KPMG

# HETCH HETCHY WATER AND POWER ENTERPRISE

Financial Statements

June 30, 2008 and 2007

(With Independent Auditors' Report Thereon)

## HETCH HETCHY WATER AND POWER ENTERPRISE

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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 Hetch Hetchy Water and Power 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 Enterprise 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 12 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(o) and 7(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

# HETCH HETCHY WATER AND POWER ENTERPRISE

Management's Discussion and Analysis

June 30, 2008 and 2007

(Dollars in thousands)

This section presents management's analysis of the San Francisco Hetch Hetchy Water and Power'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 dollar 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 was established as a result of the Raker Act of 1913, which granted water and power resource rights-of-way on the Tuolumne River in Yosemite National Park and the Stanislaus National Forest to the City. The Enterprise is engaged in the collection and conveyance of approximately 85% of the City's water supply and in the generation and transmission of electricity from that resource. Approximately half of the electricity generated by the Enterprise is used by the City's municipal customers (including the San Francisco Municipal Railway, Recreation and Parks Department, the Port of San Francisco, San Francisco General Hospital, street lights, Moscone Center, and the SFPUC Water and Wastewater enterprises). The balance of electricity is sold to other publicly owned utilities, such as the Turlock and Modesto Irrigation Districts. The Enterprise includes a system of reservoirs, hydroelectric power plants, aqueducts, pipelines, and transmission lines, carrying water and power more than 165 miles from Sierra Nevada to customers in the City and portions of the surrounding San Francisco Bay Area.

**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.

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, non-capital, 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 exclude 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

### *Financial Highlights for Fiscal Year 2008*

- The total assets of the Enterprise exceed the total liabilities by $421,156.
- Net assets decreased by $14,689, or 3.4%, during the fiscal year.
- Capital assets (net of accumulated depreciation) decreased by $19,444, or 7.0%, to $259,376.
- During the fiscal year, operating revenue, which excludes interest and investment income and other nonoperating revenue, increased by $11,631, or 10.7%, to $119,855.
- Operating expenses increased by $14,416, or 15.2%, to $109,436.

(Dollars in thousands)

## *Financial Position*

**Table 1**

**Comparative Condensed Net Assets**

June 30, 2008, 2007, and 2006

| | 2008 | 2007 | 2006 | 2008 – 2007 Change | 2007 – 2006 Change |
|---|---|---|---|---|---|
| Current and other assets | $ 200,836 | 178,076 | 163,189 | 22,760 | 14,887 |
| Capital assets, net of accumulated depreciation | 259,376 | 278,820 | 270,073 | (19,444) | 8,747 |
| Total assets | 460,212 | 456,896 | 433,262 | 3,316 | 23,634 |
| Current liabilities | 22,209 | 14,847 | 14,262 | 7,362 | 585 |
| Long-term liabilities | 16,847 | 6,204 | 6,945 | 10,643 | (741) |
| Total liabilities | 39,056 | 21,051 | 21,207 | 18,005 | (156) |
| Net assets: | | | | | |
| Invested in capital assets, net of related debt | 259,376 | 278,820 | 270,073 | (19,444) | 8,747 |
| Unrestricted | 161,780 | 157,025 | 141,982 | 4,755 | 15,043 |
| Total net assets | $ 421,156 | 435,845 | 412,055 | (14,689) | 23,790 |

## *Fiscal Year 2008*

The Enterprise's net assets decreased by $14,689, or 3.4%, during the year (see Table 1). Contributing to this net decrease was an addition of $3,316 in total assets combined with an increase in total liabilities of $18,005. The largest portion of the Enterprise's net assets ($259,376, or 61.6%) represents investment in capital assets, net of related debt.

Current and other assets increased by $22,760, or 12.8% (see Table 1), the most significant portion of which was an increase in cash of $19,674, or 13.5% (see statements of cash flow for details). Interest and other receivables increased $2,741, or 77.6%, due to additional billings for the combustion turbine project. Deferred charges and other assets increased $2,120, from energy banked with Pacific Gas and Electric Company (PG&E) at fiscal year end. Due from other government agencies decreased by $1,149, or 6.5%, due to repayments received for the MECA (Mayor's Energy Conservation Account) loans. The loan receivable also decreased by $134, or 29.4%, due to repayments received from the San Francisco Housing Authority. In fiscal year 2008, the Enterprise received all of the prior year settlement proceeds from PG&E, and there was no addition to the receivable in the current year, resulting in a net decrease of $515, or 100%, in settlement receivables.

Total liabilities increased by $18,005, or 85.5%. The increase was primarily due to an increase in estimated damage and claims liabilities of $10,519, or 220.0%, as a result of pending litigation cases. Accounts payable increased by $2,776, or 27.9%, due to additional expenses in the current year compared to prior year. The other post employment benefits obligation liability increased by $2,723 due to the adoption of, 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. Deposits, advances and other liabilities also increased by $1,917, or 523.8%, mainly for deposits from PG&E of $1,842.

***Fiscal Year 2007***

The Enterprise's net assets increased by $23,790, or 5.8%, during the year (see Table 1). Contributing to this net increase was an addition of $23,634 in total assets combined with a decrease in total liabilities of $156. The largest portion of the Enterprise's net assets ($278,820, or 64.0%) represents investment in capital assets, net of related debt.

Current and other assets increased by $14,887 or 9.1% (see Table 1). The largest increase was in cash by $24,243 or 19.9% (see statements of cash flow for details). Interest and other receivables increased $2,543, or 257.4%, due to additional billings for the combustion turbine project. Due from other governmental agencies also had an increase of $1,982, or 12.6%, mainly as a result of a new receivable of $2,600 from Treasure Island Development Authority (TIDA) related to a loan made to construct an underwater transmission cable. However, charges for services receivable decreased by $4,620, or 32.9%, mostly due to lower power sales to third parties, the Modesto Irrigation District (MID), and the Turlock Irrigation District (TID). In fiscal year 2007, the Enterprise received all except $515 in settlement proceeds receivable from Pacific Gas and Electric Company (PG&E), and there was no addition to the receivable in the current year, resulting in a net decrease of $9,124, or 94.7%, from prior year.

Total liabilities also decreased by $156 or 0.7%. The decrease was primarily due to a reduction in damage and claims liabilities of $215. The Enterprise reached settlement with PG&E; therefore, there were no accrued liabilities at year-end.

(Dollars in thousands)

### *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

| | 2008 | 2007 | 2006 | 2008 – 2007 Change | 2007 – 2006 Change |
|---|---|---|---|---|---|
| Revenues: | | | | | |
| Charges for services | $ 119,630 | 108,009 | 139,627 | 11,621 | (31,618) |
| Rental income | 225 | 215 | 234 | 10 | (19) |
| Settlement proceeds | — | — | 9,639 | — | (9,639) |
| Interest and investment income | 6,420 | 6,478 | 3,564 | (58) | 2,914 |
| Other nonoperating revenues | 10,146 | 4,108 | 7,735 | 6,038 | (3,627) |
| Total revenues | 136,421 | 118,810 | 160,799 | 17,611 | (41,989) |
| Expenses: | | | | | |
| Operating expenses | (109,436) | (95,020) | (119,146) | (14,416) | 24,126 |
| Total operating expenses | (109,436) | (95,020) | (119,146) | (14,416) | 24,126 |
| Net income before transfers and special item | 26,985 | 23,790 | 41,653 | 3,195 | (17,863) |
| Special item: | | | | | |
| Impairment loss | (41,224) | — | — | (41,224) | — |
| Income (loss) before transfers | (14,239) | 23,790 | 41,653 | (38,029) | (17,863) |
| Transfers to City and County of San Francisco | (450) | — | — | (450) | — |
| Changes in net assets | (14,689) | 23,790 | 41,653 | (38,479) | (17,863) |
| Net assets at beginning of year | 435,845 | 412,055 | 370,402 | 23,790 | 41,653 |
| Net assets at end of year | $ 421,156 | 435,845 | 412,055 | (14,689) | 23,790 |

***Fiscal Year 2008***

The Enterprise's total revenue of $136,421 had increased by $17,611, or 14.8%, over the prior year. The majority of the increase for the year was primarily due to charges for services revenue of $11,621, or 10.8%, attributable to: increases in electricity sales of $3,369 to Modesto Irrigation District (MID), and Turlock Irrigation District (TID) and third party sales to other Municipalities and Governmental Agencies under Western System Power Pool (WSPP) agreements; increase in sales of $2,785 to City Departments; an increase in water assessment fees of $2,000 to San Francisco Water Enterprise; and an increase of $3,271 in revenue from Treasure Island Development Authority (TIDA) attributable mainly to a $2,029 reversal of allowance for doubtful accounts.

Other nonoperating revenue increased by $6,038, or 147.0% primarily due to: a $1,975 increase in incentive rebates from PG&E for self-generation; a $1,941 increase in reimbursement for the combustion turbine development costs; a $972 increase in license fee from the Trans Bay Cable project; a $215 increase in damage and claims collected by the City Attorney's Office on behalf of the Enterprise; and a $134 increase in overhead charges to other City departments for work performed through custom work orders.

The Enterprise's total operating expenses increased by $14,416, or 15.2%, to $109,436, primarily due to an increase in general and administrative and other operating expenses of $9,310, attributable to estimated claims. Power purchases also increased in the current year by $3,656 due to an increase in energy market prices, which was offset by $2,120 in costs related to power banked with PG&E. Other post employment benefits expense increased by $2,723 due to the adoption of GASB 45, as noted previously.

During the current fiscal year, the Enterprise wrote down $41,224 of the combustion turbine project and presented it under the special item category (see note 11 for details).

Overall, these changes result in the Enterprise having a decrease of net assets of $14,239 before transfers.

***Fiscal Year 2007***

The Enterprise's total revenue of $118,810 decreased by $41,989, or 26.1%, compared to fiscal year 2006. The majority of the decrease was from a change in service charges revenue of $31,618, or 22.6%. The reduction in revenue included decreased power sales of $21,493 to third parties, including reductions of $6,133 to Modesto Irrigation District and $5,539 to Turlock Irrigation District. Contracts with both Districts changed as a result of negotiating modifications to existing agreements, which reduced the Enterprise's obligation to procure energy when energy is not available for the Hetch Hetchy Project. The revised MID agreement was effective January 1, 2008 and the revised TID agreement was effective April 18, 2005. The most significant change in the agreements was that the Enterprise was no longer obligated to purchase market power, and then to resell that power to the Districts at a reduced contract price. The power purchase contract with the Calpine Corporation (Calpine) ended in the fiscal year 2006, resulting in decreased power purchases and decreased power sales. Additionally, two consecutive dry hydrological years reduced the amount of excess power available to sell to the Districts or other third parties. Settlement proceeds also declined by $9,639, or 100%, as claims with PG&E were settled in fiscal year 2006.

Other nonoperating revenue decreased by $3,627, or 46.9%. The largest decrease was in services to other governmental agencies of $1,264 due to completion of the energy research and development projects. Other significant decreases were due to a decline in reimbursement for combustion turbine projects' development cost by $1,173 and in PG&E rebates for self-generation incentive programs by $1,113.

(Dollars in thousands)

The Enterprise's total operating expenses decreased by $24,126, or 20.2%, to $95,020, primarily due to a decrease in power purchases from Calpine of $21,850. Other decreases were in general and administrative, and other operating expenses of $5,088 due to lower litigation and judgment expenses. Offsetting these decreases was the increase in personal service of $2,813 due to an increase in staffing and higher salaries.

Overall, these changes resulted in the Enterprise having an increase of net assets of $23,790.

## Capital Assets and Debt Administration

### *Capital Assets*

**Table 3**

**Capital Assets, Net of Depreciation**

Year ended June 30, 2008, 2007, and 2006

| | | 2008 | 2007 | 2006 | 2008 – 2007 Change | 2007 – 2006 Change |
|---|---|---|---|---|---|---|
| Facilities, improvement, machinery, and equipment | $ | 230,265 | 215,480 | 212,228 | 14,785 | 3,252 |
| Land and rights-of-way | | 4,594 | 4,215 | 4,215 | 379 | — |
| Construction work in progress | | 24,517 | 59,125 | 53,630 | (34,608) | 5,495 |
| Total | $ | 259,376 | 278,820 | 270,073 | (19,444) | 8,747 |

### *Fiscal Year 2008*

The Enterprise had net capital assets of $259,376 invested in a broad range of utility capital assets as of June 30, 2008. This amount represents a decrease of $19,444, or 7.0%, due to a combination of a $14,785 increase in structures, buildings, and equipment and a $34,608 net decrease in construction work in progress. The decrease includes the impairment loss of the combustion turbine project of $41,224. The investment in capital assets includes land, buildings, improvements, hydropower facilities, dams, transmission lines, machinery, and equipment.



(Continued)

(Dollars in thousands)

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

| | | |
|---|---|---|
| San Francisco Electrical Reliability Power Project | $ | 7,841 |
| Solar Project at San Francisco International Airport | | 3,778 |
| Street Light Underground Utilities | | 2,317 |
| San Joaquin Pipeline Improvement | | 1,190 |
| Kirkwood Powerhouse Rewind | | 1,144 |
| Solar Project at North Point Treatment Plant | | 1,063 |
| San Joaquin Pipeline #1 – Motor Lining | | 1,018 |
| Other project additions individually below $1,000 | | 12,907 |
| | $ | 31,258 |

Major facilities, improvements, machinery and equipment placed in service during the year ended June 30, 2008 included:

| | | |
|---|---|---|
| Solar Photovoltaic System at San Francisco International Airport | $ | 6,040 |
| Streetlights | | 2,316 |
| Solar Power Plant at North Point Treatment Plant | | 2,243 |
| Solar Photovoltaic System at Central Distribution Division | | 1,153 |
| Other items individually below $1,000 | | 14,065 |
| | $ | 25,817 |

***Fiscal Year 2007***

The Enterprise had net capital assets of $278,820 invested in a broad range of utility capital assets as of June 30, 2007. This amount represents an increase of $8,747, or 3.2%, compared to the prior fiscal year. The investment in capital assets includes land, buildings, improvements, hydropower facilities, dams, transmission lines, machinery, and equipment.

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

| | | |
|---|---|---|
| San Francisco Electrical Reliability Power | $ | 2,488 |
| Solar Project at San Francisco International Airport | | 2,270 |
| Priest Restoration – Pipeline Alignment | | 1,832 |
| Solar Project at Northpoint | | 1,237 |
| Solar Project at Pier 96 | | 1,098 |
| Early Intake Slides – Emergency | | 1,074 |
| Street Lights Underground Utilities | | 1,059 |
| Turbine Generator – Renovate and Replace | | 1,019 |
| Hetch Hetchy Microwave Replacement | | 964 |
| Other project additions individually below $964 | | 10,495 |
| | $ | 23,536 |

(Dollars in thousands)

Major facilities, improvements, machinery and equipment placed in service during the year ended June 30, 2007 included:

| | | |
|---|---|---|
| Duct Bank (Underground Electrical Transmission and Distribution Cables) | $ | 5,516 |
| Solar Renewable Energy Power Plant | | 2,455 |
| Mechanically Stabilized Earth Wall | | 1,126 |
| Street Lights | | 1,059 |
| Other items individually below $1,000 | | 4,023 |
| | $ | 14,179 |

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

### *Debt Administration*

As of June 30, 2008, the Enterprise had the following long-term debt outstanding with California Energy Commission (CEC). The loan was issued in November 2002 with an interest rate of 3% to help the San Francisco General Hospital (SFGH) complete the construction phase of its Lighting Retrofit Project.

**Table 4**

**Outstanding Debt**

June 30, 2008, 2007, and 2006

| | | 2008 | 2007 | 2006 | 2008 – 2007 Change | 2007 – 2006 Change |
|---|---|---|---|---|---|---|
| State of California CEC loan | $ | 282 | 390 | 494 | (108) | (104) |

The Enterprise did not issue any new debt during fiscal years 2008 and 2007.

San Francisco General Hospital will reimburse the Enterprise by providing 15 biannual payments of $59 each on June 12 and December 12, which commenced on December 12, 2003, and will end on December 12, 2010. This payment schedule coincides with the Enterprise's loan repayment schedule to the CEC for this project. The amounts to be repaid by SFGH are reduced by amounts received by the Enterprise under state grant programs.

More detailed information on the Enterprise's long-term liabilities is presented in note 5 to the financial statements.

## Economic Factors and Next Year's Rates

In the coming year, the Commission expects to issue $6,325 of Clean Renewable Energy Bonds to finance the installation of solar energy facilities on selected City-owned properties.

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.

**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.

**HETCH HETCHY WATER AND POWER ENTERPRISE**

Statements of Net Assets

June 30, 2008 and 2007

(In thousands)

| | | 2008 | 2007 |
|---|---|---|---|
| Assets: | | | |
| Current assets: | | | |
| Cash and investments with City Treasury | $ | 165,846 | 146,172 |
| Cash and investments outside City Treasury | | 10 | 10 |
| Receivables: | | | |
| Charges for services (net of allowance for doubtful accounts of $0 in 2008 and $2,193 in 2007) | | 9,424 | 9,427 |
| Settlement | | — | 515 |
| Due from other governmental agencies, current portion | | 110 | 107 |
| Interest and other | | 6,272 | 3,531 |
| Loan receivable, current portion | | 134 | 132 |
| Total receivables | | 15,940 | 13,712 |
| Deferred charges and other assets | | 2,120 | — |
| Inventories | | 296 | 270 |
| Total current assets | | 184,212 | 160,164 |
| Noncurrent assets: | | | |
| Capital assets not being depreciated | | 29,111 | 63,340 |
| Capital assets being depreciated, net of accumulated depreciation | | 230,265 | 215,480 |
| Due from other governmental agencies | | 16,436 | 17,588 |
| Loan receivable, net of current portion | | 188 | 324 |
| Total noncurrent assets | | 276,000 | 296,732 |
| Total assets | | 460,212 | 456,896 |
| Liabilities: | | | |
| Current liabilities: | | | |
| Accounts payable | | 12,726 | 9,950 |
| Accrued payroll | | 1,223 | 1,062 |
| Accrued vacation and sick leave, current portion | | 1,330 | 1,276 |
| Accrued workers' compensation, current portion | | 380 | 428 |
| Damage and claims liability, current portion | | 4,157 | 1,658 |
| Deposits, advances, and other liabilities | | 2,283 | 366 |
| Loan payable, current portion | | 110 | 107 |
| Total current liabilities | | 22,209 | 14,847 |
| Long-term liabilities: | | | |
| Other post employment benefits obligation | | 2,723 | — |
| Accrued vacation and sick leave, less current portion | | 1,041 | 1,039 |
| Accrued workers' compensation, less current portion | | 1,767 | 1,758 |
| Damage and claims liability, less current portion | | 11,144 | 3,124 |
| Loan payable, less current portion | | 172 | 283 |
| Total long-term liabilities | | 16,847 | 6,204 |
| Total liabilities | | 39,056 | 21,051 |
| Net assets: | | | |
| Invested in capital assets, net of related debt | | 259,376 | 278,820 |
| Unrestricted | | 161,780 | 157,025 |
| Total net assets | $ | 421,156 | 435,845 |

See accompanying notes to financial statements.

**HETCH HETCHY WATER AND POWER 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 | $ | 119,630 | 108,009 |
| Rental income | | 225 | 215 |
| Total operating revenues | | 119,855 | 108,224 |
| Operating expenses: | | | |
| Personal services | | 32,175 | 28,992 |
| Contractual services | | 3,972 | 5,711 |
| Purchased power and related costs | | 28,548 | 24,892 |
| Materials and supplies | | 2,291 | 2,339 |
| Depreciation | | 11,021 | 10,919 |
| Services provided by other departments | | 3,701 | 3,301 |
| General and administrative | | 20,997 | 11,687 |
| Other | | 6,731 | 7,179 |
| Total operating expenses | | 109,436 | 95,020 |
| Operating income | | 10,419 | 13,204 |
| Nonoperating revenues (expenses): | | | |
| Federal grants | | 52 | — |
| Interest and investment income | | 6,420 | 6,478 |
| Other nonoperating revenues, net | | 10,094 | 4,108 |
| Total nonoperating revenues, net | | 16,566 | 10,586 |
| Net income before special items and transfers | | 26,985 | 23,790 |
| Special item: | | | |
| Impairment loss | | (41,224) | — |
| Income (loss) before transfers | | (14,239) | 23,790 |
| Transfers to the City and County of San Francisco | | (450) | — |
| Changes in net assets | | (14,689) | 23,790 |
| Net assets at beginning of year | | 435,845 | 412,055 |
| Net assets at end of year | $ | 421,156 | 435,845 |

See accompanying notes to financial statements.

**HETCH HETCHY WATER AND POWER 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 | $ | 125,541 | 119,456 |
| Cash received from tenants for rent | | 225 | 215 |
| Cash paid to employees for services | | (28,647) | (28,291) |
| Cash paid to suppliers for goods and services | | (57,163) | (52,917) |
| Cash paid for judgments and claims | | (1,264) | (2,687) |
| Net cash provided by operating activities | | 38,692 | 35,776 |
| Cash flows from noncapital financing activities: | | | |
| Federal and state grants | | 52 | — |
| Cash received from settlements | | 4,866 | 2,925 |
| Cash received from rebates and incentive programs | | 3,361 | 611 |
| Cash from other sources | | 1,676 | 572 |
| Transfers in (out) | | (450) | — |
| Net cash provided by noncapital financing activities | | 9,505 | 4,108 |
| Cash flows from capital and related financing activities: | | | |
| Acquisition and construction of capital assets | | (32,284) | (20,005) |
| Proceeds from sale of capital assets | | 55 | 18 |
| Payments on loans payable | | (108) | (104) |
| Net cash used in capital and related financing activities | | (32,337) | (20,091) |
| Cash flows from investing activities: | | | |
| Interest income received | | 3,814 | 4,450 |
| Net cash provided by investing activities | | 3,814 | 4,450 |
| Increase in cash and cash equivalents | | 19,674 | 24,243 |
| Cash and cash equivalents: | | | |
| Beginning of year | | 146,182 | 121,939 |
| End of year | $ | 165,856 | 146,182 |
| Reconciliation of cash and cash equivalents to the statements of net assets: | | | |
| Cash and investments with City Treasury | $ | 165,846 | 146,172 |
| Cash and investments outside City Treasury | | 10 | 10 |
| Total cash and investments | $ | 165,856 | 146,182 |



(Continued)

**HETCH HETCHY WATER AND POWER ENTERPRISE**

Statements of Cash Flows

Years ended June 30, 2008 and 2007

(In thousands)

| | | 2008 | 2007 |
|---|---|---|---|
| Reconciliation of operating income to net cash provided by operating activities: | | | |
| Operating income | $ | 10,419 | 13,204 |
| Adjustment to reconcile operating income to net cash provided by operating activities: | | | |
| Depreciation | | 11,021 | 10,919 |
| Provision for uncollectible accounts | | (2,193) | (179) |
| Write off of capital assets | | 1,245 | 4,583 |
| Gain/loss from sale of capital asset | | (43) | (10) |
| Changes in operating assets and liabilities: | | | |
| Receivables: | | | |
| Charges for services | | 2,196 | 4,799 |
| Due from other governmental agencies | | 1,150 | (1,982) |
| Deferred charges and other assets | | (2,120) | — |
| Settlement receivable | | 515 | 8,609 |
| Loan receivable | | 134 | 131 |
| Inventories | | (26) | 6 |
| Accounts payable | | 1,056 | (4,045) |
| Accrued payroll | | 162 | (353) |
| Accrued other post employment benefits obligation | | 2,723 | — |
| Accrued vacation and sick leave | | 56 | 173 |
| Accrued workers' compensation | | (39) | 248 |
| Damage and claims liability | | 10,520 | (217) |
| Deposits, advances, and other liabilities | | 1,916 | (110) |
| Total adjustments | | 28,273 | 22,572 |
| Net cash provided by operating activities | $ | 38,692 | 35,776 |
| Noncash transaction: | | | |
| Accrued capital asset costs | $ | 6,895 | 5,122 |

See accompanying notes to financial statements.

## (1) Definition of Reporting Entity

Hetch Hetchy Water and Power (the Enterprise) was established as a result of the Raker Act of 1913, which granted water and power resources rights-of-way on the Tuolumne River in Yosemite National Park and Stanislaus National Forest to the City and County of San Francisco (the City). The Enterprise is engaged in the collection and conveyance of approximately 85% of the City's water supply and in the generation and transmission of electricity from that resource. Approximately half of the electricity is used by the City's municipal customers (e.g., the San Francisco Municipal Railway, the Recreation and Parks Department, the Port of San Francisco, San Francisco General Hospital, street lights, Moscone Center, and the SFPUC Water and Wastewater enterprises). Also as a result of the 1913 Raker Act, energy produced above the City's Municipal Load is sold next to Modesto and Turlock Irrigation Districts (the Districts) to cover their pumping and municipal load needs and any remaining energy either sold to other Municipalities and/or Government Agencies (not for resale) or deposited into a banked energy account under the City's agreement with PG&E. The Enterprise consists of a system of reservoirs, hydroelectric power plants, aqueducts, pipelines, and transmission lines. This system carries water and power more than 165 miles from the Sierra Nevada to customers in the City and portions of the surrounding San Francisco Bay Area.

The Enterprise also purchases wholesale electric power from various energy providers that are used in conjunction with owned hydro resources to meet the power requirements of its customers. Operations and business decisions can be greatly influenced by market conditions, state and federal power matters before the California Public Utilities Commission (CPUC), the California Independent System Operator (CAISO), and the Federal Energy Regulatory Commission (FERC). Therefore, the Enterprise serves as the City's representative at CPUC, CAISO and FERC forums and continues to monitor regulatory proceedings.

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, Wastewater, and the Water Enterprises 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, 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 and are included as an enterprise fund of the City and County of San Francisco, California. The activities of this fund 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 operations are included on the statements of net assets; revenues are recorded when earned, and expenses are recorded when liabilities are incurred. Operating revenues are defined as charges to customers and rental income.

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 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*

Cash and cash equivalents include all highly liquid investments, including restricted assets, with an original purchased maturity of three months or less.

The Enterprise considers its pooled deposits and investments held with the City Treasury to be demand deposits and, therefore, cash equivalents for the purposes of the statements of cash flows. Deposits and investments held outside the City Treasury are also considered cash and cash equivalents.

***(c) Investments***

Investments are stated at fair value based on quoted market prices. Changes in fair value are recognized as investment gains or losses.

***(d) Deferred Charges***

Deferred charges consist of costs incurred to generate the power that has been placed in the Municipal Deviation (MDA) and Deferred Delivery (DDA) Accounts under the provisions of the interconnection agreement with PG&E (see note 10).

***(e) Inventory***

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

***(f) Capital Assets***

Capital assets are stated at cost. Depreciation is computed using the straight-line method based on the estimated useful lives of the related assets, which range from 3 to 100 years for equipment and 3 to 100 years for buildings, structures, and improvements. No depreciation is recorded in the year of acquisition, and a full year's depreciation is recorded in the year of disposal.

***(g) 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.

***(h) 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.

***(i) 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.

***(j) 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.

***(k) Income Taxes***

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

***(l) Revenue Recognition***

Water and power revenues are based on water and power consumption and billing rates. Generally, customers are billed monthly. Revenues earned but unbilled are accrued as charged for services receivable on the statements of net assets.

***(m) Use of Estimates***

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America 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 revenue and expenses during the reporting period. Actual results could differ from those estimates.

***(n) Reclassifications***

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

***(o) 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 nonpension 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 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.

(Dollars in thousands)

## (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. 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 Treasurer allocates monthly income from the investment of pooled cash in proportion to the Enterprise's end-of-month balances.

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

| Investment maturities (in months) | | | |
|---|---|---|---|
| **Under 1** | **1 to less than 6** | **6 to less than 12** | **12 – 36** |
| 6.9% | 52.7% | 11.6% | 28.8% |

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

| Investment maturities (in months) | | | |
|---|---|---|---|
| **Under 1** | **1 to less than 6** | **6 to less than 12** | **12 – 36** |
| 25.9% | 43.6% | 28.4% | 2.1% |

As of June 30, 2008 and 2007, deposits and investments consisted of the following:

| | | **2008** | **2007** |
|---|---|---|---|
| Noncategorized investments: | | | |
| Pooled investments with City Treasury | $ | 165,846 | 146,172 |
| Nonpooled investments outside City Treasury | | 10 | 10 |
| Net cash provided by operating activities | $ | 165,856 | 146,182 |

Additional cash outside of the investment pool includes $10 for June 30, 2008 and 2007, held at a commercial bank in a non-interest-bearing checking account that is covered by depository insurance. This account was established as provided by the City's Administrative Code.

(Dollars in thousands)

## (4) Capital Assets

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

| | Balance July 1, 2007 | Increases | Decreases | Balance June 30, 2008 |
|---|---|---|---|---|
| Capital assets not being depreciated: | | | | |
| Land | $ 4,215 | 379 | — | 4,594 |
| Construction in progress | 59,125 | 31,258 | (65,866) | 24,517 |
| Total capital assets not being depreciated | 63,340 | 31,637 | (65,866) | 29,111 |
| Capital assets being depreciated: | | | | |
| Facilities and improvements | 464,657 | 19,910 | — | 484,567 |
| Machinery and equipment | 42,764 | 5,907 | (170) | 48,501 |
| Total capital assets being depreciated | 507,421 | 25,817 | (170) | 533,068 |
| Less accumulated depreciation for: | | | | |
| Facilities and improvements | (261,598) | (9,353) | — | (270,951) |
| Machinery and equipment | (30,343) | (1,668) | 159 | (31,852) |
| Total accumulated depreciation | (291,941) | (11,021) | 159 | (302,803) |
| Total capital assets being depreciated, net | 215,480 | 14,796 | (11) | 230,265 |
| Total capital assets, net | $ 278,820 | 46,433 | (65,877) | 259,376 |

(Dollars in thousands)

| | | Balance July 1, 2006 | Increases | Decreases | Balance June 30, 2007 |
|---|---|---|---|---|---|
| Capital assets not being depreciated: | | | | | |
| Land | $ | 4,215 | — | — | 4,215 |
| Construction in progress | | 53,630 | 23,536 | (18,041) | 59,125 |
| Total capital assets not being depreciated | | 57,845 | 23,536 | (18,041) | 63,340 |
| Capital assets being depreciated: | | | | | |
| Facilities and improvements | | 452,785 | 11,872 | — | 464,657 |
| Machinery and equipment | | 40,563 | 2,307 | (106) | 42,764 |
| Total capital assets being depreciated | | 493,348 | 14,179 | (106) | 507,421 |
| Less accumulated depreciation for: | | | | | |
| Facilities and improvements | | (252,313) | (9,285) | — | (261,598) |
| Machinery and equipment | | (28,807) | (1,634) | 98 | (30,343) |
| Total accumulated depreciation | | (281,120) | (10,919) | 98 | (291,941) |
| Total capital assets being depreciated, net | | 212,228 | 3,260 | (8) | 215,480 |
| Total capital assets, net | $ | 270,073 | 26,796 | (18,049) | 278,820 |

Capital assets with a useful life of 50 years or greater include buildings and structures, dams, reservoirs, pump stations, generators, tunnels, and pipelines.

During fiscal year 2008, the Enterprise’s capital assets not being depreciated had an increase of $31,637 and a decrease of $65,866 which result in a net decrease of $34,229. The $34,229 net decrease was mainly due to assets write off. In fiscal years 2008 and 2007, the Enterprise wrote off construction in progress of $42,469 and $4,583, respectively. The write off was mainly due to $41,224 for the combustion turbine project because at the end of fiscal year 2008, the San Francisco Public Utilities Commission made a decision to terminate the project, withdrawing project approval, and recommending sale of the combustion turbine generators (see note 11). The Enterprise’s capital assets being depreciated had an increase of $25,817 and a decrease of $170 which resulted in a net increase of $25,647.



(Continued)

(Dollars in thousands)

## (5) Changes in Long-Term Liabilities

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

| | | July 1, 2007 | Additions | Reductions | June 30, 2008 | Due with in one year |
|---|---|---|---|---|---|---|
| State of California Energy CEC Commission loan | $ | 390 | — | (108) | 282 | 110 |
| Other postemployment benefits obligation | | — | 2,723 | — | 2,723 | — |
| Accrued vacation and sick leave | | 2,315 | 1,407 | (1,351) | 2,371 | 1,330 |
| Accrued workers' compensation | | 2,186 | 587 | (626) | 2,147 | 380 |
| Damage and claims liability | | 4,782 | 13,713 | (3,194) | 15,301 | 4,157 |
| | $ | 9,673 | 18,430 | (5,279) | 22,824 | 5,977 |

| | | July 1, 2006 | Additions | Reductions | June 30, 2007 | Due with in one year |
|---|---|---|---|---|---|---|
| State of California Energy CEC Commission loan | $ | 494 | — | (104) | 390 | 107 |
| Accrued vacation and sick leave | | 2,142 | 1,445 | (1,272) | 2,315 | 1,276 |
| Accrued workers' compensation | | 1,938 | 881 | (633) | 2,186 | 428 |
| Damage and claims liability | | 4,999 | 2,718 | (2,935) | 4,782 | 1,658 |
| | $ | 9,573 | 5,044 | (4,944) | 9,673 | 3,469 |

***State of California Energy Commission Loan***

In November 2002, the Enterprise received a $971 loan from the California Energy Commission with an annual interest rate of 3% and semiannual repayments of $74 beginning on December 22, 2003. The loan has a final maturity date of December 22, 2010. Proceeds from the loan were used to provide funding for an energy conservation project undertaking at San Francisco General Hospital (the Hospital). Under the loan terms, the Enterprise is required to prepare and submit annual energy use reports to the California Energy Commission for three years following the completion of the project. The reports are to demonstrate the cost of energy saved as a result of the project. In August 2003, the California Energy Commission loan was renegotiated and the Enterprise received a $200 grant, which was utilized to pay down the original loan.

(Dollars in thousands)

The future annual debt service relating to the state loan outstanding as of June 30, 2008, is as follows:

| | | Principal | | Interest |
|---|---|---|---|---|
| Year ending June 30: | | | | |
| 2009 | $ | 110 | | 8 |
| 2010 | | 115 | | 4 |
| 2011 | | 57 | | 1 |
| | | 282 | $ | 13 |
| Less current portion | | (110) | | |
| Long-term portion as of June 30, 2008 | $ | 172 | | |

Pursuant to the terms of a memorandum of understanding agreement entered into between the San Francisco General Hospital and the Enterprise, the San Francisco General Hospital is required to repay the Enterprise for the cost of the project, less any amount received by the Enterprise under state grant programs (see note 7). Payments received from the San Francisco General Hospital will be used to satisfy the debt service requirements of the loan.

## (6) Other Revenue – Trans Bay Cable Construction and Licensing Fees

On August 7, 2007, San Francisco Mayor Gavin Newsom and the Board of Supervisors approved and adopted Resolution No. 070315, two nonexclusive licenses to the Trans Bay Cable LLC (the Licensee) for the Trans Bay Cable Project.

The Trans Bay Cable LLC proposes to install, operate and maintain approximately 53 miles of high voltage direct current (HVDC) PLUS transmission cable bundle of approximately 10 inches in diameter running from the City of Pittsburg to the City and County of San Francisco (the City). Approximately 9.4 miles of the cable are in submerged lands, a small portion of shoreline, and on a portion of a street that are under Port Commission jurisdiction (the License Area).

The first license is a Construction License, Port Commission License No. 14324, a nonexclusive license to install a 400 MW high voltage transmission line, with a four (4) years term. The Licensee will pay the Port of San Francisco some money under this license and the Enterprise $3.5 million in 36 annual installments of $97 as the Renewable Energy, Transmission and Grid Reliability Payment. The Enterprise received the first annual installment in September 2007.

The second license is an Operational License, Port Commission License No. 14325, a nonexclusive license for operation of the transmission line with twenty-five (25) years term with an option to renew for ten (10) years. The Licensee will pay the SFPUC in excess of $20 million in 10 separate installments, or $2 million annually, subject to increases in the Consumer Price Index (Base Year: 2010) as the SF Electric Reliability Payment to implement, advance, promote or enhance policies and projects consistent with City Energy Policies. Once the project is operational, which is currently scheduled in 2010, the Enterprise will receive the first installment.

At June 30, 2008, $972 has been included in revenue related to this project, and are restricted for purposes designated by the San Francisco Board of Supervisors under the agreement.

## (7) 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 provides 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 are 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* – both the Enterprise and its employees make Contributions to the basic Plan. Employee contributions are mandatory. Employee contribution rates for 2008, 2007, and 2006 were from 5.0% to 8.0% as a percentage of covered payroll. Due to certain bargaining agreements, the Enterprise contributed from 0.5% to 8.0% of covered payroll on behalf of some employees. In addition, the Enterprise was required to contribute for 2008, 2007, and 2006 at an actuarially determined contribution rate as a percentage of covered payrolls of 5.91%, 6.24%, and 6.58% respectively. The Enterprise's required contribution was approximately $1,326 in 2008, $1,335 in 2007, and $1,364 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 $3,424 and $3,096 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 $907 and $803 for 2008 and 2007, respectively, to provide postretirement benefits for retired employees, on a pay-as-you-go basis.

The City has determined a Citywide Annually 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 $3,630 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 allocation and the amount paid was $2,723 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 2.5% 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 as current bargaining agreements expire June 30, 2009 through June 30, 2010.

## (8) Related Parties

During 2008 and 2007, the Enterprise delivered power without charge to certain City departments, which amounted to $4,227 and $4,541, respectively, based on metered usage and applicable power rates. These amounts were excluded from operating revenues in the accompanying financial statements.

Included in 2008 and 2007 operating revenues are sales of power to departments within the City of $60,815 and $59,154, respectively.

A variety of City departments provide services such as engineering, purchasing, legal, data processing, telecommunication, and human resources to the Enterprise and charge amounts designed to recover those departments' costs. These charges totaling approximately $3,701 and $3,301 for the years ended June 30, 2008 and 2007, respectively, have been included in services provided by other departments in the accompanying financial statements.

Various common costs incurred by the Commission are allocated prorated among the Enterprise, the San Francisco Water Enterprise, and the San Francisco 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 department and the information available. For the years ended June 30, 2008 and 2007, the Commission allocated $9,991 and $7,114, respectively, in administrative costs to the Enterprise, which is included in 2008 financial statements under various expense categories.

(Dollars in thousands)

The San Francisco Water Enterprise purchases water from the Enterprise. This amount, totaling $21,000 and $19,037 for the years ended June 30, 2008 and 2007, respectively, has been included in operating revenues in the accompanying financial statements.

The San Francisco Water Enterprise also purchases electricity from the Enterprise. This amount, totaling $5,485 and $5,596 for the years ended June 30, 2008 and 2007, respectively, has been included in operating revenues in the accompanying financial statements.

The San Francisco Wastewater Enterprise purchases electricity from the Enterprise. This amount, totaling $7,672 and $7,744 for the years ended June 30, 2008 and 2007, respectively, has been included in operating revenues in the accompanying financial statements.

The Enterprise facilitates all electric and gas service connections between Pacific Gas and Electric Company (PG&E) and City departments. In this capacity, the Enterprise facilitates and coordinates the terms and payment for the service connections that are performed by PG&E. As of June 30, 2008 and 2007, there were no outstanding amounts due from City departments related to this work. However, the Enterprise received money from PG&E after project completion. Those monies are to be refunded back to the City Departments for their perspective amounts.

The Enterprise serves as the City’s agency for energy efficiency projects and maintains the Sustainable Energy Account (SEA) (formerly known as the Mayor’s Energy Conservation Account (MECA)) fund to sponsor and financially support such projects at various City departments. In this role, the Enterprise may secure low-interest financing to supplement funds available in the SEA fund. At June 30, 2008 and 2007, projects completed or underway throughout the City amounted to $13,947 and $15,096, respectively, and are recorded as due from other governmental agencies.

Besides funding the SEA projects, in 2008 the Enterprise also funded a project for the Treasure Island Development Authority (TIDA) and recorded as due from other governmental agencies. The details of these projects are as follows:

| | | 2008 | 2007 |
|---|---|---|---|
| Moscone Center | $ | 10,700 | 11,700 |
| San Francisco General Hospital | | 1,869 | 2,086 |
| San Francisco Department of Public Health | | 1,140 | 1,247 |
| San Francisco Department of Public Works | | 134 | — |
| Port of San Francisco | | 83 | 63 |
| San Francisco International Airport | | 21 | — |
| Total SEA related projects | | 13,947 | 15,096 |
| Treasure Island Development Authority | | 2,599 | 2,599 |
| Total due from other governmental agencies | | 16,546 | 17,695 |
| Less current portion | | (110) | (107) |
| Long-term portion as of June 30 | $ | 16,436 | 17,588 |



(Continued)

The amount owed to the Enterprise is reported as due from other governmental agencies in the accompanying statements of net assets.

## (9) Risk Management

The Enterprise's risk management program encompasses both self-insured and insured coverage. Risk assessments and coverage are coordinated by the City 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 city-wide 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 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.

(Dollars in thousands)

**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:

| | | Beginning of year | Claims and changes in estimates | Claims paid | End of year |
|---|---|---|---|---|---|
| 2006 – 2007 | $ | 4,999 | 2,718 | (2,935) | 4,782 |
| 2007 – 2008 | | 4,782 | 13,713 | (3,194) | 15,301 |

***(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:

| | | Beginning of year | Claims and changes in estimates | Claims paid | End of year |
|---|---|---|---|---|---|
| 2006 – 2007 | $ | 1,938 | 881 | (633) | 2,186 |
| 2007 – 2008 | | 2,186 | 587 | (626) | 2,147 |



(Continued)

### *(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 and 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.

## (10) Commitments and Litigation

### *(a) Commitments*

Effective September 2007, the City renegotiated the Interconnection Agreement (agreement) with PG&E to provide transmission and distribution services on PG&E's system where needed to deliver the Enterprise's power to its customers. In addition, agreement provides supplemental power and energy banking and other support services to the Enterprise. The agreement provides audit rights to review past billings paid by the Enterprise and to retroactively (up to two years) adjust these payments as determined necessary. During fiscal years 2008 and 2007, the Enterprise purchased $13,579 and $17,024, respectively, of transmission, distribution services, and other support services from PG&E under the terms of the agreement.

The City's Interconnection Agreement with PG&E contains a contractual provision allowing it to bank excess power produced, with a maximum of 110,000 Megawatt hours (MWh). During fiscal year 2008, the Enterprise generated 1,421,966 MWh of power, banked (deposited) in the Deferred Delivery Account (DDA) 86,885 MWh and used (withdrew) 42,206 MWh. At June 30, 2008 and 2007, the balance in the bank was 102,436 MWh or $2,120 and 57,755 MWh or $1,196, respectively.

The Enterprise's purchased energy transactions (purchases and sales) were with six different market entities through the Western System Power Pool (WSPP). During fiscal year 2008, the Enterprise purchased 131,350 MWh at a cost of $9,004. Sales of excess power, after meeting the Enterprise's obligations were 125,618 MWh, or $9,247.

To meet certain requirements of the Don Pedro Reservoir operating license, the City entered into an agreement with the Modesto and Turlock Irrigation Districts (the Districts) in which the Districts would be responsible for an increase in water flow releases from the reservoir in exchange for annual payments from the City, which are included in the Enterprise's operating expenses. The payment amounts were $4,426 and $3,930 in fiscal years 2008 and 2007, respectively. The payments are to be made for the duration of the license, but may be terminated with one year's prior written notice after 2001. The City and the Districts have also agreed to monitor the fisheries in the lower Tuolumne River for the duration of the license. A maximum monitoring expense of $1,400 is to be shared between the City and the Districts over the term of the license. The City's share of the monitoring costs is 52%, while the Districts are responsible for 48% of the costs.

In April 1988, the Enterprise entered into a long-term power sales agreement (the Agreement) with the Districts. In June 2003, the Enterprise amended the terms of the Agreement with the Modesto Irrigation District (MID). Under the terms of the amended and restated long-term power sales agreement, which became effective on January 1, 2003, the expiration date was shortened to December 31, 2007. The agreement with MID was renegotiated and became effective January 1, 2008 which removed the Enterprise's obligation to provide firm power and eliminated MID's rights to excess energy from the Project. This agreement expires June 30, 2015. In April 2005, the Enterprise amended the terms of the Agreement with Turlock Irrigation District (TID). The settlement agreement between SFPUC and TID restates and amends the power sales agreement and terminates San Francisco's obligation to provide firm power at below market costs to TID to the end of the agreements term on June 30, 2015. The SFPUC will continue to comply with the Raker Act by making Hetch Hetchy water system generated hydropower available at cost to MID and TID for its agricultural pumping and municipal loads as energy is available. For fiscal years 2008 and 2007, energy sales to the Districts totaled 386,568 MWhrs or $9,940 and 548,459 MWhrs or $13,907, respectively.

As of June 30, 2008 and 2007, the Enterprise had outstanding commitments with third parties of $20,296 and $21,762, respectively, for various capital projects and other purchase agreements for materials and services.

### *(b) Energy Risk Management*

The Enterprise is exposed to risks that could negatively impact its ability to generate net revenues to fund operating and capital investment activities. Hydroelectric generation facilities in the Sierra Nevada are the primary source of electricity for the Enterprise. For this reason, the financial results of the Enterprise are sensitive to variability in watershed hydrology and market prices for energy.

### *(c) Litigation*

The Enterprise is a defendant in various legal actions and claims that arise during the normal course of business. The final disposition of these 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 changes in net assets of the Enterprise.

(Dollars in thousands)

**(11) Legal Settlement**

On January 21, 2003, the City's Board of Supervisors authorized the settlement of a lawsuit filed on January 18, 2001 by the City, on behalf of the people of the State of California (the State), against certain energy companies. Under the terms of the settlement, the City received (i) four combustion turbine generator sets valued at approximately $33 million for use at two power plants, one within the City and one at the San Francisco International Airport (SFIA), (ii) future funding from a State administered fund (the Fund) to assist with the costs of siting and developing electric generating equipment in the City, and (iii) payment to the City of $500 for attorneys' fees and other expenses of litigation.

Effective January 23, 2003, the City entered into an implementation agreement (the Agreement) with the Attorney General of the state of California (the Attorney General), the California Consumer Power and Conservation Financing Authority (the Authority), and the California Department of Water Resources (the Department). In accordance with the terms of the Agreement:

1. The Attorney General transferred all rights, title, and interest in the four gas turbine generator sets to the City.

2. To the extent received by the Attorney General under the terms of the Settlement Agreement, the Attorney General has agreed to make the following deposits into the Fund, as soon as practicable after the receipt date for such amounts, to assist with the costs of siting and developing electric generating equipment in the City:

| | | |
|---|---|---|
| Receipt and closing date | $ | 2,667 |
| January 1, 2004 | | 2,667 |
| January 1, 2005 | | 2,267 |
| January 1, 2007 | | 1,667 |
| January 1, 2008 | | 1,333 |
| January 1, 2009 | | 1,333 |
| January 1, 2010 | | 1,333 |
| | $ | 13,267 |

3. The City and the Authority have reviewed and approved a budget for the development of a power generating facility (the Facility), which is based upon key milestones.

4. The City has agreed that it will only seek monies from the Fund for those reasonable and necessary purpose required to meet the key milestones in the development (and not construction) of the Facility.

In the event that the (i) City has not met project milestone according to agreement between the parties, (ii) the Attorney General determines that the City has ceased development of the Facility, or (iii) the City decides not to develop the Facility pursuant to the terms of the Agreement, the Authority shall have the right (but not the obligation) to purchase any or all of the combustion turbine generator sets from the City at a price of $2.5 million per unit and terminate the Agreement. Should the Authority elect not to exercise its option to acquire the gas turbine generator sets from the City pursuant to the terms of the Agreement, the City must promptly sell the units by means of a public bidding process. The City is entitled to retain (i) the first $2.5 million from the sale of each unit plus 5% of any amount in excess of $2.5 million and (ii) any eligible amounts incurred by the City in excess of the amount provided by the Fund.

In December 2002, the City entered into an agreement (the Power Purchase Agreement) with the Department in anticipation of the settlement and implementation agreements. Under the terms of the Power Purchase Agreement, the Department has agreed to purchase power and rated capacity.

The following Agreements were developed to complete the transaction:

1. Design Build Agreement
2. Operations and Maintenance Agreement
3. San Francisco International Airport (SFIA) Memorandum of Understanding (MOU) Amendment for land use
4. MOU for the Municipal Transportation Agency (MTA)/Port (land, easements, swale)
5. Turbine Upgrade, Insurance and Delivery Agreements
6. Power Purchase Agreement Amendment
7. Implementation Agreement Amendment
8. Interconnection Amendments

During the fiscal year 2008, the City selected a design-build contractor, negotiated the contract terms and conditions and was actively working with General Electric (GE) to get the turbines upgraded and shipped. GE was also being considered for the operations maintenance contract.

The Department, the Enterprise and the Developer were proceeding to secure all agreements by the end of 2008. The preliminary objective was to have the Power Plant constructed and operating by the end of 2009.

In conjunction with the execution of the Settlement Agreement, the Attorney General has received cash up to $10,765 as of June 30, 2008 from the defendants and deposited that amount into the Fund. The City has actual costs incurred in the development of the facility up to $17,897 and $10,055 as of June 30, 2008 and 2007, respectively. The Enterprise has recognized $4,866 of revenue from the Fund for this fiscal year and a cumulative total of $14,133 for reimbursement from the Fund as of June 30, 2008. Under the terms of the Agreement, the City only has claim to the proceeds held by the Fund to the extent that eligible costs are incurred and limited to reimbursement schedule (see above). As such, the corresponding revenue will be recognized as eligible costs are incurred.

At the end of fiscal year 2008, the San Francisco Public Utilities Commission made a decision to terminate the project, withdrawing project approval, and recommending sale of the combustion turbine generator sets.

On July 22, 2008, the San Francisco Public Utilities Commission rescinded project approval and recommended to the Mayor and the Board of Supervisors to cease development of the two power plants, in-City and at the SFIA, and take any necessary steps to initiate the sales of the projects in accordance with the Implementation Agreement. Consequently, the project was written down by $41,224 to its net realizable value of approximately $10,000 as of June 30, 2008.

The City is investigating other reliability alternatives including retrofitting the Mirant-owned Potrero Power Plant to natural gas, and pursing transmission from Newark to San Francisco. The City's license with the California Energy Commission (CEC) to build and operate the City power plant is valid through October 2011 if no other solution to the power reliability issue can be found. If the City determines that its still has the need for in-City generation later, it will require new authorization from the Commission. The State of California has been fully appraised of the current status.

## (12) Subsequent Event

The Enterprise issued $6,325 in Clean Renewable Energy Bonds (CREBs) on November 7, 2008 to finance the installation of solar energy equipment on selected City-owned facilities. The Enterprise has not previously issued debt and has instead up to this point relied on revenue from ratepayers to fund renewable energy projects, CREBs provide the San Francisco Public Utilities Commission with low-cost access to capital to further its green power objects.

The Enterprise will begin making principal payments in the amount of $422 on December 15, 2008 and continuing annually for fifteen years until December 15, 2022. Funding for these payments will be guaranteed by the Enterprise net revenues. Interest payments will not be made, since interest on the bonds is paid in the form of federal tax credits in lieu of interest paid by the issuer.

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**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 Hetch Hetchy Water and Power 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's adoption of the provisions of Governmental Accounting Standards Board GASB 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 a deficiency in internal control over financial reporting that we consider to be a significant deficiency.

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 deficiency described in the accompanying schedule of findings and responses as 08-01, to be a significant deficiency 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 the significant deficiency described above is not a material weakness.

**Compliance and Other Matters**

As part of obtaining reasonable assurance about whether the Enterprise's financial statements arc 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

**2008-1 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 $2.5 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 Hetch Hetchy Water and Power 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.