December 20, 2006

The Honorable Mayor Gavin Newsom
The Honorable Members of the Board of Supervisors
Citizens of the City and County of San Francisco
San Francisco, California

Ladies and Gentlemen:

I am pleased to present the Comprehensive Annual Financial Report (CAFR) of the City and County of San Francisco, California (the City or primary government) for the fiscal year ended June 30, 2006, with the Independent Auditor’s Report. The report is submitted in compliance with City Charter sections 2.115 and 3.105, and California Government Code Sections 25250 and 25253. The Office of the Controller prepared the CAFR in conformance with the principles and standards for financial reporting set forth by the Governmental Accounting Standards Board (GASB).

The City is responsible for the accuracy of the data and for the completeness and fairness of its presentation. The existing comprehensive structure of internal accounting controls in the City provides reasonable assurance that the financial statements are free of any material misstatements. I believe that the reported data is accurate in all material respects and that its presentation fairly depicts the City’s financial position and changes to its financial position as measured by the financial activity of its various funds. I am confident that the included disclosures provide the reader with an understanding of the City’s financial affairs.

The City’s Charter requires an annual audit of the Controller’s records. The records have been audited by Macias Gini & O’Connell LLP and are presented in this CAFR. The CAFR also incorporates financial statements for San Francisco International Airport (SFO or Airport), the San Francisco Water Department (Water Department), Hetch Hetchy Water and Power (Hetch Hetchy), the Municipal Transportation Agency (MTA), the San Francisco Wastewater Enterprise (Wastewater), the Port of San Francisco (Port), the City of San Francisco Market Corporation (Market Corporation), the City and County of San Francisco Finance Corporation (Finance Corporation), the City and County of San Francisco Health Service System (Health Service System), the San Francisco City and County Employees’ Retirement System (Retirement System), and the San Francisco Redevelopment Agency (Redevelopment Agency or Agency).

This letter of transmittal is designed to complement the Management’s Discussion and Analysis (MD&A) section of the CAFR. The MD&A provides a narrative overview and analysis of the Basic Financial Statements and is presented after the independent auditor’s report.

The CAFR is divided into the following sections:

The Introductory Section includes information about the organizational structure of the City, the City’s economy, major initiatives and status of City services.

The Financial Section includes the MD&A, Basic Financial Statements, notes to the Basic Financial Statements, and required supplementary information. The Basic Financial Statements include the government-wide financial statements that report on all City financial operations, including fund financial statements that present information for all City funds. The independent auditor’s report on the Basic Financial Statements is also included.

The financial statements of several enterprise activities and of all component units of government are included in this CAFR. Some component units’ financial statements are blended with the City’s, such as: the San Francisco County Transportation Authority, the Finance Corporation, and the San Francisco Parking Authority. The reason for this is that the primary government is financially accountable for the operations of these agencies. In other instances, namely, for the Redevelopment Agency and the Treasure Island Development Authority (TIDA), financial reporting is done separately.
The Statistical Section includes up to ten years of historical financial data and miscellaneous social and economic information that conforms to GASB standards for reporting—Statement No. 44. This section may be of special interest to prospective investors in our bonds.

Profile of San Francisco’s Government

The City and County of San Francisco was established by Charter in 1850 and is the only legal subdivision of the State of California with the governmental powers of both a city and a county. The City’s legislative power is exercised through a Board of Supervisors, while its executive power is vested upon a Mayor and other appointed and elected officials. The most prominent services provided by the City include public safety and protection, public transportation, construction and maintenance of all public facilities, water, parks, public health systems, social services and planning. The heads of most of these departments are appointed by the Mayor and advised by commissions and boards appointed by City elected officials.

Elected officials include the Mayor, Members of the Board of Supervisors, Assessor-Recorder, City Attorney, District Attorney, Public Defender, Sheriff, Superior Court Judges, and Treasurer. Since November 2000, the eleven-member Board of Supervisors has been elected through district elections. The eleven district elections are staggered for five and six seats at a time, and held in even-numbered years. Board members serve four-year terms and vacancies are filled by Mayoral appointment.

San Francisco’s Budgetary Process

The City adopts annual budgets for all governmental funds and typically adopts project-length budgets for capital projects and certain debt service funds. The budget is adopted at the character level of expenditure within each department, and the department level is the legal level of budgetary control. Note 2 (c) to the Basic Financial Statements summarizes the budgetary roles of City officials and the timetable for their various budgetary actions according to the City Charter.

San Francisco’s Local Economy

At 17,000 residents per square mile, San Francisco is the most densely populated forty-seven square miles in the state. The City is a cultural and economic hub for the Bay Area. It is undergoing substantial demographic and socioeconomic changes that represent challenges to and opportunities for its citizens and local government.

San Francisco continued its economic recovery for fiscal year 2005-2006, reaching an estimated gross level of economic activity (Gross City Product) of $56.47 billion. A booming leisure-tourism sector and increased investment and transactions in local real estate markets contributed to this rebound. Tourism helped to improve the City’s retail and hospitality sectors, which translated into greater hotel and sales tax revenues for City government. Real estate market investing in office and housing markets continued to further invigorate the construction sector, as well as increase property and transfer tax revenues.

Population

The California Department of Finance estimates the City’s population in calendar year 2005 at 794,850, which represents a growth of 0.4 percent over the prior year. Population size affects some or our intergovernmental revenues, which in total make up 20 percent of all budgeted sources, or 28 percent of General Fund sources.

The City’s population composition is changing, including a declining racial and ethnic diversity. Recent demographic evidence from the U.S. Census’ American Community Survey 2005 finds substantial

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1 Source: Controller’s Office of Economic Analysis.
numbers of Latinos and African Americans leaving San Francisco since 2000. Population trends can ultimately impact future uses of funds.

Employment

Net job creation of 6,300 (a 1.2 percent increase) took place in calendar year 2005. Recent growth reflects more value-added, new-economy jobs in professional services and life science technology, but employment declines in industrial, manufacturing, and information technology sectors. The unemployment rate in the City, which reached a peak of 7.9 percent in July 2002, has continued its decline to 4.6 percent, as of June 2006.²

The State of California 2006 metropolitan occupational survey, reports that the average annual wage in the San Francisco Metropolitan area rose by 2.6 percent, from $52,355 in the previous year to $53,727, whereas the median wage increased by 3.7 percent, from $41,190 to $42,703 during the same period.³

Housing Markets and Property Taxes

Residential property values in San Francisco continued to rise during the current fiscal year. The main reason for this trend is the constrained growth of the supply of housing relative to the increase in purchasing power of buyers. Consequently, transfer tax and property tax revenues increased strongly from the previous fiscal year.

As of June 2006, the median price for an existing home in California was $567,360. San Francisco has a comparable median price of $754,630 for the same period.⁴ This represents a 4.1 percent increase over last year’s median price for the City. Despite steady construction, including an estimated 2,142 new units in San Francisco during calendar year 2005, supply constraints continue to put upward pressure on prices.⁵ Demand outpacing supply contributes to continuing declines in affordability.

In part due to these affordability hurdles and excess demand conditions, 65 percent of the City’s residents rent their homes and only 35 percent own. While this proportion of owners and renters is substantially different from the national average of 69 percent owners and 31 percent renters, the City’s share of owner and renter-occupied housing is comparable to other densely populated urban centers in the country such as New York City and Chicago.⁶

As of June 2006, the average occupancy rate for market-rate apartments in San Francisco was 96.4 percent, 0.3 percent higher than the same period in 2005. Average rental rates increased slightly in June 2006 to $1,936 per month, compared to $1,834 in the prior year - a 5.6 percent increase.⁷

As of June 2006, the average single family home’s assessed valuation in the City stood at $404,000.⁸ Average assessed valuations tend to be lower than market prices because of limits on the growth in taxable property values under California’s Proposition 13, which provides an incentive to buy and hold property. Property tax revenues of $783 million are the single largest source of General Fund monies accounting for nearly one third of the City’s total sources of General Funds. Property tax revenues grew 10.4 percent over 2005.

² Source: State of California, Employment Development Department.
³ Source: State of California, Employment Development Department. Recent county level data not yet reported. The median annual wage represents the level of income at which half of wage earners earned more, and the other half earned less.
⁴ Source: California Association of Realtors.
⁵ Source: California Association of Realtors.
⁷ Source: Real Facts.
⁸ Source: Office of the Assessor, City and County of San Francisco.
On a related note, another major project under way during this fiscal year is the continuing construction at Rincon Hill. When the first of two Rincon Hill towers is finished, in the spring of 2008, it will rise 550 feet, and unit prices are expected to range from $600,000 for a small condo to $2.5 million for a three-bedroom unit at the top.

Commercial Real Estate

The performance of the commercial real estate sector is consistent with the economic recovery and increase in professional service jobs in the City. San Francisco's real estate office market continues to show improvement since June 2005, when the vacancy rate was 17.3 percent. The overall vacancy rate was 13.9 percent as of June 2006. This represents absorption of 19.7 percent of available space, or a net increase of 1.75 million square feet of newly rented space.

The average price for office space rose from approximately $28.68 to $33.60 per square foot, per year—a 17.2 percent increase—during the same period. These market rents are still lower than the $65.88 average per square foot peak rents reached in the third quarter of 2000. We expect continued growth in office space occupancy because the City economy is producing jobs requiring the use of high-end office space.

Commercial sales activities contributed significantly to the City's transfer tax revenues which reached a peak of $131.3 million (including both commercial and residential) in fiscal year 2005-2006. While there were fewer major property transactions than in the past fiscal year, the square footage of space transacted was slightly larger than in 2005. In tandem with higher transaction prices per square foot, the net result was an increase in transfer tax revenue from all real estate transactions of 12.4 percent from the previous fiscal year.

On a related note, Westfield's San Francisco Centre's $460 million expansion, anchored by Bloomingdale's, was completed in August 2006. The San Francisco Business Times reports that the new retail mall near Union Square is the largest operating retail center in the Bay Area. It covers 1.5 million square feet of retail space dedicated to shopping, entertainment, personal and retail services, and even a higher education program—San Francisco State University's MBA Program.

Other Tax Sources

This fiscal year, payroll tax revenues rose 10.5 percent over the previous fiscal year, to $315.5 million. These increases reflect improved employment and wage growth. Hotel room tax revenues reached $179.5 million, a 13.6 percent increase over the previous fiscal year, reflecting a rebound in tourism.

Travel and Tourism

The City's Convention and Visitors Bureau estimates that 15.7 million people visited the City in calendar year 2005 and spent $7.37 billion, a 9.5 percent increase over calendar year 2004. On a related note, PKF Consulting reports that hotel occupancy rates averaged 76.7 percent in fiscal year 2005-2006, a 3.6 percent increase from the prior fiscal year. Additionally, average daily room rates increased 8.3 percent to $160.55, compared to $148.21 in the prior year.

Bookings and attendance for conventions in San Francisco have been strong, which impacts sales tax and hotel tax revenues favorably. According to the San Francisco Convention and Visitors Bureau, 2006 is on track to exceed 2005 room night numbers. Increasing international passenger traffic at SFO is another indication of the continuing growth in tourism and travel. A total of 4.09 million international travelers flew into SFO, a 4.3 percent increase over the last fiscal year. Qantas, Air Canada, Song, Air New Zealand and Independence have either begun or expanded service to more cities from SFO. As of June 2006, a total of 16.5 million passengers arrived at SFO, representing 1.5 percent more passengers.

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9 Source: Cushman & Wakefield, Inc.
than the prior fiscal year, and signaling continued recovery in air travel demand to and from San Francisco.

Cruise ship calls to San Francisco have quadrupled since 2004, from 12 to 49, and passengers arriving to the City by cruise ship increased to 137,000 passengers through June 2006. This represents nearly 50,000 more passengers than the same period one year prior. By the end of calendar year 2006, the Port is projecting total passenger volume increases of 14 percent over calendar year 2005 levels.

**Improving Bond Ratings**

The City’s fiscal health continued to improve over the last fiscal year. This was reflected favorably through investment grade bond ratings on City municipal debt. Moody's and Fitch Ratings both upgraded their outlooks on general obligation municipal debt issue by the City in 2006 from “stable” to “positive” in 2005. Additionally, Fitch noted our financial management exhibited “spending restraint and conservative budgeting that has resulted in increased year-end reserves.” These results translate into lower debt financing costs, of particular importance to planned capital projects. Voter approval must be obtained in the coming years to fund most of the capital projects noted in the 10-Year Plan.

**City Government Initiatives and Updates**

A number of significant initiatives, outlined below, are underway in San Francisco that will have a positive effect on the City’s economic health and its ability to provide services to residents and businesses.

**City and County of San Francisco 10-Year Capital Plan**

In May 2006, the City introduced for the first time in its history a 10-Year Capital Plan (the Plan). Total investments of $15.6 billion are planned for the period between fiscal year 2006-2007 and fiscal year 2015-2016. The Plan included detailed expenditures of $3.3 billion toward General Fund items such as health care, criminal justice, streets and right-of-ways, recreation and parks, the arts, fire protection and emergency response. $2.3 billion of these funds would be expended in projects during the first five years. It also calls for $12.3 billion in enterprise department funding, including $7.2 billion for public utilities, $3.6 billion for municipal transportation, $1.1 billion for Airport projects, and $414 million for infrastructure projects at the Port. The Plan was approved by the Board of Supervisors on June 20, 2006.

**San Francisco Redevelopment Agency: Bayview Hunter’s Point Redevelopment Plan**

The Bayview Hunters Point Redevelopment Plan calls for 2.4 million square feet of commercial, retail, industrial and residential floor space. It is expected to yield over 5,500 jobs and approximately 3,700 net new dwelling units supported by institutional, utility and transportation networks and by a multitude of mitigation plans and alternatives over the next 30 years. Dramatic zoning and infrastructure changes will soon begin transforming the landscape of the 1,575 acres of redevelopment project area.¹¹

The Environmental Impact Report for projects to come in the Bayview Hunter’s Point Redevelopment area was completed in February 21, 2006, and approved by the Redevelopment Agency on March 7, 2006. The Board of Supervisors passed an ordinance on June 1, 2006 clearing the way for the Agency to move forward with its redevelopment and rezoning plan.

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Port of San Francisco

The Port has many ongoing projects in planning and development stages:\n
- Piers 27-31 Mixed Use Recreation Project,
- Piers 1½ -3-5 Historic Rehabilitation Project,
- Piers 15-17 Exploratorium and Rincon Park Restaurants,
- Bryant Street Piers (Piers 30-32 and Seawall Lot 330) Cruise Terminal and Mixed-Use Development,
- Brannan Street Wharf, Pier 70 Area, and Pier 90 - 94 Backlands.

The Port Authority's 10-Year Capital Plan identified a total of $1.2 billion primarily for deferred maintenance and seismic upgrade work required for Port facilities over the coming decade to finance all of the above improvements. Of that total, they expect $414 million of the funding to come from Port tenants, the Port's operating budget, revenue bonds, development projects and Infrastructure Financing District bonds. The remainder continues to be unfunded and deferred.

Treasure Island Development Authority

TIDA has completed various aspects of the proposed redevelopment project for Treasure Island, including plans addressing land use, open space, affordable housing, infrastructure, transportation, community facilities, fiscal impact, phasing and jobs and equal opportunity programs. The proposed project includes 1,800 affordable housing units and 4,200 market-rate dwellings. Total land development costs are estimated at approximately $1.2 billion and the proposed plan has estimated the following sources of funding for capital improvements:

- $498 million in private capital from the Treasure Island Community Development, LLC,
- $361 million in Mello-Roos (tax-exempt) bonds, and
- $338 million in projected tax increment financing.

In May 2006, the Treasure Island Community Development, LLC, the City's venture partner in TIDA, presented to the Land Use and Economic Development Committee of the Board of Supervisors a revised draft of the Treasure Island Transportation Plan. The plan proposes a mix of transportation modes and systems that may mitigate additional traffic congestion from the dramatic increase in the Islands' resident population.

Third Street Light Rail Project

The first stage of the Third Street Muni Metro light rail service will extend south from the current terminal at Fourth and King Streets along Third Street and Bayshore Boulevard, ending at the Bayshore CalTrain Station in Visitacion Valley. Track work has been completed in the center of the street to improve the safety and reliability of the service along the 19 stops. This phase of the light rail project is expected to open for service in spring of 2007.

A second, not yet funded, phase of the project would extend light rail service north from King Street along Third Street, entering a new Central Subway near Bryant Street, crossing beneath Market Street and running under Stockton Street to Clay Street. Underground subway stations will be located at Moscone Center, Market Street, Union Square and Clay Street in Chinatown. Muni and the City are actively pursuing funding for the Central Subway.

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12 Source: City and County of San Francisco Capital Plan FY 2007-2016.
Toward Universal Health Care: Health Care Access Program

In 2005, approximately 82,000 San Francisco residents lacked health care insurance coverage on any given day. The Department of Public Health is planning a Health Care Access Program to address the problem of the lack of access to health care coverage by residents and workers in San Francisco. The program’s initial projected cost approximates $198 million, and its implementation is expected to be phased in fiscal year 2007-2008. Funding for the program will be achieved by reallocating funds from current uses. In addition, employers’ contributions to employee health care spending accounts may be instituted to supplement funding of this program.

San Bruno Jail

In August 2006, San Francisco opened its newest jail facility in San Bruno. This modern site houses up to 768 inmates in a safer and more humane environment and replaces County Jail #3, a facility built in the 1930’s. Certificates of participation with a final maturity of 2033 funded the $137 million project.

311 Call Center

The City’s goal of developing and deploying an easily accessible, centralized call center for City residents to channel customer service and information requests is soon to be a reality. The 311 Call Center will provide a single point of contact for all non-emergency City services, and allow customers to call one easy-to-remember number to receive information and access City services. When fully implemented, it will be staffed 24 hours a day, 7 days a week. Trained customer service representatives from all City departments will be available to respond to residents’ needs for City services. The 311 Call Center will go live in the spring of 2007.

Affordable Housing and Homeownership Program

The Affordable Housing and Homeownership Programs were created to provide the City’s homeless, seniors, and low- and moderate-income families with affordable dwellings. During the two-year fiscal periods ending 2003 to 2005, a total of 1,277 units were completed. For fiscal year 2005-2006, an additional 240 units were completed. Two ordinances were passed by the Board of Supervisors during fiscal year 2005-2006, expanding and increasing the inclusionary housing affordability program requirements on market-rate development to apply to any development with five or more units, where below-market rate units must comprise at least 15 percent of the units developed onsite, or 20 percent of units developed off-site, or pay an in-lieu fee to otherwise satisfy the requirements. Previously, these thresholds were applicable to developments with ten or more units, where 12 percent of on-site or 17 percent of off-site units had to be priced below-market. These initiatives promise to yield even a greater number of affordable housing units in the coming years.

Homeless Housing Outreach Efforts

Project Homeless Connect is a landmark service program that links community volunteers and health and human services and programs with the homeless and indigent. It originated in San Francisco in 2004 and has been so successful that it has been emulated in thirty-two cities across the United States. As of June 2006, 18,107 volunteers have provided services to more than 12,000 homeless clients. The main goal of this program is to transition the City’s homeless off the streets and into permanent, supportive housing.

San Francisco Connect

Project Homeless Connect has evolved and led to the formation of San Francisco Connect. This diverse partnership of agencies with different goals have come together to serve not just the needs of the homeless and the indigent, but also support services for City residents at large, and for youth and families. As of August 2006, a dozen San Francisco Connect events have taken place in which corporate
and community volunteers have provided goods and services to over 24,000 persons. One example is Project Green Connect, where volunteers can improve neighborhood parks, street gardens and other public spaces.

Disaster Preparedness

Over the past year, the City has increased its emergency planning and preparedness activities by expanding the size and role of the City’s Disaster Council, developing a Bay Area Regional Preparedness Plan, and implementing the San Francisco’s new Emergency Notification Plan, known as SF Alert. Under the expanded Council, the City’s leaders in emergency preparedness met together to manage the City’s Homeland Security grants, update the City’s emergency planning documents, and participate in training exercises. Over the past year, the City has managed Homeland Security grants totaling $85.6 million, of which $20.8 was received in fiscal year 2005-2006 to fund planning, training, equipment, and disaster recovery activities. The City has updated its emergency operations plan and continues to conduct simulations and exercises for its emergency workers to prepare for natural and manmade disasters. Comprehensive and redundant back-up systems are being developed to secure financial data so that checks can be issued to City employees and vendors. City staff is trained to abide by federal emergency reimbursement guidelines to ensure damage is assessed accurately, costs are quantified, and reimbursement claims are filed. Alternate operation centers are established in the event City offices become inaccessible.

The Bay Area Regional Response Plan has been developed, under the leadership of the San Francisco Office of Emergency Services. The new plan includes ten Bay Area counties and the cities of Oakland, San Francisco and San Jose. The plan enables the region to effectively respond to a major disaster, comply with the national requirements for incident command structures, integrate communications, information sharing, transportation, regional care and shelter, and coordinate fire and search and rescue efforts.

San Francisco’s new emergency notification system enables the City’s first response command staff to be alerted and assembled within minutes of a disaster. Also, it delivers a consistent message to all pertinent staff within minutes, and reduces the need for manual notification.

San Francisco General Hospital Medical Center

San Francisco General Hospital Medical Center, like all acute care hospitals in California, is required under state law to make the hospital seismically safe or face closure after 2013. In fiscal year 2005-2006, the City funded a $1.1 million environmental impact report and began to conduct a feasibility study to rebuild the hospital. The City has budgeted $12 million in fiscal year 2006-2007 towards pre-development costs to more accurately project costs for the new hospital to be able to fully inform voters who will need to approve the bonds necessary to complete the project. A general obligation bond will be needed to fund construction.

Laguna Honda Hospital

In fiscal year 2005-2006, the replacement of Laguna Honda Hospital began. There are five buildings that will be affected and completion of the buildings is expected between July 2008 through September 2009. Residents are expected to move into the Link and South buildings in November 2008.

Awards

Certificate of Achievement

The Government Finance Officers Association of the United States and Canada (GFOA) awarded a Certificate of Achievement for Excellence in Financial Reporting to the City for its Comprehensive Annual Finance Report (CAFR) for the fiscal year ended June 30, 2005. This was the twenty-fourth consecutive year (fiscal years ended June 30, 1982 – 2005) that the City has achieved this prestigious award. In
order to be awarded a Certificate of Achievement, a government must publish an easily readable and efficiently organized CAFR. The CAFR must satisfy both Generally Accepted Accounting Principles (GAAP) and applicable legal requirements.

A Certificate of Achievement is valid for a period of one year only. We believe our current report continues to meet the Certificate of Achievement Program’s requirements and we are submitting it to the GFOA to determine its eligibility for another certificate.

The City also received the Award for Outstanding Financial Reporting, issued by the California Society of Municipal Finance Officers (CSMFO) for its CAFR for the fiscal year ended June 30, 2005. The award was issued in recognition of the City meeting the professional standards and criteria in reporting which reflect a high level of quality in the annual financial statements and in the underlying accounting system from which the report was prepared.

Acknowledgements

I would like to express my appreciation to the entire staff of the Controller’s Office whose professionalism, dedication, and efficiency are responsible for the preparation of this report. I would also like to thank Macias Gini & O’Connell LLP for their invaluable professional support during the audit. Finally, I want to thank the Mayor and the Board of Supervisors for their interest and support in planning and conducting the City’s financial operations.

Respectfully submitted,

Edward Harrington
Controller