



SAN FRANCISCO WATER ENTERPRISE

Financial Statements

June 30, 2008 and 2007

(With Independent Auditors' Report Thereon)

SAN FRANCISCO WATER ENTERPRISE

June 30, 2008 and 2007

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KPMG LLP
55 Second Street
San Francisco, CA 94105

Independent Auditors' Report

The Honorable Mayor and Board of Supervisors
City and County of San Francisco

We have audited the accompanying financial statements of the San Francisco Water Enterprise (the Enterprise), a department of the City and County of San Francisco, California (the City), as of and for the years ended June 30, 2008 and 2007, as listed in the table of contents. These financial statements are the responsibility of the Enterprise's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing the audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Enterprise's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As discussed in note 1, the financial statements of Enterprise are intended to present the financial position, and the changes in financial position and cash flows of only that portion of the City that are attributable to the transactions of the Enterprise. They do not purport to, and do not, present fairly the financial position of the City as of June 30, 2008 and 2007, the changes in its financial position, or, where applicable, its cash flows for the years then ended in conformity with U.S. generally accepted accounting principles.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the San Francisco Water Enterprise of the City and County of San Francisco, California as of June 30, 2008 and 2007, and the changes in its financial position and its cash flows for the years then ended in conformity with U.S. generally accepted accounting principles.

In accordance with *Government Auditing Standards*, we have also issued our report dated December 5, 2008, on our consideration of the Enterprise's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, grant agreements, and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of our audit.

The management's discussion and analysis on pages 3 through 14 is not a required part of the basic financial statements but is supplementary information required by U.S. generally accepted accounting principles. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit the information and express no opinion on it.

As discussed in notes 2(r) and 10(b) to the financial statements, the Enterprise adopted the recognition and disclosure provisions of Governmental Accounting Standards Board Statement No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions*, as of July 1, 2007.

KPMG LLP

December 5, 2008

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Management's Discussion and Analysis

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This section presents management's analysis of the San Francisco Water Enterprise's (the Enterprise) financial condition and activities as of and for the years ended June 30, 2008 and 2007. Management's Discussion and Analysis (MDA) is intended to serve as an introduction to the Enterprise's financial statements. This information should be read in conjunction with the audited financial statements that follow this section. All amounts, unless otherwise noted, are expressed in thousands of dollars.

The information in this MDA is presented under the following headings:

- Organization and Business
- Overview of the Financial Statements
- Financial Analysis
- Capital Assets and Debt Administration
- Economic Factors and Next Year's Rates
- Request for Information

Organization and Business

The San Francisco Public Utilities Commission (the Commission) is an agency of the City and County of San Francisco (the City) that is responsible for the maintenance, operation, and development of three utility enterprises, including the Enterprise. The Enterprise collects, transmits, treats, and distributes high-quality drinking water to a total population of approximately 2.5 million people, including retail customers in the City and wholesale customers located in San Mateo, Santa Clara, and Alameda Counties. The Enterprise delivered approximately 90,566 million gallons in the year ended June 30, 2008. Approximately two-thirds of the water delivered by the Enterprise is to wholesale customers. Retail customers include residential, commercial, industrial, and governmental users, and the Enterprise recovers cost of service through user fees. Wholesale customers include cities, water districts, one private utility, and one nonprofit university. Service to these customers is provided pursuant to the Master Water Sales Contract which establishes the basis for determining the costs of wholesale service. The current contract is set to expire June 30, 2009 and a new agreement is currently being renegotiated.

Overview of the Financial Statements

The Enterprise's financial statements include:

Statements of Net Assets present information on the Enterprise's assets and liabilities as of year-end, with the difference between the two reported as net assets. Over time, increases or decreases in net assets may serve as a useful indicator of whether the financial position of the Enterprise is improving or deteriorating.

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While the Statements of Net Assets provide information about the nature and amount of resources and obligations at year-end, the *Statements of Revenues, Expenses, and Changes in Net Assets* present the results of the Enterprise's operations over the course of the fiscal year and information as to how the net assets changed during the year. These statements can be used as an indicator of the extent to which the Enterprise has successfully recovered its costs through user fees and other charges. All changes in net assets are reported during the period in which the underlying event giving rise to the change occurs, regardless of the timing of the related cash flows. Thus revenues and expenses are reported in these statements from some items that will result in cash flows in future fiscal periods, such as delayed collection of operating revenues and the expense of employee earned but unused vacation leave.

The *Statements of Cash Flows* present changes in cash and cash equivalents resulting from operational, capital, noncapital, and investing activities. These statements summarize the annual flow of cash receipts and cash payments, without consideration of the timing of the event giving rise to the obligation or receipt and excludes noncash accounting measures of depreciation or amortization of assets.

The *Notes to Financial Statements* provide information that is essential to a full understanding of the financial statements that is not displayed on the face of the financial statements.

Financial Analysis

2008 Financial Highlights

- The total assets of the Enterprise exceeded the total liabilities by \$461,333.
- Net assets increased by \$22,759, or 5.2%, during the fiscal year.
- Capital assets increased by \$193,739, or 18.0 %, to \$1,267,994.
- During the fiscal year, operating revenue, which excludes interest and investment income and other nonoperating revenue, increased by \$17,685, or 8.2%, to \$234,216.
- Operating expenses, which exclude interest expense and other nonoperating expenses, increased by \$20,554, or 10.2%, to \$223,052.

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Management's Discussion and Analysis

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Financial Position

Table 1

Comparative Condensed Net Assets

June 30, 2008, 2007, and 2006

	<u>2008</u>	<u>2007</u>	<u>2006</u>	<u>2008 – 2007 change</u>	<u>2007 – 2006 change</u>
Current and other assets	\$ 259,432	440,895	599,030	(181,463)	(158,135)
Capital assets, net of accumulated depreciation	<u>1,267,994</u>	<u>1,074,255</u>	<u>907,754</u>	<u>193,739</u>	<u>166,501</u>
Total assets	<u>1,527,426</u>	<u>1,515,150</u>	<u>1,506,784</u>	<u>12,276</u>	<u>8,366</u>
Revenue and capital appreciation bonds	961,790	980,759	997,370	(18,969)	(16,611)
Other liabilities	<u>104,303</u>	<u>95,817</u>	<u>76,352</u>	<u>8,486</u>	<u>19,465</u>
Total liabilities	<u>1,066,093</u>	<u>1,076,576</u>	<u>1,073,722</u>	<u>(10,483)</u>	<u>2,854</u>
Net assets:					
Invested in capital assets, net of related debt	324,091	300,996	275,038	23,095	25,958
Restricted	27,434	56,196	79,813	(28,762)	(23,617)
Unrestricted	<u>109,808</u>	<u>81,382</u>	<u>78,211</u>	<u>28,426</u>	<u>3,171</u>
Total net assets	<u>\$ 461,333</u>	<u>438,574</u>	<u>433,062</u>	<u>22,759</u>	<u>5,512</u>

Net Assets Fiscal Year 2008

For the year ended June 30, 2008, the Enterprise's net assets increased by \$22,759, or 5.2% from the prior year (see Table 1). This increase was attributable to; an increase of \$193,739 in capital assets, net of accumulated depreciation, a decrease of \$18,969 in revenue and capital appreciation bonds, a decrease of \$181,463 in current and other assets, and an increase in other liabilities of \$8,486. The decrease in current and other assets is mainly due to a reduction in restricted cash used for capital expenditures and the payment of bond principal and interest. The increase in other liabilities is primarily due to a combination of a \$15,048 increase in other post employment benefits liability and a \$4,815 decrease in due to other City department funds. The increase in post employment benefits liability is a result of the adoption of the Government Accounting Standards Board (GASB) Statement 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions*, during the fiscal year ended June 30, 2008. The decrease in due to other City department funds is attributed to payment of the balance owed to the City's General Fund for the acquisition of 525 Golden Gate property.

Net Assets Fiscal Year 2007

For the year ended June 30, 2007, the Enterprise's net assets increased by \$5,512 or 1.3% from the prior year (see Table 1). This increase was attributable to; an increase of \$166,501 in capital assets, net of accumulated depreciation, a decrease of \$16,611 in revenue and capital appreciation bonds, a decrease of \$158,135 in current and other assets, and an increase in other liabilities of \$19,465. The decrease in current assets and other is mainly

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due to the use of restricted cash for capital expenditures and payment of bond principal and interest. The increase in other liabilities is mainly caused by an increase in accrued capital project costs of \$14,064.

Results of Operations

The following table summarizes changes in the Enterprise's net assets for the year.

Table 2

Comparative Condensed Revenues, Expenses and Changes in Net Assets

Years ended June 30, 2008, 2007, and 2006

	<u>2008</u>	<u>2007</u>	<u>2006</u>	<u>2008 – 2007 change</u>	<u>2007 – 2006 change</u>
Revenues:					
Charges for services	\$ 216,819	202,787	189,603	14,032	13,184
Rents and concessions	9,645	9,929	8,763	(284)	1,166
Other operating revenues	7,752	3,815	3,467	3,937	348
Interest and investment income	12,456	24,547	11,665	(12,091)	12,882
Other nonoperating revenues	29,681	11,798	1,741	17,883	10,057
Total revenues	<u>276,353</u>	<u>252,876</u>	<u>215,239</u>	<u>23,477</u>	<u>37,637</u>
Expenses:					
Operating expenses	(223,052)	(202,498)	(186,934)	(20,554)	(15,564)
Interest expense	(29,750)	(34,326)	(26,650)	4,576	(7,676)
Nonoperating expenses	(792)	(777)	(1,006)	(15)	229
Total expenses	<u>(253,594)</u>	<u>(237,601)</u>	<u>(214,590)</u>	<u>(15,993)</u>	<u>(23,011)</u>
Income before transfers	<u>22,759</u>	<u>15,275</u>	<u>649</u>	<u>7,484</u>	<u>14,626</u>
Transfers to City and County of San Francisco	<u>—</u>	<u>(9,763)</u>	<u>(602)</u>	<u>9,763</u>	<u>(9,161)</u>
Changes in net assets	<u>22,759</u>	<u>5,512</u>	<u>47</u>	<u>17,247</u>	<u>5,465</u>
Net assets at beginning of year	<u>438,574</u>	<u>433,062</u>	<u>433,015</u>	<u>5,512</u>	<u>47</u>
Net assets at end of year	<u>\$ 461,333</u>	<u>438,574</u>	<u>433,062</u>	<u>22,759</u>	<u>5,512</u>

Rate Setting Process

Proposition E, as approved by the Voters on November 2002, amended the City Charter by adding the new Article VIIB, entitled "Public Utilities," which changed the Commission's ability to issue new revenue bonds and set retail water rates. The Commission is required to:

- Establish rates, fees, and charges based on cost of service;
- Retain an independent rate consultant to conduct cost of service studies at least every five years;

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- Consider establishing new connection fees;
- Consider conservation incentives and lifeline rates;
- Adopt a rolling five-year forecast annually; and
- Establish a Rate Fairness Board.

Wholesale customer rates are set pursuant to the Master Water Sales Contract, which was approved by the City and the wholesale customers in 1984 (see note 9 to the financial statements).

The following table is a history of the Enterprise's rate adjustments since July 1, 2004:

Historical rate adjustments

	<u>Retail</u>	<u>Wholesale</u>
Effective date:		
July 1, 2004	0.0%	2.7%
July 1, 2005	15.0	(9.7) ¹
July 1, 2006	15.0	18.8
July 1, 2007	15.0 ²	6.3
July 1, 2008	15.0	9.5

¹ Adjustment effective April 1, 2005

² Adjustment effective July 14, 2007

Fiscal Year 2008

The Enterprise's total revenues for the year of \$276,353 represented an increase of \$23,477 or 9.3% compared to the prior year (see Table 2). The increase was largely attributable to a \$14,032 increase in retail and wholesale water sales. The revenue from the sale of water to retail customers increased \$6,553 or 6.9% largely attributable to a 15.0% retail rate increase. Revenue from the sale of water to wholesale customers increased \$7,479 or 6.9%. The rate charged wholesale customers increased 6.3% based on an estimate of costs and consumption, with revenue collection increasing to \$113,923 from \$106,916 over the prior year. The balancing account due from suburban customers increased \$2,004 from the prior year, based on the difference between revenues received and costs of service. In the prior year, revenue collection of \$106,916 for wholesale water sale was supplemented by \$1,532 added to the balancing account to match the wholesale cost of service. Interest and investment income decreased by \$12,091 or 49.3% on lower average daily cash balances and lower interest earnings. Also, other nonoperating revenue increased by \$17,883 or 151.6% primarily due to net gains of \$24,335 from the sale of surplus land to other government agencies.

The Enterprise's total expenses of \$253,594 for the year increased by \$15,993 or 6.7% (see Table 2) over the prior year. The change was attributable to an increase of \$20,554 in operating expenses partially offset by a decrease of \$4,576 in interest expense. The change in operating expenses includes increases in post employment benefits of \$15,048; depreciation of \$2,063; judgments and claims of \$3,173; and higher payments to Hetch

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Hetchy for water allocation of \$1,945. The decrease in interest expense was a result of lower outstanding bond debt throughout fiscal year 2008.

Fiscal Year 2007

The Enterprise's total revenues for the year of \$252,876 represented an increase of \$37,637 or 17.5% compared to the prior year (see Table 2). The increase was largely attributable to a \$13,184 increase in retail and wholesale water sales. The revenue from the sale of water to retail customers increased \$7,562 or 8.7% largely attributable to a 15.0% retail rate increase. Revenue from the sale of water to wholesale customers increased \$5,622 or 5.5%. The rate charged wholesale customers increased 18.8% based on an estimate of costs and consumption, with revenue collection increasing to \$106,916 from \$84,478 over the prior year. Actual water consumption increased 7.3%. The balancing account due from suburban customers increased \$1,532 and \$18,350 from the prior years ended June 30, 2007 and 2006, respectively, based on the difference between revenues received and costs of service. Interest and investment income increased by \$12,882 or 110.0% on higher average daily cash balance and higher interest earnings. Also other nonoperating revenue increased by \$10,057 or 577.7.0% primarily due to a one-time federal grant of \$2,999 and sale of capital assets of \$6,526.

The Enterprise's total expenses of \$237,601 for the year increased by \$23,011 or 10.7% (see Table 2) over the prior year. The change was attributable to an increase of \$15,564 in operating expenses and \$7,676 increase in interest expense. The change in operating expenses was due to increases in personal services, contractual services, and depreciation. The change in interest expense was a result of higher outstanding bond debt throughout fiscal year 2007. The increase in transfers to the City of \$9,161 is primarily due to the purchase of the 525 Golden Gate building for \$9,900.

Capital Assets and Debt Administration

Capital Assets

Table 3

Capital Assets, Net of Depreciation

Years ended June 30, 2008, 2007, and 2006

	<u>2008</u>	<u>2007</u>	<u>2006</u>	<u>2008 – 2007 change</u>	<u>2007 – 2006 change</u>
Facilities, improvements, machinery, and equipment	\$ 827,045	744,881	690,170	82,164	54,711
Land and rights-of-way	17,886	18,277	17,929	(391)	348
Construction work in progress	<u>423,063</u>	<u>311,097</u>	<u>199,655</u>	<u>111,966</u>	<u>111,442</u>
Total	<u>\$ 1,267,994</u>	<u>1,074,255</u>	<u>907,754</u>	<u>193,739</u>	<u>166,501</u>

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Water System Improvement Program (WSIP)

The Enterprise has embarked on a multi-billion dollar, multi-year program to upgrade its Regional and Local Water Systems, known as the Water System Improvement Program (WSIP). The WSIP will deliver capital improvements that enhance the Enterprise's ability to provide reliable, affordable, high quality drinking water to its 27 wholesale customers and regional retail customers in Alameda, Santa Clara and San Mateo Counties, and to 800,000 retail customers in the City and County of San Francisco, in an environmentally sustainable manner. The program is structured to cost-effectively meet water quality requirements, improve seismic and delivery reliability, and meet water supply objectives for the year 2030.

The program is on target to achieve an overall completion date of December 2014. The program, as a whole, is in the design phase and transition of the WSIP's larger regional projects to the construction phase is anticipated to begin in late 2008 to early 2009. As of June 30, 2008, there are eight (8) regional projects in planning, twenty-eight (28) in design, one (1) in bid & award, five (5) in construction, five (5) in closeout; three (3) regional projects were completed, and three (3) had multiple active phases.

The total estimated cost for the WSIP is \$4.4 billion; this includes \$3.9 billion for capital projects and the balance, \$462.4 million, for financing costs. To date, nearly \$939.9 million has been budgeted for the WSIP and the program has expended approximately \$523.4 million through FY 2007-2008. Over the next six years, the SFPUC will require approximately \$3.5 billion in additional funding for the completion of the program.

Additional details regarding the WSIP are available in the Annual Reports published on the Enterprise's web site at <http://sfwater.org>.

Fiscal Year 2008

The Enterprise had net capital assets of \$1,267,994 invested in a broad range of utility capital assets as of June 30, 2008. The investment in capital assets includes land, buildings, improvements, water treatment plants, aqueducts, water transmission, and distribution mains, water storage facilities, pump stations, water reclamation facilities, machinery and equipment. This amount includes an increase of \$82,164 or 11.0% over the prior year in structure, buildings and equipment, and an increase of \$111,966 or 36.0% over the prior year in construction in progress, consistent with the Enterprise's implementation of the ten-year Water System Improvement Program. The Enterprise's net revenue, commercial paper, and long-term debt are used to finance capital investments.

The Enterprise had invested \$5,413 in development costs and \$9,900 in site acquisition as of June 30, 2008 for an office building located at 525 Golden Gate Avenue. The building is currently envisioned as a twelve story building encompassing approximately 212,000 square feet, and is intended to consolidate divisions of the San Francisco Public Utilities Commission that are currently renting space at multiple locations throughout the City. The existing structure is expected to be demolished. The project was placed on hold in July 2008 to allow management to evaluate construction cost estimates and alternative courses of action given current market conditions.

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The major additions to construction work in progress during the year ended June 30, 2008 included:

Sunset Reservoir North Basin Rehabilitation and Upgrade	\$	29,545
Stanford Heights Reservoir Rehabilitation and Upgrade		10,886
East/West Transmission Main		10,668
Water Main and Feeder Replacement, Citywide		10,665
Bay Division Pipeline (BDPL) Reliability Upgrade – Pipeline		9,846
Calaveras Dam Replacement		9,369
Irvington Tunnel Alternatives		8,495
San Joaquin Pipeline No 4 New		7,940
525 Golden Gate		6,490
Existing San Joaquin Pipeline Rehabilitation		6,332
BDPL Hydraulic Capacity Upgrade		6,292
Crystal Springs Pump Stations and Pipelines		5,647
Irvington Tunnel, Phase 2		5,249
Harry Tracy Water Treatment Plant Improvements		4,793
Seismic Upgrade BDPL at Hayward Fault		4,566
McLaren Park Pump Station Upgrade		3,891
McLaren Tank No. 2 Rehabilitation and Seismic Upgrade		3,644
New Crystal Springs Bypass Tunnel		3,526
New Services, Citywide		3,496
University Mound Reservoir North Basin Upgrade		3,304
Lower Crystal Springs Dam Improvements		3,206
Hetch Hetchy Advanced Ultra Violet Disinfection		3,189
Sunol Capacity Improvement, 240 Million Gallons Per Day		3,163
Lake Merced Pump Station Upgrade		3,040
Sky View – Aqua Vista Pump Station Upgrade		2,984
Recycled Water Project		2,852
Crystal Springs Pipeline No. 2 Replacement, In City		2,784
Renewed Services, Citywide		2,714
Baden and San Pedro Valve Lots		2,708
Palo Alto Pump Station Upgrade		2,552
Fulton and 6th Streets 30 Inch Main Replacement		2,501
Forest Knolls Pump Station Upgrade		2,432
Other project additions individually below \$2,400		54,185
	\$	<u>242,954</u>

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The major structures, buildings and equipment placed in service during the year ended June 30, 2008 included:

Underground Concrete	\$	17,555
New Services, Citywide		6,464
Renew Services, Citywide		5,651
Water Main Replacement, Avenues		5,417
University Mound 48 Inch Steel Pipeline		5,196
Other items individually below \$5,000		87,883
	\$	<u>128,166</u>

Fiscal Year 2007

The Enterprise had net capital assets of \$1,074,255 invested in a broad range of utility capital assets as of June 30, 2007. The investment in capital assets includes land, buildings, improvements, water treatment plants, aqueducts, water transmission, and distribution mains, water storage facilities, pump stations, water reclamation facilities, machinery and equipment. This amount includes an increase of \$54,711 or 7.9% over the prior year in structure, buildings and equipment, and an increase of \$111,442 or 55.8% over the prior year in construction in progress, consistent with the Enterprise's implementation of the ten-year Water System Improvement Program. The Enterprise's net revenue, commercial paper, and long-term debt are used to finance capital investments.

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The major additions to construction work in progress during the year ended June 30, 2007 included:

Sunset Reservoir Rehabilitation and Upgrade, North Basin	\$	19,177
Bay Division Pipeline (BDPL) Seismic Upgrade, Hayward Fault		14,276
Program Management Services – Water System Improvement Program		10,127
East/West Transmission Main		9,809
Water Main and Feeder Main Replacement, Citywide		9,312
Motorized and Other Critical Valves		8,860
Calaveras Dam Replacement		7,736
BDPL Reliability Upgrade, Pipeline		6,797
San Joaquin Pipeline System		6,250
BDPL Reliability Upgrade, Bay Tunnel		5,237
New Irvington Tunnel		5,041
Water Main Replacement Program		4,536
Summit Pump Station Upgrade		4,130
McLaren Tank Number 1 Rehabilitation and Seismic Upgrade		3,840
Potrero Heights Reservoir Rehabilitation and Upgrade		3,354
Hayward Fault Mitigation		2,999
New Services Citywide		2,968
Environmental Impact Project (PEIR)		2,940
Renew Services Citywide		2,937
Crystal Springs Pipeline Number Replacement		2,542
La Grande Tank Rehabilitation and Seismic Upgrade		2,507
Pipeline Repair and Readiness Improvements		2,323
Crystal Springs-San Andreas Transmission Upgrade		2,289
Alameda Siphon Number 4		2,109
New Crystal Springs Bypass Tunnel		2,036
Other project additions individually below \$2,000		72,656
	\$	<u>216,788</u>

The major structures, buildings and equipment placed in service during the year ended June 30, 2007 included:

Central Pump Station Upgrades	\$	15,326
Lincoln Way Transmission Line		12,972
Summit Reservoir Upgrade		12,097
Water Main and Feeder Main Replacement, Citywide		11,578
Sunset Reservoir Upgrade		8,761
Potrero Heights Reservoir Upgrade		8,183
Other items individually below \$8,000		29,696
	\$	<u>98,613</u>

More detailed information about the Enterprise's capital assets is presented in notes 2(e), 2(f), and 4 to the financial statements.

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Debt Administration

Table 4

Outstanding Debt, Net of Amortized Costs

June 30, 2008, 2007, and 2006

	<u>2008</u>	<u>2007</u>	<u>2006</u>	<u>2007 – 2006 change</u>	<u>2007 – 2006 change</u>
Revenue bonds	\$ 958,410	977,604	994,425	(19,194)	(16,821)
Capital appreciation bonds	<u>3,380</u>	<u>3,155</u>	<u>2,945</u>	<u>225</u>	<u>210</u>
Total	<u>\$ 961,790</u>	<u>980,759</u>	<u>997,370</u>	<u>(18,969)</u>	<u>(16,611)</u>

As of June 30, 2008, the Enterprise had \$961,790 total debt outstanding, a decrease of \$18,969 over the prior year. Total debt outstanding at June 30, 2008, consisted of \$958,410 in fixed-rate long-term revenue bonds and \$3,380 in capital appreciation bonds. The change in total debt outstanding was due to (i) the retirement of revenue bond principal and (ii) a change in the accreted value of certain capital appreciation bonds, amortization of bond discounts, bond premium, and refunding loss.

As of June 30, 2007, the Enterprise had \$980,759 total debt outstanding, a decrease of \$16,611 over the prior year. Total debt outstanding at June 30, 2007, consisted of \$977,604 in fixed-rate long-term revenue bonds and \$3,155 in capital appreciation bonds. The change in total debt outstanding was due to (i) the retirement of revenue bond principal, (ii) the refunding and defeasance of the 1996 Series A bonds with the issuance of the 2006 Series C bonds and (iii) a change in the accreted value of certain capital appreciation bonds, amortization of bond discounts, bond premium, and refunding loss.

Credit Ratings and Bond Insurance – At June 30, 2008 and 2007, the Enterprise carried underlying ratings of “A1” and “A+” from Moody’s and Standard & Poor’s (S&P), respectively. In connection with the sale of substantially all the Enterprise’s revenue bonds, municipal bond insurance has been purchased by the Commission or the underwriters from XL Capital (XL), Financial Security Assurance Corporation (FSA), and MBIA Insurance Corporation (MBIA) to guarantee the payment of principal and interest when due. XL was acquired by Syncora Holdings (Syncora) in August 2008. With the insurance, Moody’s and S&P have assigned their municipal bond ratings of “Aaa” and “AAA”, respectively, to the Enterprise’s insured revenue bonds. The downgrade of various bond insurance companies by credit rating agencies in 2008 did not cause any change in the Enterprise’s underlying ratings. In October 2008, Moody’s and S&P had downgraded Syncora to “Caal” and “BBB-”, respectively. In November 2008, MBIA was downgraded by Moody’s and S&P to “Baa1” and “AA-”, respectively. In November 2008, Moody’s downgraded FSA to “Aa3”, and S&P put FSA on negative outlook, but maintained a “AAA” rating.

SAN FRANCISCO WATER ENTERPRISE

Management's Discussion and Analysis

June 30, 2008 and 2007

(Dollars in thousands, unless otherwise stated)

Debt Service Coverage – Pursuant to the Amended and Restated Indenture, the Enterprise is required to collect sufficient net revenues each fiscal year, together with any Enterprise funds (except Bond Reserve Funds) which are available for payment of debt service and are not budgeted to be expended, at least equal to 1.25 times annual debt service for said fiscal year. During fiscal years 2008 and 2007, the Enterprise's net revenues, together with fund balances available to pay debt service and not budgeted to be expended, were sufficient to meet the rate covenant requirements under the Enterprise's Amended and Restated Indenture.

Debt Authorization – Pursuant to the Charter, the Enterprise can incur indebtedness upon two-thirds vote of the Board of Supervisors, as approved by voters in Proposition E in November 2002. The Enterprise can also incur indebtedness of up to \$1.628 billion for improvements to the water system pursuant to Proposition A that was approved by the voters in November 2002. As of June 30, 2008, \$507.8 million of the \$1.628 billion was issued. The Enterprise is also authorized to issue up to \$250 million in commercial paper.

Cost of Capital – The Enterprise's outstanding long-term debt had interest rates ranging from 2.5% to 7.0% as of June 30, 2008. In the prior year, the Enterprise's outstanding long-term debt had interest rates ranging from 2.5% to 7.0%.

More information about the Enterprise's debt activities is presented in notes 6 and 7 to the financial statements.

Economic Factors and Next Year's Rates

The Master Water Sales Contract (MWSC) expires on June 30, 2009. A new agreement is currently being negotiated with the Wholesale Customers represented by the Bay Area Water Supply and Conservation Agency (BAWSCA). No assurance can be given that the MWSC will be extended beyond its stated expiration date, or that negotiations will be successful for a new contract as the Enterprise and the Wholesale Customers must formally approve the new agreement. However, should a new MWSC not be in place by the expiration date, the terms of the current contract can remain in effect.

Pursuant to the City and County of San Francisco Charter Section 8B.125, an independent rate study is performed at least once every five years. A rate study will be undertaken in the coming year to examine the future revenue requirements and cost of service of the Enterprise.

The Commission intends to use debt financing as necessary to fund its capital improvement program related to water quality, delivery reliability and seismic upgrades. In the coming year, the Commission expects to issue \$500 million of water revenue bonds and has increased its retail water rates 15.0% and wholesale rates 9.5% to meet projected costs and coverage requirements.

Request for Information

This report is designed to provide our citizens, customers, investors, and creditors with a general overview of the Enterprise's finances and to demonstrate the Enterprise's accountability for the money it receives. Questions regarding any of the information provided in this report or requests for additional financial information should be addressed to San Francisco Public Utilities Commission, Chief Financial Officer, 1155 Market Street, 11th Floor, San Francisco, CA 94103.

SAN FRANCISCO WATER ENTERPRISE

Statements of Net Assets

June 30, 2008 and 2007

(In thousands)

	<u>2008</u>	<u>2007</u>
Assets:		
Current assets:		
Cash and investments with City Treasury	\$ 138,654	105,730
Cash and investments outside City Treasury	36	40
Receivables:		
Charges for services (net of allowance for doubtful accounts of \$1,439 in 2008 and \$1,265 in 2007)	33,690	32,421
Suburban water rate agreement	13,870	11,866
Due from other funds	250	208
Federal and state grants and subventions	59	—
Interest and other	786	2,126
Total receivables	<u>48,655</u>	<u>46,621</u>
Inventories	1,872	1,563
Total current assets	<u>189,217</u>	<u>153,954</u>
Noncurrent assets:		
Restricted assets – cash and investments with City Treasury	21,740	219,521
Restricted assets – cash and investments outside City Treasury	41,051	56,215
Restricted assets – interest receivable	260	3,578
Capital assets not being depreciated	440,949	329,375
Capital assets, net of accumulated depreciation	827,045	744,880
Bond issuance costs (net of accumulated amortization of \$2,976 in 2008 and \$2,509 in 2007)	7,164	7,627
Total noncurrent assets	<u>1,338,209</u>	<u>1,361,196</u>
Total assets	<u>1,527,426</u>	<u>1,515,150</u>
Liabilities:		
Current liabilities:		
Accounts payable	8,394	7,659
Accrued payroll	6,009	5,528
Accrued vacation and sick leave, current portion	5,738	5,761
Accrued workers' compensation, current portion	1,512	1,699
Due to other City departments	—	4,815
Damage and claims liability, current portion	3,011	1,652
Deposits, advances, and other liabilities	7,157	7,927
Bond interest payable	7,434	7,574
Environmental cleanup liability, current portion	2,339	5,311
Revenue bonds, current portion	25,520	19,170
Current liabilities payable from restricted assets	27,322	29,245
Total current liabilities	<u>94,436</u>	<u>96,341</u>
Long-term liabilities:		
Other post employment benefits obligations	15,048	—
Accrued vacation and sick leave, less current portion	5,118	5,410
Accrued workers' compensation, less current portion	6,623	6,647
Damage and claims liability, less current portion	8,243	5,282
Revenue bonds, less current portion	932,890	958,434
Capital appreciation bonds	3,380	3,155
Environmental cleanup liability, less current portion	355	1,307
Total long-term liabilities	<u>971,657</u>	<u>980,235</u>
Total liabilities	<u>1,066,093</u>	<u>1,076,576</u>
Net assets:		
Invested in capital assets, net of related debt	324,091	300,996
Restricted – debt service	27,434	56,196
Unrestricted	109,808	81,382
Total net assets	<u>\$ 461,333</u>	<u>438,574</u>

See accompanying notes to financial statements.

SAN FRANCISCO WATER ENTERPRISE

Statements of Revenues, Expenses, and Changes in Net Assets

Years ended June 30, 2008 and 2007

(In thousands)

	2008	2007
Operating revenues:		
Charges for services	\$ 216,819	202,787
Rents and concessions	9,645	9,929
Other revenues	7,752	3,815
	<u>234,216</u>	<u>216,531</u>
Total operating revenues		
Operating expenses:		
Personal services	102,233	87,200
Contractual services	11,292	12,437
Materials and supplies	11,506	10,661
Depreciation	45,958	43,895
Services provided by other departments	34,698	33,242
General and administrative	8,209	4,523
Other	9,156	10,540
	<u>223,052</u>	<u>202,498</u>
Total operating expenses		
Operating income	<u>11,164</u>	<u>14,033</u>
Nonoperating revenues (expenses):		
Federal grant	1,958	2,999
Interest and investment income	12,456	24,547
Interest expense	(29,750)	(34,326)
Net gain from sale of land	24,335	977
Other nonoperating revenues, net	2,596	7,045
	<u>11,595</u>	<u>1,242</u>
Net nonoperating revenue		
Income before transfers	<u>22,759</u>	<u>15,275</u>
Transfers to the City and County of San Francisco	<u>—</u>	<u>(9,763)</u>
Changes in net assets	<u>22,759</u>	<u>5,512</u>
Net assets at beginning of year	<u>438,574</u>	<u>433,062</u>
Net assets at end of year	<u>\$ 461,333</u>	<u>438,574</u>

See accompanying notes to financial statements.

SAN FRANCISCO WATER ENTERPRISE

Statements of Cash Flows

Years ended June 30, 2008 and 2007

(In thousands)

	2008	2007
Cash flows from operating activities:		
Cash received from customers, including cash deposits	\$ 222,676	203,038
Cash received from tenants for rent	9,749	9,853
Cash paid to employees for services	(85,633)	(83,280)
Cash paid to suppliers for goods and services	(71,369)	(54,718)
Cash paid for judgments and claims	(2,359)	(5,415)
Net cash provided by operating activities	73,064	69,478
Cash flows from noncapital and related financing activities:		
Transfers out	—	(4,949)
Operating grants	1,899	2,999
Net cash provided by (used in) noncapital financing activities	1,899	(1,950)
Cash flows from capital and related financing activities:		
Proceeds from sale of capital assets	24,402	6,169
Cash paid to escrow agent	—	(1,419)
Interest paid on long-term debt	(45,023)	(48,955)
Principal paid on long-term debt	(19,170)	(15,684)
Acquisition and construction of capital assets	(234,624)	(195,208)
Net cash used in capital and related financing activities	(274,415)	(255,097)
Cash flows from investing activities:		
Interest income received	16,600	22,446
Proceeds from sale of investments outside City Treasury	65,317	69,633
Purchase of investments outside City Treasury	(50,153)	(46,766)
Other investing activities	2,827	1,889
Net cash provided by investing activities	34,591	47,202
Decrease in cash and cash equivalents	(164,861)	(140,367)
Cash and cash equivalents:		
Beginning of year	325,291	465,658
End of year	\$ 160,430	325,291
Reconciliation of cash and cash equivalents to the statement of net assets:		
Cash and investments with City Treasury:		
Unrestricted	\$ 138,654	105,730
Restricted	21,740	219,521
Cash and investments outside City Treasury:		
Unrestricted	36	40
Cash and cash equivalents at end of year on statements of cash flows	\$ 160,430	325,291

SAN FRANCISCO WATER ENTERPRISE

Statements of Cash Flows

Years ended June 30, 2008 and 2007

(In thousands)

	<u>2008</u>	<u>2007</u>
Reconciliation of operating income to net cash provided by operating activities:		
Operating income	\$ <u>11,164</u>	<u>14,033</u>
Adjustment to reconcile operating income to net cash provided by operating activities:		
Depreciation	45,958	43,895
Environmental cleanup	(3,925)	(1,457)
Write-off of capital assets	8,337	10,193
Changes in operating assets and liabilities:		
Receivables:		
Charges for services, net	(1,260)	(1,987)
Interest and other	498	5
Inventories	(308)	175
Accounts payable	(884)	2,883
Due to (from) other City departments	(4,856)	(63)
Accrued payroll	482	1,488
Accrued other post employment benefit liability	15,048	—
Accrued vacation and sick leave	(315)	776
Accrued workers' compensation	(210)	(373)
Suburban water rate agreement	(2,004)	(1,532)
Damage and claims liability	4,320	1,134
Deposits, advances, and other liabilities	<u>1,019</u>	<u>308</u>
Total adjustments	<u>61,900</u>	<u>55,445</u>
Net cash provided by operating activities	\$ <u><u>73,064</u></u>	<u><u>69,478</u></u>
Noncash transactions:		
Accrued capital asset costs	\$ 27,322	29,245
Land acquired through real property exchange	—	354

See accompanying notes to financial statements.

SAN FRANCISCO WATER ENTERPRISE

Notes to Financial Statements

June 30, 2008 and 2007

(Dollars in thousands, unless otherwise stated)

(1) Definition of Reporting Entity

The San Francisco Water Enterprise (the Enterprise) was established in 1930 under the provisions of the Charter of the City and County of San Francisco. The Enterprise acquired the fully developed, mature water works for San Francisco on March 3, 1930. Since then, the City and County of San Francisco (the City) has operated and maintained the water works as the San Francisco Water Enterprise. The Board of Supervisors of the City has adopted resolutions (the Water Resolutions) providing for the issuance of various water revenue and refunding bond series. The Enterprise, which consists of a system of reservoirs, storage tanks, water treatment plants, pump stations, and pipelines, is engaged in the distribution of water to San Francisco and certain suburban areas. In fiscal 2008, the Enterprise delivered approximately 90,566 million gallons of water to nearly 2.5 million people within San Francisco and certain suburban areas.

The San Francisco Public Utilities Commission (the Commission), established in 1932, is responsible for providing operational oversight of the public utility enterprises of the City, which include the Enterprise along with the City's power and sewer utilities (i.e., Hetch Hetchy Water and Power [Hetch Hetchy] and the San Francisco Wastewater Enterprise [Wastewater]). The Commission is responsible for determining such matters as the rates and charges for services, approval of contracts, and organizational policy.

Until August 1, 2008, the Commission consisted of five members, all appointed by the Mayor. Proposition E, a City and County of San Francisco Charter amendment approved by the voters in the June 3, 2008 election, terminated the terms of the all five existing members of the Commission, changed the process for appointing new members, and set qualifications for all members. Under the amended Charter, the Mayor continues to nominate candidates to the Commission, but nominees do not take office until the Board of Supervisors votes to approve their appointments by a majority (at least six members). The amended Charter requires the Commission members meet the following qualifications:

1. Seat 1 must have experience in environmental policy and an understanding of environmental justice issues.
2. Seat 2 must have experience in ratepayer or consumer advocacy.
3. Seat 3 must have experience in project finance.
4. Seat 4 must have expertise in water systems, power systems, or public utility management.
5. Seat 5 would be an at-large member.

The amended Charter provides for staggered four-year term for members. Initially, the new members for seats 2 and 4 will serve two years and the new members for seats 1, 3 and 5 will serve for four years.

The Commission is a department of the City, and as such, the financial operations of the Enterprise, Hetch Hetchy, and the Wastewater Enterprise are included in the Comprehensive Annual Financial Report of the City as enterprise funds. These financial statements present only the financial operations of the Enterprise alone and are not intended to present the financial position of the City as a whole or consolidated entity,

SAN FRANCISCO WATER ENTERPRISE

Notes to Financial Statements

June 30, 2008 and 2007

(Dollars in thousands, unless otherwise stated)

the changes in its financial position, and the cash flows of its proprietary funds in conformity with U.S. generally accepted accounting principles.

(2) Significant Accounting Policies

(a) *Basis of Accounting and Measurement Focus*

The accounts of the Enterprise are organized on the basis of a proprietary fund type, specifically an enterprise fund. The activities of this Enterprise are accounted for with a separate set of self-balancing accounts that comprise the Enterprise's assets, liabilities, net assets, revenues, and expenses. Enterprise funds account for activities (i) that are financed with debt that is secured solely by a pledge of the net revenues from fees and charges of the activity; or (ii) that are required by laws or regulations that the activity's costs of providing services, including capital costs (such as depreciation or debt service), be recovered with fees and charges, rather than with taxes or similar revenues; or (iii) that the pricing policies of the activity establish fees and charges designed to recover its costs, including capital costs (such as depreciation or debt service).

The financial activities of the Enterprise are accounted for on a flow of economic resources measurement focus, using the accrual basis of accounting. Under this method, all assets and liabilities associated with its operations are included on the statement of net assets; revenues are recorded when earned, and expenses are recorded when liabilities are incurred.

The Enterprise does not apply Financial Accounting Standards Board (FASB) statements and interpretations issued after November 30, 1989. The Enterprise applies all applicable Governmental Accounting Standards Board (GASB) pronouncements, as well as statements and interpretations of the FASB, Accounting Principles Board Opinions, and Accounting Research Bulletins of the Committee on Accounting Procedures issued on or before November 30, 1989, unless those pronouncements conflict with or contradict GASB pronouncements.

(b) *Cash and Cash Equivalents*

The Enterprise considers its pooled deposits and investments held with the City Treasury to be demand deposits and therefore cash equivalents for financial reporting. The City also holds nonpooled deposits and investments for the Enterprise. Nonpooled restricted deposits and restricted deposits and investments held outside the City Treasury with maturities of three months or less are also considered to be cash equivalents.

(c) *Investments*

Money market funds and banker's acceptances that have a remaining maturity at the time of purchase of one year or less are carried at amortized cost. All other investments are stated at fair value based on quoted market prices. Changes in fair value are recognized as investment gains or losses.

SAN FRANCISCO WATER ENTERPRISE

Notes to Financial Statements

June 30, 2008 and 2007

(Dollars in thousands, unless otherwise stated)

(d) Inventory

Inventory primarily consists of construction materials and maintenance supplies, and is generally valued at cost or average cost. Inventory is expensed as it is consumed.

(e) Capital Assets

Capital assets are stated at cost. Depreciation and amortization are computed using the straight-line method based on the estimated useful lives of the related assets, which range from 3 to 75 years for equipment and 3 to 175 years for buildings, structures, and improvements. No depreciation or amortization is recorded in the year of acquisition, and a full year's depreciation is recorded in the year of disposal.

(f) Construction in progress

The cost of acquisition and construction of major plant and equipment is recorded as construction in progress. As facilities are accepted by the Enterprise and become operative, they are transferred to the facilities and improvements or machinery and equipment accounts and depreciated in accordance with the Enterprise's depreciation policies. Costs of construction projects that are discontinued are recorded as expense in the year in which the decision is made to discontinue such projects.

(g) Capitalization of Interest

A portion of the interest cost incurred on capital projects is capitalized on assets that require a period of time for construction or to otherwise prepare them for their intended use. Such amounts are amortized over the useful lives of the assets.

(h) Bond Discount, Premium, and Issuance Costs

Bond discount, premium, and issuance costs are amortized over the term of the related bonds on a method which approximates the effective interest method basis.

(i) Accrued Vacation and Sick Leave

Accrued vacation pay, which may be accumulated up to ten weeks per employee, is charged to expense as earned. Sick leave earned subsequent to December 6, 1978 is nonvesting and may be accumulated up to six months per employee.

(j) Workers' Compensation

The Enterprise is self-insured for workers' compensation claims and accrues the estimated cost of those claims, including the estimated cost of incurred but not reported claims.

(k) Damage and Claims Liability

The Enterprise is self-insured for general liability and property damage claims. The liability represents an estimate of the cost of all outstanding claims, including adverse loss development and estimated incurred but not reported claims.

SAN FRANCISCO WATER ENTERPRISE

Notes to Financial Statements

June 30, 2008 and 2007

(Dollars in thousands, unless otherwise stated)

(l) *Arbitrage Rebate Payable*

Certain bonds are subject to arbitrage rebate requirements in accordance with regulations issued by the U.S. Treasury Enterprise. The requirements generally stipulate that earnings from the investment of the tax-exempt bond proceeds that exceed related interest costs on the bonds must be remitted to the federal government on every fifth anniversary of each bond issue. There was no arbitrage rebate liability as of June 30, 2008 and 2007.

(m) *Refunding Debt*

Gains or losses occurring from advance refunding of debt are deferred and amortized into interest expense over the remaining life of the old bonds or the life of the new bonds, whichever is shorter.

(n) *Income Taxes*

As a government agency, the Enterprise is exempt from both federal income taxes and California state franchise taxes.

(o) *Revenue Recognition*

Water service charges are based on water usage as determined by the Enterprise. In general, customers are billed on a cyclical basis with large commercial and industrial customers billed monthly, and all other customers bimonthly.

Revenues earned but unbilled are accrued as charges for services receivable on the statements of net assets.

(p) *Use of Estimates*

The preparation of financial statements in conformity with U.S. generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

(q) *Reclassifications*

Certain reclassifications have been made to prior year amounts to conform to current year presentation.

(r) *Effects of New Pronouncements*

In June 2004, GASB issued Statement No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions*, which addresses how state and local governments should account for and report their costs and obligations related to post employment healthcare and other non-pension benefits. Collectively, these benefits are commonly referred to as other post employment benefits, or OPEB. The statement generally requires that employers account for and report the annual cost of OPEB and the outstanding obligations and commitments related to

SAN FRANCISCO WATER ENTERPRISE

Notes to Financial Statements

June 30, 2008 and 2007

(Dollars in thousands, unless otherwise stated)

OPEB in essentially the same manner as they currently do for pensions. The annual OPEB cost for most employers will be based on actuarially determined amounts that, if paid on an ongoing basis, generally would provide sufficient resources to pay benefits as they come due. This statement's provisions may be applied prospectively and do not require governments to fund their OPEB plans. An employer may establish its OPEB transition liability at zero as of the beginning of the initial year of implementation; however, the unfunded actuarial liability is required to be amortized over future periods. This statement also establishes disclosure requirements for information about the plans in which an employer participates, the funding policy followed, the actuarial valuation process and assumptions, and, for certain employers, the extent to which the plan has been funded over time. As of July 1, 2007, the Enterprise implemented the new reporting requirements in the financial statements and established its OPEB transition liability at zero.

(3) Cash, Cash Equivalents and Investments

The Enterprise's cash, cash equivalents and investments with the City Treasury are invested in an unrated City pool pursuant to investment policy guidelines established by the City Treasurer and are treated as cash equivalents for financial reporting purposes. The objectives of the policy guidelines are, in order of priority, preservation of capital, liquidity, and yield. The policy addresses soundness of financial institutions in which the City will deposit funds, types of investment instruments as permitted by the California Government Code, and the percentage of the portfolio which may be invested in certain instruments with longer terms to maturity. The City Treasury allocates monthly income from the investment of pooled cash in proportion to the Enterprise's end-of-month balances.

Restricted assets are held by an independent trustee outside the City's investment pool. The assets are held for the purpose of paying future interest and principal on the bonds and for eligible capital project expenditures. The balances as of June 30, 2008 and 2007 were \$41,051 and \$56,215, respectively. The Enterprise held all investments in either guaranteed investment contracts or in money funds consisting of Treasury Obligations. The guaranteed investment contracts mature in 2008 and 2013. The Treasury Obligations have an average maturity of 14 days in fiscal year 2008 and 1 day in fiscal year 2007.

The primary objectives of the Enterprise's policy of investment are consistent with the City's policy.

Funds held by the trustee established under the 2002 amended and restated Indentures agreements are invested in "Permitted Investments," as defined in the agreement, which includes money market funds and investment agreements. The agreement permits investment in money market funds registered under the Federal Investment Company Act of 1940 and whose shares are also registered under the Federal Securities Act of 1933 and having a rating by Standard & Poor's of AAAm-G, AAAM or AAm and a rating by Moody's of Aaa, Aa1 or Aa2. Investment agreements must be with a U.S. bank or trust company having a rating by Moody's and S&P of "A" or higher, or are guaranteed by any entity with a rating of "A" or higher, at the time the agreement is entered into. The credit ratings of the guaranteed investment contracts as of June 30, 2008 were Aa2 by Moody's and AA- by Standard & Poor's. The credit ratings of the money market funds as of June 30, 2008 and June 30, 2007, were Aaa by Moodys and AAAM by Standard & Poor's.

SAN FRANCISCO WATER ENTERPRISE

Notes to Financial Statements

June 30, 2008 and 2007

(Dollars in thousands, unless otherwise stated)

Additional cash outside of the investment pool includes \$36 for June 30, 2008 and \$40 for June 30, 2007, which is held in a commercial bank in non-interest bearing checking accounts which are covered by depository insurance. These accounts were established as provided by the City's Administrative Code.

The Enterprise's cash, cash equivalents and investments are shown on the accompanying statements of net assets as follows:

	<u>2008</u>	<u>2007</u>
Current assets:		
Cash and investments with City Treasury	\$ 138,654	105,730
Cash and investments outside City Treasury	36	40
Noncurrent assets – restricted assets:		
Cash and investments with City Treasury	21,740	219,521
Cash and investments outside City Treasury	<u>41,051</u>	<u>56,215</u>
	<u>\$ 201,481</u>	<u>381,506</u>

The following table shows the percentage distribution of the City's pooled investments by maturity as of June 30, 2008:

<u>Investment maturities (in months)</u>			
<u>Under 1</u>	<u>1 to less than 6</u>	<u>6 to less than 12</u>	<u>12 to 36</u>
6.9%	52.7%	11.6%	28.8%

The following table shows the percentage distribution of the City's pooled investments by maturity as of June 30, 2007:

<u>Investment maturities (in months)</u>			
<u>Under 1</u>	<u>1 to less than 6</u>	<u>6 to less than 12</u>	<u>12 to 36</u>
25.9%	43.6%	28.4%	2.1%

SAN FRANCISCO WATER ENTERPRISE

Notes to Financial Statements

June 30, 2008 and 2007

(Dollars in thousands, unless otherwise stated)

(4) Capital Assets

Capital assets as of June 30, 2008 and 2007 consisted of the following:

	<u>Balance</u> <u>July 1, 2007</u>	<u>Increases</u>	<u>Decreases</u>	<u>Balance</u> <u>June 30, 2008</u>
Capital assets not being depreciated:				
Land	\$ 18,277	—	(391)	17,886
Construction in progress	<u>311,098</u>	<u>242,954</u>	<u>(130,989)</u>	<u>423,063</u>
Total capital assets not being depreciated	<u>329,375</u>	<u>242,954</u>	<u>(131,380)</u>	<u>440,949</u>
Capital assets being depreciated:				
Facilities and improvements	1,166,073	121,331	—	1,287,404
Machinery and equipment	<u>122,584</u>	<u>6,835</u>	<u>(661)</u>	<u>128,758</u>
Total capital assets being depreciated	<u>1,288,657</u>	<u>128,166</u>	<u>(661)</u>	<u>1,416,162</u>
Less accumulated depreciation for:				
Facilities and improvements	(458,981)	(37,905)	—	(496,886)
Machinery and equipment	<u>(84,796)</u>	<u>(8,053)</u>	<u>618</u>	<u>(92,231)</u>
Total accumulated depreciation	<u>(543,777)</u>	<u>(45,958)</u>	<u>618</u>	<u>(589,117)</u>
Total capital assets being depreciated, net	<u>744,880</u>	<u>82,208</u>	<u>(43)</u>	<u>827,045</u>
Total capital assets, net	\$ <u>1,074,255</u>	<u>325,162</u>	<u>(131,423)</u>	<u>1,267,994</u>

SAN FRANCISCO WATER ENTERPRISE

Notes to Financial Statements

June 30, 2008 and 2007

(Dollars in thousands, unless otherwise stated)

	<u>Balance</u> <u>July 1, 2006</u>	<u>Increases</u>	<u>Decreases</u>	<u>Balance</u> <u>June 30, 2007</u>
Capital assets not being depreciated:				
Land	\$ 17,929	354	(6)	18,277
Construction in progress	<u>199,655</u>	<u>216,788</u>	<u>(105,345)</u>	<u>311,098</u>
Total capital assets not being depreciated	<u>217,584</u>	<u>217,142</u>	<u>(105,351)</u>	<u>329,375</u>
Capital assets being depreciated:				
Facilities and improvements	1,074,491	92,636	(1,054)	1,166,073
Machinery and equipment	<u>116,893</u>	<u>5,977</u>	<u>(286)</u>	<u>122,584</u>
Total capital assets being depreciated	<u>1,191,384</u>	<u>98,613</u>	<u>(1,340)</u>	<u>1,288,657</u>
Less accumulated depreciation for:				
Facilities and improvements	(424,816)	(35,218)	1,053	(458,981)
Machinery and equipment	<u>(76,398)</u>	<u>(8,677)</u>	<u>279</u>	<u>(84,796)</u>
Total accumulated depreciation	<u>(501,214)</u>	<u>(43,895)</u>	<u>1,332</u>	<u>(543,777)</u>
Total capital assets being depreciated, net	<u>690,170</u>	<u>54,718</u>	<u>(8)</u>	<u>744,880</u>
Total capital assets, net	\$ <u><u>907,754</u></u>	<u><u>271,860</u></u>	<u><u>(105,359)</u></u>	<u><u>1,074,255</u></u>

Capital assets with a useful life of 50 years or greater include buildings and structures, reservoirs, dams, treatment plants, pump stations, certain water mains and pipelines, sewer systems, tunnels, and bridges.

Financial Accounting Standards Board (FASB) Statement 34 *Capitalization of Interest Costs*, requires that interest expense incurred during construction of assets be capitalized. Interest included in the Construction in Progress and total interest expense incurred during the years ended June 30 2008 and 2007 is as follows:

	<u>2008</u>	<u>2007</u>
Interest expensed	\$ 29,750	34,326
Interest included in construction in progress	<u>15,333</u>	<u>10,968</u>
Total interest cost incurred	\$ <u><u>45,083</u></u>	<u><u>45,294</u></u>

During fiscal years 2008 and 2007, the Enterprise expensed \$7,885 and \$10,185, respectively, related to capitalized design and planning costs on certain projects. The amounts of the write-offs were recognized as other operating expenses in the accompanying statements of revenues, expenses, and changes in net assets.

SAN FRANCISCO WATER ENTERPRISE

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During the fiscal year ending June 30 2007, the Enterprise purchased 525 Golden Gate for \$9,900 from the City General Fund and as of June 30, 2008 has spent \$5,413 in development costs. Currently, this project is on hold pending further feasibility studies, given current market conditions.

(5) Restricted Assets

Pursuant to the Indentures, all revenues of the Enterprise (except amounts on deposit in the rebate fund) are irrevocably pledged to the punctual payment of debt service on the Water Revenue and Refunding Bonds. Accordingly, the revenues of the Enterprise shall not be used for any other purpose while any of its Water Revenue and Refunding Bonds are outstanding, except as expressly permitted by the Indentures. Further, all revenues shall be deposited by the City Treasurer, by instruction of the Enterprise, in special funds designated as the Water Enterprise Revenue Fund (the Water Revenue Fund), which must be maintained in the City Treasury. These funds, held at the City Treasury, are recorded in the statements of net assets of the Enterprise as deposits and investments with the City Treasury. Deposits in the Water Revenue Fund, including earnings thereon, shall be appropriated, transferred, expended, or used for the following purposes pertaining to the financing, maintenance, and operation of the Enterprise in accordance with the following priority:

1. The payment of operation and maintenance expenses for such utility and related facilities.
2. The payment of pension charges and proportionate payments to such compensation and other insurance or outside reserve funds as the Enterprise may establish or the Board of Supervisors may require with respect to employees of the Enterprise.
3. The payment of principal, interest, reserve, sinking fund, and other mandatory funds created to secure Revenue Bonds issued by the Enterprise for the acquisition, construction, or extension of facilities owned, operated, or controlled by the Enterprise.
4. The payment of principal and interest on General Obligation Bonds issued by the City for the Enterprise's purposes.
5. Reconstruction and replacement as determined by the Enterprise or as required by any of the Enterprise's Revenue Bond ordinances duly adopted and approved.
6. The acquisition of land, real property, or interest in real property for, and the acquisition, construction, enlargement, and improvement of, new and existing buildings, structures, facilities, equipment, appliances, and other property necessary or convenient to the development or improvement of such utility owned, controlled, or operated by the Enterprise; and for any other lawful purpose of the Enterprise, including the transfer of surplus funds pursuant to Section 6.407(e) of the City's Charter.

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In accordance with the Indenture, the Program maintains certain restricted cash and investment balances in trust. Restricted assets held in trust consisted of the following as of June 30, 2008 and 2007:

	2008	2007
Cash and investments with City Treasury:		
Water Revenue Bond Construction Fund	\$ 21,740	219,521
Cash and investments outside City Treasury:		
1991 Water Revenue Bond Fund	15	15
2001A Water Revenue Bond Fund	2,585	2,503
2002A Water Revenue Bond Fund	3,315	3,206
2002B Water Revenue Bond Fund	4,580	4,434
2006A Water Revenue Bond Fund	25,781	41,177
2006B Water Revenue Bond Fund	2,882	2,814
2006C Water Revenue Bond Fund	1,893	2,066
Total cash and investments outside City Treasury	41,051	56,215
Interest receivable:		
Water Bond Construction Fund	260	3,578
Total restricted assets	\$ 63,051	279,314

Restricted deposits listed above as deposits and investments with City Treasury are held in subfunds of the Water Revenue Fund of the City Treasury.

(6) Short-Term Debt

The Commission and Board of Supervisors have authorized the issuance of up to \$250 million in commercial paper. Pursuant to the voter-approved 2002 Proposition A, the Enterprise is authorized to issue up to \$1.628 billion of indebtedness, of which, \$507.8 million had been issued as of June 30, 2008. The Enterprise had no commercial paper notes outstanding as of June 30, 2008 and 2007.

SAN FRANCISCO WATER ENTERPRISE

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(Dollars in thousands, unless otherwise stated)

(7) Changes in Long-Term Liabilities

Long-term liability activities for the years ended June 30, 2008 and 2007 were as follows:

	Interest rate	Final maturity date	July 1, 2007	Additions	Reductions	June 30, 2008	Due within one year
Revenue Bonds:							
2001A Revenue Bonds (c)	4.0 – 5.0%	2031	\$ 83,115	—	(2,705)	80,410	2,830
2002A Revenue Bonds (d)	2.5 – 5.0	2032	153,570	—	(2,950)	150,620	3,100
2002B Revenue Refunding Bonds (e)	3.0 – 5.0	2015	63,495	—	(5,915)	57,580	6,155
2006A Revenue Bond (f)	4.0 – 5.0	2036	507,815	—	(2,585)	505,230	8,170
2006B Revenue Refunding Bonds (g)	4.0 – 5.0	2026	110,065	—	(2,835)	107,230	2,985
2006C Revenue Refunding Bonds (h)	4.0 – 5.0	2026	48,020	—	(2,180)	45,840	2,280
Less deferred amounts:							
For issuance premiums			26,912	—	(960)	25,952	—
For refunding loss			(15,388)	(119)	1,055	(14,452)	—
Total revenue bonds payable			977,604	(119)	(19,075)	958,410	25,520
Capital appreciation bonds (a)	7.0	2019	3,155	225	—	3,380	—
Other post employment benefits obligation			—	15,048	—	15,048	—
Accrued vacation and sick leave			11,171	7,500	(7,815)	10,856	5,738
Accrued workers' compensation			8,346	1,557	(1,768)	8,135	1,512
Damage and claims liability			6,934	13,104	(8,784)	11,254	3,011
Environmental cleanup liability (note 13)			6,618	168	(4,092)	2,694	2,339
Total long-term liabilities			\$ 1,013,828	37,483	(41,534)	1,009,777	38,120

	Interest rate	Final maturity date	July 1, 2006	Additions	Reductions	June 30, 2007	Due within one year
Revenue Bonds:							
1996A Revenue Refunding Bonds (b)	5.0 – 6.5%	2026	\$ 52,630	—	(52,630)	—	—
2001A Revenue Bonds (c)	4.0 – 5.0	2031	85,675	—	(2,560)	83,115	2,705
2002A Revenue Bonds (d)	2.5 – 5.0	2032	156,375	—	(2,805)	153,570	2,950
2002B Revenue Refunding Bonds (e)	3.0 – 5.0	2015	69,205	—	(5,710)	63,495	5,915
2006A Revenue Bond (f)	4.0 – 5.0	2036	507,815	—	—	507,815	2,585
2006B Revenue Refunding Bonds (g)	4.0 – 5.0	2026	110,065	—	—	110,065	2,835
2006C Revenue Refunding Bonds (h)	4.0 – 5.0	2026	—	48,730	(710)	48,020	2,180
Less deferred amounts:							
For issuance premiums			27,487	503	(1,078)	26,912	—
For issuance discounts			(1,268)	—	1,268	—	—
For refunding loss			(13,559)	(2,861)	1,032	(15,388)	—
Total revenue bonds payable			994,425	46,372	(63,193)	977,604	19,170
Capital appreciation bonds (a)	7.0	2019	2,945	210	—	3,155	—
Accrued vacation and sick leave			10,395	8,146	(7,370)	11,171	5,761
Accrued workers' compensation			8,719	1,658	(2,031)	8,346	1,699
Damage and claims liability			5,800	4,518	(3,384)	6,934	1,652
Environmental cleanup liability (note 13)			8,077	1,100	(2,559)	6,618	5,311
Total long-term liabilities			\$ 1,030,361	62,004	(78,537)	1,013,828	33,593

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(a) Capital Appreciation Bonds

The capital appreciation bonds mature from November 1, 2018 through November 1, 2019. Interest on the capital appreciation bonds is due upon maturity and is recognized as annual interest expense over the life of the bonds using the interest method. The Enterprise has recognized \$3,380 and \$3,155 of unpaid principal and interest on the capital appreciation bonds as of June 30, 2008 and 2007, respectively, and has reported it as capital appreciation bonds in the accompanying statements of net assets.

(b) Water Revenue Refunding Series 1996A

During fiscal year 1997, the Enterprise issued \$131,470 of 1996 Series A Water Revenue Bonds (1996 Series A Bonds) with interest rates ranging from 5.0% to 6.5% and maturing on November 1, 2026. In March 2006, \$62,665 of the 1996 Series A serial and term bonds with maturities of November 2007 to November 2026 were refunded by the 2006 Refunding Series B Water Revenue Bonds. In July 2006, the remaining amount of the 1996 Series A bonds were refunded and defeased by the 2006 Refunding Series C Water Revenue Bonds.

(c) Water Revenue Bonds Series 2001A

During fiscal year 2002, the Enterprise issued \$140,000 of Water Revenue Bonds 2001 Series A (2001 Series A Bonds). The bonds were insured by FSA and carried Aaa and AAA ratings from Moody's and Standard & Poor's, respectively. The Revenue Bonds include current interest serial and term bonds with interest rates varying from 4% to 5%. The current interest serial bonds mature through November 1, 2021 and the current interest term bonds mature on November 1, 2024, 2027, and 2031. In March 2006, \$45,630 of the 2001 A serial and term bonds with maturities of November 2016 to November 2024 were refunded by the 2006 Refunding Series B Water Revenue Bonds.

(d) Water Revenue Bonds Series 2002A

During fiscal year 2003, the Enterprise issued \$164,000 of Water Revenue Bonds 2002 Series A (2002 Series A Bonds). The bonds were insured by MBIA and carried Aaa and AAA ratings from Moody's and Standard & Poor's, respectively. The Revenue Bonds include interest and serial and term bonds with interest rates varying from 2.5% to 5.0%. The current interest serial bonds mature through November 1, 2026 and the current interest term bonds mature on November 1, 2025 and 2032.

(e) Water Revenue Refunding Series 2002B

During fiscal year 2003, the Enterprise issued 2002 Water Revenue Refunding Bonds, Series B (the 2002B Refunding Bonds) in the amount of \$85,260 with interest rates ranging from 3% to 5%. The bonds were insured by MBIA and carried Aaa and AAA ratings from Moody's and Standard & Poor's, respectively. The current interest serial bonds mature through November 1, 2015.

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(f) Water Revenue Bonds Series 2006A

During fiscal year 2006, the Enterprise issued 2006 Water Revenue Bonds, Series A (the 2006 Series A Bonds) in the amount of \$507,815. The purpose of the bonds is to finance improvements to the City's water systems pursuant to Proposition A and to retire commercial paper outstanding. The bonds were insured by FSA and carried Aaa and AAA ratings from Moody's and Standard & Poor's, respectively. The 2006 Series A Bonds include current interest and serial and term bonds with interest rates ranging from 4% to 5%. The current interest serial bonds mature through November 1, 2027 and the current interest term bonds mature on November 1, 2031 and 2033 and 2036.

(g) Revenue Refunding Bonds Series 2006B

During fiscal year 2006, the Enterprise issued 2006 Water Revenue Refunding Bonds, Series B (the 2006B Refunding Bonds) in the amount of \$110,065. The purpose of the bonds is to refund a portion of the 1996A Series A Bonds and the 2001 Series A Bonds. The bonds were insured by Syncora (formerly XL) and carried Aaa and AAA ratings from Moody's and Standard & Poor's, respectively. The 2006B Refunding Bonds include serial bonds with interest rates varying from 4% to 5%. The current interest serial bonds mature through November 1, 2026.

(h) Revenue Refunding Bonds Series 2006C

During fiscal year 2007, the Enterprise issued 2006 Water Revenue Refunding Bonds, Series C (the 2006 Refunding Bonds) in the amount of \$48,730 for the purpose of refunding the remaining portion of the outstanding 1996 Series A Bonds maturing on and after November 1, 2007 (the Refunded 1996 Series A Bonds). The bonds were insured by Syncora (formerly XL) and carried Aaa and AAA ratings from Moody's and Standard & Poor's, respectively. The 2006C Refunding Bonds include serial bonds with interest rates varying from 4% to 5%. The current interest serial bonds mature through November 1, 2026.

The Enterprise applied a portion of the proceeds from sale of the 2006 Refunding Series C Bonds to establish an irrevocable escrow to refund and legally defease, on a current basis, the Refunded 1996 Series A Bonds.

A portion of the proceeds on the 2006 Refunding Series C Bonds were deposited with the Trustee, acting as escrow agent under the irrevocable Refunding Instructions, dated August 1, 2006, given by the Enterprise to the escrow agent.

The amounts deposited from the proceeds of the 2006 Refunding Series C Bonds, together with certain other available moneys, were held by the escrow agent under the Refunding Instructions and invested in noncallable Federal Securities (as described in the Indenture) consisting of United States Treasury Securities-State and Local Government Series (SLGS), the principal of and interest on which, when received, were sufficient to pay the principal redemption price of, including premium and interest on the Refunded 1996 Series A Bonds on November, 2006, by optional redemption on that date.

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The 1996 Series A Bonds maturing on November 1, 2006, in the principal amount of \$4,375 remained outstanding following the issuance of the 2006 Refunding Series C Bonds, and paid by the Enterprise from its funds at maturity on November 1, 2006.

The refunding resulted in the recognition of a deferred accounting loss of \$2,861, the Enterprise in effect reduced its aggregate debt service payments by approximately \$2,887 (based on average interest rates of 4.415% and 5.012% for the new debt and old debt, respectively). The economic gain for this refunding based on net present values is calculated to be \$1,581.

(i) Future Annual Debt Service of Revenue Bonds

The future annual debt service relating to the Revenue and Refunding Bonds outstanding as of June 30, 2008 is as follows:

	Principal	Interest
Years ending June 30:		
2009	\$ 25,520	44,065
2010	26,605	42,991
2011	27,795	41,784
2012	29,190	40,401
2013	30,610	38,984
2014 – 2018	159,260	171,728
2019 – 2023	152,595	135,624
2024 – 2028	179,985	95,631
2029 – 2033	199,000	50,041
2034 – 2037	116,350	11,308
	946,910	\$ 672,557
Less current portion	(25,520)	
Add unamortized bond premium, net of discount and refunding loss	11,500	
Long – term portion as of June 30, 2008	\$ 932,890	

As defined in the Indentures, the principal and interest of the Enterprise’s Revenue and Refunding Bonds are payable from its corresponding revenue, as well as monies deposited in certain funds and accounts pledged thereto (note 5).

(j) Proposition A

On November 5, 2002, the San Francisco voters passed Proposition A, which provides for the issuance of revenue bonds and/or other forms of indebtedness by the Commission in a principal amount not to exceed \$1.628 billion to finance the acquisition and construction of improvements to the City’s Water System. As of June 30, 2008, no commercial paper was outstanding pursuant to this authorization and \$507.8 million of bonds had been issued against this authorization.

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(8) Revenue Pledge

The Enterprise has pledged future revenues to repay various revenue bonds. Proceeds from the revenue bonds provided financing for various capital construction projects, and to refund previously issued bonds. The bonds are payable solely from revenues of the Enterprise and are payable through the year ending 2036. Annual principal and interest payments on the bonds are expected to require less than 57% of future revenues through the year 2036.

The original amount of revenue bonds issued, total principal and interest remaining, principal and interest paid during 2008, and applicable revenues for 2008 are as follows:

	<u>2008</u>
Bonds issued with revenue pledge	\$ 1,108,500
Principal and interest remaining due at the end of the year	1,619,467
Principal and interest paid during the year	64,193
Net revenue for the year ended June 30	143,926

(9) Suburban Water Rate Agreement

During 1984, the City entered into a Settlement Agreement and Master Water Sales Contract (the Suburban Water Rate Agreement) with certain suburban customers, which establishes the basis for water rates to be charged to those customers (the Suburban Purchasers). Pursuant to the terms of the Suburban Water Rate Agreement, the City is required to establish water rates applicable to the Suburban Purchasers at the beginning of each fiscal year. The suburban water rates are based on an estimate of the level of revenues necessary to recoup the cost of distributing water to the Suburban Purchasers in accordance with the methodology outlined in Article IV of the Suburban Water Rate Agreement (the Suburban Revenue Requirement). During fiscal years 2008 and 2007, the Suburban Revenue Requirement, net of adjustments, charged to such suburban customers was \$115,927 and \$108,448, respectively. Such amounts are subject to final review by the suburban customers, based on the Suburban Revenue Requirement calculation.

Pursuant to Article V, Section 5.07 of the Suburban Water Rate Agreement, the City is required to recompute the Suburban Revenue Requirement after the close of each fiscal year based on the actual costs incurred in the delivery of water to the Suburban Purchasers. The difference between the suburban revenues earned during the year and the “actual” Suburban Revenue Requirement is recorded in a separate account (the Balancing Account) and represents the cumulative amount that is either owed to the Suburban Purchasers (if the suburban revenues exceed the Suburban Revenue Requirement) or owed to the City (if the Suburban Revenue Requirement exceeds the suburban revenues paid). In accordance with Article V of the Suburban Water Rate Agreement, the amount recorded in the Balancing Account shall earn interest at a rate equal to the average rate received by the City during the year on the invested pooled funds of the City Treasurer, and shall be taken into consideration in the determination of subsequent suburban water rates. Upon the expiration of the Suburban Water Rate Agreement, the remaining balance in the Balancing Account shall be settled between the City and the Suburban Purchasers. As of June 30, 2008 and 2007, the Suburban Purchasers owed the Enterprise \$13,870 and \$11,866, respectively, under the terms of the

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Suburban Water Rate Agreement. Subsequently, the June 30, 2007 amount was revised to \$12,882, based on the audited final balancing account statement dated September 4, 2008.

(10) Employee Benefits

(a) Retirement Plan

Plan Description – The Enterprise participates in the City’s single-employer defined benefit retirement plan (the Plan) which is administered by the San Francisco City and County Employees’ Retirement System (the Retirement System). The Plan covers substantially all full-time employees of the Enterprise along with other employees of the City. The Plan provides basic service retirement, disability, and death benefits based on specified percentages of final average salary and provide cost-of-living adjustments after retirement. The Plan also provides pension continuation benefits to qualified survivors. The San Francisco City and County Charter and Administrative Code is the authority which establishes and amends the benefit provisions and employer obligations of the Plan. The Retirement System issues a publicly available financial report that includes financial statements and required supplementary information for the Plan. That report may be obtained by writing to the San Francisco City and County Employees’ Retirement System, 30 Van Ness Avenue, Suite 3000, San Francisco, CA 94102, or by calling (415) 487-7020.

Funding Policy – Contributions are made to the basic plan by both the Enterprise and its employees. Employee contributions are mandatory. Employee contribution rates for 2008, 2007 and 2006 varied from 5.0% to 8% as a percentage of covered payroll. Due to certain bargaining agreements, the Enterprise contributed from 0.5% to 8% of covered payroll on behalf of some employees. In addition, the Enterprise is required to contribute for 2008, 2007 and 2006 at an actuarially determined rate as a percentage of covered payroll of 5.91%, 6.24% and 6.58%, respectively. The Enterprise’s required contribution was approximately \$7,694 in 2008, \$7,614 in 2007 and \$7,322 in 2006.

(b) Health Care Benefits

Health care benefits of the Enterprise employees, retired employees and surviving spouses are financed by beneficiaries and by the City through the City and County of San Francisco Health Service System (the Health Service System). The Enterprise’s annual contribution, which amounted to approximately \$18,660 and \$16,866 in fiscal years 2008 and 2007, respectively, is determined by a San Francisco Charter provision based on similar contributions made by the 10 most populous counties in California.

Included in these amounts are \$5,518 and \$4,903 for 2008 and 2007, respectively, to provide post retirement benefits for retired employees, on a pay-as-you-go basis.

The City has determined a Citywide Annual Required Contribution (ARC) and OPEB cost based upon an actuarial valuation performed in accordance with GASB 45, by the City’s actuaries. The City has allocated \$20,566 of the Citywide ARC and OPEB cost to the Enterprise for the year ended June 30, 2008 based upon its percentage of Citywide payroll costs. The difference between the

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allocation and the amount paid was \$15,048 which has been recorded as a net OPEB obligation by the Enterprise as of June 30, 2008.

The City issues a publicly available financial report that includes the complete note disclosures and Required Supplementary Information (RSI) related to the City's post retirement health care obligations. The report may be obtained by writing to the City and County of San Francisco, Office of the Controller, 1 Dr. Carlton B. Goodlett Place, Room 316, San Francisco, CA 94102, or by calling (415) 554-7500.

(c) Wellness Incentive Program

Effective July 1, 2002, the City established a pilot "Wellness Incentive Program" (the Wellness Program) to promote workforce attendance. Under the Wellness Program, any full-time employee leaving the employment of the City upon service or disability retirement may receive payment of a portion of accrued sick leave credits at the time of separation.

The amount of this payment shall be equal to two and one-half percent of accrued sick leave credits at the time of separation times the number of whole years of continuous employment times an employee's salary rate, exclusive of premiums or supplements, at the time of separation. Vested sick leave credits, as set forth under Civil Service Commission Rules, shall not be included in this computation.

The Wellness Program shall be discontinued upon the expiration of current bargaining agreements on June 30, 2009 through June 30, 2010.

(11) Related Parties

During 2008 and 2007, the Enterprise delivered water without charge to certain City departments which amounted to \$1,072 and \$7,553, respectively, based on metered usage and applicable water rates, which has been excluded from operating revenues in the accompanying financial statements. Beginning in fiscal year 2008, the Enterprise charged all City departments for water with the exception of fire hydrants that are under the control of the Fire Department. See note 14.

Various common costs incurred by the Commission are allocated proratably between the Enterprise, Hetch Hetchy, and the Wastewater Enterprise. The allocations are based on the Commission management's best estimate and may change from year to year depending on the activities incurred by each Enterprise and the information available. For the year ended June 30, 2008, the Commission allocated \$28,480 in administrative costs to the Enterprise. For the year ended June 30, 2007, the Commission allocated \$29,085 in administrative costs to the Enterprise.

The Enterprise purchases water from Hetch Hetchy. This amount, totaling \$21,000 for year ended June 30, 2008 and \$19,037 for year ended June 30, 2007, has been included in the services provided by other departments in the accompanying financial statements.

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The Enterprise purchases electricity from Hetch Hetchy. This amount, totaling \$5,485 and \$5,596 for the years ended June 30, 2008 and 2007, respectively, has been included in services provided by other departments in the accompanying financial statements.

A variety of City departments provide services such as engineering, purchasing, legal, data processing, telecommunications, and human resources to the Enterprise and charge amounts designed to recover those departments' costs. These charges totaling \$8,213 and \$8,609 for the years ended June 30, 2008 and 2007, respectively, have been included in services provided by other departments in the accompanying financial statements.

During fiscal year ending June 30, 2007 the Enterprise took ownership of 525 Golden Gate Avenue property from the City's General Fund for a total consideration of \$9,900 which was reported as a transfer. As of fiscal year 2007, \$5,085 had been paid and the remaining \$4,815 was paid in fiscal year 2008.

(12) Risk Management

The Enterprise's risk management program encompasses both self-insured and insured coverage. Risk assessments and coverage are coordinated by the City's Office of Risk Management. With certain exceptions, the City and the Enterprise's general policy is to first evaluate self-insurance for the risk of loss to which it is exposed. Based on this analysis, mitigating risk through a 'self-retention' mechanism is more economical as it manages risks internally and administers, adjusts, settles, defends, and pays claims from budgeted resources (i.e. *pay-as-you-go* fund). When economically more viable or when required by debt financing covenants, the Enterprise obtains commercial insurance. At least annually, the City actuarially determines general liability and workers' compensation risk exposures. The Enterprise does not maintain commercial earthquake coverage, with certain minor exceptions, such as a sub-limit for fire-sprinkler leakage due to earthquake under the Property Insurance program.

Primary risks	Typical coverage approach
General liability	Self-insure
Property	Purchase insurance and self-insure
Workers' compensation	Self-insure through citywide pool
Other risks	Typical coverage approach
Surety bonds	Purchased and contractually transferred
Professional liability	Combination of self-insure, purchased insurance and contractual risk transfer
Errors and omissions	Combination of self-insure, purchased insurance and contractual risk transfer
Builders risk	Purchased insurance and contractual risk transfer

(a) Damage and Claims Liability

Through coordination with the Controller and the City Attorney's Office, the general liability risk exposure is actuarially determined and is addressed through pay-as-you-go funding as part of the

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budgetary process. Associated costs are also booked as expenses as required under Generally Accepted Accounting Principles (GAAP) for financial statement purposes for both the Enterprise and the City and County of San Francisco’s Comprehensive Annual Financial Report (CAFR). The claim expense allocations are determined based on actuarially determined anticipated claim payments and the projected timing of disbursement.

Property

The Enterprise’s property risk management approach varies depending on whether the facility is currently under construction, or if the property is part of revenue-generating operations. For new construction projects, the Enterprise has utilized traditional insurance, owner-controlled insurance programs (OCIPs) or other alternative insurance programs. Under the latter two approaches, the insurance program usually provides coverage for the entire construction project, along with multiple risk coverages, such as for general liability, property damage and workers compensation, for example. When a traditional insurance program is used for property risks, the Enterprise requires each contractor to provide its own insurance, while ensuring that the full scope of work be covered with satisfactory levels to limit the Enterprise’s risk exposure. The majority of purchased insurance program is for either: 1) revenue-generating facilities, 2) debt-financed facilities, and 3) mandated coverage to meet statutory requirements for bonding of various public officials.

The changes for the Damage and Claims Liabilities for the years ended June 30, 2008 and 2007 are as follows:

	<u>Beginning of year</u>	<u>Claims and changes in estimates</u>	<u>Claims paid</u>	<u>End of year</u>
2006 – 2007	\$ 5,800	4,518	(3,384)	6,934
2007 – 2008	6,934	13,104	(8,784)	11,254

(b) Workers’ Compensation

The City actuarially determines and allocates workers’ compensation costs to the Enterprise according to a formula based on the following: (i) the dollar amount of claims; (ii) yearly projections of payments based on historical experience; and (iii) the size of the Enterprise’s payroll. The administration of workers’ compensation claims and payouts are handled by the Workers’ Compensation Division of the City’s Department of Human Resources. Statewide workers’ compensation reforms have resulted in budgetary savings in recent years. The City continues to develop and implement improved programs, such as return-to-work programs, to lower or mitigate the growth of workers’ compensation costs. Programs include: accident prevention, investigation and duty modification for injured employees with medical restrictions so return to work can occur as soon as possible.

SAN FRANCISCO WATER ENTERPRISE

Notes to Financial Statements

June 30, 2008 and 2007

(Dollars in thousands, unless otherwise stated)

The changes in the liabilities for Worker’s Compensation for the years ended June 30, 2008 and 2007 are as follows:

	<u>Beginning of year</u>	<u>Claims and changes in estimates</u>	<u>Claims paid</u>	<u>End of year</u>
2006 – 2007	\$ 8,719	1,658	(2,031)	8,346
2007 – 2008	8,346	1,557	(1,768)	8,135

(c) Surety Bonds

Bonds are required in most phases of the public works construction contracting process for such phases, as bid, performance, and payment or maintenance. Additionally, bonds may be required in other contracts where goods or services are provided to ensure compliance with applicable terms and conditions such as warranty. Additionally, all public officials with financial oversight responsibilities are bonded, including Commission members, the General Manager and the Chief Financial Officer.

(d) Professional Liability, Errors, and Omissions

Professional liability policies are either directly purchased insurance on behalf of the Enterprise, transferred through contract to the contracted professional, or retained through self-insurance on a case by case basis depending on the size, complexity or scope of construction or professional service contracts. Examples of contracts providing any form of the coverages described are engineers, architects, design professionals and other licensed or certified professional service providers.

(e) Builders Risk

Builder’s Risk policies of insurance are required to be provided either through OCIP or the contractor on all construction projects for the full value of the construction.

(f) Owner Controlled Insurance Program

As of June 30, 2008, the Enterprise has one OCIP program in final closeout phase. The program was ended in February of 2006 and has been in process of closeout. Additional retroactive premium adjustment payments in the amount of \$438 were accrued as of June 30, 2008. The retroactive adjustment is due to final audits of contractor payrolls for the program period as well as a contract required retro-rate increase. Final closeout is expected during the fiscal year ending June 30, 2009, and the Enterprise has no further obligation for claims funding beyond these premium adjustments.

For more information about how the Enterprise’s risk management program consolidates into and is coordinated with the City’s, please see the City’s CAFR Note 16.

SAN FRANCISCO WATER ENTERPRISE

Notes to Financial Statements

June 30, 2008 and 2007

(Dollars in thousands, unless otherwise stated)

(13) Commitments and Litigation

(a) *Commitments*

As of June 30, 2008 and 2007, the Enterprise has outstanding commitments with third parties of \$134,715 and \$140,494, respectively, for various capital projects and other purchase agreements for materials and services.

(b) *Grants*

Grants that the Enterprise receives are subject to audit and final acceptance by the granting agency. Current and prior year costs of such grants are subject to adjustment upon audit.

(c) *Litigation*

The Enterprise is a defendant in various legal actions and claims that arise during the normal course of business, although the final disposition of those legal actions and claims is not determinable. However, in the opinion of management, the outcome of any litigation of these matters will not have a material effect on the financial position or results of operations of the Enterprise.

(d) *Environmental Issue*

The Enterprise owns approximately 23 acres of land in the city of Menlo Park, which it formerly subleased to a third party. During the life of the lease, the tenant conducted a business on the premises that caused contamination to the property and surrounding areas. In July 1999, the staff of the California Regional Water Quality Control Board (CRWQCB) issued an interim directive instructing the Commission to develop a remedial action plan that addresses environmental contamination located at this property. In response to the directive, the Commission completed an interim remedial action plan. During fiscal year 2002, the Commission received the final directive from the CRWQCB instructing the Commission to execute a remedial action plan with regard to this issue. As of June 30, 2008 and 2007, the environmental cleanup liability reported in the accompanying statements of net assets amounts to \$2,694 and \$6,618, respectively. The Enterprise paid \$4,101 and \$2,559 in fiscal years 2008 and 2007, respectively, in accordance with the remedial action plan.

(14) Proposition 218 Compliance

Proposition 218, which added Articles XIII C and XIII D to the California Constitution in 1996, imposes procedural and substantive requirements on the adoption and collection of "property-related fees" adopted by local agencies. After almost ten years of controversy and litigation over applicability of proposition 218 to consumption-based utility fees, the California Supreme Court issued its opinion in *Bighorn-Desert View Water Agency v. Verjil* 39 Cal.App-4th 205 (2006) in July 2006, determining that such consumption-based fees are subject to the procedural and substantive requirements of Proposition 218. Given the *Bighorn* decision, in order to bring the Enterprise into compliance with Proposition 218, the Enterprise changed its methodology for rate setting and implemented the changes with the next rate adjustment process, which became effective July 1, 2007. The Enterprise also discontinued providing free water service to certain City departments in fiscal year 2008.

SAN FRANCISCO WATER ENTERPRISE

Notes to Financial Statements

June 30, 2008 and 2007

(Dollars in thousands, unless otherwise stated)

(15) Subsequent Event

The Enterprise is authorized to issue \$250,000 in commercial paper (CP), none of which was outstanding as of June 30, 2008 or 2007. The Enterprise issued \$150,000 on July 2, 2008. On October 2, 2008, \$59,000 matured and reissue was delayed until November 25, 2008 due to market conditions. The remaining outstanding balance of \$91,000 is currently being remarketed by JP Morgan.



KPMG LLP
55 Second Street
San Francisco, CA 94105

**Report on Internal Control over Financial Reporting and on Compliance and
Other Matters Based on an Audit of Financial Statements
Performed in Accordance with *Government Auditing Standards***

The Honorable Mayor and Board of Supervisors
City and County of San Francisco, California:

We have audited the financial statements of the San Francisco Water Enterprise (the Enterprise), a department of the City and County of San Francisco, California (the City) as of and for the year ended June 30, 2008, and have issued our report thereon, dated December 5, 2008. Our audit report included an explanatory paragraph related to the Enterprise adoption of the provision of Governmental Accounting Standards Board Statement No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions*, as of July 1, 2007. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States.

Internal Control over Financial Reporting

In planning and performing our audit, we considered the Enterprise's internal control over financial reporting as a basis for designing our auditing procedures for the purpose of expressing an opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Enterprise's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of the Enterprise's internal control over financial reporting.

Our consideration of internal control over financial reporting was for the limited purpose described in the preceding paragraph and would not necessarily identify all deficiencies in internal control that might be significant deficiencies or material weaknesses. However, as discussed below, we identified certain deficiencies in internal control over financial reporting that we consider to be significant deficiencies.

A control deficiency exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis. A significant deficiency is a control deficiency, or combination of control deficiencies, that adversely affects the entity's ability to initiate, authorize, record, process, or report financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the entity's financial statements that is more than inconsequential will not be prevented or detected by the entity's internal control over financial reporting. We consider the deficiencies described in the accompanying schedule of findings and responses as 08-01, 08-02 and 08-03 to be significant deficiencies in internal control over financial reporting.

A material weakness is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected by the entity's internal control. Our consideration of the internal control over financial reporting was for the limited purpose described in the first paragraph of this section and would not

necessarily identify all deficiencies in the internal control that might be significant deficiencies and, accordingly, would not necessarily disclose all significant deficiencies that are also considered to be material weaknesses. However, we believe that none of the significant deficiencies described above is a material weakness.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the Enterprise's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*.

The Enterprise's response to the finding identified in our audit is described in the accompanying schedule of findings and responses. We did not audit the Enterprise's response and, accordingly, we express no opinion on it.

This report is intended solely for the information and use of the City and County of San Francisco Government Audit and Oversight Committee, the Commission and management, and is not intended to be and should not be used by anyone other than these specified parties.

KPMG LLP

December 5, 2008

SAN FRANCISCO WATER ENTERPRISE

Schedule of Findings and Responses

Year ended June 30, 2008

2008-01 Lack of controls over the reporting of capital assets

Criteria

A control deficiency exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis.

Condition

We noted that a check for \$2.3 million to settle a lawsuit was incorrectly posted to capital assets, specifically the construction in progress account. This resulted in an overstatement of capital assets.

Cause

An adequate control over the reconciliation and review of the construction in progress account was not performed.

Recommendation

As part of the year-end closing process, management should ensure that the capital asset accounts are reconciled and that the reconciliations are appropriately reviewed. This will help ensure that transactions recorded to account balances are discussed and if necessary, corrected in a timely manner.

Management Response

Management concurs. The entry was unusual, not identified timely, and not corrected properly. Procedures have been implemented to ensure that unusual entries are identified and corrected in a timely manner.

SAN FRANCISCO WATER ENTERPRISE

Schedule of Findings and Responses

Year ended June 30, 2008

08-02 Lack of control over the review of the suburban water rate agreement balancing account.

Criteria

A control deficiency exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis.

Condition and Context

We found that the suburban water rate balancing account was understated by approximately \$1.5 million. This understatement was a result of approximately \$3.4 million of work order recoveries for services provided to other City departments (general and administrative expenses) being recorded as reductions to expenses, instead of revenues.

Cause

An adequate control over the review of the suburban water rate balancing account calculation was not in place for purposes of preparing the financial statements.

Recommendation

Management should implement a process to ensure that the suburban water rate agreement balancing account calculation is adequately reviewed. We recommend that, as part of the preparation and review process, management incorporate analytical reviews to identify unexpected differences, investigate them, and amend the suburban water rate balancing account interim calculation as appropriate.

Management Response

Management concurs. The calculation for and entry to adjust the balancing account was based on an estimate that was not updated after the actual amounts were known. Additional review processes have been established to ensure that the interim calculation of the balancing account is reasonable and appropriate.

SAN FRANCISCO WATER ENTERPRISE

Schedule of Findings and Responses

Year ended June 30, 2008

2008-3 Lack of control over the review of the cash flow statement presentation of acquisition and construction of capital assets and cash paid to suppliers for goods and services

Criteria

A control deficiency exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis.

Condition and Context

Non-capitalizable costs of approximately \$5.4 million were included as additions to construction in progress and as deletions to construction in progress. This impacted the cash flow statement causing an overstatement of acquisition and construction of capital assets and an understatement of cash paid to suppliers for goods and services. This also resulted in a gross up of additions and deletions in note 4 of the financial statements.

Cause

The Water Enterprise has a process in place to capitalize all costs to construction in progress. Non-capitalizable costs are then removed as deletions as part of the year-end reporting process.

Recommendation

Management should ensure that the statement of cash flows and the notes to the financial statements are appropriately adjusted to correct this gross up.

Management Response

Management concurs. Processes that are in place have been communicated to staff and an additional level of review has been added to ensure that capital asset additions are properly reported.