 14-15
2011 Series B*	—	—	100.00	100.00	
2012 Series A*	—	30.66	69.34	100.00	
2015 Series A/ 2006 Series A Refunding	33.71	13.10	53.19	100.00	FY 09-10 7.06
2015 Series A/ 2009 Series A Refunding	31.65	10.43	57.92	100.00	FY 09-10 7.06
2016 Series A/ 2009 Series A Refunding	31.65	10.43	57.92	100.00	FY 09-10 7.06
2016 Series A/ 2009 Series B Refunding	—	12.63	87.37	100.00	FY 10-11
2016 Series A/ 2010 Series F Refunding	—	—	100.00	100.00	FY 14-15
2016 Series C*	—	—	100.00	100.00	
2017 Series A*	—	—	100.00	100.00	
2017 Series B*	—	70.40	29.60	100.00	
2017 Series C*	—	—	100.00	100.00	
2017 Series D/ 2011 Series A Refunding	—	6.47	93.53	100.00	FY 14-15
2017 Series D/ 2012 Series A Refunding*	—	30.66	69.34	100.00	
2017 Series F/ 2011 Series B Refunding*	—	—	100.00	100.00	
2017 Series G/ 2011 Series A Refunding	—	6.47	93.53	100.00	FY 14-15

* Expected allocation to be trued up when bond reaches Substantially Expended status (note 5b)

(Continued)

Table 3 – Wholesale Customers Debt Service Allocation ($)

	Costs prior to July 1, 2009	Retail projects	Regional projects	Total	Proportional annual use	Total wholesale debt service
2009 Series A	$ 3,051,361	1,005,551	5,584,038	9,640,950	66.04%	3,687,699
2009 Series B	—	1,247,563	8,630,215	9,877,778	66.04%	5,699,394
2010 Series B	—	2,420,925	31,676,616	34,097,541	66.04%	20,919,237
2010 Series D	—	346,044	12,191,775	12,537,819	66.04%	8,051,448
2010 Series E	—	631,318	19,410,508	20,041,826	66.04%	12,818,700
2010 Series F	—	—	6,266,056	6,266,056	66.04%	4,138,103
2010 Series G	—	—	24,414,807	24,414,807	66.04%	16,123,539
2011 Series A	—	1,460,699	21,115,786	22,576,485	66.04%	13,944,865
2011 Series B	—	—	1,776,219	1,776,219	65.91% *	1,170,706
2012 Series A	—	7,392,429	16,718,559	24,110,988	66.04%	11,040,936
2015 Series A/ 2006 Series A Refunding	6,168,502	2,397,134	9,733,094	18,298,730	66.04%	6,427,736
2015 Series A/ 2009 Series A Refunding	583,692	192,351	1,068,165	1,844,208	66.04%	705,416
2016 Series A/ 2009 Series A Refunding	4,310,621	1,420,530	7,888,505	13,619,657	66.04%	5,209,569
2016 Series A/ 2009 Series B Refunding	—	1,931,651	13,362,495	15,294,146	66.04%	8,824,592
2016 Series A/ 2010 Series F Refunding	—	—	6,844,953	6,844,953	66.04%	4,520,407
2016 Series C	—	—	14,572,053	14,572,053	66.04%	9,623,384
2017 Series A	—	—	—	—	66.04%	—
2017 Series B	—	—	—	—	66.04%	—
2017 Series C	—	—	—	—	65.91% *	—
2017 Series D/ 2011 Series A Refunding	—	248,368	3,590,394	3,838,762	66.04%	2,371,096
2017 Series D/ 2012 Series A Refunding	—	640,551	1,448,655	2,089,206	66.04%	956,692
2017 Series F/ 2011 Series B Refunding	—	—	148,710	148,710	65.91% *	98,015
2017 Series G/ 2011 Series A Refunding	—	20,561	297,236	317,797	66.04%	196,294
	$ 14,114,176	21,355,674	206,738,841	242,208,691		136,527,828
Adjustment for Penstock Assessment Renovation (CUH97514) project consistent with FY 2014–15 7.06 settlement						(8,295)
Adjustment for Moccasin Afterbay Rehab (CUH97518) project consistent with FY 2014–15 7.06 settlement						(14,484)
Adjustment for Mather Facilities (CUH97703) project consistent with FY 2014–15 settlement						(6,771)
Adjustment for Lower Cherry Aqueduct (CUH 10003) project consistent with FY 2013–14 7.06 settlement						(6,438)
						$ 136,491,841

*Adjusted Proportional Annual Use (note 5c)

(b) Substantially Expended Bond Series

The WSA Section 5.04 required the revised allocation factor be used in the year when the bond series became substantially expended and thereafter. The difference between the amount of net debt service paid by the Wholesale Customers prior to the year that the bond series became substantially expended and the amount of the net debt service that they should have paid will be taken into account in the calculation of the Balancing Account in the year the bond series became substantially expended. Table 2 shows the Fiscal Year during which each bond reached substantially expended. As of June 30, 2018 there were no additional bond series that reached substantially expended status.

(c) Debt-Funded Capital Projects – Hetch Hetchy

The Wholesale Customers are allocated a share of water-related costs on the basis of Adjusted Proportional Annual Use. Joint assets are allocated 45% to water-related activities.

2011 Series B and 2017 Series C were issued as Water Revenue Bond Series to fund the Hetch Hetchy water-related capital project expenditures. Wholesale share of the debt on these series for the year ended June 30, 2018 was allocated using the Adjusted Proportional Annual Use percentage of 65.91%.

(d) Revenue-Funded Capital Projects – Water Enterprise

The following is a summary of the wholesale share of appropriations for regional revenue-funded capital projects under the Water Enterprise for the year ended June 30, 2018:

FAMIS Project #	Project	Appropriations	Allocation %	Wholesale share
CUW273	Water Transmission Program	17,938,000	66.04%	11,846,255
CUW274	Water Supply and Storage	6,908,000	66.04	4,562,043
CUW275	Watershed and Land Management	1,990,000	66.04	1,314,196
CUW276	Communication & Monitoring Program	994,000	66.04	656,438
	Water revenue-funded capital projects	$ 27,830,000		$ 18,378,932

(e) Excess Accumulation of Unexpended and Unencumbered Appropriation

Collections for revenue-funded regional capital assets are based on appropriation rather than actual expenditures. To prevent excess accumulation of unexpended and unencumbered appropriation, WSA Section 6.08 requires the calculation of the *Wholesale Revenue-Funded Capital Fund – Balancing Account Adjustment* every five years. The first review was completed in FY 2014–15 which covered FY 2009–10 through FY 2013–14, and an adjustment of $20,274,453 was credited to the benefit of the Wholesale Customers. The next five-year review will be completed in FY 2019–20 for FY 2014–15 through FY 2018–19. In addition, the WSA amendments which are expected to be ratified soon make substantial changes to the true-up methodology for revenue-funded capital, including a shift to an annual review beginning in FY 2019-20 (note 11b).

(6) Wholesale Revenue Billings

During the year ended June 30, 2018, the SFPUC billed a total of $263,608,529 (net of amounts remitted to BAWSCA) in wholesale revenue for costs of service associated with deliveries from the regional water system. This total includes $3,208,116 in penalty fees associated with customers who did not meet their minimum purchase requirements (note 1e). As applicable, a portion of these billings relate to deposits by the Wholesale Customers to meet their Wholesale Revenue Coverage Reserve and Working Capital

(Continued)

Reserve requirements per Article VI, Section 6.06 and Section 6.07 of the WSA, respectively, which reduced total wholesale revenue billings. For the year ended June 30, 2018, $4,830,843 was deposited to Wholesale Revenue Coverage Reserve and Working Capital Reserve. The net amount billed after deposits to the Coverage Reserve, and which is applied to the revenue requirement, is $258,777,686.

Gross and net wholesale revenue billings are summarized below:

Gross wholesale amounts billed – net of adjustments	$ 285,087,004
Imputed water sales from minimum purchase requirements	3,208,116
Amount remitted to BAWSCA	(24,686,592)
Subtotal	263,608,529
Deposits to wholesale revenue coverage reserve	(4,830,843)
Net wholesale revenues billed	$ 258,777,686

(7) Wholesale Revenue Coverage Reserve

During the year ended June 30, 2018, $4,830,843 in deposits to the Wholesale Revenue Coverage Reserve account were made from the Balancing Account in accordance with Article VI, Section 6.06 of the WSA. As of June 30, 2018, the Wholesale Revenue Coverage Reserve balance was $33,730,188, representing total deposits since July 1, 2009.

As of June 30, 2018, the Wholesale Revenue Coverage Reserve amount exceeded the Working Capital Requirement of 60 days of the wholesale share of Operations and Maintenance, Administrative and General, and Property Taxes, as shown in the below table:

	Wholesale revenue coverage reserve	Debt service coverage requirement	Working capital coverage requirement	Net interest
Balance, June 30, 2017	$ 28,974,681			
Fiscal Year 2017-18 7.06 adjustment to coverage reserve	(75,336)			
Adjusted balance, June 30 2017	28,899,345			
Deposits to wholesale revenue coverage reserve (note 2a)	4,830,843			
Balance, June 30, 2018	$ 33,730,188			
Calculation of adequacy of reserve requirement:				
Wholesale revenue coverage reserve balance, June 30, 2018		$ 33,730,188	33,730,188	
Coverage reserve requirement, June 30, 2018		(34,122,960)	(16,573,775)	
Coverage reserve excess/(deficiency)		$ (392,772)	17,156,413	
Net interest due to (from) Wholesale Customers	$ 513,712			513,712

Net interest of $513,712, calculated as the annual interest on the Wholesale Revenue Coverage Reserve less any Working Capital Requirement not met, will be made to the Balancing Account in favor of the Wholesale Customers during the year ended June 30, 2019, in accordance with Article VI, Section 6.06 of the WSA.

(8) 2013 Rim Fire

In August 2013, the SFPUC's Hetch Hetchy Water and Power was challenged by the third largest fire in California history, the Rim Fire, in Stanislaus National Forest and Yosemite National Park, which burned over 250,000 acres.

Governor Brown declared a state of emergency for San Francisco on August 23, 2013 and President Obama followed with a federal state of emergency declaration. Through the U.S. Department of Homeland Security Federal Emergency Management Agency and the State of California Office of Emergency Services, federal and state funding is available on a cost-sharing basis to the City to help offset the costs of emergency work and the repair or replacement of facilities damaged by the Rim Fire. Additionally, many of the SFPUC assets impacted by the Rim Fire were insured.

For the fiscal year ending June 30, 2018, Hetch Hetchy incurred expenses of approximately $0.3 million bringing cumulative total expenses related to facilities and infrastructure damage, and costs related to emergency response to approximately $24.2 million. Reimbursements to date from insurance and federal and state grants totals approximately $12.7 million. An expense and reimbursement summary is shown in the following table.

2013 Rim Fire Expense and Reimbursement Summary

(in millions)	Hetch Hetchy Power	Hetch Hetchy Water	Hetch Hetchy Joint	Total
Actual expenditures:				
Cumulative through Fiscal Year 2016-17	$ 11.0	1.0	12.0	23.9
Fiscal Year 2017-18	-	-	0.3	0.3
Cumulative actual expenditures	11.0	1.0	12.3	24.2
Less reimbursements:				
Insurance				
Cumulative through Fiscal Year 2016-17	(3.3)	(0.2)	(2.2)	(5.7)
Fiscal Year 2017-18	(0.4)	(0.1)	(0.4)	(0.9)
Cumulative insurance	(3.7)	(0.3)	(2.6)	(6.6)
Federal/state grant				
Cumulative through Fiscal Year 2016-17	(3.1)	-	(2.7)	(5.8)
Fiscal Year 2017-18	-	(0.3)	-	(0.3)
Cumulative federal/state grant	(3.1)	(0.3)	(2.7)	(6.1)
Net expenditures:				
Cumulative through Fiscal Year 2016-17	4.6	0.8	7.1	12.5
Fiscal Year 2017-18	(0.4)	(0.4)	(0.1)	(0.9)
Cumulative net expenditures	$ 4.2	0.4	6.9	11.6
Joint allocation percentage			45%	
Adjusted proportional share of water deliveries Fiscal Year 2017-18		65.91%	65.91%	
Potential wholesale customer share:				
Cumulative through Fiscal Year 2016-17	$ -	0.5	2.1	2.6
Fiscal Year 2017-18	-	(0.2)	(0.0)	(0.3)
Cumulative potential wholesale customer share	$ -	0.3	2.1	2.3

The WRRs for the years ended June 30, 2014 through June 30, 2018 did not include allocation of the Rim Fire related costs because insurance reimbursements, government grants, and expenditures have not been finalized. SFPUC will allocate Rim Fire related costs to Wholesale Customers once final expense amounts and related cost reimbursements are known.

(Continued)

(9) Wholesale Customer Review of Fiscal Year 2015-16 and Fiscal Year 2016-17 Wholesale Revenue Requirements

Article VII, Section 7.06 of the WSA provides the Wholesale Customers the right to conduct a review of the SFPUC's calculation of the annual Wholesale Revenue Requirement and changes in the Balancing Account.

The Wholesale Customers and SFPUC entered into a settlement agreement on March 8, 2018 to resolve issues pertaining to the calculation of the Wholesale Revenue Requirement for Fiscal Year 2015-16, and on March 29, 2019 to resolve issues pertaining to the calculation of the Wholesale Revenue Requirement for Fiscal Year 2016-17. These settlement agreements resulted in adjustments described Statement to the Changes in the Balancing Account June 30, 2017 in Note 2(b). However, disagreements still exist in Fiscal Year 2015-16 and Fiscal Year 2016-17 on certain issues affecting the calculation of the Wholesale Revenue Requirement. The Wholesale Customers and SFPUC have entered into a tolling agreement to resolve these issues by October 30, 2019. The disputes described in the tolling agreement are as follows:

(a) Federal Build America Bonds (BABs) Interest Subsidy (BABs Subsidy) for Bond Series 2010B, 2010E and 2010G (both fiscal years)

Due to changes in the timing of the recognition of BABs subsidies on the calculation of the Wholesale Revenue Requirement, the SFPUC and the Wholesale Customers disagree on the amount of the BABs subsidies that should be applied to the WRR in June 30, 2016. Any adjustment, if made, will be reflected in the Balancing Account as of July 1, 2018.

(b) WSIP Financing Costs (both fiscal years)

Wholesale Customers disagree with the SFPUC on WSIP financing costs (project CUW300) included in the FY 2015-16 WSA Attachment L-3 schedules of bond series 2009B, 2010B, 2010D, 2010E, 2011A and 2012A. Any adjustment, if made, will be reflected in the Balancing Account as of July 1, 2019.

(c) Work Order Fund Salaries and Direct Salaries Charges to Other City Departments (Non SFPUC Departments) (both fiscal years)

WSA section 5.06.B requires that SFPUC Bureau expenses be allocated among SFPUC enterprises on the basis of the actual salaries of employees in each enterprise, as illustrated on the WSA Attachment N-2, Schedule 7 and Schedule 7.1. The SFPUC and Wholesale Customers are in discussion regarding the inclusion of certain salaries related to SFPUC staff performing work for other City departments. For the FY 2017-18 WRR, these "work order" salaries have been included, where appropriate under the terms of the WSA, in Retail Water and Power salaries, which are used to allocate Bureau expenses. If accepted by the Wholesale Customers, the same methodology will be applied to the FY 2015-16 and FY 2016-17 WRRs. The potential adjustments are unknown at this time.

(d) Bay Delta and FERC Relicensing (FY 2016-17)

Wholesale customers required additional detail and discussions on Bay Delta Plan and FERC relicensing expenditures. While these costs were identified as primarily Water only, Wholesale Customers requested additional time to review this detail. No Balancing Account adjustments are expected at this time.

(e) New Water Direct Wholesale Cost Category for Water Enterprise Administrative and General Expenses – Services of SFPUC Bureaus and Allocation Factor (FY 2016-17)

WSA section 5.06.B requires that SFPUC Bureau expenses be allocated among SFPUC enterprises on the basis of the actual salaries of employees in each enterprise, as illustrated on the WSA Attachment N-2, Schedule 7 and Schedule 7.1. Wholesale customers required additional discussions on the inclusion of Water Direct Wholesale cost allocation of SFPUC Bureau costs. Once the parties agree to the interpretation of the calculation of the bureaus expense allocation factor for FY 2016-17, the FY 2016-17 WRR will be recalculated as necessary, including interest.

(10) Amendments to WSA

On December 11, 2018 the SFPUC amended the 2009 WSA with Resolution 18-0212. The Amended and Restated Water Supply Agreement was subsequently ratified by all BAWSCA member agencies as of April 2019. The Amended and Restated WSA, including all amendments, is available at www.sfwater.org/wsaamended2018. The following describes the amendments which directly impact the calculation of the Wholesale Revenue Requirement.

(a) Asset Classification

WSA section 5.11 and definitions, section 5.12, and Attachment R were amended to clarify the classification of Hetch Hetchy Water assets. For the assets shown in the table below, the classification of operating expenses will remain as shown in the “Asset Classification” column, but specific capital project expenses, going forward and retroactively to the date shown in the table, will be reclassified. The methodology for implementing these changes, especially the required retroactive adjustment, will be discussed between the SFPUC and Wholesale Customers. Adjustments to the Balancing Account to reflect the revised capital classification will be incorporated as expediently as possible; the amount of adjustments is not known at this time.

Asset	Asset Classification	Project Classification
Lower Cherry Aqueduct	Joint	Water
Mountain Tunnel Interim Work	Joint	Water
Mountain Tunnel Long Term Repairs	Joint	Water
Mountain Tunnel Flow Control Facility	Joint	Joint
Kirkwood Penstock	Power	Joint
Moccasin Penstock	Power	Joint
Moccasin Lower Dam	Water	Joint

(b) Wholesale Capital Fund

WSA Section 6.08.E was amended to allow for the true up of excess balance in the Wholesale Capital Fund to be completed on an annual basis in conjunction with the annual review of the Wholesale Revenue Requirement from the previous five-year cycle. Additionally, the WSA section was amended to reflect a larger wholesale capital fund target balance, which more accurately reflects that fact that it takes multiple years to spend down these revenue funded capital appropriations. The new process will be implemented beginning with the five-year true-up in the FY 2018-19 Wholesale Revenue Requirement; the impact to the Balancing Account is not known at this time.

(c) Other Amendments

Other Amendments, which are not directly relevant to the calculation of the balancing account, include: 2018 Decisions, WSIP Completion Reference, Tier One Shortage Allocation Plan, Westside Basin Conjunctive Use Program, Capital Improvement Program Oversight Plan. See link above for full details.

(11) Other Items Under Discussion

The following are items that are under discussion between the Wholesale Customers and the SFPUC. The discussion of these items and the path to resolution may have an impact on the calculation of the Wholesale Revenue Requirement.

(a) Article VI, Section 6.06 – Debt Service Coverage Reserve (Note 7)

SFPUC implemented a revised debt service coverage policy on March 28, 2017 (Resolution 17-0060). Under the revised policy the indenture debt service coverage ratio increased by 10 basis points from 1.25x to 1.35x. The Wholesale Customers and SFPUC are in discussion regarding the implementation of this new policy, following the procedures outlined in Article VII, Section 6.06 of the WSA. If agreed to by the Wholesale Customers, the revised policy will materially increase the debt service coverage reserve.

(b) Implementation of WSA Amendments (Note 10)

Timing for implementation of the SFPUC adopted December 11, 2018 WSA amendments directly affecting the calculation of the Wholesale Revenue Requirement is still to be discussed and agreed upon. The SFPUC will share a plan for implementation of these amendments with Wholesale Customers before proceeding with implementation. While timing is to be discussed, the substance of these amendments is complete, and the parties endeavor to implement as expediently as is possible. Impact to the Balancing Account is not known at this time.

(c) Paid Time Off Adjustment Methodology

Since FY 2013-14, the WRR has included a “paid time off adjustment” (PTO adjustment) to account for differences in the allocation of employees’ work time and time off (including sick leave, vacation, etc.). While employees typically record work time to various specific charts of accounts, which are then classified for the WRR, PTO expenses are generally recorded to a default chart of accounts for each employee. The purpose of the PTO adjustment is to allocate PTO time consistently with work time.

During the FY 2017-18 audit, the SFPUC proposed a revision to the existing methodology that would address identified issues related to shifts across enterprises (i.e., shifting costs from Hetch Hetchy Water and Power to the Water Enterprise). The SFPUC's proposed methodology change would result in an estimated Balancing Account impact for FY 2017-18 of approximately $1.7 million due to the Wholesale Customers.

Due to the timing of the proposal during the audit process and the magnitude of the potential impact, the SFPUC has determined that the best course of action is for the SFPUC to address this issue with the Wholesale Customers during the 7.06 process. Any agreed-upon adjustments will be incorporated into the Balancing Account as of July 1, 2018.

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San Francisco, CA 94105

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To the Honorable Mayor, Members of the Board of Supervisors,
and Management of the City and County of San Francisco,
and the Wholesale Customers:

In planning and performing our audit of the Statement of Changes in the Balancing Account (the statement) of the San Francisco Water Enterprise (Water Enterprise) and Hetch Hetchy Water and Power (Hetch Hetchy), under the jurisdiction of the San Francisco Public Utilities Commission (SFPUC), for the year ended June 30, 2018, in accordance with auditing standards generally accepted in the United States of America, we considered SFPUC's internal control over financial reporting (internal control) as a basis for designing audit procedures that are appropriate in the circumstances for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control. Accordingly, we do not express an opinion on the effectiveness of the Company's internal control.

Our consideration of internal control was for the limited purpose described in the preceding paragraph and was not designed to identify all deficiencies in internal control that might be significant deficiencies and therefore, significant deficiencies may exist that were not identified. However, as discussed below, we identified certain deficiencies in internal control that we consider to be significant deficiencies.

A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, misstatements on a timely basis. A material weakness is a deficiency, or a combination of deficiencies, in internal control, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected, on a timely basis. We consider the following deficiencies in the SFPUC's internal control to be significant deficiencies:

Restriction on Use

This report is intended solely for the information and use of the Mayor, Board of Supervisors, San Francisco Public Utilities Commission, City Management, and the Wholesale Customers, and is not intended to be and should not be used by anyone other than these specified parties.

Very truly yours,

KPMG LLP

Yano Accountancy Corporation

Finding 2017-8 – Classification of Operations and Maintenance, and Property Tax Expenses

Criterion

Water Supply Agreement Article V, Section 5.02E describes two general principles of allocating costs to the Wholesale Customers, and states in part that "…(1) the Wholesale Customers should not pay for expenses of SFPUC operations from which they receive no benefit and (2) the Wholesale Customers should pay their share of expenses incurred by the SFPUC in delivering water to them…"

Observations and Effects

We observed the following during the audit of the Balancing Account. SFPUC management agreed with these observations, and accordingly corrected the Balancing Account.

1. Certain City Attorney-related HH Power-specific expenses were classified as Joint, and certain Bureau-Retail expenses were classified as Bureau-Regional. The resulting correction to the Balancing Account resulted in an increase due to the Wholesale Customers of approximately $261,000.

2. Certain expenses allocated to the University Mound Reservoir (a specifically-identified "Terminal Reservoir" in the WSA) were classified as O&M Retail instead of O&M Regional in the Balancing Account. The resulting correction to the Balancing account resulted in a decrease due to the Wholesale Customers of approximately $253,000.

3. Water Enterprise Property Tax recoveries were overstated by $190,000. The resulting correction to the Balancing account resulted in a decrease due to the Wholesale Customers of approximately $126,000.

4. Certain labor used in Attachment N2, Schedule 7.1 included benefits in addition to labor, which resulted in an incorrect allocation of PUC expenses to the four SFPUC enterprises. The resulting correction to the Balancing Account resulted in an increase due to the Wholesale Customers of approximately $80,000.

Cause

The cause of the first three conditions identified was inadequate review of account balances and expenditure summaries. The cause of the fourth condition was inadequate knowledge of amounts that should have been used to allocate PUC expenses to the enterprises.

Recommendation

SFPUC should improve its review and evaluation practices to: 1) ensure that account balances and expenditure summaries are properly classified in the Balancing Account; and 2) ensure that the proper amounts are included in allocation calculations.

Views of SFPUC Management

Management concurs with the findings.

To prevent re-occurrence of the items above, management will implement the following changes to improve the review process.

The team will prioritize manual review of expenses in targeted and high priority areas, including City Attorney expenses.

Additionally, the team will develop and implement an internal review and reporting framework that highlights and explains specific line item increases or decreases of 10% from the prior year. While this practice is already in place to describe variances to the wholesale customers' share of increases at the highest summary level (Attachment O), a similar framework will be developed and used internally to explain variances in applicable N-2 working schedules from the prior year.