SAN FRANCISCO PUBLIC UTILITIES COMMISSION:

Expenditures of the Lake Merced Pump Station Essential Upgrade Project Are in Accordance With Bond Resolutions; However SFPUC Should Improve Its Recognition of Costs

February 13, 2012
OFFICE OF THE CONTROLLER
CITY SERVICES AUDITOR

The City Services Auditor (CSA) was created in the Office of the Controller through an amendment to the Charter of the City and County of San Francisco (City) that was approved by voters in November 2003. Under charter Appendix F, CSA has broad authority to:

- Report on the level and effectiveness of San Francisco’s public services and benchmark the City to other public agencies and jurisdictions.
- Conduct financial and performance audits of city departments, contractors, and functions to assess efficiency and effectiveness of processes and services.
- Operate a whistleblower hotline and website and investigate reports of waste, fraud, and abuse of city resources.
- Ensure the financial integrity and improve the overall performance and efficiency of city government.

CSA may conduct financial audits, attestation engagements, and performance audits. Financial audits address the financial integrity of both city departments and contractors and provide reasonable assurance about whether financial statements are presented fairly in all material aspects in conformity with generally accepted accounting principles. Attestation engagements examine, review, or perform procedures on a broad range of subjects such as internal controls; compliance with requirements of specified laws, regulations, rules, contracts, or grants; and the reliability of performance measures. Performance audits focus primarily on assessment of city services and processes, providing recommendations to improve department operations.

CSA conducts its audits in accordance with the Government Auditing Standards published by the U.S. Government Accountability Office (GAO). These standards require:

- Independence of audit staff and the audit organization.
- Objectivity of the auditors performing the work.
- Competent staff, including continuing professional education.
- Quality control procedures to provide reasonable assurance of compliance with the auditing standards.

Audit Team:  Irella Blackwood, Audit Manager
             Nicole Doran, Associate Auditor
Purpose of the Audit

The objective of the audit was to determine whether the San Francisco Public Utilities Commission (SFPUC) used bond proceeds in accordance with bond resolutions, legislation, intended uses, and action of the Public Utilities Commission itself for the Water System Improvement Program’s (WSIP) Lake Merced Pump Station Essential Upgrade Project (project). The audit period was January 1, 2010, through June 30, 2011.

Highlights

The Lake Merced Pump Station is the major pumping station in the City and County of San Francisco (City), supplying water to the Sunset and Sutro Reservoirs, which, in turn, supply water to other regions of the City. The continual operation of this facility is critical to the delivery of water to approximately 60 percent of San Francisco. Therefore, it is a vital component of the SFPUC’s City Distribution Division system.

The project’s expenditures from July 1, 2006, to June 30, 2011, were $38,071,102. To conduct the audit, the audit team:

- Reviewed charter provisions, bond indenture agreements, official statements, and SFPUC resolutions.
- Interviewed staff and managers to understand SFPUC’s project management processes and expenditure approval processes.
- Assessed the project’s internal controls for expenditure processing.
- Tested $12,604,827 (80 percent) of $15,677,696 in vendor expenditure transactions by purposefully selecting 15 out of 94 vendor expenditure transactions.
- Purposefully selected 2 non-vendor expenditure transactions for testwork based on their unusual transaction descriptions.

The audit found that the project’s expenditures were in accordance with bond resolutions. However, SFPUC recognized program management costs before the costs were incurred, which resulted in the recognition of $227,991 of future-year program management costs in the current year. The audit also found that:

1. SFPUC does not reconcile its approved budget-based allocations of the project’s program management costs when actual costs become available, resulting in overallocations.

2. SFPUC’s allocation process caused some program management costs to be recognized in the wrong period, resulting in less accurate reporting.

Recommendations

The audit report includes four recommendations for SFPUC:

1. Reflect program management costs in the accounting and project management systems in proportion to the project’s percentage of completion.

2. Cease recognizing program management expenses before they are incurred.

3. Develop a method of adjusting program management costs to reflect actual costs before a project is capitalized.

4. Ensure that WSIP project managers review, at least quarterly, all expenses, including material, service, and labor expenditures charged to the project.

Copies of the full report may be obtained at:
Controller’s Office  ●  City Hall, Room 316  ●  1 Dr. Carlton B. Goodlett Place  ●  San Francisco, CA 94102  ●  415.554.7500
or on the Internet at http://www.sfgov.org/controller
February 13, 2012

Aimee Brown, Chair
Public Utilities Revenue Bond Oversight Committee
City Hall, Room 244
1 Dr. Carlton B. Goodlett Place
San Francisco, CA  94102

Dear Ms. Brown:

The Office of the Controller, City Services Auditor Division (CSA), presents its audit report on the Lake Merced Pump Station Essential Upgrade Project (project) of the San Francisco Public Utilities Commission (SFPUC). The audit objective was to determine whether SFPUC used bond proceeds in accordance with bond resolutions, intended uses, and action of the governing body of the San Francisco Public Utilities Commission (commission) for the project.

The audit found that the project’s expenditures were in accordance with bond resolutions. However, SFPUC fully recognized all of the program management costs allocated to the project before the project’s completion and that SFPUC’s method of allocating those costs to WSIP projects needs improvement. The audit report includes four recommendations for SFPUC, which focus on the improvement of its project manager review and program management cost-allocation procedures.

SFPUC’s response to the audit report is attached as an appendix. CSA will work with the SFPUC to follow up on the status of the recommendations in the report.

We appreciate the assistance and cooperation that SFPUC staff provided to us during the audit.

Respectfully,

Tonia Lediju
Director of Audits
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<tr>
<td>project</td>
<td>Lake Merced Pump Station Essential Upgrade Project</td>
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<td>RBOC</td>
<td>Public Utilities Revenue Bond Oversight Committee</td>
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<td>SFPUC</td>
<td>San Francisco Public Utilities Commission (a city department)</td>
</tr>
<tr>
<td>WSIP</td>
<td>Water System Improvement Program</td>
</tr>
</tbody>
</table>
INTRODUCTION

Audit Authority

Text This audit was conducted under the authority of the Charter of the City and County of San Francisco (City), which requires that the Office of the Controller, as the City Services Auditor (CSA), conduct periodic, comprehensive financial and performance audits of city departments, services, and activities.

CSA established an agreement with the Public Utilities Revenue Bond Oversight Committee (RBOC), to perform a series of five audits. RBOC was formed in November 2003 to monitor the bond expenditures of the San Francisco Public Utilities Commission (SFPUC). At the request of RBOC, CSA evaluated the bond-funded expenditures of the Lake Merced Pump Station Essential Upgrade Project (project) to determine if bond proceeds were used in accordance with bond resolutions, legislation, intended use, and Public Utilities Commission (commission) action. The commission consists of five members, nominated by the mayor and approved by the Board of Supervisors to provide operational oversight in areas such as rates and charges for services, approval of contracts, and organizational policy.

Background on the Water System Improvement Program

In 2002 SFPUC initiated the Water System Improvement Program (WSIP), a $4.6 billion effort funded pursuant to a revenue bond measure approved by San Francisco voters. WSIP is intended to repair, replace, and seismically upgrade the system’s deteriorating pipelines, tunnels, reservoirs, pump stations, storage tanks, and dams. WSIP is divided into five large regions (San Joaquin, Sunol Valley, Bay Division, Peninsula, and San Francisco), with each region encompassing smaller projects. All 46 projects are scheduled to be complete by 2016. The costs to complete these projects are allocated in proportion to the quantities of water delivered among San Francisco and its regional customers in Alameda, Santa Clara, and San Mateo counties.

Approximately 800,000 retail customers in the City need safe and clean water. They and others depend on SFPUC’s regional water system, many parts of which are 75 to 100 years old and do not meet today’s seismic codes, although major pipelines cross active earthquake faults. WSIP will
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benefit SFPUC’s 26 wholesale customers and regional retail customers in Alameda, Santa Clara, and San Mateo counties.

Background on SFPUC Bonds and Intended Uses

The city charter, Section 8B.124, authorizes SFPUC to issue revenue bonds, subject to the approval of the Board of Supervisors, for reconstructing, replacing, expanding, repairing, or improving water facilities under the jurisdiction of SFPUC. From 2006 through 2010, SFPUC issued a series of water and wastewater revenue bonds, each of which is designated for a specific purpose, as described in Exhibit 1.

<table>
<thead>
<tr>
<th>Bond Series</th>
<th>Used to Finance and Refinance…</th>
</tr>
</thead>
<tbody>
<tr>
<td>2006 Series A Water Revenue Bonds</td>
<td>improvements to the City’s water system under Proposition A. The improvements are defined as those that will restore, rehabilitate, and enhance the ability of SFPUC to deliver water to its customers.</td>
</tr>
<tr>
<td>2009 Series A/B</td>
<td>a portion of the design, acquisition, and construction of various capital projects in furtherance of the WSIP.</td>
</tr>
<tr>
<td>2010 Series D/E/F/G Water Revenue Bonds</td>
<td>a portion of the design, acquisition, and construction of various capital projects in furtherance of WSIP, and to finance the acquisition and installation of automated digital water meters in furtherance of SFPUC’s Advanced Metering Infrastructure System.</td>
</tr>
<tr>
<td>2010 Series A/B/C Water Revenue Bonds</td>
<td>a portion of the costs of planning, design, construction and improvement of various capital projects in furtherance of the Capital Improvement Program and the proposed Sewer System Improvement Program of SFPUC’s Wastewater Enterprise.</td>
</tr>
<tr>
<td>2010 Series A/B Bonds Wastewater Revenue Bonds</td>
<td></td>
</tr>
</tbody>
</table>

Source: Official statements of each bond series.

The WSIP program was funded by the following SFPUC water revenue bonds:

- 2006 Water Revenue Bond Series A
- 2009 Water Revenue Bond Series A/B
- 2010 Water Revenue Bond Series
Background on the Project

The Lake Merced Pump Station Essential Upgrade Project will construct a new Lake Merced pump station and electrical utility buildings and seismically upgrade the existing station structure. Outdated mechanical and electrical systems will be replaced with new pumps, motors, emergency generators, surge tanks, electrical distribution, and station-control systems and the ground at the station will be improved by stabilizing the soil.

Built in 1953, the existing pump station building, pumping equipment, and mechanical and electrical systems had exceeded their useful lives and were in need of replacement. The Sunset system pumps were inefficient and the surge tank was inadequate to provide the proper surge protection. The station was vulnerable to earthquake damage as the surrounding soil was susceptible to serious seismic-related problems. Maintenance was difficult to administer because the station was cramped and it had not been upgraded to current building, electrical, and seismic codes or Americans with Disabilities Act requirements. The pump station and generator buildings also lacked fire protection and ventilation systems.

The project was expected to be completed under budget but behind schedule. The project was originally estimated to be completed by July 15, 2011, with an original baseline budget of $69.1 million. According to WSIP cost reports, the 2011 approved budget was revised to $47.3 million, with an anticipated completion date of September 28, 2012.

The Budget Division establishes the structure to track funds in a project.

SFPUC’s Budget Division establishes accounting index codes for the department in the Financial Accounting and Management Information System (FAMIS), the City’s accounting system. To create the structure to track projects’ expenditures, each project is assigned a project number, project phases, and accounting index codes in FAMIS. The Budget Division works with the project managers to establish project budgets and put them into FAMIS. When the project managers need to either re-allocate funds among project phases or increase or decrease their budget, project managers contact the Budget Division. Exhibit 2 shows the project’s expenditure transactions by fiscal year.
Office of the Controller, City Services Auditor

Expenditures of the Lake Merced Pump Station Essential Upgrade Project Are in Accordance With Bond Resolutions; However SFPUC Should Improve Its Recognition of Costs

<table>
<thead>
<tr>
<th>EXHIBIT 2</th>
<th>Expenditure Transactions from Fiscal Year 2006-07 Through 2010-11</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fiscal Year</td>
<td>Amount</td>
</tr>
<tr>
<td>2006-07</td>
<td>898,754</td>
</tr>
<tr>
<td>2007-08</td>
<td>3,040,104</td>
</tr>
<tr>
<td>2008-09</td>
<td>2,188,011</td>
</tr>
<tr>
<td>2009-10</td>
<td>13,775,535</td>
</tr>
<tr>
<td>2010-11</td>
<td>18,168,698</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$38,071,102</strong></td>
</tr>
</tbody>
</table>

Source: FAMIS data as of November 1, 2011.

*The six types of project expenditures*

According to SFPUC, there are six types of project expenditures:

- Labor charges of SFPUC infrastructure staff
- Material, service, and labor expenses by other city departments
- Professional service charges
- Construction charges
- Material, service, and labor expenses by SFPUC operations
- Other expenses

*Objectives*

The main objective of the audit was to determine whether bond proceeds were used in accordance with bond resolutions, legislation, intended use, and commission action for the project. Specifically, the objectives were to ensure that SFPUC:

- Appropriately authorized the project’s expenditures
- Adequately allocated bond proceeds to allowable expenditures
- Established adequate procedures and controls over the project’s expenditures
- Maintained evidence of the project’s expenditures

*Scope and Methodology*

The scope of the audit included the project’s expenditures in fiscal years 2009-10 and 2010-11 because, as shown in Exhibit 2, these years had the majority of project expenditures.

To conduct the audit, the audit team:

- Reviewed charter provisions, bond indenture agreements, official statements, use of proceeds certificates, and SFPUC resolutions.
Interviewed staff and managers to understand SFPUC’s project management processes and expenditure approval processes.

Interviewed staff regarding project expenditures in FAMIS.

Assessed the project’s internal controls for expenditure processing and review.

Tested $12,604,827 (80 percent) of $15,677,696 in vendor expenditure transactions by specifically selecting 15 out of 94 vendor expenditure transactions to include a wide range of vendors, large dollar transactions, potential duplicate payments, and a range of time periods.

Purposefully selected an additional 2 non-vendor expenditure transactions for testwork based on their unusual transaction description. No-vendor expenditure transactions include program management costs, overhead costs, SFPUC labor costs and certain refunds.

**Statement of Auditing Standards**

This performance audit was conducted in accordance with generally accepted government auditing standards. These standards require planning and performing the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for the findings and conclusions based on the audit objectives. We believe that the evidence obtained provides a reasonable basis for the findings and conclusions based on the audit objectives.
Audience Results

Summary Paragraph

Vendor expenditure transactions for the project were in accordance with bond resolutions, legislation, intended uses, and action of the commission. However, contrary to best practices, SFPUC recognized 100 percent of the project’s program management costs before the project’s completion and, therefore, recognized too much of these costs too soon. SFPUC is aware that changes in project budgets reduce the accuracy of its methodology of allocating program management costs, and has taken steps to compensate for these inaccuracies.

SFPUC’s methodology for allocating program management costs to individual WSIP projects needs improvement because it often uses outdated budget information and does not address misallocations of program management costs to individual projects. Further, SFPUC should improve procedures to ensure that WSIP project managers review, at least quarterly, all expenses, including material, service, and labor expenditures that SFPUC operations staff charges to projects.

Finding 1

SFPUC fully recognized all of the program management costs allocated to the project before the project’s completion.

Of the 94 expenditure transactions worth $15,677,696 paid to vendors for the project from fiscal year 2006-07 through fiscal year 2010-11, the audit selected and analyzed 15 (16 percent) worth $12,604,827 (80 percent) that were incurred in fiscal years 2009-10 and 2010-11. No evidence of any unallowable vendor costs funded through the project was found. The audit inspected 2 non-vendor expenditures, one related to the allocation of program management costs to the project and the other related to a reimbursement from Pacific Gas and Electric Company. No exception was noted regarding the reimbursement. However, the other non-vendor expenditure revealed that SFPUC recognized $227,911 of the project’s program management costs before the costs were incurred.

SFPUC includes as program management costs all expenditures associated with program-level development and implementation benefitting WSIP as a whole and not attributable to any specific project. Major program management costs include the following functions or
activities:
- General oversight and coordination among the various SFPUC, city organizations and consultants involved in WSIP
- Construction management planning
- Risk management
- Program controls and reporting
- Program communication and public outreach
- Legal services at the program level
- Cost estimating and scheduling at the program level
- Contract management
- All consulting services for program support

At the end of the fiscal year, SFPUC allocates the year’s program management costs to the individual WSIP projects based on each project’s share of total WSIP costs.

Program management costs budgeted for all of WSIP totaled $110,525,250, which represented 3 percent of the WSIP program’s total costs as of the budget realignment of June 25, 2009.

SFPUC’s allocation is based on each project’s share of the total WSIP budget. The WSIP program’s budgeted cost, excluding program management costs and associated financing costs, was $3,924,098,350, while the Lake Merced project’s costs were budgeted to be $49,340,000, or 1.3 percent of the WSIP budget. Thus, when allocating program management costs, the Lake Merced project was assigned 1.3 percent, or $1,389,699, of the $110,525,250 WSIP program management budget over the life of the project. As of June 2011, when the Lake Merced project was only 84 percent complete, an entry was made in FAMIS to recognize the remaining $517,911 of the project’s program management costs. This caused all of the $1,389,699 of program management costs allocated to the project to be recognized before the project’s completion, resulting in premature recognition of $227,911. Following its usual practice, SFPUC in this way recognized future year expenses in the current year, contrary to best practices.

SFPUC recognized the project’s remaining program management costs to allocate more of those costs to projects nearing completion because it is SFPUC’s policy that no further costs can be allocated to a project once it has been capitalized, which occurs once the project has been completed. The decision to weight program management cost allocations more heavily on projects
nearing completion is SFPUC’s attempt to ensure that each project receives its full amount of program management costs.

Accounting best practices require expenses to be recorded in the fiscal period in which they occur and can be reasonably measured. Because SFPUC is recognizing program management expenses before they have been incurred, it is not in compliance with best practices.

**Recommendations**

The San Francisco Public Utilities Commission should:

1. Properly reflect program management costs in the accounting and project management systems in proportion to the project’s percentage of completion.

2. Cease recognizing program management expenses before they are incurred.

**Finding 2**

SFPUC does not reconcile its approved budget-based allocations of program management costs when actual costs become available, resulting in overallocation.

WSIP operates under the most recent budget approved by the SFPUC’s governing body (commission), which may not be the most recent information available. SFPUC stated that it can only make decisions based on the approved budget because of a state law, the Wholesale Regional Water System Security and Reliability Act.¹ The law requires improvements to the San Francisco Bay regional water system to ensure emergency preparedness and includes requirements for planning, financing, and reporting, as well as a specific process for adjusting the plan. According to SFPUC, this law’s requirements result in SFPUC having to use only the approved budget when managing WSIP, including when calculating the program management costs allocations, even if it has more current cost information available.

The baseline WSIP budget was first approved in 2005 and the commission has updated that baseline budget every two years to account for adjustments in project scope or fluctuation in prices. The project’s program management cost allocation for fiscal year 2010-11 was

¹ California Water Code §73500-7314.
Expenditures of the Lake Merced Pump Station Essential Upgrade Project Are in Accordance With Bond Resolutions; However SFPUC Should Improve Its Recognition of Costs

The commission-approved budget can differ significantly from current cost estimates.

Based on a WSIP budget approved by the commission in June 2009. Because the project’s budget has continued to change since 2009, the 2009 realignment does not reflect SFPUC’s most current estimate of some projects’ total costs. As a result, the project’s program management costs were overallocated.

SFPUC continually monitors the status of each project, including its past expenditures and projections of final cost. The department produces quarterly WSIP reports that provide updates on the project’s status. The updated project’s budget shown in quarterly WSIP reports differs from the official budget approved by the commission in 2009.

Exhibit 4 demonstrates the differences between the 2009 commission-approved budget used to allocate fiscal year 2010-11 program management costs and the fourth quarter fiscal year 2010-11 quarterly WSIP report for the project that reflects the estimated budget at the end of fiscal year 2010-11.

<table>
<thead>
<tr>
<th>EXHIBIT 3</th>
<th>Lake Merced Pump Station Essential Upgrade Project Budget: Comparison of June 2009 Commission-approved Budget and Estimated Project Budget in WSIP Report for Fourth Quarter of Fiscal Year 2010-11 (in thousands)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2009 Project Budget Used in Calculation</td>
<td>Project Budget in Q4 2010-11 WSIP Quarterly Report</td>
</tr>
<tr>
<td>$49,340</td>
<td>$47,292</td>
</tr>
</tbody>
</table>

Source: Commission-approved budget and SFPUC reported budget for the Lake Merced Pump Station Essential Upgrade

SFPUC is aware that the changes in project estimates as compared to previously adopted budgets may cause variances in allocating program management costs. Specifically, if the project’s budget was to decrease significantly, it would likely have been allocated significantly too much in program management costs.

SFPUC takes steps to compensate for these variances. During the annual allocation process, the department identifies projects that have already been overallocated and ensures that they receive no further allocation. However, SFPUC does not make any adjustments to remove the overallocated costs from those projects. Consequently, program management costs are shifted away from projects that will ultimately be underallocated and left in other
projects that remain overallocated, such as the Lake Merced Pump Station Essential Upgrade Project.

Recommendation

3. The San Francisco Public Utilities Commission should develop a method of adjusting program management costs to reflect actual costs before a project is capitalized.

Finding 3

The project manager does not review certain SFPUC staff expenditures for materials, services, and labor.

The project manager should regularly review all expenses, including material, service, and labor expenses made by SFPUC operations staff.

The WSIP project manager for the Lake Merced project did not specifically review two of the 17 expenditures analyzed by the audit. These 2 expenditures accounted for $56,878 (0.4 percent) of the $13,109,175 in expenditures examined. Expenditures for services, materials, and labor made by SFPUC divisions that are initiated by the operational group are to be reviewed by the project manager. However, by not regularly monitoring all of these types of expenses, the project manager is not fully informed about what is happening in the field. The project manager is generally responsible for managing all phases of the project, and there is the possibility in any project that expenses are not used in accordance with the bond proceeds or that employees have misused funds. Although the audit did not find misuse of funds in the expenditures selected for review, this risk should be mitigated and controlled by a thorough review of all expenses.

Exhibit 4 lists the frequency and levels of review for each expenditure type before approval by the SFPUC Accounting unit.
**EXHIBIT 4** Review Process for the Six Project Expense Types

<table>
<thead>
<tr>
<th>Expense Type</th>
<th>Reviewed By</th>
<th>Frequency</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 SFPUC infrastructure staff labor</td>
<td>Project Manager</td>
<td>Monthly</td>
</tr>
<tr>
<td></td>
<td>Project Controls</td>
<td></td>
</tr>
<tr>
<td>2 Material, service, and labor expenses by other city departments</td>
<td>Project Manager</td>
<td>As Needed</td>
</tr>
<tr>
<td></td>
<td>Project Controls</td>
<td></td>
</tr>
<tr>
<td>3 Professional service charges*</td>
<td>Infrastructure Budget &amp; Administrative Services Bureau (IBAS)</td>
<td>Monthly</td>
</tr>
<tr>
<td></td>
<td>Contract Administration Bureau (CAB)</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Technical Lead</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Project Manager</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Contract Manager</td>
<td></td>
</tr>
<tr>
<td>4 Construction charges</td>
<td>IBAS</td>
<td>Monthly</td>
</tr>
<tr>
<td></td>
<td>Technical Lead</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Project Manager</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Contract Manager</td>
<td></td>
</tr>
<tr>
<td>5 Material, service, and labor expenses by SFPUC operations</td>
<td>Operational Manager for Regional and Local Water Systems</td>
<td>As Needed</td>
</tr>
<tr>
<td>6 Other expenses</td>
<td>Project Manager</td>
<td>As Needed</td>
</tr>
<tr>
<td></td>
<td>Department Head</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Assistant General Manager of Infrastructure</td>
<td></td>
</tr>
</tbody>
</table>

Note: *WSIP program management costs are only reviewed by IBAS and CAB.*

Sources: SFPUC policies and procedures and interviews with SFPUC staff

**Recommendation**

4. The San Francisco Public Utilities Commission should ensure that Water System Improvement Program project managers review, at least quarterly, all expenditures, including material, service, and labor expenditures that operations staff charges to projects.
February 8, 2012

Tonia Lediju, Audit Director
Office of the Controller, City Services Auditor Division
City Hall, Room 476
1 Dr. Carlton B. Goodlett Place
San Francisco, CA 94102

Subject: Management’s responses to the audit report, Expenditures of the Lake Merced Pump Station Essential Upgrade Project Are in Accordance With Bond Resolutions; However SFPUC Should Improve Its Recognition of Costs

Dear Ms. Lediju,

Thank you for providing us the opportunity to review the audit report, Expenditures of the Lake Merced Pump Station Essential Upgrade Project Are in Accordance With Bond Resolutions; However SFPUC Should Improve Its Recognition of Costs.

Attached for your review and consideration are SFPUC Management’s responses to the recommendations detailed in the audit report, dated 2/6/12.

If you have any questions or need additional information, please do not hesitate to contact me at (415) 554-1600.

Sincerely,

ED HARRINGTON
General Manager

cc: Michael Carlin, Deputy General Manager
    Todd L. Rydstrom, AGM Business Services & Chief Financial Officer
    Harlan Kelly, Jr., AGM Infrastructure
    Nancy L. Hom, Director, Assurance & Internal Controls
AUDIT RECOMMENDATIONS AND RESPONSES

<table>
<thead>
<tr>
<th>Recommendation</th>
<th>Responsible Agency</th>
<th>Response</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. The Department should properly reflect program management costs in the accounting and project management systems in proportion to the project’s percentage of completion.</td>
<td>SFPUC</td>
<td>The SFPUC will revisit the method and frequency of cost allocation, and decide on a process and frequency that provides for more accurate allocations based on current actual expenses, which would not anticipate future year project expenses, and which would include controls to determine when costs are materially misallocated, along with proper resolution for reallocating the misallocation. Ensure that these costs are appropriately reflected in both the project management and accounting systems. Estimated timeline: Quarter 4 – FY 11-12</td>
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<td>2. The Department should cease recognizing program management expenses before they are incurred.</td>
<td>SFPUC</td>
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<td>3. The Department should develop a method of adjusting program management costs to reflect actual costs before a project is capitalized.</td>
<td>SFPUC</td>
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<td>4. The Department should ensure that Water System Improvement Program project managers review, at least quarterly, all expenditures, including material, service, and labor expenditures that operations staff charges to projects.</td>
<td>SFPUC</td>
<td>As an already existing process, project costs are reviewed and authorized by operations management to ensure that segregation of duties exists in terms of authorization of actual expenditures, and to ensure that all expenses are appropriate project expenses. Additionally, Project Managers also review project costs monthly as part of routine monitoring controls.</td>
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