Audit of Sewer Utilities

MHC Acquisition One, LLC. – Sewer

For the Year Ended December 31, 2018

Utility Audits Branch
June 1, 2020

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A digital copy of this report can be found at:
http://www.cpuc.ca.gov/utilityaudits/

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EXECUTIVE SUMMARY

The Utility Audits Branch (UAB), formerly known as the Utility Audit, Finance and Compliance Branch (UAFCB)[1], is in the Utility Audits, Risk and Compliance Division (UARCD), which reports directly to the Executive Director of the California Public Utilities Commission (CPUC). Pursuant to California Public Utilities (PU) Code, Sections 314.5, 314.6, 581, 582, and 584, the CPUC has statutory authority to inspect and audit the books and records of the utilities to ensure that ratepayers' money is well spent. PU Code Section 314.5 specifies that the CPUC shall inspect and audit the books and records for regulatory and tax purposes at least once every three years for utilities serving over 10,000 customers and at least once every five years for utilities serving 10,000 or fewer customers. PU Code Section 314.6(a) states that "the Commission may conduct financial and performance audits of any entity or program created by any order, decision, motion, settlement, or other action of the Commission."

MHC Acquisition One, LLC (MHC), which is comprised of Water and Sewer Operations, was incorporated in California on August 19, 1996. UAB performed an audit on the 2018 Annual Report of MHC's Sewer Operations' (MHC–Sewer). MHC–Sewer is a regulated Class D sewer utility, which serves approximately 206 customer service connections in De Anza Santa Cruz Manufactured Home Community and surrounding areas located in Santa Cruz, California. MHC–Sewer is a subsidiary of Equity Lifestyle Properties, Inc. (ELS), which is a publicly traded company. As a regulated sewer utility, MHC–Sewer is required to prepare its financial statements on accrual basis of accounting set forth in the Uniform System of Accounts (USOA) for Water Utilities adopted in Decision 16-11-006 by the CPUC on November 16, 2016, which is a comprehensive basis of accounting other than the generally accepted accounting principles in the United States of America.

The UAB conducted the audit of MHC–Sewer's 2018 Annual Report filed with the CPUC in accordance with applicable PU Code, regulations, and CPUC's directives. The primary objectives of this audit are to ensure the fair presentation of the financial information in MHC–Sewer's 2018 Annual Report and to determine whether MHC–Sewer complied with the applicable regulations and CPUC's directives. The scope of our audit was limited to the financial information presented in MHC–Sewer's 2018 Annual Report filed with the CPUC. In addition, UAB evaluated the effectiveness of MHC–Sewer's internal control over its accounting and reporting functions as it relates to the audit objectives.

Based on our audit, the following findings were identified:

- Finding 1: MHC–Sewer does not have formal written policies and procedures for multiple areas to guide its accounting and reporting practices. As a result, there is a reasonable possibility that material misstatements in MHC-Sewer's Annual Reports may not be prevented or detected timely.

- Finding 2: MHC-Sewer misclassified two expenses during the audit period, resulting in inaccurate presentations of various expense accounts reported in the Income Statement.

[1] Effective January 2020, Utility Audit, Finance and Compliance (UAFCB) was renamed to Utility Audits Branch (UAB).

- Finding 3: MHC–Sewer did not remit CPUC Users Fee to the CPUC since 2000. For the year ended December 31, 2018, the unremitted CPUC Users Fee totaled $1,261. Due to the limitation of the audit scope, UAB was unable to determine the total amount of the CPUC Users Fee that MHC–Sewer failed to remit from 2000 through 2017.

- Finding 4: MHC–Sewer failed to accrue $760 of Contract Work expense incurred during 2018.

RESTRICTED USE OF THIS AUDIT REPORT

This audit report is intended solely for the information and use by the CPUC and the management of MHC–Sewer. It is not intended to be used and should not be used by anyone other than the specified parties. However, this report is a matter of public record and its distribution is not limited.

AUDIT REPORT

BACKGROUND

The California Public Utilities Commission (CPUC) was established by Constitutional Amendment as the Railroad Commission in 1911. The Legislature passed the Public Utilities Act in 1912 to expand the CPUC's regulatory authority over natural gas, electric, telephone, and water companies as well as railroads and marine transportation companies. In 1946, the Railroad Commission was renamed the California Public Utilities Commission.[2] The California Public Utilities (PU) Code granted CPUC's regulatory authority over Investor-Owned Utilities (IOU) in California. The Utility Audits Branch (UAB), formerly known as the Utility Audit, Finance and Compliance Branch (UAFCB)[3], is in the Utility Audits, Risk and Compliance Division (UARCD), which reports directly to the Executive Director of the CPUC. The UAB provides auditing, accounting, financial, and advisory services on regulated utilities and monitors compliance with laws and CPUC directives.

PU Code, Section 314.5(a) states, in part:

> The commission shall inspect and audit the books and records for regulatory and tax purposes as follows… (2) At least once every five years in the case of every electrical, gas, heat, telegraph, telephone, and water corporation serving 10,000 or fewer customers.

In addition, PU Code, Section 314.6(a) states that "The commission may conduct financial and performance audits of any entity or program created by any order, decision, motion, settlement, or other action of the commission." Regulated utilities are required to comply with PU Code Sections 581, 582, and 584 by timely submitting to the CPUC the requested documents in the form and detail prescribed by the CPUC.

On November 10, 2016, CPUC approved Decision (D.)16-11-006 to update its Uniform System of Accounts (USOA), which is a basis of accounting other than the generally accepted accounting principles in the United States, for the regulated water and sewer IOUs in California. All regulated water and sewer utilities are required to comply with the accounting requirements specified in the updated USOA, which became effective on January 1, 2018. Among other requirements, the USOA requires that "The books of account of all water utilities shall be kept by the double entry method, on an accrual basis. Each utility shall post its accounts monthly and shall close its books at the end of each calendar year." [4]

For the purpose of applying systems of accounts prescribed by the CPUC, regulated water utilities are divided into four classes based on the number of service connections as follows:

Class A Utilities—having more than 10,000 service connections.
Class B Utilities—having between 2,001 service connections and 10,000 service connections.
Class C Utilities—having between 501 service connections and 2,000 service connections.
Class D Utilities—having 500 service connections or less.

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[2] https://www.cpuc.ca.gov/history/
[3] Effective January 2020, Utility Audit, Finance and Compliance (UAFCB) was renamed to Utility Audits Branch (UAB).
[4] D.16-11-006, Page B13.

Classes B, C, and D water utilities are commonly referred to as "Small Water Utilities."

MHC Acquisition One, LLC (MHC), which is comprised of Water and Sewer Operations, was incorporated in California on August 19, 1996. UAB performed an audit on the 2018 Annual Report of MHC's Sewer Operations (MHC–Sewer). MHC–Sewer is a regulated Class D sewer corporation, which serves approximately 206 customers connections in the De Anza Santa Cruz Manufactured Home Community and surrounding areas located in Santa Cruz, California. MHC is a subsidiary of Equity Lifestyle Properties, Inc. (ELS), which is a publicly traded company.

OBJECTIVE AND SCOPE

UAB conducted the audit of MHC–Sewer's 2018 Annual Report filed with the CPUC in accordance with applicable PU Code, regulations, and CPUC's directives. The primary objectives of this audit are to ensure the fair presentation of the financial information in MHC–Sewer's 2018 Annual Report and to determine whether MHC–Sewer complied with the applicable regulations and CPUC's directives. The scope of our audit was the financial information presented in MHC–Sewer's 2018 Annual Report filed with the CPUC. In addition, UAB evaluated the effectiveness of MHC–Sewer's internal control over its accounting and reporting functions as it relates to the audit objectives.

METHODOLOGY

To determine MHC–Sewer's compliance with the applicable regulation and CPUC directives in reporting the financial information in its 2018 Annual Report and to assess MHC–Sewer's internal controls over its accounting and reporting, UAB obtained sufficient and appropriate evidence to achieve the audit objectives. The specific procedures performed during this audit included, but were not limited to, the following:

1. Obtained an understanding of the company's business operation and its accounting system.

2. Performed analytical procedures on the reported financial data to identify year-to-year trends and significant fluctuations of individual accounts over the past three-year period.

3. Assessed the company's internal controls through observation, inquiry, and documentation. Specific procedures included, but were not limited to:
   - Reviewed the company's policies and procedures, and their implementation pertaining to accounting, recording, reporting, and record retention.
   - Interviewed key company personnel to obtain an understanding of its internal control structure and operating environment.
   - Reviewed the company's organization chart to evaluate segregation of duties, authorization and approval processes, performance monitoring and controls, and compliance with regulatory requirements and CPUC's directives.

4. Performed risk assessment and determined materiality level based on the auditor's understanding of the company's operations, the evaluation of its internal control, and UAB's financial analysis.

5. Determined the company's compliance with applicable regulations and CPUC directives regarding the timeliness of filing the Annual Report; compliance with USOA accounting

requirements; treatment of public grants, loans, utility plant, facility fees, and user fees; disclosure and accounting treatment of affiliated transactions, etc.

6. Reconciled the amounts reported in the Annual Report to underlying accounting records presented in the general ledger (G/L) and trial balance for the year ended December 31, 2018.

7. Reviewed the list of sewer plant assets, related invoices, purchase orders, work orders, and depreciation schedules to determine the existence, completeness, rights, and valuation of utility plant.

8. Reconciled Utility Plant in Service and depreciation expense balances shown in the Annual Reports to the G/L and depreciation schedules.

9. Reviewed the loan agreements and bank statements to determine the obligation, completeness, classification, and valuation of reported liabilities.

10. Determined the occurrence, completeness, accuracy, classification, and cutoff of the recorded expenditures by reviewing relevant supporting documents, such as purchase requisitions, canceled checks, bank statements, invoices, contracts or agreements, and insurance policies, etc. Performed sample-testing as appropriate.

11. Determined the completeness, accuracy, and cutoff of the recorded revenues by reviewing the billing records and money received from ratepayers; and performing reasonableness tests of reported revenues based on the CPUC approved tariffs for the audit period.

12. Reconciled the amounts reported on the Annual Report to the underlying accounting records presented on the general ledger and trial balance for the year ended December 31, 2018.

13. Determined that cash existed and was supported by bank statements and bank reconciliations. Determined that cash balance is properly classified (facilities fees, customer's deposits, contributions) in the financial statements and any restrictions on the use of the funds are properly disclosed.

14. Analyzed Common Stock and Other Paid-in Capital accounts by reviewing common stock certificates, par value, shares outstanding, and recalculated average share price.

15. Determined and disclosed if any related/affiliated party transactions per D.10-10-019.

AUDIT FINDINGS AND RECOMMENDATIONS

The results of our audit of MHC–Sewer's 2018 Annual Report are described below. The audited financial statements and UAB's Audit Adjustments are presented in the next section, titled "Audited Financial Statements."

Finding 1: MHC–Sewer does not have formal written policies and procedures for multiple areas to guide its accounting and reporting practices.

Condition:
UAB noted MHC–Sewer does not have formal written policies and procedures which present a reasonable possibility that material misstatements in the Annual Report will not be prevented or detected on a timely basis:

A. Record retention.
B. Revenue recording and reporting including recording and remittance procedures for surcharges collected.
C. Recording and reporting cash disbursements.
D. Payroll process.
E. Inventory, recording, and reporting of Materials and Supplies.
F. Asset acquisition, retirement, abandonment, and deletion due to obsolescence.
G. Preparation, filing, and maintenance of annual reports filed or to be filed with the CPUC.

Criteria:
Good internal controls and prudent business practices require MHC–Sewer to establish proper written policies and procedures to carry out complex and routine operations.

Cause:
MHC–Sewer's management has not developed written policies and procedures to governs its business operations.

Effect:
The absence of formal written policies and procedures to govern MHC–Sewer's business operations could result in inaccurate accounting records and mismanagement of its financial statements in MHC-Sewer's Annual Reports not being prevented or detected timely.

Recommendations:
MHC–Sewer should establish written policies and procedures for the aforementioned areas to governs its business operations. In addition, MHC–Sewer should provide a copy of its written policies and procedures to UAB along with its corrective action plan.

Finding 2: Misclassifications of expenses

Condition:
MHC-Sewer misclassified the following expenses:

- The expenses for postage, envelopes, print, and mail should have been recorded in Account 681—Office Supplies and Expenses instead of Account 689—General Expense.
- The expenses for meter charges should have been recorded into Account 650—Contract Work instead of Account 689—General Expense.

Office Supplies and Expenses account was understated by $682; the Contract Work account was understated by $1,448; and General Expenses were overstated by $2,130.

Criteria:
The USOA defines the aforementioned accounts as follow:

> Acct 650—Contract Work
> This account shall include the cost of all repair and maintenance work not performed by water company employees. Examples of such expenses are pump repairs, repairs of water system leaks by local plumbers, painting of tanks by painting contractors, and testing of water by laboratories. This account shall include materials that are part of a contract price if the cost of such materials is not separately stated, and incidental operation and maintenance expenses not chargeable to accounts 630 or 640. The following subaccounts shall be used, if applicable. 650.1 Contract Water Quality and Testing Work and 650.2 Other Contract Work
>
> Account 681—Office Supplies and Expenses
> This account shall include the cost of office supplies and expenses, including printing, stationery, general accounting supplies, repair, maintenance and telephone, utilities, and other office expenses.
>
> Account 689—General Expense
> This account shall include all expenses not includible in other operating expense accounts. General expenses include advertising, subscriptions, collection agency fees and Water Association dues.

Cause:
MHC–Sewer lacks adequate internal control over its accounting and reporting functions to ensure its expenses were recorded and reported accurately.

Effect:
Inaccurate reporting of Office Supplies and Expenses, General Expense, and Contract work distorted MHC–Sewer's Income Statement for the year ended December 31, 2018.

Recommendation:
MHC–Sewer establish and implement adequate controls over its accounting and reporting functions, which will help ensure its expenses are recorded and reported in proper accounts.

Finding 3: MHC–Sewer did not remit the CPUC Users Fee to the CPUC.

Condition:
MHC–Sewer has not remitted CPUC Users Fee to the CPUC since 2000. PU Code, Sections 431 and 433 require utilities to bill and collect Users Fee from customers and remit the fees collected to the CPUC quarterly or annually. The CPUC Users Fee rate for 2018 was 1.4 percent. MHC–Sewer's 2018 customer billing detail showed that MHC–Sewer did not consistently apply the CPUC Users Fee to its customer bills. During 2018 MHC–Sewer charged its common area customers Users fee of 1.4 percent, or $283. However, MHC–Sewer did not apply the Users Fee rate of 1.4 percent to its residential customer bills. UAB determined that during 2018 MHC–Sewer should have billed and collected from its residential customers a total of $978 of CPUC Users Fee ($69,833 revenues × 1.4%). MHC–Sewer did not remit to the CPUC $1,261 for the year ended 2018. Due to the scope limitation of the audit, UAB was unable to determine the total amount of the CPUC Users Fee that MHC–Sewer failed to remit from 2000 through 2017 to the CPUC.

Criteria:
PU Code, Section 431(a) states that:

> The commission shall annually determine a fee to be paid by every electrical, gas, telephone, telegraph, water, sewer system, and heat corporation and every other public utility providing service directly to customers and subscribers and subject to the jurisdiction of the commission other than a railroad, except as provided in Article 2 (commencing with Section 421).

PU Code, Section 433 states that:

> Except as provided in Section 404, every public utility subject to Section 431 shall make payment of the required fee in accordance with the following schedule:
> (a) Every public utility with annual gross intrastate revenues of seven hundred fifty thousand dollars ($750,000) or less shall make payment of the fee to the commission on an annual basis on or before January 15.
> (b) Every other public utility not subject to subdivision (a) shall make payment of the fee to the commission on a quarterly basis between the first and 15th days of July, October, January, and April.

General Accounting Instruction 9.B. of the USOA states that:

> Class A water utilities pay a percentage of gross revenues quarterly; Class B, C, and D water utilities pay a designated amount, based on gross revenues, on January 15 of the following year. Sales of water for resale and Interdepartmental water sales should be excluded from gross revenues when computing the Water Utility Users fee.

CPUC Resolution M-4832 states, in part, that:

> Effective January 1, 2018, the current [Public Utilities Commission Utilities Reimbursement Account] PUCURA user fees shall be revised as follows:
> Water and Sewer System Corporations 0.01400 (1.40%) x Revenue.

Cause:
MHC–Sewer's management lacks procedures to ensure Users Fee was properly collected and remitted to the CPUC.

Effect:
MHC–Sewer did not remit $1,261 of CPUC Users Fee to the CPUC for the year ended December 31, 2018. Due to the limitation of the audit scope, UAB is unable to determine the amount of CPUC Users Fee that MHC–Sewer failed to remit from 2000 and 2017 to the CPUC.

Recommendations:
MHC–Sewer establish and implement adequate controls over its accounting and reporting functions, which will help ensure MHC-Sewer properly and timely remits all CPUC Users Fee to the CPUC. Payment of Users Fee to the CPUC should be recorded into the Regulatory Commission Expense account when payments are due. MHC–Sewer should immediately remit all CPUC Users Fee it owes to the CPUC for the years from 2000 through 2018. MHC–Sewer should provide proof of remittance of such fees in its corrective action plan to UAB and the CPUC's Water Division.

Finding 4: MHC–Sewer failed to accrue Contract Work Expenses.

Condition:
Account 650—Contract Work was recorded when paid, instead of in the period when the expenses were incurred. The USOA mandates the utility's books must be kept on the accrual basis. The cash basis method recognizes certain expenses when paid rather than when incurred. As a result, expenses for Contract Work was overstated by $760.

Criteria:
General Instructions 2 in USOA for Class B, C, And D Water Utilities adopted in D.16-11-006 states in part, that:

> A. The books of account of all water utilities shall be kept by the double entry method, on an accrual basis. Each utility shall post its accounts monthly and shall close its books at the end of each calendar year.

Cause:
MHC–Sewer did not have adequate internal control to ensure that expenses were recorded in the period incurred.

Effect:
Misstated expenses for Contract Work (Account 650) in the Annual Report, which may be used during the MHC's General Rate Case (GRC) application review process, could potentially impact the sewer rates for MHC–Sewer's ratepayers.

Recommendation:
MHC–Sewer should establish and implement adequate controls over its accounting and reporting functions, which will help ensure its expenses are recorded in the proper accounting period.

CONCLUSION

In conducting this audit, we obtained an understanding of MHC–Sewer's internal controls, including any information systems controls that we considered significant within the context of our audit objective. We assessed whether those controls were properly designed, implemented, and operating effectively. Any deficiencies in internal control that were identified during this audit and determined to be significant within the context of our audit objective are included in this report.

MHC–Sewer's management is responsible for the preparation and fair presentation of its 2018 Annual Report filed with the CPUC. The CPUC requires that the statements be in accordance with the accounting requirements as set forth in the USOA. MHC–Sewer's management is also responsible for the design, implementation, and maintenance of internal controls relevant to the preparation and fair presentation of its 2018 Annual Report that are free from material misstatements, whether due to fraud or error. In addition, MHC–Sewer's management is responsible for the development of its policies and procedures to ensure full compliance with applicable regulations and CPUC directives.

We conducted our audit in accordance with the applicable PU Code, regulations, and CPUC's directives. We planned and performed the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings, audit adjustments, and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings, audit adjustments, and recommendations presented in this report.

MHC–Sewer's Management should submit an electronic copy of its corrective action plan to the UAB at UtilityAudits@cpuc.ca.gov , with a copy to Lucian Filler, Deputy Executive Director of CPUC, at Lucian.Filler@cpuc.ca.gov, and Bruce DeBerry, Program Manager of Water Division, at Bruce.DeBerry@cpuc.ca.gov no later than July 17, 2020. The corrective action plan should address how MHC–Sewer will implement the recommendations and provide the timing of incorporating UAB's audit adjustments to MHC–Sewer's books and records. If MHC–Sewer is unable to implement UAB's recommendations, the corrective action plan should state the reason(s) for not being able to implement any of the recommendations. MHC–Sewer should use the audited amounts in UAB's audit report as the basis to file its 2019 Annual Report with the CPUC.

VIEWS OF RESPONSIBLE OFFICIAL

On April 24, 2020, UAB provided a draft audit report to MHC–Sewer for comments. On May 22, 2020, MHC–Sewer provided its comments to UAB, which are included in Appendix C of this report. UAB's evaluations of and rebuttals to those comments are in Appendix D of this report. The audit findings and recommendations presented in this report represent our final determination of this audit.

Angie Williams

Angie Williams, Director
Utility Audits, Risk and Compliance Division

cc: Alice Stebbins, Executive Director, CPUC
Lucian Filler, Deputy Executive Director, CPUC
Masha Vorobyova, Assistant Director, UAB
Bruce DeBerry, Program Manager, Water Division
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Khusbindar Kaur, Senior Management Auditor, UAB
Sharmin Wellington, Public Utilities Regulatory Analyst V, UAB

MHC Sewer Company

BALANCE SHEET (AS AUDITED)

As of December 31, 2018

ASSETS	
UTILITY PLANT	
Sewer Plant in Service	$420,364
Accumulated Depreciation of Sewer Plant	(397,726)
Net Utility Plant	22,638
CURRENT AND ACCRUED ASSETS	
Cash	8,553
Accounts Receivable - Customers	262
Total Current and Accrued Assets	8,815
Total Assets	$31,453
CAPITALIZATION AND LIABILITIES	
Proprietary Capital	
Proprietary Capital	($891,673)
Total Proprietary Capital	(891,673)
CURRENT AND ACCRUED LIABILITIES	
Payables to Affiliated Companies	906,375
Accounts Payable	8,476
Other Current Liabilities	7,163
Total Current and Accrued Liabilities	922,014
DEFERRED CREDITS	
Other Credits	1,112
To Deferred Credits	1,112
Total Equity and Liabilities	$31,453

(The accompanying Notes to Financial Statements are an integral part of these Financial Statements)

MHC Sewer Company
INCOME STATEMENT (AS AUDITED)
For Year Ended December 31, 2018

OPERATING REVENUES	
Unmetered Sewer Revenue	$92,082
Total Operating Revenue	92,082
OPERATING EXPENSES	
Plant Operation and Maintenance Expenses	
Contract Work	103,190
Total Plant Operation and Maintenance Expenses	103,190
Administrative and General Expenses	
Office Supplies and Expenses	682
Professional Services	14,600
Insurance	301
General Expenses	819
Net Administrative and General Expenses	16,402
Total Operating Expenses	119,592
Depreciation Expense	1,498
Taxes Other Than Income Taxes	2,016
Total Operating Revenue Deductions	123,106
Net Income / (Loss)	($31,024)

(The accompanying Notes to Financial Statements are an integral part of these Financial Statements)

MHC Sewer Company
STATEMENT OF PROPRIETARY CAPITAL (AS COMPILED [5])
For Year Ended December 31, 2018

Proprietary Capital, Beginning of Year	($811,462)
CREDITS:	
Credits	0
Total Credits	0
DEBITS:	
Net Losses	(31,024)
Other Debits: Allocation of Proprietary Capital from Water	(49,187)
Total Debits	(80,211)
Proprietary Capital, End of Year	($891,673)

(The accompanying Notes to Financial Statements are an integral part of these Financial Statements)

[5] UAB compiled the Statement of Proprietary Capital based on the audited Balance Sheet and Income Statement, and other relevant financial data.

MHC SEWER COMPANY

NOTES TO FINANCIAL STATEMENTS

Regulated Sewer utilities are required to prepare their financial statements on Accrual basis of accounting set forth in the Uniform System of Accounts (USOA) for Sewer Utilities adopted in Decision (D.) 16-11-006 by the CPUC on November 16, 2016, which is a comprehensive basis of accounting other than the generally accepted accounting principles (GAAP) in the United States of America. The following describes certain differences in accounting treatments between GAAP and USOA, the company's current accounting practices, and its compliance with applicable regulation and CPUC directives.

Related Party Disclosure
MHC is a subsidiary of Equity Lifestyle Properties, Inc. (ELS), which is a publicly traded company. ELS hires an accounting firm to compile MHCs Water and Sewer Operations' Annual Reports submitted to the CPUC. The management fee charged by ELS to its subsidiaries is determined in part by the number of customers, type of operations, etc. In setting a management fee, ELS uses an estimate of the cost based on what other utilities are paying to a third party within the ELS. ELS charges $1,000 per month to MHC–Sewer Operations and $1,000 per month to MHC–Water Operations related to corporate and administrative overhead charges. All invoices related directly to the utility system operation are posted on the utility's property ledger specific to MHC.

1. Purpose of Financial Information and Targeted Audience

The objective of preparing financial statements in accordance with GAAP is to provide information that is useful in making decisions about providing resources to the entity. Users of the financial information include existing and potential investors, lenders, and other creditors.

The purpose of using USOA to prepare financial statements is to have the utilities provide financial transparency of their water operations on a consistent basis. The primary user of the financial information is the CPUC for ratemaking and other compliance purposes.

2. Property, Plant, and Equipment

The USOA distinguishes the plant assets for water operations (i.e., Account 101, Water Plant in Service) from those for non-water operations (i.e., Account 121, Non-Water Utility Property and Other Assets), for ratemaking purposes.

(1) Depreciation Methodology

GAAP allows entities to elect a depreciation methodology of their choices, such as straight-line, double-declining balance, or sum-of-the-years digits depreciation method.

USOA requires utilities to use "Straight-line remaining life method." "Remaining life" implies that estimates of future life and salvage value will be re-evaluated periodically and that depreciation rates will be adjusted to reflect any changes in estimates. Water utilities are required to comply with the CPUC's Standard Practice (SP) U-4-SM and SP U-4-M when determining depreciation accruals. Specifically, for the water plant with over $100,000, the utility must maintain separate depreciation reserve by different plant accounts in accordance with Appendix B1 of SP U-4-SM; for the water plant under $100,000, if the utility elects not to separate or maintain the depreciation reserve by accounts, it is appropriate to develop a composite value for remaining life for the entire plant in accordance with Appendix B2 or B3 of SP U-4-SM. The USOA suggested that all utilities maintain a separate accumulated depreciation subaccount for each depreciable plant account; and, it is mandatory for water utilities having more than 500 customers.[6] The utility must obtain prior written approval from the CPUC for any practice deviates from the aforementioned SPs.

The depreciation expense was computed at a computed rate of 3.58 percent in order to depreciate all plant assets for ratemaking purposes and for reporting all the depreciation expense in MHC–Sewer's Annual Reports filed with the CPUC. MHC–Sewer provided supporting documents for the 3.58 percent composite rate it used to depreciate its plant assets. Therefore, UAB was able to verify the accuracy of this account.

(2) Asset Retirement

USOA requires that the water plant be recorded at its original cost. In USOA's depreciation schedule, the difference between the estimated cost of removal and the salvage value is included in the depreciable base to obtain the annual depreciation expense. When retiring an asset, the cost of removal will reduce the balance of Account 108, Accumulated Depreciation of Water Plant, while the cash received from the salvage value or sale price will increase the balance of Account 108, Accumulated Depreciation of Water Plant. The gain or loss from the asset retirement that is recognized under GAAP is accumulated in Account 108, Accumulated Depreciation of Water Plant under USOA.

The utility plant is recorded at its original cost when first constructed or purchased. Retired utility plant assets are removed from utility plant accounts based on the estimated cost and charged against accumulated depreciation. MHC–Sewer maintained a detail list of sewer plant assets. UAB was able to satisfy itself by other auditing procedures concerning this account balance of $420,364. Therefore, UAB was able to verify the accuracy of this account.

3. Utility Users Fee

PU Code, Sections 431 and 433 authorized the CPUC to set a fee annually to utilities to cover the costs incurred by the CPUC in regulating them. USOA requires utilities to credit regular operating revenue accounts with amounts of Users Fee billed to customers and charge Account 688, Regulatory Commission Expense, with fees paid to the CPUC.[7]

MHC–Sewer did not consistently include the Users Fee into the sewer services billings charged to their customers. MHC–Sewer has not remitted the Users Fee to the CPUC since the year 2000. For 2018, MHC–Sewer should have remitted $1,261 Users Fee to the CPUC. See Finding 3 of this report for detailed description.

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[6] D.16.11-006 dated November 10, 2016, General Accounting Instructions 4 on Page B14.

[7] D.16.11-006 dated November 10, 2016, General Accounting Instructions 9 on Pages B18 and B19.

4. Form of Financial Statements [8]

(1) Balance Sheet

Unlike the financial statements of other industries, the financial statements of regulated water utilities present the water plant as the first major caption on the asset side of the balance sheet, and capitalization is first on the liability side. Current assets and current liabilities are relegated to a comparatively unimportant position in the center of the balance sheet, rather than being placed prominently as in statements for non-regulated industries.

(2) Income Statement

The form of Income Statement reflects the classification of revenues and expenses in ratemaking. Operating revenues and expenses are referred to as "above the line" because they are allowable in ratemaking, and the result of deducting total operating expenses from total operating revenues is the operating income. Other Income and Deductions are referred to as "below the line" because they are applied after operating income and are not allowable in ratemaking. The "below the line" items include interest revenue, dividend income, other revenues that are from non-water utility operations and/or non-water utility properties, expenses that are unrelated to water utility operations, and interest expense (the interest expense is recovered through the authorized rate of return). The concept of "above the line" revenues and expenses being allowable in ratemaking affect the form of the income statement, the classification of revenues and expenses, and decisions of management in incurring expenses.

MHC–Sewer has complied with these requirements to present the financial statements, which are comprised of the balance sheet as of December 31, 2018, and the related statements of income.

5. Exclusion of Statement of Cash Flows

Financial Accounting Standards Board specifies in its Statement of Financial Accounting Standards No. 95 that a Statement of Cash Flows is part of a complete set of financial statements under GAAP. However, Codification of Statements on Auditing Standards AU-C Section 800.A35 states, in part, that, "Special purpose financial statements may not include a statement of cash flows…." Since the USOA is an accounting framework other than GAAP for regulatory purposes, the Statement of Cash Flows is not required and therefore excluded from this audit report.

6. Compliance filing of 2018 Annual Report with the CPUC

PU Code, Sections 581, 582, and 584, and the CPUC's directive (i.e., Water Division's annual memorandum to water and sewer utilities) require all regulated water and sewer IOUs to file an Annual Report with the CPUC every year. For the year being audited, MHC–Sewer has complied with these requirements.

[8] Regulated Utilities Manual—A Service for Regulated Utilities by Deloitte & Touche USA LLP, pages 36-37.

UAB'S AUDIT ADJUSTMENTS

FOR THE YEAR ENDED DECEMBER 31, 2018

Audit Adj. No.	Annual Report				Description	Debit	Credit
	Sch.	Line	Col.	Acct No.			
1	B-2	23	C	681	Office Supplies and Expenses	$682	
	B-2	11	C	650	Contract Work	1,448	
	B-2	27	C	689	General Expense		$2,130
					To reclassify the expense of postage, envelopes, print, and mail to Office Supplies and Expense and meter read charges to Contract Work.		

APPENDICES

APPENDIX A—BALANCE SHEETS (AS REPORTED) [9]

	As of	
	12/31/2018	**12/31/2017**
ASSETS		
UTILITY PLANT		
Sewer Plant in Service	$420,364	$420,364
Accumulated Depreciation of Sewer Plant	(397,726)	(396,228)
Net Utility Plant	22,638	24,136
CURRENT AND ACCRUED ASSETS		
Cash	8,553	4,196
Accounts Receivable	262	334
Total Current and Accrued Assets	8,815	4,530
Total Assets	$31,453	$28,666
CAPITALIZATION AND LIABILITIES		
CORPORATE CAPITAL AND SURPLUS		
Proprietary Capital		
Proprietary Capital	($891,673)	($811,462)
CURRENT AND ACCRUED LIABILITIES		
Payable to Affiliated Companies	906,375	830,203
Accounts Payable	8,476	3,653
Other Current Liabilities	7,163	5,172
Total Current and Accrued Liabilities	922,014	839,028
DEFERRED CREDITS		
Other Credits	1,112	1,100
Total Deferred Credits	1,112	1,100
Total Equity and Liabilities	$31,453	$28,666

[9] The reported amounts were derived directly from MHC's 2017 and 2018 Annual Reports. They do not represent the audited amounts. They are included here for disclosure purposes only.

APPENDIX B—INCOME STATEMENTS (AS REPORTED) [10]

	For the Year of	
	2018	**2017**
OPERATING REVENUES		
Unmetered Sewer Revenue	$92,082	$91,289
Total Operating Revenue	92,082	91,289
OPERATING EXPENSES		
Plant Operation and Maintenance Expenses		
Contract Work	101,742	92,493
Total Plant Operation and Maintenance Expenses	101,742	92,493
Administrative and General Expenses		
Professional Services	14,600	15,675
Insurance	301	301
General Expenses	2,949	2,394
Net Administrative and General Expenses	17,850	18,370
Total Operating Expenses	119,592	110,863
Depreciation Expense	1,498	1,498
Taxes Other Than Income Taxes	2,016	2,016
Total Operating Revenue Deductions	123,106	114,377
Net Income / (Loss)	($31,024)	($23,088)

[10] The reported amounts were derived directly from MHC's 2017 and 2018 Annual Reports. They do not represent the audited amounts. They are included here for disclosure purposes only.

APPENDIX C—MHC'S COMMENTS

els

Equity LifeStyle Properties
Two North Riverside Plaza
Chicago, IL 60606

May 22, 2020

Raymond Yin
Program and Project Supervisor
Utility Audits Branch
California Public Utilities Commission
505 Van Ness Avenue
San Francisco, CA 94102

Re: RESPONSE TO AUDIT FINDINGS RE AUDIT OF 2018 FINANCIAL STATEMENTS FOR MHC ACQUISITION ONE, LLC (MHC) - SEWER

Dear Mr. Yin:

Finding 1: UAB noted weaknesses in MHC-Sewer's system of internal control over its financial reporting, which present a reasonable possibility that material misstatements on MHC-Sewer's Annual Reports will not be prevented or detected timely.

MHC Response:

MHC does not have any employees. MHC is accounted for as a subsidiary property investment of Equity Lifestyle Properties (ELS). Note that ELS is a publicly traded company. While ELS has designed and implemented controls for its overall entity, actual written policies and procedures have not been developed specifically for MHC. The accounting manager and select staff handle all accounting for CPUC Reporting for MHC. ELS recognizes the importance and benefits of written policies and will work to develop policies specific to MHC.

Finding 2: UAB noted multiple misclassifications of expenses during the audit period, resulting in inaccurate presentation of various expense accounts in the reported Income Statement.

MHC Response:

MHC will endeavor to classify expenses properly to specific accounts according to the USOA. As explained in the reply to finding #1, an accounting department for MHC does not exist. The accounting is done by the parent company (ELS).

Finding 3: MHC- Sewer did not remit CPUC User Fee to the CPUC since 2000. For the year ended December 31, 2018, the unremitted user fee totaled $1,261. Due to the limitation of the audit scope, UAB was unable to determine the total amount of the CPUC User Fees that MHC – Sewer failed to remit from 2000-2017.

MHC Response:

MHC is currently in the process of determining the amount of unremitted user fees. After the amount is determined, MHC will promptly remit all user fees due for all periods outstanding.

Finding 4: MHC – Sewer failed to accrue Contract Work Expenses of $760 for 2017 and paid the $760 in 2018.

MHC Response:

This error was an oversight and will be corrected moving forward.

APPENDIX D—UAB'S EVALUATION OF MHC'S COMMENTS

On May 22, 2020, MHC Acquisition One, LLC (MHC–Sewer) submitted its responses to Utility Audits Branch's (UAB) draft report dated April 24, 2020. In reviewing MHC–Sewer's responses, UAB noted that MHC–Sewer agreed with the audit findings and recommendations except for an element of Finding 1 presented in the draft audit report. Therefore, UAB devoted its attention to addressing MHC–Water's comments that disagreed with UAB's finding. UAB appreciates MHC–Sewer's willingness to prospectively implement UAB's recommendations. Appendix C contains MHC–Sewer's responses in its entirety.

Finding 1: Internal Control Deficiencies

MHC stated that it does not have employees and all the business functions are performed by the staff of Equity Lifestyle Properties (ELS), the parent company of MHC. MHC also stated that ELS has designed and implemented controls for its overall entity, but actual written policies and procedures have not been developed for MHC. However, MHC also stated that "ELS recognizes the importance and benefits of written policies and procedures and will work to develop policies specific to MHC."

Although MHC did not have its own employees during the audit period, having written policies and procedures established and implemented will strengthen MHC's internal controls over its accounting, reporting, and business operations; and to ensure consistency when it hires new employees.

For the reasons stated above, UAB's Finding 1 and the related recommendation remain unchanged. UAB appreciates MHC's willingness to prospectively implement UAB's recommendation.