



HETCH HETCHY WATER AND POWER

Financial Statements

June 30, 2009 and 2008

(With Independent Auditors' Report Thereon)

HETCH HETCHY WATER AND POWER

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KPMG LLP
55 Second Street
San Francisco, CA 94105

Independent Auditors' Report

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

We have audited the accompanying financial statements of the San Francisco Hetch Hetchy Water and Power (Hetch Hetchy), an enterprise fund of the City and County of San Francisco, California (the City), as of and for the years ended June 30, 2009 and 2008, as listed in the table of contents. These financial statements are the responsibility of Hetch Hetchy'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 Hetch Hetchy's internal control over financial reporting. Accordingly, we express no such opinion. An audit 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 Hetch Hetchy are intended to present the financial position, and the changes in financial position and cash flows of only that portion of the City that is attributable to the transaction of Hetch Hetchy. They do not purport to, and do not, present fairly the financial position of the City as of June 30, 2009 and 2008, the changes in its financial position, or, where applicable, the 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 Hetch Hetchy as of June 30, 2009 and 2008, 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 October 30, 2009, on our consideration of Hetch Hetchy'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 13 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.

KPMG LLP

October 30, 2009

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Management's Discussion and Analysis

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(Dollars in thousands)

This section presents management's analysis of the San Francisco Hetch Hetchy Water and Power's (Hetch Hetchy) financial condition and activities as of and for the years ended June 30, 2009 and 2008. Management's Discussion and Analysis (MDA) is intended to serve as an introduction to Hetch Hetchy'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
- 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, the Water Enterprise, the Wastewater Enterprise and Hetch Hetchy Water and Power. Hetch Hetchy Water and Power 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. Hetch Hetchy Water and Power 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 79% of the electricity generated by Hetch Hetchy 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 International Airport Commission, San Francisco General Hospital, street lights, Moscone Center, and the Water and Wastewater enterprises). The majority of remaining 21% of electricity generated is sold to other publicly owned utilities, such as the Turlock and Modesto Irrigation Districts. Hetch Hetchy 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

Hetch Hetchy's financial statements include:

Statements of Net Assets present information on Hetch Hetchy'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 Hetch Hetchy 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

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Hetch Hetchy'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 Hetch Hetchy 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 non-cash 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 2009

- Total assets of Hetch Hetchy exceeded total liabilities by \$444,377.
- Net assets increased by \$23,221 or 5.5% during the fiscal year.
- Capital assets, net of accumulated depreciation, increased by \$14,263 or 5.5% to \$273,639.
- During the fiscal year, charges for services, excluding interest and investment income, rental income and other non-operating revenues, decreased by \$4,602 or 3.8% to \$115,028.
- Operating expenses, which exclude interest expense and other non-operating expenses, decreased by \$13,208 or 12.1% to \$96,228.

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Financial Position

Table 1

Comparative Condensed Net Assets

June 30, 2009, 2008, and 2007

	<u>2009</u>	<u>2008</u>	<u>2007</u>	<u>2009 – 2008</u> <u>Change</u>	<u>2008 – 2007</u> <u>Change</u>
Current and other assets	\$ 214,759	200,836	178,076	13,923	22,760
Capital assets, net of accumulated depreciation	<u>273,639</u>	<u>259,376</u>	<u>278,820</u>	<u>14,263</u>	<u>(19,444)</u>
Total assets	<u>488,398</u>	<u>460,212</u>	<u>456,896</u>	<u>28,186</u>	<u>3,316</u>
Current liabilities	22,881	22,209	14,847	672	7,362
Long-term liabilities	<u>21,140</u>	<u>16,847</u>	<u>6,204</u>	<u>4,293</u>	<u>10,643</u>
Total liabilities	<u>44,021</u>	<u>39,056</u>	<u>21,051</u>	<u>4,965</u>	<u>18,005</u>
Net assets:					
Invested in capital assets, net of related debt	273,639	259,376	278,820	14,263	(19,444)
Unrestricted	<u>170,738</u>	<u>161,780</u>	<u>157,025</u>	<u>8,958</u>	<u>4,755</u>
Total net assets	<u>\$ 444,377</u>	<u>421,156</u>	<u>435,845</u>	<u>23,221</u>	<u>(14,689)</u>

Net Assets Fiscal Year 2009

Hetch Hetchy's net assets increased by \$23,221 or 5.5% during the year (see Table 1). Contributing to this net increase was an addition of \$28,186 in total assets offset by an increase in total liabilities of \$4,965. The largest portion of Hetch Hetchy's net assets (\$273,639 or 61.6%) represents investment in capital assets, net of related debt.

Current and other assets increased by \$13,923 or 6.9%, as a result of increases of \$7,484 in current assets and \$6,439 in other assets (see Table 1). Current assets increased by \$7,484 or 4.1% mainly due to increases in unrestricted cash of \$4,265 or 2.6%, accounts receivable of \$1,751 or 18.6%, primarily related to the Modesto Irrigation District, deferred charges and other assets of \$1,358 or 64.0% due to increased energy banked with PG&E at fiscal year end, \$215 or 195.5% in current portion due from other governmental agencies (Wastewater Enterprise and the Port of San Francisco for lighting retrofit and other energy conservation projects), and other current assets of \$29. The increases are offset by a decrease in current loan receivable of \$134 or 100%. Increase in unrestricted cash is attributable to net cash provided by operating activities of \$27,865 cash provided by interest income of \$4,167 offset by cash used in capital and related financing activities of \$21,672 and noncapital financing activities of \$4. Other assets increased by \$6,439 or 38.7% mainly due to an increase of restricted cash by \$6,089 of proceeds from Clean Renewable Energy Bonds (CREBs) issued in November 2008, increases of \$496 in non-current portion of the due from other governmental agencies, and \$40 of bond issuance costs. These increases are offset by a decrease in non-current loan receivable of \$188 due to repayments received and the

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expiration of the memorandum of understanding between Hetch Hetchy and the San Francisco Housing Authority.

Total liabilities increased by \$4,965 or 12.7% primarily due to \$5,717 in Clean Renewable Energy Bonds issued in November 2008, of which \$422 relates to the short term principal obligation. Accounts payable increased by \$2,127 or 16.7% due to higher expenditures compared to prior year. Deposits, advances and other liabilities decreased by \$1,331 or 58.3%, mainly due to the allocation of gas settlement proceeds to City Departments. Other postemployment benefits obligation increased by \$3,076 based on actuarial estimates. Damage and claim liability decreased by \$4,990 or 32.6% due to settlement of two lawsuits filed by the U.S. Forest Service related to fires in proximity to Hetch Hetchy power lines. California Energy Commission's loans payable were retired during the fiscal year in the amount of \$282 or 100%. Other liabilities of accrued payroll, vacation and sick leave, and workers compensation increased by \$648 or 11.3%.

Net Assets Fiscal Year 2008

Hetch Hetchy'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 Hetch Hetchy Water and Power'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 governmental 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, Hetch Hetchy 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 claim 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 postemployment 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.

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Results of Operations

The following table summarizes changes in Hetch Hetchy's net assets for the year:

Table 2
Comparative Condensed Revenues, Expenses, and Changes in Net Assets

Years ended June 30, 2009, 2008, and 2007

	<u>2009</u>	<u>2008</u>	<u>2007</u>	<u>2009 – 2008</u> <u>Change</u>	<u>2008 – 2007</u> <u>Change</u>
Revenues:					
Charges for services	\$ 115,028	119,630	108,009	(4,602)	11,621
Rents and concessions	246	225	215	21	10
Interest and investment income	4,160	6,420	6,478	(2,260)	(58)
Other nonoperating revenues	<u>2,705</u>	<u>10,296</u>	<u>4,201</u>	<u>(7,591)</u>	<u>6,095</u>
Total revenues	<u>122,139</u>	<u>136,571</u>	<u>118,903</u>	<u>(14,432)</u>	<u>17,668</u>
Expenses:					
Operating expenses	96,228	109,436	95,020	(13,208)	14,416
Other nonoperating expenses	<u>2,389</u>	<u>150</u>	<u>93</u>	<u>2,239</u>	<u>57</u>
Total expenses	<u>98,617</u>	<u>109,586</u>	<u>95,113</u>	<u>(10,969)</u>	<u>14,473</u>
Net income before transfers and special item	23,522	26,985	23,790	(3,463)	3,195
Special item:					
Impairment loss	<u>—</u>	<u>(41,224)</u>	<u>—</u>	<u>41,224</u>	<u>(41,224)</u>
Income (loss) before transfers	23,522	(14,239)	23,790	37,761	(38,029)
Transfers to City and County of San Francisco	<u>(301)</u>	<u>(450)</u>	<u>—</u>	<u>149</u>	<u>(450)</u>
Changes in net assets	23,221	(14,689)	23,790	37,910	(38,479)
Net assets at beginning of year	<u>421,156</u>	<u>435,845</u>	<u>412,055</u>	<u>(14,689)</u>	<u>23,790</u>
Net assets at end of year	<u>\$ 444,377</u>	<u>421,156</u>	<u>435,845</u>	<u>23,221</u>	<u>(14,689)</u>

Fiscal Year 2009

Hetch Hetchy's total revenues of \$122,139 decreased by \$14,432 or 10.6% over the prior year (see Table 2). Revenues from charges for services decreased by \$4,602 or 3.8%, attributable to a decrease in electricity sales of \$6,648 to Modesto Irrigation District (MID), Turlock Irrigation District (TID), and third party sales to other Municipalities and Governmental Agencies under Western System Power Pool (WSPP) agreements, a decrease of \$2,636 in revenue from Treasure Island Development Authority (TIDA) resulting from the deletion of \$2,028

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allowance in fiscal year 2008 per the new agreement, other Treasure Island customers, the San Francisco Port power customers and other non-City department power customers. The decreases are offset by an increase in power sales of \$2,597 to City departments and an increase in water assessment fees of \$2,085 to the San Francisco Water Enterprise and other water customers.

Other non-operating revenues decreased by \$7,591 or 73.7%, which is attributed primarily to the absence of one-time revenues in prior fiscal year 2008 for combustion turbine reimbursements of \$4,866 and PG&E refunds of \$3,361. Other decreases include services to other governmental agencies of \$79, sale of fixed assets proceeds, overhead charges and other miscellaneous items of \$253, and recognition of natural gas proceeds of \$968 in fiscal year 2009.

Investment and interest income decreased by \$2,260 or 35.2% mainly due to lower interest rates.

Total operating expenses decreased by \$13,208 or 12.1% to \$96,228, primarily due to a decrease in purchased power and related costs. Power purchases from the Western System Power Pool were lower by \$10,082, resulting in lower transmission costs from PG&E. In addition, there was a decrease in general and administrative expenses of \$13,650 due to a reduction of estimated liability claims in fiscal year 2009 compared to fiscal year 2008. These decreases are offset by a \$4,126 increase in expenses attributable to: (i) professional and specialized services of \$3,692 and (ii) rents and leases services of \$402. Other increased expenses included services provided by other departments of \$776, other operating expenses of \$480, personal services of \$4,294 due to higher other postemployment benefit obligation actuarial estimates, and depreciation of \$848. Non-operating expenses increased by \$2,239 mainly due to the implementation of the new San Francisco Go-Solar incentive program, where rebate payments of \$2,232 were made in fiscal year 2009.

Overall, these changes result in Hetch Hetchy having an increase in net assets of \$23,522 before transfers.

Fiscal Year 2008

Hetch Hetchy'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: an increase 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 the San Francisco Water Enterprise; and an increase of \$3,271 in revenue from the Treasure Island Development Authority (TIDA) attributable mainly to a \$2,029 reversal of allowance for doubtful accounts.

Other non-operating 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 Hetch Hetchy; and a \$134 increase in overhead charges to other City departments for work performed through custom work orders.

Hetch Hetchy'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

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was offset by \$2,120 in costs related to power banked with PG&E. Other postemployment benefits expense increased by \$2,723 due to the adoption of GASB 45, as noted previously.

During the current fiscal year, Hetch Hetchy 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 Hetch Hetchy having a decrease of net assets of \$14,239 before transfers.

Capital Assets and Debt Administration

Capital Assets

Table 3

Capital Assets, Net of Depreciation

Year ended June 30, 2009, 2008, and 2007

	<u>2009</u>	<u>2008</u>	<u>2007</u>	<u>2009 – 2008</u> <u>Change</u>	<u>2008 – 2007</u> <u>Change</u>
Facilities, improvements, machinery, and equipment	\$ 229,998	230,265	215,480	(267)	14,785
Land and rights-of-way	4,676	4,594	4,215	82	379
Construction work in progress	<u>38,965</u>	<u>24,517</u>	<u>59,125</u>	<u>14,448</u>	<u>(34,608)</u>
Total	<u>\$ 273,639</u>	<u>259,376</u>	<u>278,820</u>	<u>14,263</u>	<u>(19,444)</u>

Fiscal Year 2009

Hetch Hetchy had net capital assets of \$273,639 invested in a broad range of utility capital assets as of June 30, 2009 (see Table 3). This amount represents an increase of \$14,263 or 5.5%, attributable to a \$267 decrease in facilities, improvements, machinery and equipment offset by a \$14,448 net increase in construction work in progress and \$82 of additions in land and rights-of-way.

The investment in capital assets includes land, buildings, improvements, hydropower facilities, dams, transmission lines, machinery, and equipment.

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Major additions to construction work in progress during the year ended June 30, 2009 included:

Street light Underground Utilities	\$	3,173
San Joaquin Pipeline Rehabilitation		2,200
Moccasin Power House New Governors for Units 1 & 2		1,346
Hunter's Point Municipal Power		1,335
Kirkwood Powerhouse Rewind Generator		1,221
Kirkwood Power House 1 Stator Core Replacement		1,189
Replacement of Microwave Communication Device		1,000
Other project additions individually below \$1,000		12,178
	\$	<u>23,642</u>

Major facilities, improvements, machinery and equipment placed in service during the year ended June 30, 2009 included:

Street lights	\$	3,138
Moccasin Power House 1 New Governor Unit		1,004
Other items individually below \$1,000		7,463
	\$	<u>11,605</u>

Fiscal Year 2008

Hetch Hetchy 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.

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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
	\$	<u>31,258</u>

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
Street lights		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
	\$	<u>25,817</u>

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Debt Administration

As of June 30, 2009 and 2008, Hetch Hetchy has outstanding debt of \$5,717 and \$282, respectively, as shown in Table 4. Hetch Hetchy issued \$6,325 of Clean Renewable Energy Bonds (CREBs) in accordance with the Energy Tax Incentives Act of 2005 to fund solar photovoltaic projects in November 2008. The qualified bonds carry no interest costs and have a term of fifteen years. Annual payments in the amount of \$422 are due on December 15th beginning December 15, 2008.

Table 4

Outstanding Debt, Net of Unamortized Costs

June 30, 2009, 2008, and 2007

	2009	2008	2007	2009 – 2008 Change	2008 – 2007 Change
State of California CEC loan	\$ —	282	390	(282)	(108)
Clean Renewable Energy Bonds	5,717	—	—	5,717	—
Total	\$ 5,717	282	390	5,435	(108)

Additionally, the California Energy Commission (CEC) loan was retired early in April 2009. The loan was issued in November 2002 to help the San Francisco General Hospital (SFGH) complete the construction phase of its Lighting Retrofit Project. SFGH will reimburse Hetch Hetchy by continuing to provide biannual payments of \$59 each on June 12 and December 12 until 2010. This payment schedule coincides with Hetch Hetchy's original loan repayment schedule to the CEC for this project. The amounts to be repaid by SFGH are reduced by amounts received by Hetch Hetchy under State grant programs.

More detailed information on Hetch Hetchy's long-term liabilities is presented in note 6 to the financial statements.

Economic Factors

The Power's electric revenue requirement model was completed in September 2009. The electric rate setting process will occur during fiscal year 2010. Under an existing development agreement, Hetch Hetchy will construct, own and operate the electric distribution infrastructure required to provide retail electric service to residential and commercial customers in Parcel "A" of the former Hunter's Point Shipyard. To date, Hetch Hetchy has prepared service standards, developed system plans and specifications, acquired materials and equipment, and initiated construction of primary distribution facilities. Concurrent with construction activities, an analysis of projected operating and development costs along with cost-based retail electric rates is underway.

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Request for Information

This report is designed to provide our citizens, customers, investors, and creditors with a general overview of Hetch Hetchy's finances and to demonstrate Hetch Hetchy'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

Statements of Net Assets

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(In thousands)

	2009	2008
Assets:		
Current assets:		
Cash and investments with City Treasury	\$ 170,111	165,846
Cash and investments outside City Treasury	10	10
Receivables:		
Charges for services (net of allowance for doubtful accounts of \$0 in 2009 and 2008)	11,175	9,424
Due from other governmental agencies, current portion	325	110
Interest receivables	2,252	2,259
Other receivables	4,084	4,013
Loan receivable, current portion	—	134
Total receivables	17,836	15,940
Deferred charges and other assets	3,478	2,120
Inventories	261	296
Total current assets	191,696	184,212
Noncurrent assets:		
Restricted assets – cash and investments outside City Treasury	6,091	—
Capital assets not being depreciated	43,641	29,111
Capital assets, net of accumulated depreciation	229,998	230,265
Due from other governmental agencies	16,932	16,436
Bond issuance costs (net of accumulated amortization of \$2)	40	—
Loan receivable, net of current portion	—	188
Total noncurrent assets	296,702	276,000
Total assets	488,398	460,212
Liabilities:		
Current liabilities:		
Accounts payable	14,853	12,726
Accrued payroll	1,544	1,223
Accrued vacation and sick leave, current portion	1,454	1,330
Accrued workers' compensation, current portion	405	380
Damage and claim liability, current portion	3,251	4,157
Deposits, advances, and other liabilities	952	2,283
Revenue bonds, current portion	422	—
Loan payable, current portion	—	110
Total current liabilities	22,881	22,209
Long-term liabilities:		
Other post employment benefits obligation	5,799	2,723
Accrued vacation and sick leave, less current portion	1,086	1,041
Accrued workers' compensation, less current portion	1,900	1,767
Damage and claim liability, less current portion	7,060	11,144
Revenue bonds, less current portion	5,295	—
Loan payable, less current portion	—	172
Total long-term liabilities	21,140	16,847
Total liabilities	44,021	39,056
Net assets:		
Invested in capital assets	273,639	259,376
Unrestricted	170,738	161,780
Total net assets	\$ 444,377	421,156

See accompanying notes to financial statements.

HETCH HETCHY WATER AND POWER

Statements of Revenues, Expenses, and Changes in Net Assets

Years ended June 30, 2009 and 2008

(In thousands)

	2009	2008
Operating revenues:		
Charges for services	\$ 115,028	119,630
Rents and concessions	246	225
Total operating revenues	115,274	119,855
Operating expenses:		
Personal services	36,469	32,175
Contractual services	8,098	3,972
Purchased power and related costs	18,466	28,548
Materials and supplies	2,243	2,291
Depreciation	11,869	11,021
Services provided by other departments	4,477	3,701
General and administrative	7,347	20,997
Other	7,259	6,731
Total operating expenses	96,228	109,436
Operating income	19,046	10,419
Nonoperating revenues (expenses):		
Federal grants	—	52
Interest and investment income	4,160	6,420
Other nonoperating revenues	2,705	10,244
Other nonoperating expense	(2,389)	(150)
Total nonoperating revenues, net	4,476	16,566
Net income before special items and transfers	23,522	26,985
Special item:		
Impairment loss	—	(41,224)
Income before transfers	23,522	(14,239)
Transfers to the City and County of San Francisco	(301)	(450)
Changes in net assets	23,221	(14,689)
Net assets at beginning of year	421,156	435,845
Net assets at end of year	\$ 444,377	421,156

See accompanying notes to financial statements.

HETCH HETCHY WATER AND POWER

Statements of Cash Flows

Years ended June 30, 2009 and 2008

(In thousands)

	2009	2008
Cash flows from operating activities:		
Cash received from customers, including cash deposits	\$ 111,439	125,541
Cash received from tenants for rent	246	225
Cash paid to employees for services	(32,322)	(28,647)
Cash paid to suppliers for goods and services	(49,595)	(57,163)
Cash paid for judgments and claims	(1,903)	(1,264)
Net cash provided by operating activities	27,865	38,692
Cash flows from noncapital and related financing activities:		
Federal and state grants	—	52
Cash received from settlements	1,246	4,866
Cash received from rebates and incentive programs	—	3,361
Rebates and program incentives paid	(2,401)	—
License fees received	1,167	972
Cash from other sources	285	704
Transfers out	(301)	(450)
Net cash (used in) provided by noncapital financing activities	(4)	9,505
Cash flows from capital and related financing activities:		
Acquisition and construction of capital assets	(27,075)	(32,284)
Proceeds from sale of capital assets	25	55
Proceeds from bond issuance, net of discount and issuance costs	6,089	—
Principal payments on bond debt	(422)	—
Principal payments on loans payable	(282)	(108)
Interest paid on loans payable	(7)	—
Net cash used in capital and related financing activities	(21,672)	(32,337)
Cash flows from investing activities:		
Interest income received	4,167	3,814
Net cash provided by investing activities	4,167	3,814
Increase in cash and cash equivalents	10,356	19,674
Cash and cash equivalents:		
Beginning of year	165,856	146,182
End of year	\$ 176,212	165,856
Reconciliation of cash and cash equivalents to the statements of net assets:		
Cash and investments with City Treasury	\$ 170,111	165,846
Cash and investments outside City Treasury	6,101	10
Total cash and investments	\$ 176,212	165,856

HETCH HETCHY WATER AND POWER

Statements of Cash Flows

Years ended June 30, 2009 and 2008

(In thousands)

	2009	2008
Reconciliation of operating income to net cash provided by operating activities:		
Operating income	\$ 19,046	10,419
Adjustment to reconcile operating income to net cash provided by operating activities:		
Depreciation	11,869	11,021
Provision for uncollectible accounts	—	(2,193)
Write-off of capital assets	349	1,245
Gain from sale of capital asset	—	(43)
Amortization of bond discount and issuance	10	—
Changes in operating assets and liabilities:		
Receivables:		
Charges for services	(1,751)	2,196
Due from other governmental agencies	(711)	1,150
Other receivables	(71)	515
Loan receivable	322	134
Deferred charges and other assets	(1,358)	(2,120)
Inventories	35	(26)
Accounts payable	2,720	1,056
Accrued payroll	371	162
Accrued other postemployment benefits obligation	3,076	2,723
Accrued vacation and sick leave	169	56
Accrued workers' compensation	158	(39)
Damage and claim liability	(4,990)	10,520
Deposits, advances, and other liabilities	(1,379)	1,916
Total adjustments	8,819	28,273
Net cash provided by operating activities	\$ 27,865	38,692
Noncash transaction:		
Accrued capital asset costs	\$ 6,304	6,895

See accompanying notes to financial statements.

HETCH HETCHY WATER AND POWER

Notes to Financial Statements

June 30, 2009 and 2008

(Dollars in thousands)

(1) Definition of Reporting Entity

Hetch Hetchy Water and Power (Hetch Hetchy) 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). Hetch Hetchy 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 79% 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 Water and Wastewater enterprises). As a result of the 1913 Raker Act, energy produced above the City's Municipal Load is sold first 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 an account under the City's agreement with PG&E. Hetch Hetchy 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.

Hetch Hetchy 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, Hetch Hetchy 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.

HETCH HETCHY WATER AND POWER

Notes to Financial Statements

June 30, 2009 and 2008

(Dollars in thousands)

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 Hetch Hetchy Water and Power, Wastewater, and the Water are included in the Comprehensive Annual Financial Report of the City as enterprise funds. These financial statements present only the financial operations of Hetch Hetchy Water and Power 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 Hetch Hetchy 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 Hetch Hetchy are accounted for with a separate set of self-balancing accounts that comprise Hetch Hetchy'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 Hetch Hetchy 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.

Hetch Hetchy Water and Power does not apply Financial Accounting Standards Board (FASB) statements and interpretations issued after November 30, 1989. Hetch Hetchy 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*

Hetch Hetchy 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. Non-pooled restricted deposits and restricted deposits and investments held outside the City Treasury with maturities of three months or less are considered to be cash equivalents.

HETCH HETCHY WATER AND POWER

Notes to Financial Statements

June 30, 2009 and 2008

(Dollars in thousands)

(c) ***Investments***

Investments include money market funds which are carried at cost. All other investments are stated at fair value based upon 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 12(a)).

(e) ***Inventory***

Inventory consists primarily 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. 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) ***Bond Discount, Premium, and Issuance Costs***

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

(i) ***Accrued Vacation and Sick Leave***

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

(j) ***Workers' Compensation***

Hetch Hetchy 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.

HETCH HETCHY WATER AND POWER

Notes to Financial Statements

June 30, 2009 and 2008

(Dollars in thousands)

(k) *Damage and Claim Liability*

Hetch Hetchy is self-insured for general liability and uninsurable property damage claims. Commercially uninsurable property includes assets that are underground or provide transmission and distribution. Maintained commercial coverage does not cover claims attributed to loss from earthquake, contamination, pollution remediation efforts and other specific naturally occurring contaminants such as mold. The liability represents an estimate of the cost of all outstanding claims, including adverse loss development, and estimated incurred but not reported claims.

(l) *Arbitrage Rebate Requirement*

Certain bonds are subject to arbitrage rebate requirements in accordance with regulations issued by the U.S. Treasury Department. The requirements of the Clean Renewable Energy Bonds stipulate that the first payment of excess investment earnings if any, is required to be rebated to the federal government, no later than sixty days after the end of the fifth bond year of the agreement. Hetch Hetchy's arbitrage liability was zero as of June 30, 2009.

(m) *Income Taxes*

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

(n) *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 charges for services receivable on the statements of net assets.

(o) *Use of Estimates*

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

(p) *Reclassifications*

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

(q) *Postemployment Benefits Other Than Pensions*

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 postemployment healthcare and other non-pension benefits. Collectively, these benefits are commonly referred to as other postemployment benefits, or OPEB. The statement generally requires that employers account

HETCH HETCHY WATER AND POWER

Notes to Financial Statements

June 30, 2009 and 2008

(Dollars in thousands)

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, Hetch Hetchy implemented the new reporting requirements in the financial statements and established its OPEB transition liability at zero.

(r) ***Effects of New Pronouncements***

Governmental Accounting Standards Board 49, *Accounting and Financial Reporting for Pollution Remediation Obligations*:

For fiscal year ending June 30, 2009, Hetch Hetchy adopted GASB Statement 49, *Accounting and Financial Reporting for Pollution Remediation Obligations*.

To provide governments with better accounting guidance and consistency, GASB Statement 49, *Accounting and Financial Reporting for Pollution Remediation Obligations*, identifies the circumstances under which a governmental entity would be required to report a liability related to pollution remediation. According to the standard, a government would have to estimate its expected outlays for pollution remediation if it knows a site is polluted and any of the following recognition triggers occur:

- Pollution poses an imminent danger to the public or environment and a government has little or no discretion to avoid fixing the problem;
- A government has violated a pollution prevention-related permit or license
- A regulator has identified (or evidence indicates it will identify) a government as responsible (or potentially responsible) for cleaning up pollution, or for paying all or some of the cost of the clean up;
- A government is named (or evidence indicates that it will be named) in a lawsuit to compel it to address the pollution; or
- A government begins or legally obligates itself to begin cleanup or post-cleanup activities (limited to amounts the government is legally required to complete).

As a part of ongoing operations, situations may occur requiring the removal of pollution or other hazardous material. These situations typically arise in the process of acquiring an asset, preparing an asset for its intended use, or during the Design Phase of projects under review by the Project

HETCH HETCHY WATER AND POWER

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June 30, 2009 and 2008

(Dollars in thousands)

Managers. Other times, pollution may arise during the implementation and construction of a major or minor capital project.

Examples of pollution may include, but are not limited to:

- Asbestos or lead paint removal;
- Leaking of sewage in underground pipes or neighboring areas;
- Chemical spills;
- Removal and disposal of known toxic waste;
- Harmful biological and chemical pollution of water; and
- Contamination of surrounding soils by underground storage tanks (UST)

As of June 30, 2009 the pollution remediation obligation reported in the accompanying statements of net assets is \$0.

(3) Cash, Cash Equivalents and Investments

Hetch Hetchy'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 income from the investment of pooled cash at month end in proportion to Hetch Hetchy's average daily cash balances.

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

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

	<u>2009</u>	<u>2008</u>
Current and noncurrent assets:		
Pooled cash and investments with City Treasury	\$ 170,111	165,846
Nonpooled cash and investments outside City Treasury	<u>6,101</u>	<u>10</u>
Total cash, cash equivalents, and investments	<u>\$ 176,212</u>	<u>165,856</u>

HETCH HETCHY WATER AND POWER

Notes to Financial Statements

June 30, 2009 and 2008

(Dollars in thousands)

The following table shows the percentage distribution of the City's pooled investment by maturity as of June 30 2009:

Investment maturities (in months)			
Under 1	1 to less than 6	6 to less than 12	12 – 60
9.9%	27.0%	8.8%	54.3%

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 – 60
6.9%	52.7%	11.6%	28.8%

Non-pooled cash outside of the investment pool is \$6,101 and \$10 at June 30, 2009 and 2008, respectively. Balances include CREBs proceeds of \$6,091 deposited into a Federal Deposit Insurance Corporation (FDIC) insured money market fund with a weighted average maturity of 44 days, and \$10 held at a commercial bank in a non-interest bearing checking account that is covered by depository insurance. The account was established as provided by the City's Administrative Code. The money market fund was rated "AAAm" and "Aaa" by Standard & Poor's and Moody's, respectively, at June 30, 2009.

HETCH HETCHY WATER AND POWER

Notes to Financial Statements

June 30, 2009 and 2008

(Dollars in thousands)

(4) Capital Assets

Capital assets as of June 30, 2009 and 2008 consist of the following:

	<u>Balance June 30, 2008</u>	<u>Increases</u>	<u>Decreases</u>	<u>Balance June 30, 2009</u>
Capital assets not being depreciated:				
Land and rights-of-way	\$ 4,594	82	—	4,676
Construction in progress	24,517	23,642	(9,194)	38,965
Total capital assets not being depreciated	<u>29,111</u>	<u>23,724</u>	<u>(9,194)</u>	<u>43,641</u>
Capital assets being depreciated:				
Facilities and improvements	484,567	4,775	—	489,342
Machinery and equipment	48,501	6,830	(169)	55,162
Total capital assets being depreciated	<u>533,068</u>	<u>11,605</u>	<u>(169)</u>	<u>544,504</u>
Less accumulated depreciation for:				
Facilities and improvements	(270,951)	(9,915)	—	(280,866)
Machinery and equipment	(31,852)	(1,954)	166	(33,640)
Total accumulated depreciation	<u>(302,803)</u>	<u>(11,869)</u>	<u>166</u>	<u>(314,506)</u>
Total capital assets being depreciated, net	<u>230,265</u>	<u>(264)</u>	<u>(3)</u>	<u>229,998</u>
Total capital assets, net	<u>\$ 259,376</u>	<u>23,460</u>	<u>(9,197)</u>	<u>273,639</u>

HETCH HETCHY WATER AND POWER

Notes to Financial Statements

June 30, 2009 and 2008

(Dollars in thousands)

	Balance July 1, 2007	Increases	Decreases	Balance June 30, 2008
Capital assets not being depreciated:				
Land and rights-of-way	\$ 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

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 2009, Hetch Hetchy's capital assets not being depreciated had an increase of \$23,724 and a decrease of \$9,194 which result in a net increase of \$14,530. The \$14,530 net increase was mainly due to additional expenditures in construction in progress. In fiscal years 2009 and 2008, Hetch Hetchy wrote off construction in progress of \$349 and \$42,469, respectively. In fiscal year 2008, Hetch Hetchy wrote down the combustion turbine project by \$41,224 because the City's future power need is expected to be met by the Trans Bay Cable project.

Hetch Hetchy's capital assets being depreciated had an increase of \$11,605 and a decrease of \$169 which resulted in a net increase of \$11,436.

(5) Restricted Assets

Pursuant to the Master Lease/Purchase Agreement (Agreement), net power revenues of Hetch Hetchy are irrevocably pledged to the punctual payment of debt service on the Clean Renewable Energy Bonds (CREBs). Accordingly, net power revenue shall not be used for any other purpose while any of its CREBs are outstanding, except as expressly permitted by the Agreement. Further, all revenues shall be deposited

HETCH HETCHY WATER AND POWER

Notes to Financial Statements

June 30, 2009 and 2008

(Dollars in thousands)

by the City Treasurer, by instruction of Hetch Hetchy, in special funds designated at the Hetch Hetchy Water and Power Revenue Fund (the Power Revenue Fund), which must be maintained in the City Treasury. These funds, held at the City Treasury, are recorded in the statements of net assets of Hetch Hetchy as deposits and investments with the City Treasury.

Deposits in the Power Revenue Fund, including earnings thereon, shall be appropriated, transferred, expended, or used for the following purposes pertaining the financing, maintenance, and operation of Hetch Hetchy in accordance with the following priority:

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

In accordance with the Agreement, Hetch Hetchy maintains certain restricted cash and investment balances in trust. Restricted assets held in trust consist of the following as of June 30, 2009 and 2008:

	<u>2009</u>	<u>2008</u>
Restricted cash and investments outside City Treasury – 2008 Clean Renewable Energy Bond Fund	\$ 6,091	—

HETCH HETCHY WATER AND POWER

Notes to Financial Statements

June 30, 2009 and 2008

(Dollars in thousands)

(6) Changes in Long-Term Liabilities

Long-term liability activities for the years ended June 30, 2009 and 2008 were as follows:

	<u>July 1, 2008</u>	<u>Additions</u>	<u>Reductions</u>	<u>June 30, 2009</u>	<u>Due with in one year</u>
California Energy					
Commission loan	\$ 282	—	(282)	—	—
Clean Renewable Energy Bonds	—	6,325	(422)	5,903	422
Less bond discount	—	(194)	8	(186)	—
Other postemployment benefits obligation	2,723	3,076	—	5,799	—
Accrued vacation and sick leave	2,371	1,476	(1,307)	2,540	1,454
Accrued workers' compensation	2,147	533	(375)	2,305	405
Damage and claim liability	15,301	—	(4,990)	10,311	3,251
Total	<u>\$ 22,824</u>	<u>11,216</u>	<u>(7,368)</u>	<u>26,672</u>	<u>5,532</u>
	<u>July 1, 2007</u>	<u>Additions</u>	<u>Reductions</u>	<u>June 30, 2008</u>	<u>Due with in one year</u>
California Energy					
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 claim liability	4,782	13,713	(3,194)	15,301	4,157
Total	<u>\$ 9,673</u>	<u>18,430</u>	<u>(5,279)</u>	<u>22,824</u>	<u>5,977</u>

(a) State of California Energy Commission (CEC) Loan

In November 2002, Hetch Hetchy 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. Originally the loan has a final maturity date of December 22, 2010; however, the loan was retired early in April 2009. Proceeds from the loan were used to provide funding for an energy conservation project undertaking at San Francisco General Hospital (SFGH). Under the loan terms, Hetch Hetchy 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 Hetch Hetchy received a \$200 grant, which was utilized to pay down the original loan.

Pursuant to the terms of a memorandum of understanding agreement entered into between the San Francisco General Hospital and Hetch Hetchy, SFGH is required to repay Hetch Hetchy for the cost

HETCH HETCHY WATER AND POWER

Notes to Financial Statements

June 30, 2009 and 2008

(Dollars in thousands)

of the project, less any amount received by Hetch Hetchy under State grant programs. Payments received from the San Francisco General Hospital will accrue to fund balance, as the loan was paid in full.

(b) Clean Renewable Energy Bonds

Hetch Hetchy 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. Hetch Hetchy 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 Commission with low-cost access to capital to further its green power objectives.

Hetch Hetchy began making principal payments in the amount of \$422 on December 15, 2008 and will continue annual payments for fifteen years until December 15, 2022. Funding for these payments will be guaranteed by net power revenues. Interest payments are not required, since the effective equivalent of interest on the bonds is paid in the form of federal tax credits in lieu of interest paid by the issuer.

The future annual debt service relating to the CREBs outstanding as of June 30, 2009 is as follows:

Year ending June 30:	
2010	\$ 422
2011	422
2012	422
2013	422
2014	422
2015 – 2019	2,110
2020 – 2023	1,683
	<hr/>
	5,903
Less: current portion	(422)
Less: unamortized discount	(186)
	<hr/>
Long-term portion as of June 30, 2009	\$ <u>5,295</u>

(7) Revenue Pledge

Hetch Hetchy has pledged future power revenues to repay Clean Renewable Energy Bonds which were issued in fiscal year 2009. Proceeds from the revenue bonds provided financing for various capital construction projects. The bonds are payable solely from net power revenues of Hetch Hetchy and are payable through the year ending 2022. Annual principal on the bonds are expected to require less than 1.0% of future revenues through the year 2022.

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The original amount of revenue bonds issued, total principal remaining, principal paid during 2009, and applicable revenues for 2009 are as follows:

Bonds issued with revenue pledge	\$	6,325
Principal and interest remaining due at the end of the year		5,903
Principal and interest paid during the year		422
Net revenue for the year ended June 30		53,241

(8) 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 non-exclusive 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 non-exclusive license to install a 400 MW high voltage transmission line, with a four (4) year term. The “Licensee” will pay the Port of San Francisco under this license and Hetch Hetchy \$3,500 in 36 annual installments of \$97 as the “Renewable Energy, Transmission and Grid Reliability Payment”. Hetch Hetchy received the first annual payment of \$97 in September 2007.

The second license is an Operational License, Port Commission License No. 14325, a non-exclusive license for operation of the transmission line with twenty-five (25) year term with an option to renew for ten (10) years. The “Licensee” will pay Hetch Hetchy in excess of \$20,000 in 10 separate installments of \$2,000 annually with adjustments for inflation, as the “San Francisco Electric Reliability Payment” to implement, advance, promote or enhance policies and projects consistent with City Energy Policies. Once the project is on line, which is currently scheduled in 2010, Hetch Hetchy will receive the first installment of \$2,000.

For fiscal years ending June 30, 2009 and 2008, \$1,069 and \$972, respectively, of Construction License revenue have been included in revenue related to this project, and are restricted for purposes designated by the San Francisco Board of Supervisors under the agreement.

(9) Employee Benefits

(a) Retirement Plan

Plan Description – Hetch Hetchy 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

HETCH HETCHY WATER AND POWER

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Hetch Hetchy 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.

Funding Policy – Contributions to the basic Plan are made by both Hetch Hetchy and its employees. Employee contributions are mandatory. Employee contribution rates for 2009, 2008 and 2007 varied from 5.0% to 8.0% as a percentage of covered payrolls. Due to certain bargaining agreements, Hetch Hetchy contributed from 0.5% to 8.0% of covered payroll on behalf of some employees. In addition, Hetch Hetchy was required to contribute for the fiscal years ended June 30, 2009, 2008, and 2007 at an actuarially determined contribution rate as a percentage of covered payrolls of 4.99%, 5.91%, and 6.24%, respectively. Hetch Hetchy contributed 100% of its required contribution of \$1,231 in 2009, \$1,326 in 2008, and \$1,335 in 2007.

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.

(b) Health Care Benefits

Health care benefits of Hetch Hetchy 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). Hetch Hetchy's annual contribution, which amounted to approximately \$3,929 and \$3,424 in fiscal years 2009 and 2008, 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 \$921 and \$871 for 2009 and 2008, respectively, to provide postretirement benefits for retired employees, on a pay-as-you-go basis. In addition, the City allocated an additional \$29 and \$36 to Hetch Hetchy's contribution allocation for payments made from the Health Service System for postretirement health benefits in 2009 and 2008, respectively.

The City has determined a City-wide Annual Required Contribution (ARC), interest on net Other postemployment benefits other than pensions (OPEB) Obligation, ARC adjustment, and OPEB cost based upon an actuarial valuation performed in accordance with GASB 45, by the City's actuaries. The City's allocation of the OPEB related costs to Hetch Hetchy for the year ended June 30, 2009 based upon its percentage of City-wide payroll costs is presented below.

HETCH HETCHY WATER AND POWER

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(Dollars in thousands)

The following table shows the components of the City’s annual OPEB allocations for Hetch Hetchy for the years ending June 30, 2009 and 2008, for the amount contributed to the plan, and changes in the City’s net OPEB obligation:

	<u>2009</u>	<u>2008</u>
Annual required contribution	\$ 3,993	3,630
Interest on net OPEB Obligation	125	—
Adjustment to ARC	<u>(92)</u>	<u>—</u>
Annual OPEB cost (expense)	4,026	3,630
Contribution made	<u>(950)</u>	<u>(907)</u>
Increase in net OPEB obligation	3,076	2,723
Net OPEB obligation – beginning of year	<u>2,723</u>	<u>—</u>
Net OPEB obligation – end of year	\$ <u><u>5,799</u></u>	<u><u>2,723</u></u>

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 on June 30, 2010.

(10) Related Parties

Various common costs incurred by the Commission are allocated proratably among Hetch Hetchy, 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, 2009 and 2008,

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the Commission allocated \$12,081 and \$9,991, respectively, in administrative costs to Hetch Hetchy, which is included in the financial statements under various expense categories.

The City performs certain administrative services such as maintenance of accounting records and investment of cash for all fund groups within the City. The various funds are charged for these services based on the City's indirect cost allocation plan. The overhead allocation paid to the General Fund of the City by Hetch Hetchy was \$933 and \$467 for the years ended June 30, 2009 and 2008, respectively, and is included in other operating expenses in the accompanying financial statements.

During 2009 and 2008, Hetch Hetchy delivered power and gas without charge to certain City departments, which amounted to \$3,764 and \$4,227, respectively, based on metered usage and applicable power rates. These amounts were excluded from operating revenues in the accompanying financial statements.

Included in 2009 and 2008 operating revenues are sales of power to departments within the City of \$61,067 and \$60,815, respectively.

A variety of City departments provide services such as engineering, purchasing, legal, data processing, telecommunication, and human resources to Hetch Hetchy and charge amounts designed to recover those departments' costs. These charges totaling approximately \$4,477 and \$3,701 for the years ended June 30, 2009 and 2008, respectively, have been included in services provided by other departments in the accompanying financial statements.

The San Francisco Water Enterprise purchases water from Hetch Hetchy. This amount, totaling \$23,000 and \$21,000 for the years ended June 30, 2009 and 2008, respectively, has been included in operating revenues in the accompanying financial statements. The San Francisco Water Enterprise also purchases electricity from Hetch Hetchy. This amount, totaling \$5,504 and \$5,485 for the years ended June 30, 2009 and 2008, respectively, has been included in operating revenues in the accompanying financial statements.

The San Francisco Wastewater Enterprise purchases electricity from Hetch Hetchy. This amount, totaling \$8,613 and \$7,672 for the years ended June 30, 2009 and 2008, respectively, has been included in operating revenues in the accompanying financial statements.

Hetch Hetchy facilitates all electric and gas service connections between Pacific Gas and Electric Company (PG&E) and City departments. In this capacity, Hetch Hetchy facilitates and coordinates the terms and payment for the service connections that are performed by PG&E. As of June 30, 2009 and 2008, there were no outstanding amounts due from City departments related to this work. However, Hetch Hetchy received money from PG&E after project completion. Those monies are to be refunded back to the City Departments for their respective amounts.

Hetch Hetchy 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, Hetch Hetchy may secure low-interest financing to supplement funds available in the SEA fund. At June 30, 2009 and 2008, projects completed or underway throughout the City amounted to \$14,658 and \$13,947, respectively, and are recorded as due from other governmental agencies.

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Besides funding the SEA projects, in 2009 Hetch Hetchy also funded a project for the Treasure Island Development Authority (TIDA) and recorded as due from other governmental agencies. Regarding the Moscone Center, the memorandum of understanding is currently being renegotiated to extend the payment terms of the receivable.

The details of these projects are as follows:

	<u>2009</u>	<u>2008</u>
Moscone Center	\$ 10,700	10,700
San Francisco General Hospital	1,645	1,869
San Francisco Department of Public Health	1,003	1,140
San Francisco Department of Public Works	18	134
Port of San Francisco	736	83
San Francisco International Airport	—	21
Wastewater	556	—
	<u>14,658</u>	<u>13,947</u>
Total SEA related projects	14,658	13,947
Treasure Island Development Authority	2,599	2,599
	<u>17,257</u>	<u>16,546</u>
Total due from other governmental agencies	17,257	16,546
Less current portion	(325)	(110)
Long-term portion as of June 30	<u>\$ 16,932</u>	<u>16,436</u>

HETCH HETCHY WATER AND POWER

Notes to Financial Statements

June 30, 2009 and 2008

(Dollars in thousands)

(11) Risk Management

Hetch Hetchy’s risk management program encompasses both self-insured and insured coverage. Risk assessments and coverage are coordinated by the City’s Office of Risk Management. With certain exceptions, the City and Hetch Hetchy’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, Hetch Hetchy obtains commercial insurance. At least annually, the City actuarially determines general liability and workers’ compensation risk exposures. Hetch Hetchy 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.

<u>Primary risks</u>	<u>Typical coverage approach</u>
General liability	Self-Insure
Property	Purchase Insurance and Self-Insure
Workers’ compensation	Self-Insure through City-Wide Pool
<u>Other risks</u>	<u>Typical coverage approach</u>
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 Claim 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 Hetch Hetchy 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.

HETCH HETCHY WATER AND POWER

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June 30, 2009 and 2008

(Dollars in thousands)

The changes for the damage and claim liabilities for the years ended June 30, 2009 and 2008 are as follows:

	<u>Beginning of year</u>	<u>Claims and changes in estimates</u>	<u>Claims paid</u>	<u>End of year</u>
2007 – 2008	\$ 4,782	13,713	(3,194)	15,301
2008 – 2009	15,301	(3,400)	(1,590)	10,311

(b) Property

Hetch Hetchy'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, Hetch Hetchy has utilized traditional insurance or other alternative insurance programs. Under the latter approach, 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, Hetch Hetchy requires each contractor to provide its own insurance, while ensuring that the full scope of work be covered with satisfactory levels to limit Hetch Hetchy'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.

(c) Workers' Compensation

The City actuarially determines and allocates workers' compensation costs to Hetch Hetchy 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 Hetch Hetchy'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.

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June 30, 2009 and 2008

(Dollars in thousands)

The changes in the liabilities for worker’s compensation for the years ended June 30, 2009 and 2008 are as follows:

	<u>Beginning of year</u>	<u>Claims and changes in estimates</u>	<u>Claims paid</u>	<u>End of year</u>
2007 – 2008	\$ 2,186	587	(626)	2,147
2008 – 2009	2,147	533	(375)	2,305

(d) Surety Bonds

Bonds are required in most phases of the public utilities 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 provided liability coverage through a commercial Public Official Liability policy; including the Commission members, the General Manager, and the Chief Financial Officer. Hetch Hetchy also maintains a commercial crime policy in lieu of bonding its employees.

(e) Professional Liability, Errors and Omissions

Professional liability policies are either directly purchased insurance on behalf of Hetch Hetchy, 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.

(f) Builders’ Risk

Builder’s risk policies of insurance are required to be provided by the contractor on all construction projects for the full value of the construction.

(g) Owner Controlled Insurance Program

As of June 30, 2009, Hetch Hetchy completed the final close out of its OCIP program. No further obligation for claims funding will continue into future years.

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

(12) 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

HETCH HETCHY WATER AND POWER

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June 30, 2009 and 2008

(Dollars in thousands)

Hetch Hetchy's power to its customers. In addition, agreement provides supplemental power and energy banking and other support services to Hetch Hetchy. The agreement provides audit rights to review past billings paid by Hetch Hetchy and to retroactively (up to two years) adjust these payments as determined necessary. During fiscal years 2009 and 2008, Hetch Hetchy purchased \$13,264 and \$13,579, 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 2009, Hetch Hetchy generated 1,533,190 MWh of power, banked (deposited) in the Deferred Delivery Account (DDA) 104,663 MWh and used (withdrew) 102,927 MWh. At June 30, 2009 and 2008, the balance in the bank was 104,172 MWh or \$2,719 and 102,436 MWh or \$2,120, respectively.

Hetch Hetchy may purchase or sell energy with different market entities through the Western System Power Pool (WSPP). During fiscal year 2009, Hetch Hetchy did not purchase any power. Sales of excess power, after meeting Hetch Hetchy's obligations, were 217,792 MWh, or \$6,162.

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 Hetch Hetchy's operating expenses. The payment amounts were \$4,250 and \$4,426 in fiscal years 2009 and 2008, 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, Hetch Hetchy entered into a long-term power sales agreement (the Agreement) with the Districts. In June 2003, Hetch Hetchy 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 Hetch Hetchy'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, Hetch Hetchy amended the terms of the Agreement with Turlock Irrigation District (TID). The settlement agreement between the Commission 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 Commission 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 2009 and 2008, energy sales to the Districts totaled 258,268 Mwh or \$6,450 and 386,568 Mwh or \$9,940, respectively.

HETCH HETCHY WATER AND POWER

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June 30, 2009 and 2008

(Dollars in thousands)

As of June 30, 2009 and 2008, Hetch Hetchy had outstanding commitments with third parties of \$22,346 and \$20,296, respectively, for various capital projects and other purchase agreements for materials and services.

(b) Energy Risk Management

Hetch Hetchy 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 Hetch Hetchy. For this reason, the financial results of Hetch Hetchy are sensitive to variability in watershed hydrology and market prices for energy.

(c) Litigation

Hetch Hetchy 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 Hetch Hetchy.

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 \$33,000 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:

Closing date to January 1, 2007	\$	9,268
January 1, 2008		1,333
January 1, 2009		1,333
January 1, 2010		1,333
	\$	<u>13,267</u>

HETCH HETCHY WATER AND POWER

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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 \$2,500 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 \$2,500 from the sale of each unit plus 5% of any amount in excess of \$2,500 and (ii) any eligible amounts incurred by the City in excess of the amount provided by the Fund.

Additionally, in the event the Authority does not exercise its option to purchase the combustion turbines pursuant to the terms of the King's River Conservation District (KRCDD) Implementation Agreement, the Attorney General shall make deposits of any remaining amounts allocated to KRCDD that are not used for the development of the KRCDD facility to the City's account.

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. No receipts have been received subsequent to June 30, 2008. The City has actual costs incurred in the development of the facility up to \$18,172 and \$17,897 as of June 30, 2009 and 2008, respectively. Hetch Hetchy has recognized no revenue from the Fund for this fiscal year and a cumulative total of \$14,133 for reimbursement from the Fund as of June 30, 2009. 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 Commission made a decision to terminate the project, withdrawing project approval, and recommending sale of the gas turbine generator sets.

On July 22, 2008, the 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 in fiscal year 2008.

HETCH HETCHY WATER AND POWER

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(Dollars in thousands)

The City has no plans to complete the project and has submitted a proposal to the State for disposal of the combustion turbines, which is currently pending approval. Payments are past due from the State, pending an auditing of prior expenditures. The State will either approve or disallow expenditures and the sales plan to dispose of the combustion turbines.

Also in preparation of the combustion turbines for sale in fiscal year 2009-2010, some entities have shown interest in modifying steam heating plants in San Francisco to cogenerate electricity for local consumption. The Commission is instructed to analyze the feasibility of these local cogeneration projects. If any of these projects demonstrate initial feasibility and environmental benefit, and requires purchase from the City a combustion turbine unit, the Commission is instructed to report to the Mayor and Board of Supervisors on what actions would allow for consideration of these projects.

(13) Subsequent Events

(a) *U.S. Department of Energy – Energy Efficient Grant*

In October 2009, the Commission received a formula grant in the amount of \$7,739 approved from the U.S. Department of Energy under the American Recovery and Reinvestment Act of 2009 (ARRA).

(b) *Litigation Settlement*

The Board of Supervisors authorized settlement of the two lawsuits filed by United States of America on behalf of the US Forest Service related to fires that occurred in proximity to power lines. By Ordinance No. 200-09, adopted August 18, 2009, the Board approved the payment of \$7 million, in settlement of both actions. The settlement agreement did not concede Hetch Hetchy liability, nor establish legal precedent with respect to future incidents. Both of these claims have been included in the same \$7 million amount in the liabilities section of the Statement of Net Assets under damage and claim liability, as they will be paid out after June 30, 2009.

(c) *525 Golden Gate Avenue*

The City & County of San Francisco issued \$167.7 million in Certificates of Participation Series 2009 C and D on September 23, 2009 to fund the future headquarters of the San Francisco Public Utilities Commission (SFPUC) at 525 Golden Gate Avenue. The 2009 C series were issued for \$38.1 million on a tax-exempt basis, and the 2009 D series were issued for \$129.6 million as “Build America Bonds” on a taxable basis under the 2009 American Recovery and Reinvestment Act.

The City conveyed the real property to the Trustee under a property lease in exchange for the proceeds of the sale of the Certificates. The Trustee has leased the property back to the City for the City’s use under a Project Lease. The City will be obligated under the Project Lease to pay base rental payments and other payments to the Trustee each year during the thirty-two year term of the Project Lease. The Commission is obligated to pay the City the lease costs, with each of its enterprise operations responsible for their respective proportional usage share of that cost. It is anticipated that these lease costs will be offset with reductions in costs associated with current office rental expense.



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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 the San Francisco Hetch Hetchy Water and Power (Hetch Hetchy), an enterprise fund of the City and County of San Francisco, California (the City) as of and for the year ended June 30, 2009, and have issued our report thereon dated October 30, 2009. 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 Hetch Hetchy's internal control over financial reporting as a basis for designing our auditing procedures for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of Hetch Hetchy's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of Hetch Hetchy's internal control over financial reporting.

A deficiency in internal control over financial reporting 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 and correct misstatements on a timely basis. A material weakness is a deficiency, or combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis.

Our consideration of internal control over financial reporting was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control over financial reporting that might be deficiencies, significant deficiencies, or material weaknesses. We did not identify any deficiencies in internal control over financial reporting that we consider to be material weaknesses, as defined above.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether Hetch Hetchy's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those

provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*.

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

October 30, 2009