Audit of Water Utilities

MHC Acquisition One, LLC. - Water

For the Year Ended December 31, 2018

Utility Audits Branch
June 1, 2020

MEMBERS OF THE TEAM

Angie Williams, Director

Masha Vorobyova, Assistant Director

Raymond Yin, CPA
Program and Project Supervisor

Khusbindar Kaur, CPA
Senior Management Auditor

Sharmin Wellington, CPA
Public Utilities Regulatory Analyst V

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

TABLE OF CONTENTS

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 Water Operations (MHC–Water). MHC–Water, which is also known as Santa Cruz Water Company, is a regulated Class D water corporation. It serves approximately 198 residential customers, 3 Irrigation, and 5 park facilities in 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. As a regulated water utility, MHC–Water is required to prepare its financial statements on an 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.

UAB conducted the audit of MHC–Water'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–Water's 2018 Annual Report and to determine whether MHC–Water complied with the applicable regulations and CPUC's directives. The scope of our audit was limited to the financial information presented in MHC–Water's 2018 Annual Report filed with the CPUC. In addition, UAB evaluated the effectiveness of MHC–Water'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: UAB identified material weaknesses in MHC–Water's system of internal control over its financial reporting, which presents a reasonable possibility that material misstatements on MHC-Water's Annual Reports may not be prevented or detected timely.

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

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

- Finding 3: MHC–Water did not remit CPUC Users Fee to the CPUC since 2002. For the year ended December 31, 2018, the unremitted CPUC Users Fee totaled $561. Due to the limitation of the audit scope, UAB was unable to determine the total amount of the CPUC Users Fee that MHC–Water failed to remit from 2002 through 2017.

- Finding 4: UAB noted material variances between MHC–Water's general ledger (G/L), accounting records, and the Annual Report for Account 610–Purchased Water.

- Finding 5: MHC–Water incorrectly overcharged its service pertaining to the Common Area Meters (CAM). Instead of charging $7.44 per month for CAM based on the CPUC-approved Tariff Schedule, MHC–Water charged $744 per month. As a result, MHC–Water over-billed its customers by $9,713 and overstated its Metered Water Revenue in Account 470 by $9,713.

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–Water. 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, that:

> 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 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.

---

[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.

Class C Utilities—having between 501 service connections and 2,000 service connections.
Class D Utilities—having 500 service connections or less.

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 Water Operations (MHC–Water). MHC–Water, which is also known as Santa Cruz Water Company, is a regulated Class D water corporation. It serves approximately 198 residential customers, 3 Irrigation, and 5 park facilities in 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–Water'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–Water's 2018 Annual Report and to determine whether MHC–Water complied with the applicable regulations and CPUC's directives. The scope of our audit was the financial information presented in MHC–Water's 2018 Annual Report filed with the CPUC. In addition, UAB evaluated the effectiveness of MHC–Water's internal control over its accounting and reporting functions as it relates to the audit objectives.

METHODOLOGY

To determine MHC–Water's compliance with the applicable regulations and CPUC directives in reporting the financial information in its 2018 Annual Report and to assess MHC–Water'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 regulation and CPUC directives regarding the timeliness of filing the Annual Report; compliance with USOA accounting requirements; treatments of public grants, loans, utility plant, facility fees, and users fee; 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 water plant assets, related invoices, purchase orders, work orders, and depreciation schedule to determine the existence, completeness, rights and valuation of utility plant.

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

9. Reviewed lease agreements for new leases and determine whether leased assets were properly capitalized, and that related depreciation is being determined using an appropriate method and asset's useful life.

10. Determined that amounts recorded as Water Plant Construction Work in Progress are for on-going and uncompleted construction-related projects.

11. Reviewed the loan agreements and bank statements to determine the obligation, completeness, classification, and valuation of reported liabilities related to the utility's operations.

12. 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.

13. 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.

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

15. 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.

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

AUDIT FINDINGS AND RECOMMENDATIONS

The results of our audit of MHC–Water'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: Internal Control Deficiencies

Condition:
UAB identified the following deficiencies in MHC–Water's system of internal control over its financial reporting, which present a reasonable possibility that material misstatements in the Annual Report will not be prevented or detected on a timely basis:

1. MHC–Water does not have formal written policies and procedures for the following operating processes:
   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 or abandonment, and deletion due to obsolescence.
   G. Preparation, filing, and maintenance of annual reports filed or to be filed with the CPUC.

2. MHC–Water's accounting records showed a composite depreciation rate of 2.61 percent, which was inconsistent with the composite depreciation rate of 3.58 percent shown in MHC–Water's 2018 Annual Report. MHC–Water did not report the correct composite rate in its Annual Report.

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

PU Code, Sections 581 states that:

> Every public utility shall furnish to the commission in such form and detail as the commission prescribes all tabulations, computations, and all other information required by it to carry into effect any of the provisions of this part, and shall make specific answers to all questions submitted by the commission.
>
> Every public utility receiving from the commission any blanks with directions to fill them shall answer fully and correctly each question propounded therein, and if it is unable to answer any question, it shall give a good and sufficient reason for such failure.

Cause:
MHC–Water's management has not developed written policies and procedures to govern its financial reporting process. MHC–Water did not have a review process in place to ensure the information reported in its 2018 Annual Report is supported by their books.

Effect:
The absence of formal written policies and procedures to govern MHC–Water's financial reporting process could result in inaccurate accounting records and mismanagement of its financial statements.

Due to the lack of an adequate review process, the information on the 2018 Annual Report was not accurately reported.

Recommendations:
MHC–Water should establish written policies and procedures for the aforementioned areas to governs its financial reporting process. In addition, MHC–Water should provide a copy of its written policies and procedures to the UAB along with its corrective action plan. MHC–Water should review its Annual Report to ensure the information reported is accurate.

Finding 2: Misclassifications of expenses

Condition:
UAB noted misclassifications of expenses during the audit period as follows:

- 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 reading charges should have been recorded in Account 650—Contract Work instead of Account 689—General Expense.

As a result, Office Supplies and Expenses was understated by $2,065; the Contract Work account was understated by $2,759; and General Expense account was overstated by $4,824.

Criteria:
The USOA defines the aforementioned accounts as follows:

> 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–Water 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–Water's Income Statement for the year ended December 31, 2018.

Recommendation:
MHC–Water should establish and implement adequate controls over its accounting and reporting functions, which will help ensure that expenses are recorded and reported in proper accounts in accordance with account classifications prescribed by the USOA.

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

Condition:
MHC–Water has not remitted CPUC Users Fee to the CPUC since 2002. PU Code Sections 431 and 433 require utilities to collect Users Fee from their customers and remit the fees collected to the CPUC quarterly or annually. MHC–Water's 2018 billing summaries showed that it included the CPUC Users Fee in the customer billings and recorded the total billed amounts as their operating revenue; however, MHC–Water did not remit the Users Fee to the CPUC. For the year ended December 31, 2018, the unremitted CPUC Users Fee totaled $561. Due to the limitation of the audit scope, UAB was unable to determine the total amount of the CPUC Users Fee that MHC–Water failed to remit from 2002 through 2017.

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–Water's management lacks procedures to ensure Users Fee was properly collected and remitted to the CPUC.

Effect:
MHC–Water did not remit $561 of CPUC Users Fee to CPUC for the year ended December 31, 2018. Due to the limitation of the audit scope, UAB was unable to determine the total amount of the CPUC Users Fee that MHC–Water failed to remit from 2002 through 2017.

Recommendations:
MHC–Water should properly and timely remit 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–Water should immediately remit all Users Fee it owed to the CPUC for the years from 2002 through 2018. MHC–Water should provide proof of remittance of such fees in its corrective action plan to UAB and the CPUC's Water Division.

Finding 4: Material variance between MHC's General Ledger (G/L), accounting records, and the Annual Report for Account 610 – Purchased Water.

Condition:
MHC–Water's G/L showed that it paid $19,130 for the cost of water purchased for resale during the period of September 7, 2018, and October 4, 2018. However, UAB reviewed the vendor's invoice and noted that the cost of water purchased for resale during this period was only $17,033. As a result, Purchased Water expenses reported in Account 610 was overstated by $2,097 ($19,130 - $17,033).

Criteria:
General Accounting Instruction 2 of the USOA mandates the IOUs to record accounting transactions using the accrual basis of accounting and the amounts recorded must be fully supported.

Cause:
MHC did not properly calculate and allocate charges shown on the vendor invoices to its Water and Sewer Operations.

Effect:
Inaccurate reporting of Purchased Water expenses in the Annual Report, which may be used during MHC–Water's General Rate Case (GRC) application review process, could potentially impact the water rates for MHC–Water 's ratepayers.

Recommendation:
MHC should ensure that charges on vendor invoices that are applicable to both Sewer and Water Operations are properly calculated and allocated to the proper utility.

Finding 5: Revenue reporting deficiencies

Condition:
MHC–Water incorrectly overcharged its service pertaining to the Common Area Meters (CAM). According to MHC–Water's Tariff Schedule, the service charges for CAM should be $7.44 per month. However, MHC–Water charged $744 per month. As a result, MHC–Water over-billed its customers by $9,713 and the Metered Water Revenue reported in Account 470 were overstated by $9,713.

Criteria:
MHC–Water Tariff Schedule, Schedule No. 2 – Flat Rate Service, states in part:

C. Rates

Service Charges:	To the Community/Month
For entire Manufactured Home Community Facilities	$7.44

CPUC General Order 96-B, states in part that:

3.15 Tariffs
"Tariffs" refer collectively to the sheets that a utility must file, maintain, and publish as directed by the Commission, and that set forth the terms and conditions of the utility's services to its customers; "tariffs" may also refer to the individual rates, tolls, rentals, charges, classifications, special conditions, and rules of a utility.

Cause:
MHC–Water lacks adequate internal control over its billing process to ensure that bills are prepared accurately in accordance with the Tariff Schedule.

Effect
MHC–Water over-billed its customers by $9,713 and overstated its Metered Water Revenues in Account 470 by $9,713. Inaccurate reporting of Metered Revenues in the Annual Report, which may be used during MHC–Water's GRC application review process, could potentially impact the water rates for MHC–Water's ratepayers.

Recommendation
MHC–Water should develop and implement adequate controls over its billing process to ensure its customers are accurately billed using the CPUC-approved Tariff Schedule. MHC–Water should immediately refund or credit its customers for the excess charges.

CONCLUSION

In conducting this audit, we obtained an understanding of MHC–Water'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–Water'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–Water'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–Water'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–Water'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–Water will implement the recommendations and provide the timing of incorporating UAB's audit adjustments to MHC–Water's books and records. If MHC–Water 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–Water 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–Water for comments. On May 22, 2020, MHC–Water 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
Raymond Yin, Program and Project Supervisor, UAB
Khusbindar Kaur, Senior Management Auditor, UAB
Sharmin Wellington, Public Utilities Regulatory Analyst V, UAB

MHC Water Company
BALANCE SHEET (AS AUDITED)
As of December 31, 2018

ASSETS	
UTILITY PLANT	
Water Plant in Service	$205,507
Accumulated Depreciation of Water Plant	(172,567)
Net Utility Plant	32,940
CURRENT AND ACCRUED ASSETS	
Cash	8,553
Accounts Receivable	262
Total Current and Accrued Assets	8,815
Total Assets	$41,755
CAPITALIZATION AND LIABILITIES	
PROPRIETARY CAPITAL	
Proprietary Capital	($881,372)
Total Proprietary Capital	(881,372)
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	1,113
Total Deferred Credits	1,113
Total Equity and Liabilities	$41,755

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

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

OPERATING REVENUES	
Metered Water Revenue	$40,636
Total Operating Revenue	40,636
OPERATING EXPENSES	
Plant Operation and Maintenance Expenses	
Purchased Water	155,615
Contract Work	2,759
Total Plant Operation and Maintenance Expenses	158,374
Administrative and General Expenses	
Uncollectible Accounts Expense	76
Office Supplies and Expenses	2,065
Professional Services	14,600
Insurance	149
General Expenses	43
Net Administrative and General Expenses	16,933
Total Operating Expenses	175,307
Depreciation Expense	2,876
Taxes Other Than Income Taxes	993
Total Operating Revenue Deductions	179,176
Total Utility Operating Income / (Loss)	(138,540)
OTHER INCOME AND DEDUCTIONS	
Non-Utility Income	150
Total Other Income and Deductions	150
Net Income / (Loss)	($138,390)

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

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

Proprietary Capital, Beginning of Year	($799,784)
CREDITS:	
Other Credits: Allocation of Proprietary Capital to Sewer	49,187
UAB Adjustment to Metered Water Revenue	9,713
Total Credits	58,900
DEBITS:	
Net Losses	(138,390)
UAB Adjustment to Purchased Water	(2,098)
Total Debits	(140,488)
Proprietary Capital, End of Year	($881,372)

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

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

MHC WATER COMPANY

NOTES TO FINANCIAL STATEMENTS

Regulated water utilities are required to prepare their financial statements on Accrual basis of accounting set forth in the Uniform System of Accounts (USOA) for Water 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 regulations and CPUC directives.

Related Party Disclosure
MHC is a subsidiary of Equity Lifestyle Properties, Inc. (ELS), which is a publicly traded company. 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, an estimate of the cost based on what other utilities are paying to a third party within the ELS group is used as the basis. ELS charges $1,000 per month to MHC–Sewer Operations and $1,000 per month to the MHC–Water Operations related to corporate and administrative overhead. All invoices related directly to the utility system operation are directly 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 the "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 composite rate of 2.61 percent in order to depreciate all water plant assets for ratemaking purposes and for reporting all the depreciation expense; however, MHC–Water's Annual Reports filed with the CPUC reflected a composite rate of 3.58 percent. MHC–Water provided supporting documents for its composite rate 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 the 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 the 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–Water maintained a detailed list of water plant assets. UAB was able to satisfy itself by other auditing procedures concerning this account balance of $205,507. Therefore, UAB was able to verify the accuracy of this account.

3. Water Utility Users Fee

PU Code, Sections 431 and 433 authorized the CPUC to set a fee annually to water utilities to cover the costs incurred by the CPUC in regulating them. USOA requires water 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–Water included the Users Fee into the water services billings charged to their customers and recorded the total billed amounts as their operating revenue. However, MHC–Water did not properly and timely remit the Users Fee to the CPUC.

[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–Water has complied with these requirements and presentation of 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–Water has complied with these requirements.

---

[8] Regulated Utilities Manual—A Service for Regulated Utilities by Deloitte & Touché 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-1	17	C	470	Metered Water Revenue	$9,713	
	A	10	C	218	Proprietary Capital		$9,713
					To adjust Metered Water Revenue to agree with the audited amount.		
2	A	10	C	218	Proprietary Capital	$2,098	
	B-2	3	C	610	Purchased Water		$2,098
					To adjust Purchased Water to agree with the audited amount.		
3	B-2	23	C	681	Office Supplies and Expenses	$2,065	
	B-2	11	C	650	Contract Work	2,759	
	B-2	27	C	689	General Expense		$4,824
					To reclassify the expense of postage, envelopes, print, and mail to Office Supplies and Expense and meter read charges to Contract Work.		

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

	As of	
	12/31/2018	12/31/2017
ASSETS		
UTILITY PLANT		
Water Plant in Service	$205,507	$205,507
Accumulated Depreciation of Water Plant	(172,567)	(169,691)
Net Utility Plant	32,940	35,816
CURRENT AND ACCRUED ASSETS		
Cash	8,553	4,194
Accounts Receivable	262	335
Total Current and Accrued Assets	8,815	4,529
Total Assets	$41,755	$40,345
CAPITALIZATION AND LIABILITIES		
CORPORATE CAPITAL AND SURPLUS		
Proprietary Capital		
Proprietary Capital	($881,372)	($799,784)
CURRENT AND ACCRUED LIABILITIES		
Payable to Affiliated Companies	906,375	830,203
Accounts Payable	8,476	3,653
Other Current Liabilities	7,163	5,173
Total Current and Accrued Liabilities	922,014	839,029
DEFERRED CREDITS		
Other Credits	1,113	1,100
Total Deferred Credits	1,113	1,100
Total Equity and Liabilities	$41,755	$40,345

[9] The reported amounts were derived directly from MHC–Water'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]

	As of 2018	As of 2017
OPERATING REVENUES		
Metered Water Revenue	$50,349	$0
Other Water Revenue	0	47,394
Total Operating Revenue	50,349	47,394
OPERATING EXPENSES		
Plant Operation and Maintenance Expenses		
Purchased Water	157,713	129,081
Total Plant Operation and Maintenance Expenses	157,713	129,081
Administrative and General Expenses		
Uncollectible Accounts Expense	76	(67)
Professional Services	14,600	15,675
Insurance	149	149
General Expenses	4,867	2,221
Net Administrative and General Expenses	19,692	17,978
Total Operating Expenses	177,405	147,059
Depreciation Expense	2,876	2,876
Taxes Other Than Income Taxes	993	993
State Corporate Income Tax Expense	0	800
Total Operating Revenue Deductions	181,274	151,728
Total Utility Operating Income / (Loss)	(130,925)	(104,334)
OTHER INCOME AND DEDUCTIONS		
Non-utility Income	150	82
Total Other Income and Deductions	150	82
Net Income / (Loss)	($130,775)	($104,252)

[10] The reported amounts were derived directly from MHC–Water'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) – WATER

Dear Mr. Yin:

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

Finding 1:
#1: UAB noted weaknesses in MHC-Water's system of internal control over its financial reporting, which present a reasonable possibility that material misstatements on MHC-Water'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.*

#2: MHC- Water's accounting records showed a composite depreciation rate of 2.61 percent, which was inconsistent with the composite rate of 3.58 percent shown in MHC-Water's 2018 Annual Report. MHC-Water did not report the correct composite rate in its Annual Report.

> *MHC Response:*
> *The composite depreciation rate as shown in the CPUC Report was incorrect due to a calculation error. The formula will be corrected going forward.*

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).*

Equity LifeStyle Properties
Two North Riverside Plaza
Chicago, IL 60606

Finding 3: MHC- Water did not remit CPUC User Fee to the CPUC since 2002. For the year ended December 31, 2018, the unremitted user fee totaled \$561. Due to the limitation of the audit scope, UAB was unable to determine the total amount of the CPUC User Fees that MHC – Water failed to remit from 2002-2017.

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: Material variances were noted between MHC-Water's general ledger accounting records, and the Annual Report for Account 610 – Purchased Water.

MHC Response:

MHC recognizes a difference between the vendor invoice and general ledger. The difference exists because the utility and franchise taxes charged were not allocated between water, sewer, and refuse. Although the total of the utility and franchise tax was recorded on MHC's books, a portion of the utility and franchise tax belongs on the Sewer Annual Report. Moving forward, MHC will implement systems to properly allocate utility and franchise taxes charged to the appropriate operation.

MHC does not agree that this occurrence should be labeled a "material variance" as the end result is not significant to the operation as a whole. MHC objects to the term material.

Finding 5: MHC- Water incorrectly overcharged for service pertaining to the Common Area Meters (CAM). Instead charging \$7.44 per month for CAM based on the CPUP-approved Tariff Schedule, MHC-Water charged \$744 per month. As a result, MHC-Water over-billed its customers by \$9,713 and overstated its Metered Water Revenue in Account 470 by \$9,713.

MHC Response:

MHC recognized this error and has corrected the amount charged for CAM service. However, the CAM customer is also a wholly owned subsidiary of ELS. Because MHC and the customer are affiliate entities, MHC would "repay" the overcharge to the "customer" by reducing MHC's affiliate payable.

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

On May 22, 2020, MHC Acquisition One, LLC. (MHC–Water) submitted its responses to Utility Audits Branch's (UAB) draft report dated April 24, 2020. In reviewing MHC–Water's responses, UAB noted that MHC–Water agreed with the audit findings and recommendations except for an element of Finding 1 and Finding 4 in the draft audit report. Therefore, UAB devoted its attention to addressing MHC–Water's comments that disagreed with UAB's findings. UAB appreciates MHC–Water's willingness to prospectively implement UAB's recommendations. Appendix C contains MHC–Water'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.

Finding 4: Material variance between MHC's General Ledger (G/L), accounting records, and the Annual Report for Account 610 – Purchased Water.

MHC–Water does not agree that the occurrence should be labeled as a "material variance." MHC–Water explained that the misstatement noted in the finding because the utility and franchise taxes charged on the invoice were not allocated between the Water and Sewer operations. MHC–Water objected because the misstatement identified in the finding is not significant to MHC's operations as a whole.

UAB disagrees with MHC–Water's position. UAB audited MHC–Water's Annual Report as stand-alone financial statements and determined that the misstatement in the finding is material to MHC–Water utility's 2018 Income Statement.

For the reasons stated above, UAB's Finding 4 and the related recommendation remain unchanged.