



**SAN FRANCISCO WATER ENTERPRISE AND  
HETCH HETCHY WATER AND POWER ENTERPRISE**

Statement of Changes in the Balancing Account

June 30, 2008

(With Independent Auditors' Report Thereon)



*Yano Accountancy Corporation*

## **Independent Auditors' Report**

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

KPMG LLP has audited, in accordance with auditing standards generally accepted in the United States of America, the financial statements of the San Francisco Water Enterprise (Water Enterprise) and the Hetch Hetchy Water and Power Enterprise (Hetch Hetchy) under the jurisdiction of the San Francisco Public Utilities Commission (SFPUC), as of and for the year ended June 30, 2008, and has issued its reports thereon dated December 5, 2008. Our audit reports included an explanatory paragraph related to the Water Enterprise's and Hetch Hetchy's adoption of the provisions of Governmental Accounting Standards Board Statement No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions*, as of July 1, 2007. KPMG LLP and Yano Accountancy Corporation have also audited the Statement of Changes in the Balancing Account of the Water Enterprise and Hetch Hetchy for the year ended June 30, 2008, prepared pursuant to Article IV and Article V, Section 5.07 of the Settlement Agreement and Master Water Sales Contract (the Agreement), between the City and County of San Francisco (the City) and certain suburban purchasers in the counties of San Mateo, Santa Clara, and Alameda (the Suburban Purchasers) effective May 25, 1984. The Statement of Changes in the Balancing Account is the responsibility of the management of the SFPUC. Our responsibility is to express an opinion on the Statement of Changes in the Balancing Account based on our audit.

Except as discussed in the third paragraph of this report, we conducted our audit of the Statement of Changes in the Balancing Account in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the Statement of Changes in the Balancing Account is free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of Water Enterprise's and Hetch Hetchy's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the Statement of Changes in the Balancing Account, assessing the accounting principles used and the significant estimates made by management, as well as evaluating the overall presentation of the Statement of Changes in the Balancing Account. We believe that our audit provides a reasonable basis for our opinion.

We have not performed any procedures regarding the identification of specific funding sources of debt funded assets or asset operating usage classifications used in calculating the Suburban Revenue Requirement. The identification of specific funding sources of debt funded assets and asset operating usage classifications are both used to determine the return on rate base with the asset operating usage classifications also being used to determine the depreciation expense to be allocated to the Suburban Purchasers. If incorrect, the identification and classification of these assets could materially affect the Suburban Revenue Requirement and the balance due from the Suburban Purchasers as of June 30, 2008.

In our opinion, except for the effects of such adjustments, if any, as might have been determined to be necessary had we performed procedures regarding the return on rate base and depreciation expense to be allocated to the Suburban Purchasers, the Statement of Changes in the Balancing Account presents fairly, in all material respects, the balance due from the Suburban Purchasers as of June 30, 2008 in accordance with Articles IV and V (Section 5.07) of the Agreement.

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

KPMG LLP

*Jano Accountancy Corporation*

San Francisco, California  
May 27, 2009

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Year ended June 30, 2008

	<b>Total</b>	<b>Amount allocated to the Suburban Purchasers</b>
Suburban Revenue Requirement calculation:		
Operating and maintenance (O&M) expense:		
San Francisco Water Enterprise (Water Enterprise):		
Source of supply	\$ 15,612,267	9,766,214
Pumping	4,601,547	511,041
Purification	28,789,979	19,675,072
Transmission and distribution	37,634,970	11,797,568
Customer accounts	11,127,228	222,545
	<u>\$ 97,765,991</u>	<u>41,972,440</u>
Total Water Enterprise operating and maintenance		42.93%
O&M percentage of total Water Enterprise		
Hetch Hetchy Water and Power Enterprise (Hetch Hetchy):		
Operating expenses	\$ 99,163,969	10,119,345
Maintenance expenses	16,043,035	4,538,458
Administrative and general (A&G) expenses:		
Deemed city overhead charge:		
Water Enterprise	1,250,471	536,827
Hetch Hetchy	521,029	86,808
SF Public Utilities Commission:		
Water Enterprise	17,723,741	7,434,832
Hetch Hetchy	9,013,708	1,439,616
Other A&G – Water Enterprise	23,718,803	10,182,482
Contract administration expenses – Water Enterprise	258,114	129,057
Compliance audit – Water Enterprise	179,730	89,865
Property taxes (outside city only):		
Water Enterprise	1,427,485	975,543
Hetch Hetchy	172,070	116,681
Return on assets employed (unaudited):		
Water Enterprise (note 4)		18,281,816
Hetch Hetchy (note 5)		3,812,262
Depreciation allocation (unaudited):		
Water Enterprise (note 6)	23,744,041	16,651,923
Hetch Hetchy (note 6)	3,598,189	2,305,000
		<u>118,672,955</u>
Total Suburban Revenue Requirement calculation		
Balance due from Suburban Purchasers, July 1, 2007		12,881,853
Charge due from Suburban Purchasers (note 2)		2,889,614
Interest on adjusted beginning balance		554,177
Suburban revenues billed		(113,932,046)
Credit on grant received for project CUW201		(461,670)
Settlement adjustment (note 3)		21,006
		<u>20,625,889</u>
Balance as of June 30, 2008 – due from the Suburban Purchasers		\$ <u>20,625,889</u>

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

**SAN FRANCISCO WATER ENTERPRISE AND  
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Notes to Statement of Changes in the Balancing Account

June 30, 2008

**(1) Summary of Significant Accounting Policies**

**(a) *Settlement Agreement and Master Water Sales Contract***

Effective May 25, 1984, the City and County of San Francisco (the City) entered into a Settlement Agreement and Master Water Sales Contract (the Agreement) with certain suburban purchasers in the counties of San Mateo, Santa Clara, and Alameda (the Suburban Purchasers). The Agreement arose as a result of the settlement of a civil action that was originally filed against the City in 1974 by the City of Palo Alto. The civil action involved the manner in which in-City and suburban water rates were established by the City. The term of the Agreement is for a period of 25 years. The Agreement was amended by a memorandum of understanding dated November 1, 2008 for the year ended June 30, 2008.

**(b) *Basis of Presentation***

Pursuant to the terms of the Agreement, the City is required to establish water rates applicable to the Suburban Purchasers at the beginning of each fiscal year. The suburban water rates are based on an estimate of the level of revenues necessary to recoup the cost of distributing water to the Suburban Purchasers based on the methodology outlined in Article IV of the Agreement (the Suburban Revenue Requirement).

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

**(c) *Basis of Allocation of Expenses***

Pursuant to the terms of the Agreement, specific or direct Water Enterprise/Hetch Hetchy expenses are directly allocated to the user. Joint Water Enterprise operating and maintenance expenses related to source of supply, pumping, purification, transmission and distribution are to be allocated based upon the ratio of annual usage. Two percent of the expenses to administer customer accounts are allocated to the Suburban Purchasers. Water Enterprise administrative and general expenses, such as deemed city overhead charges, San Francisco Public Utilities Commission (SFPUC) expenses and other expenses are allocated based upon the ratio of the total allocated Suburban operating and maintenance expenses as a percentage of total Water Enterprise operating and maintenance expenses.

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June 30, 2008

Property taxes are allocated based upon annual usage. Joint Hetch Hetchy operating, maintenance, general and administrative expenses are allocated based upon annual usage.

**(2) Charge Due from Suburban Purchasers**

Retiree health care subsidies paid by the Water Enterprise were charged incorrectly for the fiscal years ending June 30, 2004 through June 30, 2007. The subsidies were not appropriately allocated between retail and suburban resale service, therefore understating the Suburban Revenue Requirement. The proper classification of this expense has been determined to be "Joint A&G." Under Section 8.02(d) of the agreement, the fiscal years ending June 30, 2006 and 2007 remain open with respect to changes to the Balancing Account from prior years. The Suburban Revenue Requirement has been increased as follows:

	<b>Year ended June 30,</b>	<b>Increase in the amount allocated to the Suburban Purchasers</b>
Retiree healthcare subsidy	2006	\$ 1,217,179
Retiree healthcare subsidy	2007	1,490,092
		2,707,271
Interest on adjustment	2007	63,159
Interest on adjustment	2008	119,184
Increase in beginning balance		\$ 2,889,614

**(3) Amendment to the Agreement**

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

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**(4) Water Enterprise Return on Rate Base**

**(a) Summary**

The following is a summary of the unaudited Water Enterprise return on rate base for the year ended June 30, 2008:

	<b>(Unaudited)</b>
Suburban rate base:	
Suburban share of net utility plant	\$ 289,741,488
Suburban working capital	8,981,000
Total suburban rate base	298,722,488
Times weighted average return	6.12%
Water Enterprise return on rate base	\$ 18,281,816

**(b) Weighted Average Return**

The following is a summary of the unaudited weighted average return for the year ended June 30, 2008:

		<b>(Unaudited)</b>	
	<b>Rate</b>	<b>Applicable debt/equity percentage</b>	<b>Weighted return</b>
Return on equity	8.47%	37.62%	3.19%
Cost of debt (unaudited)	4.69	62.38	2.93
Water Enterprise return on rate base		100.00%	6.12%

The 8.47% return on equity represents 85% of the 9.96% average rate of return on assets of Class A water utilities as approved by the California Public Utilities Commission. The unaudited 4.69% cost of debt represents total unaudited wholesale interest expense of \$12,527,760 divided by total unaudited average wholesale debt outstanding of \$267,140,297. The unaudited 62.38% portion of debt to equity represents the unaudited wholesale debt of \$267,140,297 divided by the sum of the unaudited total average wholesale net utility plant of \$413,500,336 plus wholesale working capital allowance of \$14,727,256.

Total Water Enterprise and Hetch Hetchy capital assets and debt as of June 30, 2008 and 2007, and depreciation and interest expenses for the year ended June 30, 2008 have been reconciled to the financial statements of the Water Enterprise and Hetch Hetchy, respectively. For copies of the Water

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Notes to Statement of Changes in the Balancing Account

June 30, 2008

Enterprise and Hetch Hetchy audited financial statements for the year ended June 30, 2008, please contact the Director of Finance, San Francisco Public Utilities Commission, 1155 Market Street, San Francisco, CA 94103.

As described below, assignments of debt to specific assets and assignment of specific assets to J-Table categories have not been subjected to audit.

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

The assignment of specific assets to specific J-Table categories is not subject to audit but is evaluated by representatives of the Suburban Purchasers. The following is the unaudited assignment of wholesale net utility plant to the various J-Table categories for the year ended June 30, 2008, and related suburban shares:

<u>J-Table category</u>	<u>J-Table factor</u>	<u>Unaudited average wholesale net utility plant</u>	
		<u>Total</u>	<u>Suburban share</u>
Equipment:			
Current base	68.34%	\$ 38,252,491	26,141,752
Current maximum day	74.71	—	—
Current maximum hour	77.54	—	—
Ultimate base	64.56	18,018,819	11,632,950
Ultimate maximum day	70.47	321,288,190	226,411,787
Ultimate maximum hour	70.17	3,155,944	2,214,526
Composite	69.97	18,335,429	12,829,300
Direct suburban	100.00	1,308,790	1,308,790
Total equipment		<u>400,359,663</u>	<u>280,539,105</u>
Land:			
Joint	69.97	13,114,518	9,176,228
Direct suburban	100.00	26,155	26,155
Total land		<u>13,140,673</u>	<u>9,202,383</u>
		<u>\$ 413,500,336</u>	<u>289,741,488</u>



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**(d) Wholesale Interest Expense and Average Wholesale Debt**

The assignment of interest expenses and related notes payable and to specific assets is not subject to audit. The following is the unaudited assignment of interest expense to wholesale assets for the year ended June 30, 2008:

<u>Bond issue</u>	<u>Total interest expenses</u>	<u>(Unaudited)</u>	
		<u>Average wholesale percentage of bonds payable</u>	<u>Wholesale portion of interest expenses</u>
Capital appreciation bonds	\$ 224,710	42.85%	\$ 96,288
2001 – Series A	4,065,583	62.99	2,560,911
2002 – Series A	7,302,275	62.99	4,599,703
2002 – Series B	2,703,735	88.17	2,383,883
2006 – Series B	4,824,063	45.76	2,207,491
2006 – Series C	2,046,023	33.21	679,484
	<u>\$ 21,166,389</u>		<u>\$ 12,527,760</u>

The following is the unaudited wholesale percentage of average bonds payable for the year ended June 30, 2008:

<u>Bond issue</u>	<u>Average bonds payable</u>	<u>Unaudited</u>	
		<u>Average wholesale percentage of bonds payable</u>	<u>Wholesale portion of bonds payable</u>
Capital appreciation bonds	\$ 3,267,327	42.85%	\$ 1,400,050
2001 – Series A	81,762,500	62.87	51,408,102
2002 – Series A	152,095,000	62.92	95,698,875
2002 – Series B	60,537,500	88.17	53,375,914
2006 – Series B	108,647,500	45.71	49,671,903
2006 – Series C	46,930,000	33.21	15,585,453
	<u>\$ 453,239,827</u>		<u>\$ 267,140,297</u>

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**(5) Hetch Hetchy Return on Rate Base**

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

<u>Expense category</u>	<u>Unaudited average net utility plant</u>	<u>Unaudited suburban share</u>	<u>Dollars</u>
		<u>Percentage</u>	
Power-only	\$ 85,423,831	—%	\$ —
Water-only	24,083,025	100	24,083,025
Joint power/water	93,259,913	45	41,966,961
	<u>\$ 202,766,769</u>		<u>66,049,986</u>
Times suburban allocation factor			<u>64.06%</u>
Allocated suburban share of unaudited average net utility plant			42,311,621
Hetch Hetchy working capital allowance			<u>2,697,371</u>
Allocated suburban share of unaudited average net utility plant plus Hetch Hetchy working capital allowance			45,008,992
Times weighted average rate of return			<u>8.47%</u>
Hetch Hetchy return on rate base			<u>\$ 3,812,262</u>

The assignment of specific Hetch Hetchy assets to power-only, water-only and joint power/water expense categories is not subject to audit. Since Hetch Hetchy has had no debt outstanding at June 30, 2008 and 2007, the weighted average rate of return is 85% of the average rate of return on assets of Class A water utilities as approved by the California Public Utilities Commission.

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June 30, 2008

**(6) Water Enterprise and Hetch Hetchy Depreciation**

The assignment of assets and related depreciation expenses to specific J-Table categories is not subject to audit but is evaluated by representatives of the Suburban Purchasers. The following is the unaudited assignment of total Water Enterprise depreciation expenses to specific J-Table categories and related suburban share of the depreciation expenses for the year ended June 30, 2008:

<u>J-Table category</u>	<u>J-Table factor</u>	<u>Unaudited depreciation expense</u>	
		<u>Total J-Table category</u>	<u>Suburban share</u>
Current base	68.34%	\$ 2,693,667	1,840,852
Current maximum day	74.71	—	—
Current maximum hour	77.54	—	—
Ultimate base	64.56	1,028,628	664,082
Ultimate maximum day	70.47	16,783,160	11,827,093
Ultimate maximum hour	70.17	76,063	53,373
Composite	69.89	2,975,756	2,079,756
Direct suburban	100.00	186,767	186,767
		<u>\$ 23,744,041</u>	<u>16,651,923</u>

The following is the unaudited assignment of total Hetch Hetchy depreciation expense to power-only, water-only and joint power/water categories for the year ended June 30, 2008:

<u>Category</u>	<u>Allocation factor</u>	<u>Unaudited depreciation expense</u>	
		<u>Category total</u>	<u>Suburban share</u>
Power-only	—%	\$ 4,616,574	\$ —
Water-only	100	2,002,415	2,002,415
Joint power/water	45	3,546,164	1,595,774
		<u>\$ 10,165,153</u>	<u>3,598,189</u>
Times Hetch Hetchy adjusted ultimate usage percentage			<u>64.06%</u>
			<u>\$ 2,305,000</u>