



Los Angeles
Department of
Water & Power

RESOLUTION NO. _____

BOARD LETTER APPROVAL


JEFFERY L. PELTOLA
Chief Financial Officer


DAVID H. WRIGHT
General Manager

DATE: December 20, 2016

SUBJECT: Amendment No. 1 to Agreement No. 47235-4 for Services to Conduct Annual Audits of Financial Statements and Perform Related Services – KPMG LLP

SUMMARY

The proposed Amendment No. 1 to Agreement No. 47235-4 (Agreement) with KPMG LLP (KPMG) is to extend the term of the Agreement for two years, with an additional one-year renewal option, upon approval by the Board of Water and Power Commissioners (Board). The Agreement will be extended from April 23, 2017 to April 23, 2020 for a total amount not to exceed \$11,862,600 (budgeted). The original contract was for three years and \$4,657,500, or approximately \$1.6 million per year. Amendment No.1 will allow KPMG, independent certified public accountants, to continue performing annual audits of LADWP's financial statements as well as perform other related audit work including potentially reviewing the Customer Care and Billing System (CCB) as required as part of the class action lawsuit settlement. Of the \$7.2 million increase, annual audits and related services are estimated to continue at approximately \$1.6 million per year. The potential review work for CCB is estimated to cost up to \$1.74 million depending on the work requested by LADWP. The remaining funds will be used to finalize the 2016 audit. This contract extension is a onetime exception to Board Resolution 005-028 passed in July 2004 that limits the number of consecutive annual audits by an audit firm to 12 years.

The audit work to be completed as part of the lawsuit settlement is to restore customer and public trust and confidence in LADWP's ability to deliver accurate and timely bills. The first audit is to be performed 18 months after the remediation period which is estimated to be in 2018. Audit work is to be done at LADWP's cost.

LADWP's external auditors currently perform audit procedures to determine how much reliance it can place on LADWP's implementation of CCB for financial reporting purposes. Using LADWP's current external auditors for the class action settlement work may leverage KPMG's prior reviews of CCB, as well as providing customers with confidence that LADWP is using a large well known firm to help restore public trust and confidence in the system. The two years and one-year renewal option extension period

is being requested to ensure enough time is allotted since the CCB audit work is to be presented to the Board, LADWP General Manager, the Office of Public Accountability, Class Counsel, and LADWP's Counsel per the settlement agreement.

City Council approval is required.

RECOMMENDATION

It is requested that the Board adopt the attached Resolution recommending City Council's approval of execution of Amendment No. 1 to Agreement No. 47235-4 with KPMG as required in Charter Section 373.

ALTERNATIVES CONSIDERED

The alternative to the proposed Amendment No.1 is to release a new Request for Proposal (RFP) for auditing services. This alternative is not recommended. LADWP issued an RFP for the current contract with KPMG. Five responses to the last RFP were received; however only one "Big Four" firm responded. The other three firms did not respond because two of the firms (Ernest & Young and Deloitte) do not have an audit presence within the state and local government sector on the west coast. The other firm, PricewaterhouseCoopers, had a large contractual obligation with LADWP to implement the new billing system, which is now in litigation. LADWP believes the service and expertise that a "Big Four" accounting firm provides is critical to the needs and complexities of LADWP. Actuaries, information technology experts, and accounting experts are skills that are part of the suite of services a "Big Four" firm brings to a client ensuring accounting standards are implemented accurately such as Governmental Accounting Standard 68, *Accounting and Financial Reporting for Pensions*. Technology controls are analyzed thoroughly, and expert reports such as actuarial studies are vetted with independent actuarial staff of the firm to help validate LADWP's actuaries are following accounting standards correctly. Based on a review of all of the investor owned and municipally owned utilities that are similar in size to the Power System, (greater than \$1.4 billion in annual retail electric sales), 62 out of 64 companies used a "Big Four" accounting firm to perform their audit services.

Also during this contract period, LADWP will also be issuing approximately \$1.5 billion a year in new debt obligations for each of the next three years to replace infrastructure, meet legal mandates, and improve ground water and energy resources. The Water System has also joined a Joint Powers Authority to secure low cost financing for the next three fiscal years. Having a "Big Four" firm consent to their audit report as part of complex bond offering documents gives prospective bond purchasers' confidence that the information in the bond document is accurate and reliable. This will ensure that resulting reports keep interest costs as competitive as possible.

FINANCIAL INFORMATION

The Amendment No. 1 extends the duration of Agreement No. 47235-4 for two years, with a one-year renewal option, and increases the expenditure limit by \$7,205,100 from \$4,657,500 to \$11,862,600 for audit services and system validation work. The amount includes a four percent contingency for matters such as adoption of new accounting standards, or other audit, accounting, or reporting matters not currently contemplated and \$401,450 to complete the FY 2015-16 financial statement audits. KPMG and their sub consultants, Simpson & Simpson and Nunez and Associates, have agreed to no cost of living increases to hourly rates until FY 2017-18, and to utilize local staff to keep audit costs down. The additional funds are budgeted.

BACKGROUND

LADWP is the largest municipal utility in the United States (U.S.) with over 1.4 million electric customers and 650,000 water customers. The Power System and Water System combined have over \$25.3 billion in assets and \$4.4 billion in annual revenue. Per the City Charter, the Master Bond Resolution, and the Municipal Securities Rulemaking Board, LADWP needs to have audits of its financial statements performed and disclosed to protect investors and LADWP as a municipal securities issuer. LADWP has complied with these requirements each year and secured large accounting firms to perform this work. Over the years the complexity of LADWP's financial statements has grown and requires specialists to participate in annual audits. Some of the complex accounting issues includes:

- Regulatory assets
- Off balance sheet financing
- Pension and postemployment benefits
- Derivative instruments and hedge effectiveness

In completing LADWP's financial activities, audits, and audit type services are needed for the following purposes:

- Financial Statement Audits to support bond offerings and compliance with the City Charter and requirements of the Municipal Rule Making Board.
- Federal Assistance Audits to ensure the federal government any funds received by LADWP directly or indirectly are being spent in accordance with federal guidelines.
- Court required audits of the current customer billing system are needed to restore customer and public trust and confidence in LADWP's ability to deliver accurate and timely bills.
- Consent letters are needed by Bond Disclosure Counsel to show LADWP external auditors have reviewed bond documents and consent to their opinion being associated with official statements and reoffering memorandums.
- Attestation services are needed to provide third parties confidence on grant applications.

In 2004, LADWP anticipated the Sarbanes Oxley Act would require mandatory audit firm rotation and set a policy in place which is currently being updated. Since then, no such legislation has passed and Congress just recently prohibited the Public Company Accounting Oversight Board (PCAOB) from imposing such mandatory audit firm rotation requirements. The PCAOB is a nonprofit corporation established by Congress to oversee the audits of public companies, among other activities, to protect investors. When LADWP changed audit firms it was a significant effort and financing activities were delayed due to the transition.

LADWP believes with the passage of the current legislation by Congress, the significant amount of audit work facing LADWP, and the lack of qualified "Big Four" firms serving the west coast state and local government sector, and the amount of debt financing over the next three years, it is in the best interest of LADWP to extend the current contract with KPMG and to issue the next RFP when some of these challenges will no longer be an issue. This contract extension is a onetime exception to Board Resolution 005-028 which limits the number of annual audits by an audit firm to 12 years. The following is a summary of the key points as this issue relates to LADWP:

- KPMG is the only "Big Four" firm qualified to bid on a new RFP. LADWP's prior auditor, PricewaterhouseCoopers, has a conflict of interest due to current litigation, and the other two "Big Four" firms do not have an audit presence in the state and local government sector on the west coast. A lack of qualified bid respondents limits LADWP's access to a depth and breadth of resources and experience that can only be offered by a "Big Four" firm, abilities that are required by such a large and complex entity such as LADWP.
- In 2013, The U.S. House of Representatives passed the *Audit Integrity and Job Protection Act, H.R. 1564*, by a vote of 321 – 62 on July 8, 2013. This law prohibits the PCAOB from requiring mandatory audit firm rotation. Through the hearing process on this legislation, the value of auditor consistency was voiced and clarified that a change in auditors does not enhance auditor objectivity or quality.
- Bond ratings tend to go up with long auditor tenure and investors place a premium on the bonds of companies that have large auditors performing independent audits. The credit rating of debt and investor confidence is very important to LADWP. As of June 2016 the Power System has approximately \$8.31 billion in debt outstanding with 83.5 percent fixed-rate and the remaining is a floating rate; the Water System has approximately \$4.81 billion in debt outstanding with about 93.2 percent of the obligations bearing a fixed interest rate. These amounts will increase over the next three years by approximately \$1.5 billion a year as many new capital projects are completed.

LADWP has two significant audits to complete with the proposed settlement of the class action lawsuit. The audit work to be completed as part of the lawsuit settlement is to restore customer and public trust and confidence in LADWP's ability to deliver accurate and timely bills. The first audit is to be performed 18 months after the

remediation period, which is estimated to be in 2018. Audits are to be done at LADWP's cost.

KPMG has provided a cost effective cost proposal in completing the work needed for the proposed contract extension, which includes no increase of rates for FYs 2015-16 to 2016-17, a reduction in the number of audit hours, and will increase the utilization of the SBE sub consultants that were part of their last RFP proposal by four percent for the amendment period, for a total of approximately 22 percent of the audit fees. KPMG has knowledge of LADWP and the CCB system including documentation and knowledge of policies, procedures, processes and the technological environment.

KPMG has provided similar services satisfactorily to LADWP under previous contracts since 2005.

The City Administrative Office report, dated November 23, 2016, is attached.

ENVIRONMENTAL DETERMINATION

In accordance with Section 15060 (c)(3) of the California Environmental Quality Act (CEQA) Guidelines, an activity is not subject to CEQA if it does not meet the definition of a project. Section 15378 (b)(5) states that organizational or administrative activities that will not result in direct or indirect physical changes in the environment do not meet that definition. Therefore, the award of a contract to provide auditing services is not subject to CEQA.

CITY ATTORNEY

The Office of the City Attorney reviewed and approved Amendment No. 1 to Agreement No. 47235-4 and the Resolution as to form and legality.

ATTACHMENTS

- Procurement Summary
- Resolution
- Amendment
- Exhibit A
- City Administrative Office Report