SAN FRANCISCO WATER ENTERPRISE

Financial Statements

June 30, 2009 and 2008

(With Independent Auditors' Report Thereon)

SAN FRANCISCO WATER ENTERPRISE

June 30, 2009 and 2008

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KPMG LLP
55 Second Street
San Francisco, CA 94105

Independent Auditors' Report

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

We have audited the accompanying financial statements of the San Francisco Water Enterprise (the Enterprise), 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 the Enterprise's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

As discussed in note 1, the financial statements of the Enterprise are intended to present the financial position, and the changes in financial position and cash flows of only that portion of the City that is attributable to the transactions of the Enterprise. They do not purport to, and do not, present fairly the financial position of the City as of June 30, 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 the San Francisco Water Enterprise of the City and County of San Francisco, California 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 November 6, 2009, on our consideration of the Enterprise's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, grant agreements, and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of our audit.

The management's discussion and analysis on pages 3 through 17 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

November 6, 2009

This section presents management's analysis of the San Francisco Water Enterprise's (the Enterprise) financial condition and activities as of and for the years ended June 30, 2009 and 2008. Management's Discussion and Analysis (MDA) is intended to serve as an introduction to the Enterprise's financial statements. This information should be read in conjunction with the audited financial statements that follow this section. All amounts, unless otherwise noted, are expressed in thousands of dollars.

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

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

Organization and Business

The San Francisco Public Utilities Commission (the Commission) is an agency of the City and County of San Francisco (the City) that is responsible for the maintenance, operation, and development of three utility enterprises, the Wastewater Enterprise, Hetch Hetchy Water and Power, and the Water Enterprise. The Water Enterprise collects, transmits, treats, and distributes high-quality drinking water to a total population of approximately 2.5 million people, including retail customers in the City and wholesale customers located in San Mateo, Santa Clara, and Alameda Counties. The Enterprise delivered approximately 86,986 million gallons in the year ended June 30, 2009. Approximately two-thirds of the water delivered by the Enterprise is to wholesale customers. Retail customers include residential, commercial, industrial, and governmental users, and the Enterprise recovers cost of service through user fees. Wholesale customers include cities, water districts, one private utility, and one nonprofit university. Service to these customers is provided pursuant to the Master Water Sales Contract which establishes the basis for determining the costs of wholesale service. The current contract expired June 30, 2009 and a new agreement has been negotiated, commencing on July 1, 2009.

Overview of the Financial Statements

The Enterprise's financial statements include:

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

While the *Statements of Net Assets* provide information about the nature and amount of resources and obligations at year-end, the *Statements of Revenues, Expenses, and Changes in Net Assets* present the results of the Enterprise's operations over the course of the fiscal year and information as to how the net assets changed during the year. These statements can be used as an indicator of the extent to which the Enterprise has successfully recovered its costs through user fees and other charges. All changes in net assets are reported during the period in which the underlying event giving rise to the change occurs, regardless of the timing of the related cash flows. Thus, revenues and expenses are reported in these statements from some items that will result in cash flows in future fiscal periods, such as delayed collection of operating revenues and the expenses 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 the Enterprise exceeded total liabilities by $462,300.
- Net assets increased by $967 or 0.2% during the fiscal year.
- Capital assets, net of accumulated depreciation, increased by $233,266 or 18.4 % to $1,501,260.
- During the fiscal year, charges for services, excluding interest and investment income, rental income, other operating and non-operating revenues, increased by $30,845 or 14.2% to $247,664.
- Operating expenses, which exclude interest expense and other non-operating expenses, increased by $25,263 or 11.3% to $248,315.

(Dollars in thousands, unless otherwise stated)

Financial Position

Table 1

Comparative Condensed Net Assets

June 30, 2009, 2008, and 2007

		2009	2008	2007	2009 – 2008 change	2008 – 2007 change
Current and other assets	$	269,975	259,432	440,895	10,543	(181,463)
Capital assets, net of accumulated depreciation		1,501,260	1,267,994	1,074,255	233,266	193,739
Total assets		1,771,235	1,527,426	1,515,150	243,809	12,276
Revenue and capital appreciation bonds		936,506	961,790	980,759	(25,284)	(18,969)
Commercial paper		229,600	—	—	229,600	—
Other liabilities		142,829	104,303	95,817	38,526	8,486
Total liabilities		1,308,935	1,066,093	1,076,576	242,842	(10,483)
Net assets:						
Invested in capital assets, net of related debt		349,629	324,091	300,996	25,538	23,095
Restricted for debt service		27,899	27,434	56,196	465	(28,762)
Restricted for capital projects		841	214	—	627	214
Unrestricted		83,931	109,594	81,382	(25,663)	28,212
Total net assets	$	462,300	461,333	438,574	967	22,759

Net Assets Fiscal Year 2009

For the year ended June 30, 2009, the Enterprise's assets exceeded liabilities by $462,300, representing an increase of $967 or 0.2% from the prior year (see Table 1). The growth in net assets is the result of an additional $243,809 in total assets offset by a $242,842 increase in total liabilities. Investment in capital assets, net of related debts, represents the largest portion of the Enterprise's net assets ($349,629 or 75.6%). The increase of $25,538 represents the excess of capital asset book values over debt-financed construction and acquisition costs. Unrestricted net assets declined $25,663 due to higher planned expenses than revenue growth.

Current and other assets is primarily comprised of restricted and unrestricted balances of cash, receivables for water deliveries and services, interfund receivables due from other governmental agencies, and inventory. This section also includes a receivable which represents cumulative amounts due from the Suburban Purchasers to match revenues with the Enterprise's costs of providing service (the "Balancing Account") in accordance with the provisions set forth in the Master Water Sales Agreement which expired on June 30, 2009.

During the fiscal year 2009, current and other assets increased by $10,543 or 4.1%, as a result of an $11,107 increase in current assets, a $234 decrease in restricted cash and investments due to declining interest rates and lower cash balances and a $330 decrease in bond issuance costs. Current assets increased mainly due to the

(Continued)

increase in accounts receivable from the wholesale customers under the Suburban Water Rate Agreement. Wholesale customers are billed based on the estimated costs of service and usage, which are adjusted to actual costs and usage at year end. The estimates billed for fiscal year 2008 and 2009 were less than actual, resulting in $13,701 additional due at June 30, 2009. There was also an increase of $4,608 in receivable balances for charges for services mainly from City retail ratepayers, net of the current year provision for uncollectible accounts, as a result of an average rate adjustment of 15% that went into effect at the beginning of the fiscal year. Part of the receivable increase was $205 in receivables resulting from an established memorandum of understanding between the Enterprise and the San Francisco Zoological Society for water consumption at its park facility. The increase of $278 due from other governmental agencies was attributable to an increase in grants receivable. In addition, there was a net increase in other current assets including interest, due from other funds, advances, and inventory of $247. Cash balances, however, declined by $7,727 due to a decrease in interest rates and related earnings, and increases in operating expenses.

Total liabilities increased by $242,842 or 22.8% primarily due to the issuance of $229,600 in commercial paper. Excluding the change in commercial paper, other current liabilities increased by $19,956 due to increases in accounts payable of $6,384 related to large capital projects such as 525 Golden Gate of $2,600, SCADA System of $950, Noe Valley Trans Line of $589, and Ripley Control Distribution Division of $419. In addition, current liabilities increased by $13,281 in restricted assets, largely related to increases in payables for the Water System Improvement Program. Long-term liabilities decreased by $6,714 due to scheduled principal payments on revenue and capital appreciation bonds outstanding of $26,369, decreases in damage and claims liability of $1,117 and pollution remediation obligation of $120 related to payment of pollution remediation costs, offset by increases in the liability for other postemployment benefits (OPEB) of $15,919, arbitrage rebate payable of $4,265, workers' compensation of $443, and accrued vacation and sick leave of $265.

Restricted cash and investments with and outside City Treasury declined by $234 at the end of the fiscal year 2009, due primarily to declining interest rates and lower cash balances held by City Treasury. Additionally, unrestricted cash with City Treasury was used to pay down current contractual obligations and other liabilities, thereby resulting in $7,727 decline in unrestricted cash balance.

Net Assets Fiscal Year 2008

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

(Dollars in thousands, unless otherwise stated)

Results of Operations

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

Table 2

Comparative Condensed Revenues, Expenses and Changes in Net Assets

Years ended June 30, 2009, 2008, and 2007

	2009	2008	2007	2009 – 2008 change	2008 – 2007 change
Revenues:					
Charges for services	$ 247,664	216,819	202,787	30,845	14,032
Rents and concessions	9,399	9,645	9,929	(246)	(284)
Other operating revenues	8,718	7,752	3,815	966	3,937
Interest and investment income	7,088	12,456	24,547	(5,368)	(12,091)
Other nonoperating revenues	7,202	29,681	11,798	(22,479)	17,883
Total revenues	280,071	276,353	252,876	3,718	23,477
Expenses:					
Operating expenses	248,315	223,052	202,498	25,263	20,554
Interest expense	28,847	29,750	34,326	(903)	(4,576)
Nonoperating expenses	799	792	777	7	15
Total expenses	277,961	253,594	237,601	24,367	15,993
Income (loss) before transfers	2,110	22,759	15,275	(20,649)	7,484
Transfers to City and County of San Francisco	(1,143)	—	(9,763)	(1,143)	9,763
Changes in net assets	967	22,759	5,512	(21,792)	17,247
Net assets at beginning of year	461,333	438,574	433,062	22,759	5,512
Net assets at end of year	$ 462,300	461,333	438,574	967	22,759

Fiscal Year 2009

The Enterprise's total revenues for the year of $280,071 represented an increase of $3,718 or 1.3% compared to the prior year (see Table 2). Charges for services increased by $30,845 or 14.2%, other operating revenue increased by $966, offset by decreases of $22,479 in non-operating revenues, $5,368 in interest and investment income, and $246 in rents and concessions.

Revenues from the sale of water to retail customers increased $14,564 or 15.6% largely attributable to an average 15.0% increase in retail rates and a slight increase in consumption. Revenues from the sale of water to wholesale or related customers increased by $15,905 or 13.7%, as revenue collection for wholesale customers increased to $131,831 from $115,926 over the prior year. Water sales to suburban non-resale customers increased by $385, and water sales to municipal customers decreased by $9. The Balancing Account due from suburban customers increased $13,701 from the prior year, based on the difference between revenues billed and costs of service. Interest and investment income decreased by $5,368 or 43.1% as a result of lower average daily cash balances and lower interest rates. Other non-operating revenue decreased by $22,479 or 92.5% primarily due to the receipt of $24,335 from the sale of surplus land in the prior year.

The Enterprise's total expenses increased by $24,367 or 9.6% to $277,961 over prior year (see Table 2), due to increases of $25,263 in operating expenses, $7 in non-operating expenses and decrease of $903 in interest expense. The change in operating expenses was mainly due to an increase of $13,727 in other operating expenses such as non-capitalized projects expenses, capital projects write-off, indirect cost reimbursement to the City's general fund, and environmental remediation. Other increases were due to $5,405 in services provided by other departments related to Hetch Hetchy water assessment fees and fees paid to the City Attorney, $4,636 in personal services, due to an increase in work hours in fiscal year 2009 by 3,500 hours which resulted in a $2,500 increase in salaries and an increase in health care costs of $1,400 in fiscal year 2009 compared to fiscal year 2008, $3,142 in depreciation, $2,327 in contractual services, $1,165 in materials and supplies, and $88 in bad debt expense, offset by a decrease of $5,227 in general and administrative expenses mainly due to lower judgment and claims. The change in non-operating expenses represents larger investments in various community based organizations (CBO's) of $299 in support of local water conservation and sustainability programs and interest expense from amortized refunding losses relating to the early retirement of bonds issued in 2002 and 2006.

Fiscal Year 2008

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

The Enterprise's total expenses for the year $253,594 increased by $15,993 or 6.7% over the prior year (see Table 2). The change was attributable to an increase of $20,554 in operating expenses partially offset by a decrease of $4,576 in interest expense. The change in operating expenses includes increases in postemployment benefits of $15,048, depreciation of $2,063, judgments and claims of $3,173, and higher payments to Hetch Hetchy for water allocation of $1,945. The decrease in interest expense was a result of lower outstanding bond debt throughout fiscal year 2008.

(Dollars in thousands, unless otherwise stated)

Capital Assets and Debt Administration

Capital Assets

Table 3

Capital Assets, Net of Depreciation

Years ended June 30, 2009, 2008, and 2007

		2009	2008	2007	2009 – 2008 change	2008 – 2007 change
Facilities, improvements, machinery, and equipment	$	935,581	827,045	744,880	108,536	82,165
Land and rights-of-way		18,386	17,886	18,277	500	(391)
Construction work in progress		547,293	423,063	311,098	124,230	111,965
Total	$	1,501,260	1,267,994	1,074,255	233,266	193,739

Water System Improvement Program (WSIP)

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

The program is on target to achieve an overall completion date of December 2015. To date, planning of the WSIP Regional Program is approximately 96% complete, whereas environmental review/permitting, design and construction efforts are about 67%, 75% and 6% complete, respectively. The transition of the WSIP's larger regional projects to the construction phase started in early 2009. As of June 30, 2009, there are two regional projects in Planning Phase, seventeen in Design Phase, ten in Bids & Award Phase, six in Construction phase, two in Close-Out phase, eight regional projects are completed, and one regional project has not yet been initiated. See table below.

Active phase	Regional projects Q4
Planning	2
Design	17
Bid & Award	10
Construction	6
Close-Out	2
Completed	8

The total estimated cost for the WSIP is $4.6 billion, including $4.1 billion for capital projects and $471.7 million for net financing costs. To date, nearly $2.9 billion has been appropriated for the WSIP, of which approximately $743 million has been expended through FY 2009. Over the next six years, the Commission will require approximately $1.7 billion in additional appropriation for the completion of the program. To help meet this funding need, additional bonds sales are planned, with the most recent sales occurring in August and September 2009. Both sales were for par value amounts of $412 million each.

Additional details regarding the WSIP are available in the Annual Reports published on the Enterprise's web site at www.sfwater.org.

Fiscal Year 2009

The Enterprise had net capital assets of $1,501,260 invested in a broad range of utility capital assets as of June 30, 2009 (see Table 3). The investment in capital assets includes land, facilities, improvements, water treatment plants, aqueducts, water transmission, and distribution mains, water storage facilities, pump stations, water reclamation facilities, machinery and equipment. This amount includes an increase of $108,536 or 13.1% over the prior year in structures, buildings and equipment, and an increase of $124,230 or 29.4% in construction in progress, consistent with the Enterprise's implementation of the ten-year capital plan, including the Water System Improvement Program. The Enterprise's net revenue, commercial paper, and long-term debt are used to finance capital investments. During the fiscal year 2009, as part of a property transfer, the Enterprise has acquired a parcel from BART located in the City of San Bruno, California, with a value of $500.

As of June 30, 2009, the Enterprise had invested $12,669 in development costs and $9,900 in site acquisition for an office building located at 525 Golden Gate Avenue. The site was acquired by the City from the State of California in 2000, and was transferred to the Enterprise in 2006. The site comprises a 0.5-acre portion of the block bounded by Polk Street, McAllister Street, Golden Gate Avenue and Van Ness Avenue, in the Civic Center district of the City. The Civic Center is home to City, State and Federal government buildings, including City Hall, Civic Center Courthouse, offices of the San Francisco Unified School District, the Philip Burton Federal Building and U.S. Courthouse, the Hiram W. Johnson State Office Building, and City cultural facilities, including the San Francisco Main Public Library, Louise M. Davies Symphony Hall, Bill Graham Civic Auditorium, the War Memorial Opera House and Veterans Building, and the Asian Art Museum of San Francisco.

The principal improvement to the site consists of a new 277,500 square-foot Class A office building containing approximately 257,000 square feet of rentable space across 13 floors plus one basement level. The finished building has been designed to include a 10,000-square-foot child development center, a café, and public art exhibition space. The building design seeks to achieve the Platinum certification standards of the Leadership in Energy and Environmental Design (LEED) Green Building Rating System, the nationally accepted benchmark for the design, construction and operation of high-performance "green" buildings.

The City has received all environmental approvals necessary for construction of the 525 Golden Gate Avenue property, and the design development phase is completed. Demolition of the existing site was completed in June 2009, while site improvement phases such as shoring, underpinning and excavation are currently underway. Construction is expected to start in January 2010 with an expected completion date of February 2012, with an expected occupancy date of April 2012.

(Continued)

(Dollars in thousands, unless otherwise stated)

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

Tesla Treatment Facility	$	22,314
McLaren Park Pump Station Upgrade		19,244
New Crystal Springs Bypass Tunnel		17,512
Local Water Main Replacement Program		16,114
Harry Tracy Water Treatment Plant (HTWTP) Short Term Improvements Phase 3		11,823
San Joaquin Pipeline System		10,916
Stanford Heights Reservoir Rehab/Upgrade		9,738
Standby Power Facility Various Locations		9,032
Calaveras Dam Replacement		8,774
Sunset Reservoir – Upgrade/Rehab North Basin		8,591
HTWTP Long Term Improvements		8,404
Sunol Valley Water Treatment Plant (SVWTP) Expansion/Treated Water Reservoir		8,314
Bay Division Pipeline (BDPL) Reliability Upgrade – Tunnel		8,183
Crystal Springs Pump Station & Crystal Springs – San Andreas Pipeline		8,051
New Irvington Tunnel		7,676
BDPL Reliability – Pipeline Upgrade		6,076
East/West Transmission Main		5,694
Irvington Tunnel Alternatives – Alameda Siphon No. 4		4,979
North University Mound System Update		4,836
525 Golden Gate		4,184
Seismic Upgrade BDPL at Hayward Fault		3,844
Forest Knolls Pump Station Upgrade		3,165
Mount Davidson Pump Station Upgrade		3,106
Rehab Existing San Joaquin Pipelines		3,075
Local Water Program New Services		3,039
Vehicle Service & Facility Upgrade		2,988
Palo Alto Pump Station Upgrade		2,898
Lower Crystal Springs Dam Improvements		2,675
Noe Valley Transmission Main Phase 2		2,595
Customer Information System		2,568
Forest Knolls Tank Upgrade		2,541
Regional Groundwater Storage & Recovery		2,518
Environmental Impact Report (EIR) Project Mitigation Planning		2,505
Calaveras Dam Replacement – San Antonio Backup Pipeline		2,496
Installation of Scada System Phase 2		2,479
lake Merced Pump Station Upgrade		2,420
Other project additions individually below $2,400		37,338
	$	282,705

(Dollars in thousands, unless otherwise stated)

Major structures, buildings and equipment placed in service during the year ended June 30, 2009 included:

Sunset Reservoir North Basin Seismic Retrofit Structure	$	50,025
East/West Transmission Main		29,754
Water Main Replacement - Bernal/Nebraska		6,647
Other items individually below $5,000		71,171
	$	157,597

Fiscal Year 2008

The Enterprise had net capital assets of $1,267,994 invested in a broad range of utility capital assets as of June 30, 2008 (see Table 3). The investment in capital assets includes land, buildings, improvements, water treatment plants, aqueducts, water transmission, and distribution mains, water storage facilities, pump stations, water reclamation facilities, machinery and equipment. This amount includes an increase of $82,165 or 11.0% over the prior year in structures, buildings and equipment, and an increase of $111,965 or 36.0% over the prior year in construction in progress, consistent with the Enterprise's implementation of the ten-year Water System Improvement Program. The Enterprise's net revenue, commercial paper, and long-term debt are used to finance capital investments.

As of June 30, 2008, the Enterprise had invested $5,413 in development costs and $9,900 in site acquisition for an office building located at 525 Golden Gate Avenue. The building was currently envisioned as a twelve story building encompassing approximately 212,000 square feet, and is intended to consolidate divisions of the Commission that are currently renting space at multiple locations throughout the City. The existing structure is expected to be demolished.

(Dollars in thousands, unless otherwise stated)

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

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

(Dollars in thousands, unless otherwise stated)

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

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

Debt Administration

Table 4

Outstanding Debt, Net of Amortized Costs

June 30, 2009, 2008, and 2007

		2009	2008	2007	2009 – 2008 change	2008 – 2007 change
Revenue bonds	$	932,886	958,410	977,604	(25,524)	(19,194)
Capital appreciation bonds		3,620	3,380	3,155	240	225
Commercial paper		229,600	—	—	229,600	—
Total	$	1,166,106	961,790	980,759	204,316	(18,969)

As of June 30, 2009, the Enterprise had $1,166,106 total debt outstanding, an increase of $204,316 over the prior year (see Table 4). The Enterprise had commercial paper notes outstanding of $229,600 at June 30, 2009 and none in the previous year. Total debt outstanding at June 30, 2009 consisted of $932,886 in fixed-rate long-term revenue bonds and $3,620 in capital appreciation bonds. The change in total debt outstanding was due to the retirement of revenue bond principal, and a change in the accreted value of all capital appreciation bonds, amortization of bond discounts, bond premium, and refunding loss.

As of June 30, 2008, the Enterprise had $961,790 total debt outstanding, a decrease of $18,969 over the prior year (see Table 4). Total debt outstanding at June 30, 2008 consisted of $958,410 in fixed-rate long-term revenue bonds and $3,380 in capital appreciation bonds. The change in total debt outstanding was due to the retirement of revenue bond principal, and a change in the accreted value of all capital appreciation bonds, amortization of bond discounts, bond premium, and refunding loss.

Credit Ratings and Bond Insurance – At June 30, 2009, the Enterprise carried underlying ratings of "A1" and "AA-" from Moody's and Standard & Poor's (S&P), respectively. At June 30, 2008, the Enterprise carried underlying ratings of "A1" and "A+" from Moody's and Standard & Poor's (S&P), respectively. In connection with the sale of substantially all of the Enterprise's revenue bonds, municipal bond insurance has been purchased by the Commission or the underwriters from XL Capital (XL), Financial Security Assurance Corporation (FSA), and MBIA Insurance Corporation (MBIA) to guarantee the payment of principal and interest when due. XL had been acquired by Syncora Holdings (Syncora) in August 2008. In November 2008, Moody's had downgraded FSA to "Aa3," and S&P had put FSA on negative outlook, but continued to maintain its "AAA" rating. In February 2009, MBIA provided further reinsurance on its public finance bond insurance portfolio through its newly created subsidiary, National Public Finance Guarantee Corporation (NPFGC). Moody's and S&P initially rated NPFGC at "Baal" and "A," respectively. With the insurance, Moody's and S&P have assigned their municipal bond ratings of "Aaa" and "AAA," respectively, to the Enterprise's insured revenue bonds. The downgrade of various bond insurance companies by credit rating agencies in 2008 had not caused any change in the Enterprise's underlying ratings. In March 2009, Moody's downgraded Syncora to "Ca" while S&P downgraded Syncora to "R" in April 2009, effectively placing Syncora under regulatory supervision due to its financial condition. In June 2009, Moody's downgraded MBIA to "Ba3," while S&P downgraded MBIA to "BB+" in September 2009 but affirmed NPFGC's rating.

Debt Service Coverage – Pursuant to the Amended and Restated Indenture, the Enterprise is required to collect sufficient net revenues each fiscal year, together with any Enterprise funds (except Bond Reserve Funds) which are available for payment of debt service and are not budgeted to be expended, at least equal to 1.25 times annual debt service for said fiscal year. During fiscal years 2009 and 2008, the Enterprise's net revenues, together with fund balances available to pay debt service and not budgeted to be expended, were sufficient to meet the rate covenant requirements under the Enterprise's Amended and Restated Indenture.

Debt Authorization – Pursuant to the Charter, the Enterprise can incur indebtedness upon two-thirds vote of the Board of Supervisors, as approved by voters in Proposition E in November 2002. The Enterprise can also incur indebtedness of up to $1,628,000 for improvements to the water system pursuant to Proposition A that was approved by the voters in November 2002. As of June 30, 2009, $507,800 of the $1,628,000 was issued. The Enterprise is also authorized to issue up to $500,000 in commercial paper. As of June 30, 2009, $229,600 was issued and outstanding.

Cost of Debt Capital – The Enterprise's outstanding long-term debt had interest rates ranging from 2.5% to 7.0% as of June 30, 2009 and 2008. The Enterprise's short-term debt had interest rates ranging from 0.25% to 0.75% as of June 30, 2009. In the prior year, the Enterprise had no outstanding short-term debt.

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

Economic Factors and Next Year's Rates

On August 11, 2009, the Enterprise sold $412,000 in 2009 Series A Bonds to finance a portion of the WSIP projects and refund outstanding commercial paper. 2009 Series B Bonds in the amount of $412,000 were sold on September 1, 2009. Outstanding revenue bonds for the Enterprise total $1,757,000 as of September 30, 2009.

Retail water rate increases of 15%, 15%, 12.5%, 12.5%, and 6.5% have been approved for the next five fiscal years 2009 through 2014. A wholesale water rate increase of 15.7% has been approved for fiscal year 2009-2010.

Rate Setting Process

The Master Water Sales Contract was approved by the City and the wholesale customers in 1984 (see note 9 to the financial statements). Proposition E, as approved by the Voters on November 2002, amended the City Charter by adding the new Article VIIB, entitled "Public Utilities," which changed the Commission's ability to issue new revenue bonds and set retail water rates. The Commission is required to:

(Dollars in thousands, unless otherwise stated)

- Establish rates, fees, and charges based on cost of service;
- Retain an independent rate consultant to conduct cost of service studies at least every five years;
- Consider establishing new connection fees;
- Consider conservation incentives and lifeline rates;
- Adopt a rolling five-year forecast annually; and
- Establish a Rate Fairness Board.

Wholesale customer rates were set pursuant to the Master Water Sales Contract, up through June 30, 2009 when the contract expired. A new agreement was negotiated between the Commission and the Wholesale Customers represented by the Bay Area Water Supply and Conservation Agency (BAWSCA). The term of the new Water Supply Agreement (WSA) began on July 1, 2009 and shall end on June 30, 2034, with two 5-year extension options.

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

	Approved average rate adjustments	
	Retail	**Wholesale**
Effective date:		
July 1, 2004	0 %	2.7 %
July 1, 2005	15.0	(9.7) [1]
July 1, 2006	15.0	18.8
July 1, 2007	15.0 [2]	6.3
July 1, 2008	15.0	10.0
July 1, 2009 [3]	15.0	15.7
July 1, 2010 [4]	15.0	17.6
July 1, 2011 [4]	12.5	17.2
July 1, 2012 [4]	12.5	17.2
July 1, 2013 [4]	6.5	13.6

[1] Adjustment effective April 1, 2005

[2] Adjustment effective July 14, 2007

[3] July 1, 2009 was the first year of the new twenty-five year agreement

[4] Wholesale rates are adopted annually. Fiscal years beginning July 1, 2010 are projected rates.

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

Request for Information

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

SAN FRANCISCO WATER ENTERPRISE

Statements of Net Assets

June 30, 2009 and 2008

(In thousands)

		2009	2008
Assets:			
Current assets:			
Cash and investments with City Treasury	$	130,927	138,654
Cash and investments outside City Treasury		36	36
Receivables:			
Charges for services (net of allowance for doubtful accounts of $1,187 in 2009 and $1,439 in 2008)		38,298	33,690
Suburban water rate agreement		27,571	13,870
Due from other funds		197	250
Due from other governments		337	59
Interest		321	666
Advances and other		788	120
Total receivables		67,512	48,655
Inventories		1,849	1,872
Total current assets		200,324	189,217
Noncurrent assets:			
Restricted assets – cash and investments with City Treasury		21,726	21,740
Restricted assets – cash and investments outside City Treasury		40,974	41,051
Restricted assets – interest receivable		117	260
Capital assets not being depreciated		565,679	440,949
Capital assets, net of accumulated depreciation		935,581	827,045
Bond issuance costs (net of accumulated amortization of $3,302 in 2009 and $2,976 in 2008)		6,834	7,164
Total noncurrent assets		1,570,911	1,338,209
Total assets		1,771,235	1,527,426
Liabilities:			
Current liabilities:			
Accounts payable		14,778	8,394
Accrued payroll		6,846	6,009
Accrued vacation and sick leave, current portion		6,071	5,738
Accrued workers' compensation, current portion		1,551	1,512
Due to other funds		23	—
Damage and claim liability, current portion		2,515	3,011
Deposits, advances, and other liabilities		4,903	7,157
Bond interest payable		7,420	7,434
Pollution remediation obligation, current portion		3,077	2,339
Revenue bonds, current portion		26,605	25,520
Commercial paper		229,600	—
Current liabilities payable from restricted assets		40,603	27,322
Total current liabilities		343,992	94,436
Long-term liabilities:			
Arbitrage rebate payable		4,265	—
Other postemployment benefits obligations		30,967	15,048
Accrued vacation and sick leave, less current portion		5,383	5,118
Accrued workers' compensation, less current portion		7,066	6,623
Damage and claim liability, less current portion		7,126	8,243
Revenue bonds, less current portion		906,281	932,890
Capital appreciation bonds		3,620	3,380
Pollution remediation obligation, less current portion		235	355
Total long-term liabilities		964,943	971,657
Total liabilities		1,308,935	1,066,093
Net assets:			
Invested in capital assets, net of related debt		349,629	324,091
Restricted for debt service		27,899	27,434
Restricted for capital projects		841	214
Unrestricted		83,931	109,594
Total net assets	$	462,300	461,333

See accompanying notes to financial statements.

SAN FRANCISCO WATER ENTERPRISE

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	$	247,664	216,819
Rents and concessions		9,399	9,645
Other revenues		8,718	7,752
Total operating revenues		265,781	234,216
Operating expenses:			
Personal services		106,869	102,233
Contractual services		13,619	11,292
Materials and supplies		12,671	11,506
Depreciation		49,100	45,958
Services provided by other departments		40,103	34,698
Bad debt expense		92	4
General and administrative		2,982	8,209
Other		22,879	9,152
Total operating expenses		248,315	223,052
Operating income		17,466	11,164
Nonoperating revenues (expenses):			
Federal and state grant		1,784	1,958
Interest and investment income		7,088	12,456
Interest expense		(28,847)	(29,750)
Net gain from sale of land		2,587	24,335
Other nonoperating revenues		2,032	2,596
Net nonoperating revenues (expenses)		(15,356)	11,595
Income before transfers		2,110	22,759
Transfers to the City and County of San Francisco		(1,143)	—
Changes in net assets		967	22,759
Net assets at beginning of year		461,333	438,574
Net assets at end of year	$	462,300	461,333

See accompanying notes to financial statements.

SAN FRANCISCO WATER ENTERPRISE

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	$	235,841	222,676
Cash received from tenants for rent		9,069	9,749
Cash paid to employees for services		(88,027)	(85,633)
Cash paid to suppliers for goods and services		(78,888)	(71,369)
Cash paid for judgments and claims		(4,126)	(2,359)
Net cash provided by operating activities		73,869	73,064
Cash flows from noncapital and related financing activities:			
Transfers out		(1,143)	—
Operating grants		—	1,899
Net cash (used in) provided by noncapital financing activities		(1,143)	1,899
Cash flows from capital and related financing activities:			
Proceeds from sale of capital assets		2,601	24,402
Proceeds from commercial paper issued		890,500	—
Payments on commercial paper		(660,900)	—
Principal paid on long-term debt		(25,520)	(19,170)
Interest paid on long-term debt		(44,065)	(45,023)
Interest paid on commercial paper		(2,104)	—
Acquisition and construction of capital assets		(251,671)	(234,624)
Capital grants		1,506	—
Net cash used in capital and related financing activities		(89,653)	(274,415)
Cash flows from investing activities:			
Interest income received		7,576	16,600
Proceeds from sale of investments outside City Treasury		70,388	65,317
Purchase of investments outside City Treasury		(70,311)	(50,153)
Other investing activities		1,533	2,827
Net cash provided by investing activities		9,186	34,591
Decrease in cash and cash equivalents		(7,741)	(164,861)
Cash and cash equivalents:			
Beginning of year		160,430	325,291
End of year	$	152,689	160,430
Reconciliation of cash and cash equivalents to the statement of net assets:			
Cash and investments with City Treasury:			
Unrestricted	$	130,927	138,654
Restricted		21,726	21,740
Cash and investments outside City Treasury:			
Unrestricted		36	36
Cash and cash equivalents at end of year on statements of cash flows	$	152,689	160,430

(Continued)

SAN FRANCISCO WATER ENTERPRISE

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	$	17,466	11,164
Adjustment to reconcile operating income to net cash provided by operating activities:			
Depreciation		49,100	45,958
Provision for uncollectible accounts		(252)	—
Write-off of capital assets		5,207	8,337
Changes in operating assets and liabilities:			
Receivables:			
Charges for services		(4,356)	(1,260)
Suburban water rate agreement		(13,701)	(2,004)
Interest and other		(666)	498
Inventories		23	(308)
Accounts payable		6,209	(884)
Due to (from) other City departments		76	(4,856)
Accrued payroll		837	482
Accrued other postemployment benefit liability		15,919	15,048
Accrued vacation and sick leave		598	(315)
Accrued workers’ compensation		482	(210)
Pollution remediation obligation		618	(3,925)
Damage and claims liability		(1,613)	4,320
Deposits, advances, and other liabilities		(2,078)	1,019
Total adjustments		56,403	61,900
Net cash provided by operating activities	$	73,869	73,064
Noncash transactions:			
Accrued capital asset costs	$	40,603	27,322
Land acquired through real property exchange		500	—

See accompanying notes to financial statements.

(1) Definition of Reporting Entity

The San Francisco Water Enterprise (the Enterprise) was established in 1930 under the provisions of the Charter of the City and County of San Francisco. The Enterprise acquired the fully developed, mature water works for San Francisco on March 3, 1930. Since then, the City and County of San Francisco (the City) has operated and maintained the water works as the San Francisco Water Enterprise. The Board of Supervisors of the City has adopted resolutions (the Water Resolutions) providing for the issuance of various water revenue and refunding bond series. The Enterprise, which consists of a system of reservoirs, storage tanks, water treatment plants, pump stations, and pipelines, is engaged in the distribution of water to San Francisco and certain suburban areas. In fiscal 2009, the Enterprise delivered approximately 86,986 million gallons of water to nearly 2.5 million people within San Francisco and certain suburban areas.

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

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

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

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

The Commission is a department of the City, and as such, the financial operations of the Enterprise, Hetch Hetchy, and the Wastewater Enterprise are included in the Comprehensive Annual Financial Report of the City as enterprise funds. These financial statements present only the financial operations of the Enterprise alone and are not intended to present the financial position of the City as a whole or consolidated entity, the changes in its financial position, and the cash flows of its proprietary funds in conformity with U.S. generally accepted accounting principles.

(2) Significant Accounting Policies

(a) Basis of Accounting and Measurement Focus

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

The financial activities of the Enterprise are accounted for on a flow of economic resources measurement focus, using the accrual basis of accounting. Under this method, all assets and liabilities associated with its operations are included on the 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, rental income and capacity fees.

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

(b) Cash and Cash Equivalents

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

(c) Investments

Money market funds are carried at cost. All other investments are stated at fair value based on quoted market prices. Changes in fair value are recognized as investment gains or losses.

(d) Inventory

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

(e) Capital Assets

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

(f) Construction in Progress

The cost of acquisition and construction of major plant and equipment is recorded as construction in progress. Costs of discontinued construction projects are recorded as an expense in the year in which the decision is made to discontinue such projects.

(g) Capitalization of Interest

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

(h) Bond Discount, Premium, and Issuance Costs

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

(i) Accrued Vacation and Sick Leave

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

(j) Workers' Compensation

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

(k) Damage and Claim Liability

The Enterprise 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 Payable

Certain bonds are subject to arbitrage rebate requirements in accordance with regulations issued by the U.S. Treasury Department. The requirements generally stipulate that earnings from the

(Continued)

investment of the tax-exempt bond proceeds that exceed related interest costs on the bonds must be remitted to the federal government on every fifth anniversary of each bond issue. The liability for arbitrage rebate was $4,265 and $0 at June 30, 2009 and June 30, 2008, respectively.

(m) Refunding of Debt

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

(n) Income Taxes

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

(o) Revenue Recognition

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

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

(p) Use of Estimates

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

(q) Reclassifications

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

(r) 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 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.

(Continued)

An employer may establish its OPEB transition liability at zero as of the beginning of the initial year of implementation; however, the unfunded actuarial liability is required to be amortized over future periods. This statement also establishes disclosure requirements for information about the plans in which an employer participates, the funding policy followed, the actuarial valuation process and assumptions, and, for certain employers, the extent to which the plan has been funded over time. As of July 1, 2007, the Enterprise implemented the new reporting requirements in the financial statements and established its OPEB transition liability at zero.

(s) Effects of New Pronouncements

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

For fiscal year ending June 30, 2009, the Enterprise has adopted GASB Statement 49, *Accounting and Financial Reporting for Pollution Remediation Obligations*. More detailed information about the Enterprise's environmental pollution remediation obligations is presented in note 13(d) to the financial statements.

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 Managers. Other times, pollution may arise during the implementation and construction of a major or minor capital project, such as the Water System Improvement Project (WSIP) or one of the many capital improvement projects currently underway in the Infrastructure Bureau.

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 from contents in underground storage tanks (UST).

The Enterprise had recorded $3,312 and $2,694 in pollution remediation costs as of June 30, 2009 and 2008, respectively.

(3) Cash, Cash Equivalents and Investments

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

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

Restricted assets are held by an independent trustee outside the City's investment pool. The assets are held for the purpose of paying future interest and principal on the bonds and for eligible capital project expenditures. The balances as of June 30, 2009 and 2008 were $40,974 and $41,051, respectively. The Enterprise held all investments in either guaranteed investment contracts or in money funds consisting of Treasury Obligations. The guaranteed investment contracts mature in 2008 and 2013. The Treasury Obligations have an average maturity of 46 days in fiscal year 2009 and 14 days in fiscal year 2008.

Funds held by the trustee established under the 2002 amended and restated Indentures agreements are invested in "Permitted Investments," as defined in the agreement, which includes money market funds and investment agreements. The agreement permits investment in money market funds registered under the Federal Investment Company Act of 1940 and whose shares are also registered under the Federal Securities Act of 1933 and having a rating by Standard & Poor's of "AAAm-G," "AAAm" or "AAm" and a rating by Moody's of "Aaa," "Aa1" or "Aa2." Investment agreements must be with a U.S. bank or trust company having a rating by Moody's and S&P of "A" or higher, or are guaranteed by any entity with a rating of "A" or higher, at the time the agreement is entered into. The credit ratings of the guaranteed investment contracts as of June 30, 2009 were "Aa2" by Moody's and "A+" by Standard & Poor's. The credit ratings of the money market funds as of June 30, 2009 and June 30, 2008, were "Aaa" by Moodys and "AAAm" by Standard & Poor's.

(Dollars in thousands)

Additional cash outside of the investment pool includes $36 at June 30, 2009 and 2008, which is held in a commercial bank in non-interest bearing checking accounts which are covered by Federal Deposit Insurance Corporation (FDIC) depository insurance. These accounts were established as provided by the City's Administrative Code for revolving fund needs.

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

		2009	2008
Current assets:			
Cash and investments with City Treasury	$	130,927	138,654
Cash and investments outside City Treasury		36	36
Noncurrent assets – restricted assets:			
Cash and investments with City Treasury		21,726	21,740
Cash and investments outside City Treasury		40,974	41,051
Total cash, cash equivalents and investments	$	193,663	201,481

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

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

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

Investment maturities (in months)			
Under 1	**1 to less than 6**	**6 to less than 12**	**12 to 60**
6.9%	52.7%	11.6%	28.8%

(Dollars in thousands)

(4) Capital Assets

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

		Balance June 30, 2008	Increases	Decreases	Balance June 30, 2009
Capital assets not being depreciated:					
Land and rights of way	$	17,886	500	—	18,386
Construction in progress		423,063	282,705	(158,475)	547,293
Total capital assets not being depreciated		440,949	283,205	(158,475)	565,679
Capital assets being depreciated:					
Facilities and improvements		1,287,404	138,776	—	1,426,180
Machinery and equipment		128,758	18,821	(791)	146,788
Total capital assets being depreciated		1,416,162	157,597	(791)	1,572,968
Less accumulated depreciation for:					
Facilities and improvements		(496,886)	(41,085)	51	(537,920)
Machinery and equipment		(92,231)	(8,015)	779	(99,467)
Total accumulated depreciation		(589,117)	(49,100)	830	(637,387)
Total capital assets being depreciated, net		827,045	108,497	39	935,581
Total capital assets, net	$	1,267,994	391,702	(158,436)	1,501,260

(Dollars in thousands)

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

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

Financial Accounting Standards Board (FASB) Statement 34, *Capitalization of Interest Costs*, requires that interest expense incurred during construction of assets be capitalized. Interest included in the Construction in Progress and total interest expense incurred during the years ended June 30, 2009 and 2008 are as follows:

	2009	2008
Interest expensed	$ 28,847	29,750
Interest included in construction in progress	22,135	15,333
	$ 50,982	45,083

During fiscal years ending in 2009 and 2008, the Enterprise expensed $5,207 and $7,885, respectively, related to capitalized design and planning costs on certain projects. The amounts of the write-offs were recognized as other operating expenses in the accompanying statements of revenues, expenses, and changes in net assets.

(Continued)

During the fiscal year ending June 30 2007, the Enterprise purchased 525 Golden Gate for $9,900 from the City General Fund and as of June 30, 2009 had spent $12,669 in development costs. The building is intended to consolidate divisions of the San Francisco Public Utilities Commission that are currently renting space at multiple locations in the Civic Center. Demolition of the existing site was completed in June 2009, while site improvement phases such as shoring, underpinning and excavation are currently underway. Construction is expected to start in January 2010 with an expected completion date of February 2012, followed by an expected occupancy date of April 2012.

(5) Restricted Assets

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

1. The payment of operation and maintenance expenses for such utility and related facilities;

2. The payment of pension charges and proportionate payments to such compensation and other insurance or outside reserve funds as the Enterprise may establish or the Board of Supervisors may require with respect to employees of the Enterprise;

3. The payment of principal, interest, reserve, sinking fund, and other mandatory funds created to secure Revenue Bonds issued by the Enterprise for the acquisition, construction, or extension of facilities owned, operated, or controlled by the Enterprise;

4. The payment of principal and interest on General Obligation Bonds issued by the City for the Enterprise’s purposes;

5. Reconstruction and replacement as determined by the Enterprise or as required by any of the Enterprise’s Revenue Bond ordinances duly adopted and approved; and

6. The acquisition of land, real property, or interest in real property for, and the acquisition, construction, enlargement, and improvement of, new and existing buildings, structures, facilities, equipment, appliances, and other property necessary or convenient to the development or improvement of such utility owned, controlled, or operated by the Enterprise; and for any other lawful purpose of the Enterprise, including the transfer of surplus funds pursuant to Section 6.407(e) of the City’s Charter.

(Continued)

(Dollars in thousands)

In accordance with the Indenture, the Program maintains certain restricted cash and investment balances in trust. Restricted assets held in trust consisted of the following as of June 30, 2009 and 2008:

		2009	2008
Cash and investments with City Treasury:			
Water revenue bond construction fund	$	21,726	21,740
Cash and investments outside City Treasury:			
1991 Water revenue bond fund		15	15
2001A Water revenue bond fund		2,611	2,585
2002A Water revenue bond fund		3,363	3,315
2002B Water revenue bond fund		4,647	4,580
2006A Water revenue bond fund		25,564	25,781
2006B Water revenue bond fund		2,869	2,882
2006C Water revenue bond fund		1,905	1,893
Total cash and investments outside City Treasury		40,974	41,051
Interest receivable:			
Water bond construction fund		117	260
Total restricted assets	$	62,817	63,051

Restricted cash listed above as cash and investments with City Treasury are held in sub-funds of the Water Revenue Fund.

(6) Short-Term Debt

The Commission and Board of Supervisors have authorized the issuance of up to $500,000 in commercial paper. Pursuant to the voter-approved 2002 Proposition A, the Enterprise is authorized to issue up to $1,628,000 of indebtedness, of which, $507,815 in long-term bonds were previously issued in fiscal year 2006 and $890,500 in short-term commercial paper were issued during fiscal year 2009. Short-term commercial paper had an average yield of 1.4% and maximum yield at 2.9% during fiscal year 2009. The Enterprise had commercial paper notes outstanding at June 30, 2009 as follows:

		Amount
Balance, beginning of year	$	—
Additions		890,500
Reductions		(660,900)
Balance, end of year	$	229,600

(Dollars in thousands)

(7) Changes in Long-Term Liabilities

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

	Interest rate	Final maturity date	July 1, 2008	Additions	Reductions	June 30, 2009	Due within one year
Revenue Bonds:							
2001A revenue bonds	4.0 – 5.0%	2031	$ 80,410	—	(2,830)	77,580	2,945
2002A revenue bonds	2.5 – 5.0	2032	150,620	—	(3,100)	147,520	3,260
2002B revenue refunding bonds	3.0 – 5.0	2015	57,580	—	(6,155)	51,425	6,375
2006A revenue bonds	4.0 – 5.0	2036	505,230	—	(8,170)	497,060	8,505
2006B revenue refunding bonds	4.0 – 5.0	2026	107,230	—	(2,985)	104,245	3,145
2006C revenue refunding bonds	4.0 – 5.0	2026	45,840	—	(2,280)	43,560	2,375
Less deferred amounts:							
For issuance premiums			25,952	—	(1,023)	24,929	—
For refunding loss			(14,452)	—	1,019	(13,433)	—
Total revenue bonds payable			958,410	—	(25,524)	932,886	26,605
Capital appreciation bonds	7.0	2019	3,380	240	—	3,620	—
Other postemployment benefits obligation			15,048	15,919	—	30,967	—
Arbitrage rebate payable			—	4,265	—	4,265	—
Accrued vacation and sick leave			10,856	8,715	(8,117)	11,454	6,071
Accrued workers' compensation			8,135	2,195	(1,713)	8,617	1,551
Damage and claim liability			11,254	7,946	(9,559)	9,641	2,515
Pollution remediation obligation			2,694	1,700	(1,082)	3,312	3,077
Total			$ 1,009,777	40,980	(45,995)	1,004,762	39,819

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

(a) Capital Appreciation Bonds

The capital appreciation bonds mature from November 1, 2018 through November 1, 2019. The bonds were insured by MBIA and carried "Aaa" and "AAA" ratings from Moody's and Standard & Poor's (S&P), respectively. In February 2009, the bonds were further reinsured by National Public Finance Guarantee Corporation (NPFGC) and carried "Baal" and "A" ratings from Moody's and S&P, respectively. As of October 2009, MBIA was rated "Ba3" and "BB+" by Moody's and S&P, respectively, while NPFGC had affirmed ratings of "Baa1" and "A" from Moody's and S&P, respectively. Interest on the capital appreciation bonds is due upon maturity and is recognized as annual interest expense over the life of the bonds using the interest method. The Enterprise has recognized $3,620 and $3,380 of unpaid principal and interest on the capital appreciation bonds as of June 30, 2009 and 2008, respectively, and has reported it as capital appreciation bonds in the accompanying statements of net assets.

(b) Water Revenue Bonds Series 2001A

During fiscal year 2002, the Enterprise issued $140,000 of Water Revenue Bonds 2001 Series A (2001 Series A Bonds). The bonds were insured by FSA and carried "Aaa" and "AAA" ratings from Moody's and Standard & Poor's, respectively. As of October 2009, FSA was rated "Aa3" and "AAA" by Moody's and S&P, respectively. The Revenue Bonds include current interest serial and term bonds with interest rates varying from 4% to 5%. The current interest serial bonds mature through November 1, 2021 and the current interest term bonds mature on November 1, 2024, 2027, and 2031. In March 2006, $45,630 of the 2001 A serial and term bonds with maturities of November 2016 to November 2024 were refunded by the 2006 Refunding Series B Water Revenue Bonds.

(c) Water Revenue Bonds Series 2002A

During fiscal year 2003, the Enterprise issued $164,000 of Water Revenue Bonds 2002 Series A (2002 Series A Bonds). The bonds were insured by MBIA and carried "Aaa" and "AAA" ratings from Moody's and Standard & Poor's, respectively. In February 2009, the bonds were further reinsured by NPFGC and carried "Baal" and "A" ratings from Moody's and S&P, respectively. As of October 2009, MBIA was rated "Ba3" and "BB+" by Moody's and S&P, respectively, while NPFGC had affirmed ratings of "Baal" and "A" from Moody's and S&P, respectively. As of October 2009, MBIA was rated "Ba3" and "BB+" by Moody's and S&P, respectively. The Revenue Bonds include interest and serial and term bonds with interest rates varying from 2.5% to 5.0%. The current interest serial bonds mature through November 1, 2026 and the current interest term bonds mature on November 1, 2025 and 2032.

(d) Water Revenue Refunding Bonds Series 2002B

During fiscal year 2003, the Enterprise issued 2002 Water Revenue Refunding Bonds, Series B (the 2002B Refunding Bonds) in the amount of $85,260 with interest rates ranging from 3% to 5%. The bonds were insured by MBIA and carried "Aaa" and "AAA" ratings from Moody's and Standard & Poor's, respectively. In February 2009, the bonds were further reinsured by NDFGC and carried "Baal" and "A" ratings from Moody's and S&P, respectively. As of October 2009, MBIA was rated “Ba3” and “BB+” by Moody’s and S&P, respectively, while NPFGC had affirmed ratings of “Baal” and “A” from Moody’s and S&P, respectively. The current interest serial bonds mature through November 1, 2015.

(e) Water Revenue Bonds Series 2006A

During fiscal year 2006, the Enterprise issued 2006 Water Revenue Bonds, Series A (the 2006 Series A Bonds) in the amount of $507,815. The purpose of the bonds is to finance improvements to the City’s water systems pursuant to Proposition A and to retire commercial paper outstanding. The bonds were insured by FSA and carried “Aaa” and “AAA” ratings from Moody’s and Standard & Poor’s, respectively. As of October 2009, FSA was rated “Aa3” and “AAA” by Moody’s and S&P, respectively. The 2006 Series A Bonds include current interest and serial and term bonds with interest rates ranging from 4% to 5%. The current interest serial bonds mature through November 1, 2027 and the current interest term bonds mature on November 1, 2031 and 2033 and 2036.

(f) Water Revenue Refunding Bonds Series 2006B

During fiscal year 2006, the Enterprise issued 2006 Water Revenue Refunding Bonds, Series B (the 2006B Refunding Bonds) in the amount of $110,065. The purpose of the bonds is to refund a portion of the 1996A Series A Bonds and the 2001 Series A Bonds. The bonds were insured by Syncora (formerly XL) and carried “Aaa” and “AAA” ratings from Moody’s and Standard & Poor’s, respectively. As of October 2009, Syncora was rated “Ca” and “R” by Moody’s and S&P, respectively. The 2006B Refunding Bonds include serial bonds with interest rates varying from 4% to 5%. The current interest serial bonds mature through November 1, 2026.

(g) Water Revenue Refunding Bonds Series 2006C

During fiscal year 2007, the Enterprise issued 2006 Water Revenue Refunding Bonds, Series C (the 2006 Refunding Bonds) in the amount of $48,730 for the purpose of refunding the remaining portion of the outstanding 1996 Series A Bonds maturing on and after November 1, 2007 (the Refunded 1996 Series A Bonds). The bonds were insured by Syncora (formerly XL) and carried “Aaa” and “AAA” ratings from Moody’s and Standard & Poor’s, respectively. As of October 2009, Syncora was rated “Ca” and “R” by Moody’s and S&P, respectively. The 2006C Refunding Bonds include serial bonds with interest rates varying from 4% to 5%. The current interest serial bonds mature through November 1, 2026.

The Enterprise applied a portion of the proceeds from sale of the 2006 Refunding Series C Bonds to establish an irrevocable escrow to refund and legally defease, on a current basis, the Refunded 1996 Series A Bonds. Accordingly, the liability for the refunded bonds has been removed from the accompanying statements of net assets.

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

(Dollars in thousands)

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

(h) Future Annual Debt Service of Revenue Bonds

The future annual debt service relating to the Revenue and Refunding Bonds outstanding as of June 30, 2009 is as follows:

		Principal		Interest
Years ending June 30:				
2010	$	26,605		42,991
2011		27,795		41,784
2012		29,190		40,401
2013		30,610		38,984
2014		32,090		37,510
2015 – 2019		153,470		164,233
2020 – 2024		159,705		128,192
2025 – 2029		184,395		86,839
2030 – 2034		188,280		41,066
2035 – 2037		89,250		6,493
		921,390	$	628,493
Less current portion		(26,605)		
Add unamortized bond premium, net of discount and refunding loss		11,496		
Long-term portion as of June 30, 2009	$	906,281		

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

(i) Proposition A

On November 5, 2002, the San Francisco voters passed Proposition A, which provides for the issuance of revenue bonds and/or other forms of indebtedness by the Commission in a principal amount not to exceed $1,628,000 to finance the acquisition and construction of improvements to the City's Water System. As of June 30, 2009, commercial paper of $229,600 was outstanding pursuant to this authorization and $507,800 of bonds had been issued in fiscal year 2006 against this authorization.

(Dollars in thousands)

(j) Proposition E

On November 5, 2002, the San Francisco voters passed Proposition E, which authorizes the issuance of revenue bonds and/or other forms of indebtedness by the Commission to finance costs for the Commission's capital programs, including WSIP. As of June 30, 2009, no commercial paper was outstanding pursuant to this authorization, but the Commission authorized the issuance of up to $1,322,000 in revenue bonds against this authorization.

(8) Revenue Pledge

The Enterprise has pledged future revenues to repay various revenue bonds. Proceeds from the revenue bonds provided financing for various capital construction projects, and to refund previously issued bonds. The bonds are payable solely from revenues of the Enterprise and are payable through the year ending 2036. Annual principal and interest payments on the bonds are expected to require less than 56% of future revenues through the year 2036.

The original amount of revenue bonds issued, total principal and interest remaining, principal and interest paid during 2009, and applicable revenues for 2009 and 2008 are as follows:

		2009	2008
Bonds issued with revenue pledge	$	1,108,500	1,108,500
Principal and interest remaining due at the end of the year		1,549,883	1,619,467
Principal and interest paid during the year		69,585	64,193
Net revenue for the year ended June 30		82,978	143,926

(9) Suburban Water Rate Agreement

During 1984, the City entered into a Settlement Agreement and Master Water Sales Contract (the Suburban Water Rate Agreement) with certain suburban customers, which establishes the basis for water rates to be charged to those customers (the Suburban Purchasers). Pursuant to the terms of the Suburban Water Rate Agreement, the City is required to establish water rates applicable to the Suburban Purchasers at the beginning of each fiscal year. The suburban water rates are based on an estimate of the level of revenues necessary to recoup the cost of distributing water to the Suburban Purchasers in accordance with the methodology outlined in Article IV of the Suburban Water Rate Agreement (the Suburban Revenue Requirement). During fiscal years ending in 2009 and 2008, the Suburban Revenue Requirement, net of adjustments, charged to such suburban customers was $131,831 and $115,927, respectively. Such amounts are subject to final review by the suburban customers, based on the Suburban Revenue Requirement calculation.

Pursuant to Article V, Section 5.07 of the Suburban Water Rate Agreement, the City is required to re-compute the Suburban Revenue Requirement after the close of each fiscal year based on the actual costs incurred in the delivery of water to the Suburban Purchasers. The difference between the suburban revenues earned during the year and the "actual" Suburban Revenue Requirement is recorded in a separate account (the Balancing Account) and represents the cumulative amount that is either owed to the Suburban Purchasers (if the suburban revenues exceed the Suburban Revenue Requirement) or owed to the City (if the Suburban Revenue Requirement exceeds the suburban revenues paid). In accordance with Article V of the Suburban Water Rate Agreement, the amount recorded in the Balancing Account shall earn interest at a rate equal to the average rate received by the City during the year on the invested pooled funds of the City Treasurer, and shall be taken into consideration in the determination of subsequent suburban water rates. Upon the expiration of the Suburban Water Rate Agreement, the remaining balance in the Balancing Account shall be determined and collected from the Suburban Purchasers. As of June 30, 2009 and 2008, the Suburban Purchasers owed the Enterprise $27,571 and $13,870, respectively, under the terms of the Suburban Water Rate Agreement. Subsequently, the June 30, 2008 amount was revised to $20,626, based on the audited final balancing account statement dated May 27, 2009.

(10) Employee Benefits

(a) Retirement Plan

Plan Description – The Enterprise participates in the City’s single-employer defined benefit retirement plan (the Plan) which is administered by the San Francisco City and County Employees’ Retirement System (the Retirement System). The Plan covers substantially all full-time employees of the Enterprise along with other employees of the City. The Plan provides basic service retirement, disability, and death benefits based on specified percentages of final average salary and 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 the Enterprise 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, the Enterprise contributed from 0.5% to 8.0% of covered payroll on behalf of some employees. In addition, the Enterprise is required to contribute for 2009, 2008 and 2007 at an actuarially determined rate as a percentage of covered payroll of 4.99%, 5.91%, and 6.24%, respectively. The Enterprise contributed 100% of its required contribution of $6,946 in 2009, $7,694 in 2008, and $7,614 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 the Enterprise employees, retired employees and surviving spouses are financed by beneficiaries and by the City through the City and County of San Francisco Health Service System (the Health Service System). The Enterprise’s annual contribution, which amounted to approximately $19,982 and $18,660 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 $5,621 and $5,317 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 $155 and $201 to the Enterprise'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 the Enterprise for the year ended June 30, 2009 based upon its percentage of City-wide payroll costs is presented below.

The following table shows the components of the City's annual OPEB allocations for the Enterprise for the years ended June 30, 2009 and 2008, for the amount contributed to the plan, and changes in the City's net OPEB obligation (dollar amount in thousands):

		2009	2008
Annual required contribution	$	21,522	20,566
Interest on net OPEB Obligation		667	—
Adjustment to ARC		(494)	—
Annual OPEB cost (expense)		21,695	20,566
Contribution made		(5,776)	(5,518)
Increase in net OPEB obligation		15,919	15,048
Net OPEB obligation – beginning of year		15,048	—
Net OPEB obligation – end of year	$	30,967	15,048

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

(c) Wellness Incentive Program

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

The amount of this payment shall be equal to 2.5% of accrued sick leave credits at the time of separation times the number of whole years of continuous employment times an employee's salary rate, exclusive of premiums or supplements, at the time of separation. Vested sick leave credits, as set forth under Civil Service Commission Rules, shall not be included in this computation.

The Wellness Program shall be discontinued as current bargaining agreements expire on June 30, 2010.

(11) Related Parties

Various common costs incurred by the Commission are allocated proratably between the Enterprise, Hetch Hetchy, and the Wastewater Enterprise. The allocations are based on the Commission management's best estimate and may change from year to year depending on the activities incurred by each Enterprise and the information available. For the year ended June 30, 2009, the Commission allocated $32,163 in administrative costs to the Enterprise. For the year ended June 30, 2008, the Commission allocated $28,480 in administrative costs to the Enterprise.

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 the Enterprise was $2,574 and $1,588 for the years ended June 30, 2009 and 2008, respectively, and is included in other operating expenses in the accompanying financial statements.

The Enterprise purchases water from Hetch Hetchy. This amount, totaling $23,000 for year ended June 30, 2009 and $21,000 for year ended June 30, 2008, has been included in the services provided by other departments in the accompanying financial statements.

The Enterprise 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 services provided by other departments in the accompanying financial statements.

Beginning in fiscal year 2008, the Enterprise charged all City departments for water with the exception of fire hydrants that are under the control of the Fire Department. During fiscal years 2009 and 2008, the Enterprise delivered water to certain City departments which amounted to $71 and $1,072, respectively, based on metered usage and applicable water rates, which has been excluded from operating revenues in the accompanying financial statements.

A variety of City departments provide services such as engineering, purchasing, legal, data processing, telecommunications, and human resources to the Enterprise and charge amounts designed to recover those departments' costs. These charges totaling $11,599 and $8,213 for the years ended June 30, 2009 and 2008, respectively, have been included in services provided by other departments in the accompanying financial statements.

During the fiscal year ending June 30, 2009, $1,143 was transferred to other City departments, including $929, representing a percentage of construction contracts to the Art Commission and $214 to the Fire Department for a water reclamation study.

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

(12) Risk Management

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

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

(a) Damage and 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 the Enterprise and the City and County of San Francisco's Comprehensive Annual Financial Report (CAFR). The claim expense allocations are determined based on actuarially determined anticipated claim payments and the projected timing of disbursement.

(Dollars in thousands)

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

		Beginning of year	Claims and changes in estimates	Claims paid	End of year
2007 – 2008	$	6,934	13,104	(8,784)	11,254
2008 – 2009		11,254	7,946	(9,559)	9,641

Property

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

(b) Workers' Compensation

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

(Dollars in thousands)

The changes in the liabilities for workers' compensation for the years ended June 30, 2009 and 2008 are as follows:

		Beginning of year	Claims and changes in estimates	Claims paid	End of year
2007 – 2008	$	8,346	1,557	(1,768)	8,135
2008 – 2009		8,135	2,195	(1,713)	8,617

(c) 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. The Enterprise also maintains a commercial crime policy in lieu bonding its employees.

(d) Professional Liability, Errors, and Omissions

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

(e) Builders' Risk

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

(f) Owner Controlled Insurance Program

As of June 30, 2009, the Enterprise 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 the Enterprise's risk management program consolidates into and is coordinated with the City's, please see the City's CAFR.

(13) Commitments and Litigation

(a) Commitments

As of June 30, 2009 and 2008, the Enterprise has outstanding commitments with third parties of $303,373 and $134,715, respectively, for various capital projects and other purchase agreements for materials and services.

(b) Grants

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

(c) Litigation

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

(d) Environmental Issue

The Enterprise owns approximately 23 acres of land in the city of Menlo Park, which it formerly subleased to a third party. During the life of the lease, the tenant conducted a business on the premises that caused contamination to the property and surrounding areas. In July 1999, the staff of the California Regional Water Quality Control Board (CRWQCB) issued an interim directive instructing the Commission to develop a remedial action plan that addresses environmental contamination located at this property. In response to the directive, the Commission completed an interim remedial action plan. During fiscal year 2002, the Commission received the final directive from the CRWQCB instructing the Commission to execute a remedial action plan with regard to this issue. This environmental issue, along with our complete review of the GASB 49 pronouncement resulted in reporting of $3,312 and $2,694 in fiscal years ending June 30, 2009 and 2008, respectively. The Enterprise paid $1,082 and $4,101 in fiscal years 2009 and 2008, respectively, in accordance with the remedial action plan.

(14) Subsequent Events

(a) Debt Issuance

On August 11, 2009, the Enterprise sold $412,000 in 2009 Series A Bonds with a true fixed interest cost of 4.82% to finance a portion of the WSIP projects and refund existing commercial paper. 2009 Series B Bonds in the amount of $412,000 were sold on September 1, 2009, with a true fixed interest cost of 4.54%. Outstanding revenue bonds for the Enterprise now total $1,757,000 as of September 30, 2009.

(b) 525 Golden Gate Avenue

The City & County of San Francisco also issued $167,670 in fixed rate Certificates of Participation Series 2009 C and D on September 23, 2009 to fund the future headquarters of the Commission at 525 Golden Gate Avenue. These series had a true interest cost of 4.17% after factoring in the impact of the Build America Bonds direct-pay subsidy. The 2009 C series were issued for $38,120 on a tax-exempt basis, and the 2009 D series were issued for $129,550 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.

The Trustee created the “certificates of participation” in the Project Lease, representing proportional interests in the principal and interest components of Base Rental it receives from the City. The Trustee will apply Base Rental it receives to pay principal and interest with respect to each Certificate when due.

(c) Water Supply Agreement (WSA)

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

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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 Water Enterprise (the Enterprise), 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 November 6, 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 the Enterprise'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 the Enterprise's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of the Enterprise's internal control over financial reporting.

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

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

November 6, 2009