KPMG

Yano Accountancy Corporation

SAN FRANCISCO WATER ENTERPRISE AND HETCH HETCHY WATER AND POWER

Statement of Changes in the Balancing Account

June 30, 2017

(With Independent Auditors' Report Thereon)

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

Yano Accountancy Corporation

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, 2017, 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, 2017 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, 2017, and our report thereon, dated November 8, 2017, 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
March 29, 2018

SAN FRANCISCO WATER ENTERPRISE AND
HETCH HETCHY WATER AND POWER

Statement of Changes in the Balancing Account

Year ended June 30, 2017

		Total	Amount allocated to the wholesale customers
Wholesale revenue requirement:			
Operating and maintenance expenses:			
San Francisco Water Enterprise (Water Enterprise):			
Source of supply	$	21,281,591	9,412,580
Pumping		1,949,479	—
Treatment		39,408,775	25,044,554
Transmission and distribution		62,772,536	17,844,582
Customer accounts		7,738,584	154,772
Total Water Enterprise operating and maintenance expenses	$	133,150,965	52,456,488
Hetch Hetchy Water and Power (Hetch Hetchy):			
Operating expenses	$	44,724,396	8,825,402
Maintenance expenses		21,007,856	5,211,665
Total Hetch Hetchy operating and maintenance expenses	$	65,732,252	14,037,067
Administrative and general (A&G) expenses:			
Countywide cost allocation plan:			
Water Enterprise	$	2,415,468	951,694
Hetch Hetchy		1,224,117	353,207
San Francisco Public Utilities Commission (Bureaus) :			
Water Enterprise		28,538,914	12,480,773
Hetch Hetchy		13,394,110	2,509,221
Other A&G – Water Enterprise		33,514,971	6,415,211
Other A&G – Hetch Hetchy		33,590,418	4,022,609
Compliance audit		175,701	87,850
Total administrative and general expenses	$	112,853,699	26,820,565
Property taxes (outside City only):			
Water Enterprise	$	1,815,772	1,166,997
Hetch Hetchy		530,625	153,106
Total property taxes	$	2,346,397	1,320,103
Capital cost recovery – existing regional assets (K-5):			
Water Enterprise (note 4)			804,106
			355,152
Capital cost contribution – new regional assets:			
Debt-funded capital projects:			
Water Enterprise (note 5a)			115,873,668
Revenue-funded capital projects:			
Water Enterprise (note 5d)			11,184,265
Total capital cost recovery and contribution			128,217,191
Revenue Credit Federal BABs Interest Subsidy			(13,792,044)
Total wholesale revenue requirement			$ 209,059,370
Balance due to wholesale customers, July 1, 2016			$ (15,712,070)
Adjustments to July 1, 2016 balance (note 2b)			(146,018)
Adjusted balance due to wholesale customers, July 1, 2016			(15,858,088)
Interest on adjusted beginning balance			(147,480)
Net Wholesale revenue billed (note 6)			(233,356,497)
Calculated wholesale revenue requirement			209,059,370
Interest on wholesale revenue coverage reserve (net of working capital requirement)			(190,381)
Revenue Coverage Shortfall			75,336
Balance due to wholesale customers, June 30, 2017			$ (40,417,740)

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. 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, and no increase in the Supply Assurance will be considered before December 31, 2018. During the period from 2009 to 2018, 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, 2017, 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

(Continued)

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 WRR 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. Due to the ongoing drought in fiscal year 2016–17, the calculation of the required minimum annual purchase was adjusted in line with conservation mandates from the California State Water Resources Control Board. As long as the savings achieved by conservation are greater than the reduction in SFPUC purchases, a Wholesale Customer is deemed to be in compliance with the minimum purchase requirement. All four customers met their adjusted minimum annual purchases requirement during the year ended June 30, 2017.

Billings will be based on the minimum purchase requirement as noted in Article III, Section 3.07 C of the WSA and WSA Attachment E starting July 1, 2018.

(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 (COWCAP), 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.

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(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 2016–17 is the third 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.

(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 and Interest Rebates on Debt Reserve Funds and Capital Projects Funds from Bond Issuance

All interest earnings on Debt Reserve Funds and interest rebates on taxable Build America Bonds 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.

(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.

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, 2017:

	As previously reported	Adjustments	Adjusted balance
Balancing account under the WSA, June 30, 2016	$ (15,712,070)	—	(15,712,070)
Fiscal year 2015–16 settlement agreement on operating expenses – (note 2b)	—	(145,046)	(145,046)
Interest on fiscal year 2015–16 settlement agreement – (note 2b)	—	(972)	(972)
Balancing account under the WSA, as adjusted, June 30, 2016	$ (15,712,070)	(146,018)	(15,858,088)
Interest on adjusted beginning balance at 0.93%			(147,480)
Net wholesale revenue billed (note 6)			(233,356,497)
Calculated wholesale revenue requirement			209,059,370
Interest on wholesale revenue coverage reserve (net of working capital requirement)			(190,381)
Wholesale revenue coverage adjustment (note 7)			75,336
Balancing account under the WSA, June 30, 2017			$ (40,417,740)

(b) Article VII, 7.06 Settlement Agreement – Fiscal Year 2015-16

In accordance with Article VII, Section 7.06 of the WSA, the SFPUC and the Wholesale Customers reached a settlement agreement on March 8, 2018 relating to costs attributable to the year ended June 30, 2016. The following are adjustments to the fiscal year 2015–16 Balancing Account agreed to by both parties to the WSA.

		Amount
Fiscal year 2015–16 settlement adjustments:		
Adjustments to June 30, 2016 beginning balance:		
Settlement agreement – operating expenses	$	(159,296)
Settlement agreement – net wholesale revenues billed		14,250
Interest on adjustments		(972)
Total fiscal year 2015–16 settlement adjustments – due to wholesale customers	$	(146,018)

(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

* 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 belongs to Wholesale share and $12,385,482 for Hetch Hetchy including interest through June 30, 2015, of which $2,923,204 belongs to Wholesale share. Based on the WSA Section 5.03, these expenditures were to be amortized over ten years at an interest rate at 4%. Wholesale share are based on Proportional Annual Use for Water Enterprise and Adjusted Proportional Annual Use for Hetch Hetchy.

		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

(Continued)

The activity in the liability account for K-5 projects for the fiscal year ended June 30, 2017 is summarized below.

		Water Enterprise	Hetch Hetchy	Total
Principal balance as of June 30, 2016	$	5,497,364	2,428,038	7,925,402
Principal payment		(595,042)	(262,814)	(857,856)
Principal balance as of June 30, 2017	$	4,902,322	2,165,224	7,067,546
Number of annual payments remaining		7	7	
Cumulative payments received through June 30, 2017:				
Applied to principal	$	1,716,156	757,980	2,474,136
Applied to interest		696,162	307,473	1,003,635
Total	$	2,412,318	1,065,453	3,477,771

As of June 30, 2017, $804,106 (including interest) was allocated as wholesale share of the WSA Attachment K-5 Water projects and $355,152 (including interest) as wholesale share of WSA Attachment K-5 Hetch Hetchy projects. Fiscal year 2016-17 is the third of ten annual cost recoveries for WSA Attachment K-5 capital projects.

(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, 2017, 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 Bond 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, and 2016 Series C . The Water Enterprise paid $213,166,962 in gross debt service during the year ended June 30, 2017. The net debt service is reduced to $212,743,037 when other net interest earnings of $423,925 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	$ 8,290,000	1,307,650	9,597,650
2009 Series B	8,290,000	1,583,250	9,873,250
2010 Series B	10,625,000	23,497,426	34,122,426
2010 Series D	9,840,000	2,702,858	12,542,858
2010 Series E	—	19,929,429	19,929,429
2010 Series F	—	1,430,051	1,430,051
2010 Series G	—	24,286,297	24,286,297
2011 Series A	—	29,582,409	29,582,409
2011 Series B	—	1,374,483	1,374,483
2012 Series A	—	27,413,791	27,413,791
2015 Series A/2006 Series A Refunding	—	18,299,144	18,299,144
2015 Series A/2009 Series A Refunding	—	1,844,250	1,844,250
2016 Series A/2009 Series A Refunding	—	7,226,034	7,226,034
2016 Series A/2009 Series B Refunding	—	8,114,449	8,114,449
2016 Series A/2010 Series F Refunding	—	3,631,653	3,631,653
2016 Series C	—	3,474,863	3,474,863
	$ 37,045,000	175,698,037	212,743,037

Table 2 – Wholesale Customers Debt Service Allocation (%)

	Costs prior to July 1, 2009	Retail projects	Regional projects	Total
2009 Series A	31.65	10.43	57.92	100.00
2009 Series B	—	12.63	87.37	100.00
2010 Series B	—	7.10	92.90	100.00
2010 Series D	—	2.76	97.24	100.00
2010 Series E	—	3.15	96.85	100.00
2010 Series F	—	—	100.00	100.00
2010 Series G	—	—	100.00	100.00
2011 Series A	—	6.47	93.53	100.00
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
2015 Series A/2009 Series A Refunding	31.65	10.43	57.92	100.00
2016 Series A/2009 Series A Refunding	31.65	10.43	57.92	100.00
2016 Series A/2009 Series B Refunding	—	12.63	87.37	100.00
2016 Series A/2010 Series F Refunding	—	—	100.00	100.00
2016 Series C	—	—	100.00	100.00

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	$ 3,037,656	1,001,035	5,558,959	9,597,650	64.27%	3,572,743
2009 Series B	—	1,246,991	8,626,259	9,873,250	64.27%	5,544,097
2010 Series B	—	2,422,692	31,699,734	34,122,426	64.27%	20,373,419
2010 Series D	—	346,183	12,196,675	12,542,858	64.27%	7,838,803
2010 Series E	—	627,777	19,301,652	19,929,429	64.27%	12,405,172
2010 Series F	—	—	1,430,051	1,430,051	64.27%	919,094
2010 Series G	—	—	24,286,297	24,286,297	64.27%	15,608,803
2011 Series A	—	1,913,982	27,668,427	29,582,409	64.27%	17,782,498
2011 Series B	—	—	1,374,483	1,374,483	64.12% *	881,318
2012 Series A	—	8,405,068	19,008,723	27,413,791	64.27%	12,216,906
2015 Series A/2006 Series A refunding	6,168,641	2,397,188	9,733,315	18,299,144	64.27%	6,255,602
2015 Series A/2009 Series A refunding	583,705	192,355	1,068,190	1,844,250	64.27%	686,526
2016 Series A/2009 Series A refunding	2,287,040	753,675	4,185,319	7,226,034	64.27%	2,689,905
2016 Series A/2009 Series B refunding	—	1,024,855	7,089,594	8,114,449	64.27%	4,556,482
2016 Series A/2010 Series F refunding	—	—	3,631,653	3,631,653	64.27%	2,334,063
2016 Series C	—	—	3,474,863	3,474,863	64.27%	2,233,294
Total	$ 12,077,042	20,331,801	180,334,194	212,743,037		115,898,725
Adjustment for Penstock Assessment Renovation (CUH97514) project consistent with FY 2014–15 7.06 settlement						(5,776)
Adjustment for Moccasin Afterbay Rehab (CUH97518) project consistent with FY 2014–15 7.06 settlement						(10,085)
Adjustment for Mather Facilities (CUH97703) project consistent with FY 2014–15 settlement						(4,714)
Adjustment for Lower Cherry Aqueduct (CUH 10003) project consistent with FY 2013–14 7.06 settlement						(4,482)
						$ 115,873,668

* 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. As of June 30, 2017 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.

Bond 2011 Series B was issued as a Water Revenue Bond Series to fund the Hetch Hetchy water-related capital project expenditures. Wholesale share of the debt for the year ended June 30, 2017 was allocated using the Adjusted Proportional Annual Use percentage of 64.12%.

(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, 2017:

Project #	Project	Appropriations	Allocation%	Wholesale share
CUW273	Water Transmission Program	7,849,000	64.27%	5,044,552
CUW274	Water Supply and Storage	7,563,000	64.27	4,860,740
CUW275	Watershed and Land Management	1,990,000	64.27	1,278,973
	Water revenue-funded capital projects	$ 17,402,000		$ 11,184,265

(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.

(6) Wholesale Revenue Billings

During the year ended June 30, 2017, the SFPUC billed a total of $233,356,487 (net of amounts remitted to BAWSCA) in wholesale revenue for costs of service associated with deliveries from the regional water system. As applicable a portion of these billings relate to deposits by the Wholesale Customers to meet their Wholesale Revenue Coverage Reserve and Working Capital Reserve requirements per Article VI, Section 6.06 and Section 6.07 of the WSA, respectively, which reduced total wholesale revenue billings. As of June 30, 2017 billings did not include deposits to Wholesale Revenue Coverage Reserve and Working Capital Reserve.

Gross and net wholesale revenue billings are summarized below:

Gross wholesale amounts billed – net of adjustments	$	258,041,277
Amount remitted to BAWSCA		24,684,780
Subtotal		233,356,497
Deposits to wholesale revenue coverage reserve		—
Net wholesale revenues billed	$	233,356,497

(7) Wholesale Revenue Coverage Reserve

During the year ended June 30, 2017, $75,366 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, 2017, the Wholesale Revenue Coverage Reserve balance was $28,974,681, representing total deposits since July 1, 2009.

As of June 30, 2017, the Wholesale Revenue Coverage Reserve amount exceeded the Working Capital Requirement as shown in the below table:

	Wholesale revenue coverage reserve	Debt service coverage requirement	Working capital coverage requirement	Net interest due to wholesale customers
Balance, June 30, 2016	$ 28,899,345			
Deposits to wholesale revenue coverage reserve (note 2a)	75,336			
Balance, June 30, 2017	$ 28,974,681			
Calculation of adequacy of reserve requirement:				
Wholesale revenue coverage reserve balance, June 30, 2017		$ 28,974,681	28,974,681	
Coverage reserve, requirement, June 30, 2017		(28,974,681)	(15,772,372)	
Coverage reserve excess		$ —	13,202,309	
Interest due to (from) Wholesale Customers	$ 268,822			268,822

A net accrual interest of $268,822 shown in above table for the excess from Wholesale Revenue Coverage Reserve will be made to the Balancing Account in favor of the Wholesale Customers during the year ended June 30, 2018, 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, 2017, 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 $23.8 million. Reimbursements to date from insurance and federal and state grants totals approximately $12.1 million. An expense and reimbursement summary is shown in the following table.

The WRRs for the years ended June 30, 2014 through June 30, 2017 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.

2013 Rim Fire Expense and Reimbursement Summary

(in millions)		Hetch Hetchy Power	Hetch Hetchy Joint	Hetch Hetchy Water	Total
Actual expenditures:					
Cumulative through FY 2016	$	10.9	11.6	1.0	23.5
FY 2017		—	0.3	—	0.3
Cumulative actual expenditures		10.9	11.9	1.0	23.8
Less reimbursements:					
Insurance					
Cumulative through FY 2016		(2.8)	(1.7)	(0.2)	(4.7)
FY 2017		(0.6)	(1.0)	—	(1.6)
Cumulative insurance		(3.4)	(2.7)	(0.2)	(6.3)

2013 Rim Fire Expense and Reimbursement Summary

(in millions)		Hetch Hetchy Power	Hetch Hetchy Joint	Hetch Hetchy Water	Total
Federal/state grant					
Cumulative through FY 2016	$	(3.0)	(2.2)	—	(5.2)
FY 2017		—	(0.6)	—	(0.6)
Cumulative federal/ state grant		(3.0)	(2.8)	—	(5.8)
Net expenditures:					
Cumulative through FY 2016		5.1	7.7	0.8	13.6
FY 2017		(0.6)	(1.3)	—	(1.9)
Cumulative net expenditures	$	4.5	6.4	0.8	11.7
Joint allocation percentage			45 %		
Adjusted proportional annual share of water deliveries					
FY 2017			64.12 %	64.12 %	64.12 %
Potential wholesale customers					
Share:					
Cumulative through FY 2016	$	—	2.3	0.6	2.9
FY 2017		—	(0.4)	—	(0.4)
	$	—	1.9	0.6	2.5

(9) Wholesale Customer Review of Fiscal Year 2015-16 Wholesale Revenue Requirement

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. This settlement agreement resulted in adjustments described in Note 2(b). However, disagreements still exist in Fiscal Year 2015-16 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 September 8, 2018. 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

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, 2017.

(b) CUW 300 Commercial Paper Related Financing Costs

Wholesale Customers disagree with the SFPUC on Project CUW 300 financing costs 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, 2017.

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

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 BAWSCA are in discussion regarding the inclusion of certain salaries related to SFPUC staff performing work for other City departments. The potential adjustments are unknown but are expected not to be material.

(10) Other Items Under Discussion

Outside the WSA Article VII, Section 7.06 process, the Wholesale Customers and the SFPUC are engaged in a discussion regarding certain items that may impact the calculation of the annual Wholesale Revenue Requirement. Should the Wholesale Customers and the SFPUC come to a resolution on these items, both parties will follow the procedures prescribed in the WSA to amend the WSA, if needed. The items that are under discussions are as follows:

(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) Article VI, Section 6.08 - Excess Accumulation of Unexpended and Unencumbered Appropriation (Note 5(e))

The Wholesale Customers and the SFPUC are in discussion regarding possible amendment of this WSA section to simplify the methodology of the calculation of the Wholesale Customers' share of revenue-funded capital projects. The expected effects any amendments to the WSA over five-year periods ending June 30, 2019, 2024, 2029 and 2034 are not expected to be material.

(c) Asset Classification

The Wholesale Customers and SFPUC are evaluating and negotiating the classification of certain assets and expenditures of the Water Enterprise and Hetch Hetchy Enterprise. Adjustments, if any, to the Balancing Account under this possible amendment as of June 30, 2017 are not expected to be material.

(11) Subsequent Events

On March 8, 2018 the SFPUC and Wholesale Customers completed the negotiations, except for some issues discussed above in Note 9, of the Wholesale Customers Review under Article V11, Section 7.06 of the WSA for the year ended June 30, 2016, which is now closed. The results of these negotiations have been reflected in the Balancing Account, as adjusted, as of June 30, 2016.

KPMG

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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, 2017, 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 SFPUC's internal control. Accordingly, we do not express an opinion on the effectiveness of SFPUC'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 material weaknesses and therefore, material weaknesses may exist that were not identified. However, as discussed below, we identified a deficiency in internal control that we consider to be a material weakness.

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 deficiency in SFPUC's internal control described in Finding 2017-1 to be a material weakness.

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

<u>Finding 2017-1 – Calculation of Enterprise Salaries on Attachment N2, Schedule 7.1 (Material Weakness)</u>

Criterion

Water Supply Agreement Article V, Sections 5.06 B.2.b and 5.08 B.2.b specify that services of SFPUC Bureaus for the Water Enterprise and Hetch Hetchy Water and Power, respectively, shall be allocated on the basis of salaries of employees in each enterprise or department, as illustrated in Attachment N-2, Schedule 7.1.

Observation and Effect

SFPUC included approximately $72,020,000 of Wastewater salaries on Attachment N2 Schedule 7.1, when the correct amount to be included was approximately $46,690,000. SFPUC agreed with our calculated misstatements of salaries on Attachment N-2, Schedule 7.1, and corrected this Schedule, resulting in an adjustment in the favor of the Retail Customers by approximately $2,340,000.

Cause

The cause was inadequate internal control over management's review of analysis reports, as prepared from data extracted from the financial system. Staff extracted and accumulated data from the Executive Information System to prepare the calculation of the Wholesale Revenue Requirement. The inadequate review resulted in a significant miscalculation that qualified as a deficiency in internal control as a material weakness.

Recommendation

SFPUC should ensure that adequate internal controls exist to ensure that enterprise salaries in Attachment N-2, Schedule 7.1 are calculated correctly.

Views of SFPUC Management

Management concurs with the findings.

Management recognizes the importance of internal controls and accuracy, and is committed to continuous improvement in its stewardship of the WSA, particularly as it relates to the Statement of Changes in the Balancing Account.

To address this deficiency, management will prioritize staff resources so that there is a subject matter expert in the preparation of the Statement of Changes in the Balancing Account. While all schedules will be reviewed by multiple SFPUC staff for both format and content, the subject matter expert will review <u>all</u> Schedules and work products to ensure consistency and accuracy.

Management will also further improve the existing formal review process for the preparation of the Statement of Changes in the Balancing Account to ensure accuracy of the statement. In addition, the expanded review process will be supported by a documented process narrative that details data sources, methodology, process and notes for each schedule of the Statement. The process narrative will be updated on a regular basis, and be made readily available to all staff.