

Statement of Changes in the Balancing Account
June 30, 2009

(With Independent Auditors' Report Thereon)



Independent Auditors' Report

The City and County of San Francisco and the Suburban Purchasers:

KPMG LLP has audited, in accordance with auditing standards generally accepted in the United States of America, the financial statements of the San Francisco Water Enterprise (Water Enterprise) and Hetch Hetchy Water and Power (Hetch Hetchy) under the jurisdiction of the San Francisco Public Utilities Commission (SFPUC), as of and for the year ended June 30, 2009, and has issued its reports thereon dated November 6 and October 30, 2009, respectively. KPMG LLP and Yano Accountancy Corporation have also audited the Statement of Changes in the Balancing Account of the Water Enterprise for the year ended June 30, 2009, prepared pursuant to Article IV and Article V, Section 5.07 of the Settlement Agreement and Master Water Sales Contract (the Agreement), between the City and County of San Francisco (the City) and certain suburban purchasers in the counties of San Mateo, Santa Clara, and Alameda (the Suburban Purchasers) effective May 25, 1984. The Statement of Changes in the Balancing Account is the responsibility of the management of the SFPUC. Our responsibility is to express an opinion on the Statement of Changes in the Balancing Account based on our audit.

Except as discussed in the third paragraph of this report, we conducted our audit of the Statement of Changes in the Balancing Account in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the Statement of Changes in the Balancing Account is free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of Water Enterprise and Hetch Hetchy'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 Statement of Changes in the Balancing Account, assessing the accounting principles used and the significant estimates made by management, as well as evaluating the overall presentation of the Statement of Changes in the Balancing Account. We believe that our audit provides a reasonable basis for our opinion.

We have not performed any procedures regarding the identification of specific funding sources of debtfunded assets or asset operating usage classifications used in calculating the Suburban Revenue Requirement. The identification of specific funding sources of debt-funded assets and asset operating usage classifications are both used to determine the return on rate base with the asset operating usage classifications also being used to determine the depreciation expense to be allocated to the Suburban Purchasers. If incorrect, the identification and classification of these assets could materially affect the Suburban Revenue Requirement and the balance due from the Suburban Purchasers as of June 30, 2009.

In our opinion, except for the effects of such adjustments, if any, as might have been determined to be necessary had we performed procedures regarding the return on rate base and depreciation expense to be allocated to the Suburban Purchasers, the Statement of Changes in the Balancing Account presents fairly,

in all material respects, the balance due from the Suburban Purchasers as of June 30, 2009 in accordance with Articles IV and V (Section 5.07) of the Agreement.

This report is intended solely for the information and use of the Mayor, Board of Supervisors, San Francisco Public Utilities Commission, City management, and the Suburban Purchasers and is not intended to be and should not be used by anyone other than these specified parties.

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KPMG LLP

San Francisco, California August 20, 2010

Statement of Changes in the Balancing Account

Year ended June 30, 2009

		Total	Amount allocated to the Suburban Purchasers
Suburban Revenue Requirement Calculation:			
Operating and maintenance (O&M) expense:			
San Francisco Water Enterprise (Water Enterprise):	¢	15 105 975	9.664.965
Source of supply Pumping	\$	15,195,875 4,693,179	8,664,865 174,046
Purification		30,931,009	20,937,200
Transmission and distribution		40,790,565	12,935,719
Customer accounts		11,308,802	226,176
Total Water Enterprise operating and maintenance	\$	102,919,430	42,938,006
O&M percentage of total Water Enterprise Hetch Hetchy Water and Power (Hetch Hetchy):			41.72%
Operating expenses	\$	52,959,490	10,233,267
Maintenance expenses	Ψ	16,128,227	3,861,347
Administrative and general (A&G) expenses:		, ,	, ,
Deemed city overhead charge:			
Water Enterprise		1,302,879	543,561
Hetch Hetchy		542,866	147,351
SF Public Utilities Commission:			
Water Enterprise		20,860,715	8,490,383
Hetch Hetchy		10,547,102	2,661,084
Other A&G – Water Enterprise Contract administration expenses – Water Enterprise		26,613,956 276,566	9,873,770 138,283
Compliance audit – Water Enterprise		230,000	115,000
Property taxes (outside city only):		230,000	113,000
Water Enterprise		1,458,668	987,372
Hetch Hetchy		463,127	117,552
Return on assets employed (unaudited):			
Water Enterprise (note 4)			19,367,641
Hetch Hetchy (note 5)			3,818,835
Depreciation allocation (unaudited): Water Enterprise (note 6)		25,609,652	17,763,677
Hetch Hetchy (note 6)		3,623,401	2,331,659
Total Suburban Revenue Requirement Calculation		2,020,101	123,388,788
Total Suburban Revenue Requirement Calculation			123,388,788
Balance due from Suburban Purchasers, July 1, 2008 Adjustment to July 1, 2008 balance (Note 2):			20,625,889
Overall rate of return (unaudited)			(1,021,713)
Long range planning			(2,165,723)
Grants received, asset classifications, and disputed costs			(1,110,943)
Interest on adjustments			(162,426)
Adjusted balance due from Suburban Purchasers, July 1, 2008			16,165,084
Interest on adjusted beginning balance			415,604
Suburban revenues billed			(118,129,615)
Calculated Suburban Revenue Requirement Settlement adjustment due from Suburban Purchasers (Note 3)			123,388,788
· · · · · · · · · · · · · · · · · · ·			21,006
Balance as of June 30, 2009 – due from Suburban Purchasers			\$ 21,860,867

See accompanying notes to the statement of changes in the balancing account.

Notes to Statement of Changes in the Balancing Account June 30, 2009

(1) Summary of Significant Accounting Policies

(a) Settlement Agreement and Master Water Sales Contract

Effective May 25, 1984, the City and County of San Francisco (the City) entered into a Settlement Agreement and Master Water Sales Contract (the Agreement) with certain suburban purchasers in the counties of San Mateo, Santa Clara, and Alameda (the Suburban Purchasers). The Agreement arose as a result of the settlement of a civil action that was originally filed against the City in 1974 by the City of Palo Alto. The civil action involved the manner in which in-City and suburban water rates were established by the City. The term of the Agreement is for a period of 25 years. The Agreement was amended by a memorandum of understanding dated November 16, 2009 for the year ended June 30, 2009. A new agreement was negotiated between the City and the Wholesale Customers represented by the Bay Area Water Supply and Conservation Agency (BAWSCA). The term of the new Water Supply Agreement (WSA) began on July 1, 2009 and shall end on June 30, 2034, with two 5-year extension options.

(b) Basis of Presentation

Pursuant to the terms of the 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 based on the methodology outlined in Article IV of the Agreement (the Suburban Revenue Requirement).

Pursuant to Article V, Section 5.07 of the Agreement, the City is required to recompute the Suburban Revenue Requirement of the San Francisco Water Enterprise (Water Enterprise) and Hetch Hetchy Water and Power (Hetch Hetchy) 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 billed 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 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 Agreement, the remaining balance in the Balancing Account shall be settled between the City and the Suburban Purchasers. The Balancing Account is reflected on the Water Enterprise's financial statements as either an asset or a liability depending on the amount due from or owed to the Suburban Purchasers, respectively.

(c) Basis of Allocation of Expenses

Pursuant to the terms of the Agreement, specific or direct Water Enterprise/Hetch Hetchy expenses are directly allocated to the user. Joint Water Enterprise operating and maintenance expenses related to source of supply, pumping, purification, transmission and distribution are to be allocated based upon the ratio of annual usage. Two percent of the expenses to administer customer accounts are

4

Notes to Statement of Changes in the Balancing Account June 30, 2009

allocated to the Suburban Purchasers. Water Enterprise administrative and general expenses, such as deemed city overhead charges, San Francisco Public Utilities Commission (SFPUC) expenses and other expenses are allocated based upon the ratio of the total allocated Suburban operating and maintenance expenses as a percentage of total Water Enterprise operating and maintenance expenses. Property taxes are allocated based upon annual usage. Joint Hetch Hetchy operating, maintenance, general and administrative expenses are allocated based upon adjusted annual usage.

(2) Adjustment to July 1, 2008 Balancing Account

Under Sections 6.06 and 8.02(d) of the agreement, the fiscal years ending June 30, 2006 through 2008 remained open with respect to changes to the Balancing Account from prior years. A settlement agreement was executed effective May 31, 2010, which closed the fiscal years June 30, 2006 and 2007. The SFPUC has modified the Balancing Account by: 1) adjusting the calculation for the Water Enterprise overall rate of return; 2) reclassifying long range planning costs from joint water/power to power-only; 3) applying credits for capital grants received by the SFPUC; and 4) making adjustments for previously disputed costs and asset classifications. Additional adjustments under the agreement are possible until expiration of the limitations period.

A summary of the changes are as follows:

SFWD Overall Rate of Return

Certain capital additions funded through the 2006A Series Revenue Bonds were previously treated as funded through the 2002 Revenue Bonds, which resulted in an incorrect calculation for the Water Enterprise overall rate of return. Recalculating the Water Enterprise overall rate of return reduced the weighted cost of debt and the related weighting factors for equity and debt-funded wholesale net plant.

The effect of the recalculation is computed as follows for the year ended:

	June 30, 2006	June 30, 2007	June 30, 2008	Total
Overall rate of return				
Previously stated	5.84%	6.03%	6.12%	
Restated	5.78%	5.92%	5.94%	
Change	(0.06)%	(0.11)%	(0.18)%	
Water Enterprise rate base	285,492,169	284,289,125	298,722,488	
Total decrease	\$ (171,295)	\$ (312,718) \$	(537,700) \$	(1,021,713)

5

Notes to Statement of Changes in the Balancing Account June 30, 2009

Long Range Planning Costs

Expenditures under a long range planning cost category were analyzed and determined to be more appropriately classified as power-only expenditures rather than joint power/water expenditures as previously classified for the three fiscal years noted below. Reclassifying these expenditures results in the following adjustment:

	_	Amount
For the year ended		
June 30, 2006		(896,972)
June 30, 2007		(718, 267)
June 30, 2008	_	(550,484)
Total decrease	\$	(2,165,723)

Capital Proceeds, Asset Classifications, and other Disputed Costs

Costs that were funded by grant proceeds were previously included in the determination of total Water Enterprise operating and maintenance costs for the fiscal year ending June 30, 2008, and proceeds from capital grants received were not allocated to the Suburban Purchasers. Additionally, the Suburban Purchasers have disputed the previous allocation of various asset classifications and costs. Accordingly, the balance due from the Suburban Purchasers has been reduced as follows for the year ended:

	June 30, 2007	June 30, 2008	Total
Credit for Grants-Funded Expenses	\$ _	\$ (897,677)	\$ (897,677)
Reversal of Credit Given for Capital Grants in prior year		461,670	461,670
Asset Classifications	(11,540)	(17,674)	(29,214)
Other Disputed Costs	(321,092)	(166,255)	(487,347)
Resulting Adjustment to Allocation of Costs		(158,375)	(158,375)
Total decrease	\$ (332,632)	\$ (778,311)	\$ (1,110,943)

6

Notes to Statement of Changes in the Balancing Account June 30, 2009

Interest on Adjustments

Interest has been recomputed on the adjustments as follows for the year ended:

	2006	2007	Total
Adjustments to July 1, 2008 Balance Fiscal year 2007 Interest @ 5.188%	1,068,267 55,422	1,363,617	2,431,884 55,422
Adjusted Balance including fiscal year 2007 Interest Fiscal year 2008 Interest @ 4.302%	1,123,689 48,341	1,363,617 58,663	2,487,306 107,004
Total adjustments to July 1, 2008 Balance	1,172,030	1,422,280	2,594,310
Interest on adjustments: Fiscal year 2007 Interest @ 5.188% Fiscal year 2008 Interest @ 4.302% Total interest on adjustments	55,422 48,341 103,763	58,663 58,663	55,422 107,004 162,426
Pooled Interest Rates: Fiscal year 2007 Fiscal year 2008	5.188% 4.302%		

(3) Agreement Settlements

The Suburban Purchasers alleged the Suburban Revenue Requirement calculation is overstated by the return and depreciation on certain disputed costs related to equipment purchases capitalized in the fiscal years ended June 30, 1998 and June 30, 1999. The City and the Suburban Purchasers reached a resolution on March 22, 2004, on the issues related to the equipment purchases capitalized during the fiscal years ended June 30, 1998 and June 30, 1999, and the write-off of certain engineering expenses related to septic system design. As part of the resolution, the City will receive a credit of \$21,006 per year commencing in the year ended June 30, 2003, and continuing through the year ending June 30, 2010.

7

Notes to Statement of Changes in the Balancing Account
June 30, 2009

(4) Water Enterprise Return on Rate Base

(a) Summary

The following is a summary of the unaudited Water Enterprise return on rate base for the year ended June 30, 2009:

	_	Unaudited
Suburban rate base: Suburban share of net utility plant Suburban working capital	\$	319,502,277 9,320,144
		328,822,421
Times weighted average return	_	5.89%
Water Enterprise return on rate base	\$	19,367,641

(b) Weighted Average Return

The following is a summary of the unaudited weighted average return for the year ended June 30, 2009:

		Unaudited		
	Rate	Applicable debt/equity percentage	Weighted return	
Return on equity	8.60%	30.36%	2.61%	
Cost of debt (unaudited)	4.71	69.64	3.28	
Water Enterprise return on	rate base	100.00%	5.89%	

The 8.60% return on equity represents 85% of the 10.12% average rate of return on assets of Class A water utilities as approved by the California Public Utilities Commission. The unaudited 4.71% cost of debt represents total unaudited wholesale interest expense of \$15,555,108 divided by total unaudited average wholesale debt outstanding of \$330,383,957. The unaudited 69.64% portion of debt to equity represents the unaudited wholesale debt of \$330,383,957 divided by the sum of the unaudited total average wholesale net utility plant of \$458,836,811 plus wholesale working capital allowance of \$15,607,344.

Total Water Enterprise and Hetch Hetchy capital assets and debt as of June 30, 2009 and 2008, and depreciation and interest expenses for the year ended June 30, 2009 have been reconciled to the financial statements of the Water Enterprise and Hetch Hetchy, respectively. For copies of the Water Enterprise and Hetch Hetchy audited financial statements for the year ended June 30, 2009, please contact the Chief Financial Officer, San Francisco Public Utilities Commission, 1155 Market Street, 11th Floor, San Francisco, CA 94103, or (415) 554-3155.

8

Notes to Statement of Changes in the Balancing Account June 30, 2009

As described below, assignments of debt to specific assets and assignment of specific assets to J-Table categories have not been subjected to audit. The J-Tables are developed based on metered water data that determines the proportion of total water deliveries to suburban resale and retail customers, respectively. In addition to the volumes of water delivered, the J-Tables include factors based on the maximum daily and hourly rates of use. These factors are the bases of allocating operating and plant investment costs to each class of service.

(c) Average Wholesale Net Utility Plant – Total and Suburban Share

The assignment of specific assets to specific J-Table categories is not subject to audit but is evaluated by representatives of the Suburban Purchasers. The following is the unaudited assignment of wholesale net utility plant to the various J-Table categories for the year ended June 30, 2009, and related suburban shares:

		Unaudited average wholesale net utility plant		
J-Table Category	J-Table Factor	Total	Suburban Share	
Equipment:				
Current base	67.69% \$	40,266,372	27,256,307	
Current maximum day	71.71%		_	
Current maximum hour	71.56%		_	
Ultimate base	64.56%	19,130,088	12,350,385	
Ultimate maximum day	70.02%	360,666,598	252,538,752	
Ultimate maximum hour	71.51%	3,079,879	2,202,421	
Composite	69.56%	21,521,859	14,970,605	
Direct suburban	100.00%	1,158,246	1,158,246	
Total equipment	<u>-</u>	445,823,042	310,476,716	
Land:				
Joint	69.56%	12,937,616	8,999,406	
Direct suburban	100.00%	26,155	26,155	
Total land	<u>-</u>	12,963,771	9,025,561	
	\$_	458,786,813	319,502,277	

9

Notes to Statement of Changes in the Balancing Account June 30, 2009

(d) Wholesale Interest Expense and Average Wholesale Debt

The assignment of interest expenses and related notes payable and to specific assets is not subject to audit. The following is the unaudited assignment of interest expense to wholesale assets for the year ended June 30, 2009:

Bond issue		Total interest expenses	Unaudited Average wholesale percentage of bonds payable	 Unaudited Wholesale portion of interest expenses
Capital appreciation bonds	\$	240,731	42.85%	\$ 103,153
2001 – Series A		3,926,167	57.13%	2,243,019
2002 – Series A		7,175,358	57.13%	4,099,282
2002 – Series B		2,460,735	88.17%	2,169,630
2006 – Series A		23,689,121	17.99%	4,261,673
2006 – Series B		4,677,313	43.34%	2,027,147
2006 – Series C	-	1,956,156	33.29%	651,204
	\$	44,125,581		\$ 15,555,108

Notes to Statement of Changes in the Balancing Account June 30, 2009

The following is the unaudited wholesale percentage of average bonds payable for the year ended June 30, 2009:

	Unaudited	Unaudited
Bond issue	Average wholesale percentage of bonds payable	Wholesale portion of bonds payable
Capital appreciation bonds	42.85%	5 1,499,771
2001 – Series A	57.13%	45,123,476
2002 – Series A	57.13%	85,156,716
2002 – Series B	88.17%	48,054,854
2006 – Series A	17.99%	89,853,761
2006 – Series B	43.34%	45,817,839
2006 – Series C	33.29%	14,877,540
	9	330,383,957

(5) Hetch Hetchy Return on Rate Base

The following is a summary of the rate of return on Hetch Hetchy net utility plant:

T		Unaudited average net	Unaudited sub	
Expense category		utility plant	Percentage	<u>Dollars</u>
Power-only	\$	95,652,916	 % \$	
Water-only		22,226,845	100	22,226,845
Joint Power/Water (55%/45%)	_	94,223,980	45	42,400,791
	\$	212,103,741		64,627,636
Times suburban allocation factor				64.35%
Allocated suburban share of the	ınauc	lited average net u	itility plant	41,587,884
Hetch Hetchy working capital allowance				2,817,175
Allocated suburban share of the	ınauc	lited average net u	itility plant	
plus Hetch Hetchy workin			7 1	44,405,059
Times weighted average rate of return				8.60%
Hetch Hetchy return on rate b	oase		\$	3,818,835

The assignment of specific Hetch Hetchy assets to power-only, water-only and joint power/water expense categories is not subject to audit. Since Hetch Hetchy has had no water-related debt outstanding at June 30,

Notes to Statement of Changes in the Balancing Account June 30, 2009

2009 and 2008, the weighted average rate of return is 85% of the average rate of return on assets of Class A water utilities as approved by the California Public Utilities Commission.

(6) Water Enterprise and Hetch Hetchy Depreciation

The assignment of assets and related depreciation expenses to specific J-Table categories is not subject to audit but is evaluated by representatives of the Suburban Purchasers. The following is the unaudited assignment of total Water Enterprise depreciation expenses to specific J-Table categories and related suburban share of the depreciation expenses for the year ended June 30, 2009:

		depreciation expense		
J-Table Category	J-Table Factor	Total J-Table Category	Suburban Share	
Current base	67.69% \$	2,993,233	2,026,119	
Current maximum day	71.71%			
Current maximum hour	71.56%		_	
Ultimate base	64.56%	1,307,345	844,022	
Ultimate maximum day	70.02%	18,035,077	12,628,161	
Ultimate maximum hour	71.51%	76,063	54,393	
Composite	69.40%	3,010,787	2,089,486	
Direct suburban	100.00%	121,496	121,496	
	\$	25,544,001	17,763,677	

The following is the unaudited assignment of total Hetch Hetchy depreciation expense to power-only, water-only and joint power/water categories for the year ended June 30, 2009:

			Unaudited depreciation expense		
Category	Allocation Factor	_	Category Total		Suburban Share
Power-only Water-only Joint power/water	—% 100 45	\$	5,468,794 2,042,766 3,512,523	\$	2,042,766 1,580,635
		\$	11,024,083		3,623,401
Times Hetch Hetchy adjusted ultimate usage percentage		_		_	64.35%
				\$_	2,331,659

12 (Continued)

Unaudited

Notes to Statement of Changes in the Balancing Account June 30, 2009

(7) Subsequent Event – Water Supply Agreement (WSA)

For the last twenty-five years, the Water Enterprise provided water service to Wholesale Customers pursuant to the terms of the 1984 Settlement Agreement and Master Water Sales Contract. This contract expired on June 30, 2009. The Commission and the Wholesale Customers negotiated and have approved a new Water Supply Agreement ("WSA"). The WSA has a twenty-five year term with options for two five-year extensions. The term of the WSA began on July 1, 2009. The existing 184 million of gallons per day (mgd) Supply Assurance continues under the WSA and no increase in the Supply Assurance will be considered before December 31, 2018. During the period from 2009 to 2018, the WSA limits the quantity of water delivered to Retail Customers and Wholesale Customers for the SFPUC watersheds to 265 mgd. Under the WSA, annual operating expenses including debt service on bonds sold to finance regional system improvements and regional capital projects funded from revenues will be allocated between Retail Customers and Wholesale Customers on the basis of proportionate annual water use. The Wholesale Customers' share of net book value of existing regional assets will be recovered through level annual payments over the twenty-five year term of the WSA at an interest rate of 5.13%. The WSA continues much of the rate setting, accounting, and dispute resolution provisions contained in the expired Master Water Sales Contract, and has emergency and drought-pricing adjustment provisions.