January 8, 2013

The Honorable Mayor Edwin Lee
The Honorable Members of the Board of Supervisors
Residents 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) for the fiscal year ended June 30, 2012, 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 accounting and 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. Because the cost of internal control should not exceed the anticipated benefits, the objective is to provide reasonable, rather than absolute, assurance that the financial statements are free of 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 in 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 the basic financial statements in this CAFR. The CAFR also incorporates financial statements for San Francisco International Airport, the San Francisco Water Enterprise, Hetch Hetchy Water and Power, the Municipal Transportation Agency, the San Francisco Wastewater Enterprise, the Port of San Francisco, the City of San Francisco Market Corporation, the City and County of San Francisco Finance Corporation, the San Francisco County Transportation Authority, the City and County of San Francisco Health Service System, the San Francisco City and County Employees’ Retirement System, the former San Francisco Redevelopment Agency, and the Successor Agency to the San Francisco Redevelopment 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.

KEY FINANCIAL REPORT SECTIONS:

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

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, and also include 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’ financials are blended with the City’s, such as the San Francisco County Transportation Authority and the San Francisco Finance Corporation. The reason for this is that the primary government is financially accountable for the operations of these agencies. In other instances, namely, for the San Francisco Redevelopment Agency (prior to February 1, 2012), and the Treasure Island Development Authority, financial reporting is shown separately. Supplemental combining statements and schedules for nonmajor governmental funds, internal service funds and fiduciary funds are also presented in the financial section.

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.

**SAN FRANCISCO’S ECONOMY:**

**Overview of Recent Trends**

Over the past fiscal year, San Francisco’s economic recovery has accelerated. Unemployment rates in fiscal year 2011-12 fell steadily, following a trend that began the previous fiscal year. Average unemployment for fiscal year 2011-12 was 8.0%, down 1.2% from the previous fiscal year’s level of 9.2%. Unemployment began the period at 8.9% in July 2011, and closed at 7.7% in June 2012.

In comparison to the U.S. economy, San Francisco entered the recent recession late and emerged from it relatively early. The San Francisco Metropolitan Division, of which the City and County of San Francisco is the largest jurisdiction, began seeing job growth over the previous year in December 2010. Over the course of fiscal year 2011-12, the San Francisco Metropolitan Division experienced a total employment increase of 4.4%.

In the period between March 2011 and March 2012, the latest data available, every major sector of the City’s economy saw growth in employment, according to the Bureau of Labor Statistics. As of March 2012, Financial, Professional and Business, and Information Services sectors grew by approximately 14,600 jobs versus the prior year, a 7.5% increase. This is a significant increase when compared to California, which only saw a 3% increase in these sectors during the same period. Overall, during the recent recession, San Francisco saw its total employment fall by nearly 6%. By December 2011, San Francisco’s private non-farm employment had recovered to 97% of its pre-recession peak level in 2008.

Other local economic indicators were also positive during this past fiscal year. Housing prices, residential and commercial rent, hotel revenues, and retail sales all showed significant signs of recovery.

San Francisco’s taxable sales have been growing rapidly, with fiscal year 2011-12 sales tax revenue up 9.2% over fiscal year 2010-11. For the last two fiscal years, San Francisco has seen record high taxable sales growth, exceeding pre-recession revenue levels in fiscal year 2011-12.

The hotel sector, which is a key barometer of San Francisco’s travel and tourism industry, saw significant growth in fiscal year 2011-12 over the previous year. Hotel room average occupancy rose to 81.9% for the fiscal year, a significant increase from the prior year and approaching a historical high. Average daily room rates grew significantly in fiscal year 2011-12, jumping 13.9% from $173 per room-night in fiscal year 2010-11 to $197 per room-night.

Key indicators of the City’s real estate market were positive during fiscal year 2011-12. Commercial and residential rents and median home prices increased. The average residential rent for one-bedroom apartments in San Francisco rose 18.2% during fiscal year 2011-12, from $2,245 to $2,653. Commercial rents saw an 18.0% increase in fiscal year 2011-12 compared to fiscal year 2010-11. The average median home price in fiscal year 2011-2012 was at $646,646, up 0.7% from the previous fiscal year.
The strength of San Francisco’s current recovery is a testament to the strength of its economic fundamentals – the education and creativity of its workforce, its environment, technological base, and cultural amenities. These fundamentals are among the strongest of any city in North America, and are likely to secure the City’s continued prosperity into the future.

**SAN FRANCISCO GOVERNMENT:**

**Profile of San Francisco 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. Key public services provided by the City include public safety and protection, public transportation, water and sewer, parks and recreation, public health, social services and land-use and planning regulation. 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 budget is adopted at the character level of expenditure within each department, and the department level and fund 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.

The City has historically adopted annual budgets for all governmental funds and typically adopts project-length budgets for capital projects and certain debt service funds. The voters adopted amendments to the Charter in November 2009 designed to further strengthen the City’s long-range financial planning. As a result of these changes, the City for the first time adopted a two-year budget for all funds for fiscal years 2012-13 and 2013-14 in July 2012. The Charter requires that the City adopt a “rolling” two-year budget each year unless the Board of Supervisors authorizes a “fixed” two-year budget appropriation for a given fund, in which case authorization occurs every two years.

As further required by these amendments, the Board of Supervisors and Mayor approved a five-year financial plan in fiscal year 2010-11, and the City is required to update this document every two years going forward. Lastly, these Charter changes provided a mechanism for the Controller to propose, and the Board to adopt, various binding financial policies which can only be suspended by a supermajority of the Board. The Board approved a set of policies governing the City’s budget reserve practices in 2010 and the use of non-recurring revenues and General Fund-backed debt in 2011.

**Internal and Budgetary Controls**

In developing and evaluating the City’s accounting system, consideration is given to the adequacy of internal accounting controls. Internal accounting controls are designed to provide reasonable, but not absolute, assurance regarding: (1) the safeguarding of assets against loss from unauthorized use or disposition, and (2) the reliability of financial records for preparing financial statements and maintaining accountability for assets. The concept of reasonable assurance recognizes that: (1) the cost of a control should not exceed the benefits likely to be derived, and (2) the evaluation of costs and benefits requires estimates and judgments by management. All internal control evaluations occur within the above framework. We believe that the City’s internal accounting controls adequately safeguard assets and provide reasonable assurance of proper recording of financial transactions.
The City maintains budgetary controls to ensure that legal provisions of the annual budget are in compliance and expenditures do not exceed budgeted amounts. Controls are exercised by integrating the budgetary accounts in fund ledgers for all budgeted funds. An encumbrance system is also used to account for purchase orders and other contractual commitments. Encumbered balances of appropriations at year-end are reported as assigned fund balance and are not reappropriated in the following year's budget.

Cash Management

The City’s pooled deposits and investments are invested pursuant to policy established by the Treasurer working with the City’s Treasury Oversight Committee. The City's investment policy seeks the preservation of capital, liquidity and a market rate of return, in that order. The policy addresses the safekeeping and custody practices with financial institutions in which the City deposits funds, types of investments permitted, and the percentage of the portfolio which may be invested in certain instruments with longer terms to maturity. The earned income yield of fiscal year 2011-12 was 1.15%. The former Redevelopment Agency’s cash and investments that were not invested with fiscal agents were transferred to an account with the Treasurer and separately managed from the Pool. As of June 30, 2012, these assets remain in the separately managed account.

Risk Management

With certain exceptions, it is the policy of the City not to purchase commercial insurance against property or liability risk. Instead, the City believes it is more economical to manage its risks internally and set aside funds as needed for estimated current claim settlements and unfavorable judgments through annual and supplemental appropriations. The City maintains limited coverage for certain facilities, primarily property of San Francisco International Airport, Port of San Francisco, Municipal Transportation Agency, Hetch Hetchy, Water Department, and art at City-owned museums. Additionally, various types of liability insurance are maintained by the City for the Port and the Airport. Claims payment history (experience) and payroll costs (exposure) are considered when calculating the claims liabilities and workers’ compensation outstanding liabilities for each department. The City’s insurance/self-insurance program is reviewed annually in the budget process. The claims liabilities and workers’ compensation liabilities are reported on the financial statements. They have been actuarially determined and include an estimate of incurred but not reported losses.

Pension Trust Fund Operations

The City has a defined benefit retirement plan in which a substantial majority of full-time employees participate. The plan’s most recent actuarial calculations, as of July 1st, 2011, estimate the plan is 87.7% funded, down from 91.1% as of that date in 2010. This decrease is primarily due to increased benefit liability as a result of benefits formula improvements for some Miscellaneous Plan Members and cost-of-living adjustments for certain retirement members under Proposition B, which was approved by City voters in 2008. The results of the July 1, 2011 actuarial valuation also reflect the impact of recent wide fluctuations in financial markets on the value of plan assets. Member contributions to the plan increased 9.0% from the prior year, and plan deductions increased 8.6%.

The City’s retiree health benefit liability has been calculated at $4.42 billion as of July 1, 2010, just slightly higher than the $4.36 billion previously reported as of July 1, 2008. In 2009, the City and employees began to pre-fund prospective obligations through contributions of 3% of salary for employees hired on or after January 10, 2009. These contributions are held in an irrevocable trust, the Retiree Health Care Trust Fund. Beginning July 1, 2016, employees hired before January 10, 2009 will also start contributing to the Trust Fund with an employer match, starting at a combined 0.5% of salary, and rising to 2% of salary on July 1, 2019. As of June 30, 2012, the Trust Fund held $18 million, more than double the prior year-end level of $8.5 million. No withdrawals are permitted from the Trust Fund before January 1, 2020. Given increasing pay-as-you-go and prefunding contributions and reductions in the benefit level for recently-hired employees, the City expects to fund the Annual Required Contribution (ARC) by fiscal year 2019-20.
General Fund Financial Position Highlights

Strong revenue growth and the implementation of new reserves policies have caused General Fund rainy day and budget stabilization reserves to rebound to $108 million from their low of $40 million as of June 30, 2010. This reserve level is close to the pre-recession peak of $118 million as of 2007 and 2008.

Total GAAP-basis fund balance, which includes funds reserved for continuing appropriations and reserves, ended fiscal year 2011-12 at $456 million, up $128 million from the prior year, though still below the prior peak of $541 million as of June 30, 2007.

The General Fund’s cash position also reflects a strong improvement in fiscal year 2011-12, rising to a new year-end peak of $530 million, up $144 million from June 30, 2011 and well above the prior peak of $490 million as of June 30, 2007.

Key Government Initiatives

San Francisco’s economy depends on investments in infrastructure and services that benefit City residents, workers, visitors, and businesses. These economic foundations range from housing and commercial development, to transportation infrastructure, investments in health and human services, and the City’s quality of life. The City is taking steps to strengthen this infrastructure, to support San Francisco’s economic recovery and long-term prosperity. Some important initiatives are described below:

Improving the City’s Public Transportation Systems

San Francisco is ideally situated to serve the Bay Area’s need to rapidly bring a large numbers of workers into a transit-accessible employment center and efficiently navigate the dense City on foot, mass transit, taxi or bicycle.

Plans for a multi-modal transit hub located in the City’s core – the Transbay Transit Center – are targeted to meet this regional need. The center is designed to provide expanded bus, commuter train, and ultimately high-speed rail connections into the City from within the region and state, and to provide pedestrian connections to nearby intracity subway, surface rail, and bus services within the City. The former terminal at the site has been demolished, with completion of the new center targeted for fiscal year 2016-17. The $1.6 billion transit center is funded through a host of revenue sources, including federal stimulus funding, tax increment and other revenues generated from planned dense, mixed-use development adjacent to the site.

The City has begun preliminary construction work on the Central Subway project, the second phase of a program designed to create a light-rail line running from Chinatown, under the heart of downtown, and connecting to the most-recent extension of the light-rail system to the Southeast portion of the City. The subway will connect to Bay Area Rapid Transit (BART) and Caltrain, the region’s two largest regional commuter rail services. The Central Subway project, with an estimated budget of $1.6 billion and a targeted completion date of 2018, is estimated to provide approximately 35,000 daily boardings at four stations along the new 1.7 mile line. Once completed, the project will reduce travel times and congestion along some of the most congested vehicular and public transit routes in California.

The City is also implementing a street repair and improvement program, funded with a $248 million general obligation bond, state and local revenue sources. Under this program, 2,540 blocks will be repaved or sealed, 1,900 curb ramps for disabled access will be constructed and over 125,000 square feet of public sidewalk will be repaired. In commercial corridors, and along busy arterials, the program will allow the City to build complete streets that enhance pedestrian and bicycle safety and enhance the vibrancy of urban neighborhoods. The bond also provides funds to rehabilitate existing traffic signal infrastructure and allow transit signal priority along key transit routes, improving transit efficiency and relieving traffic congestion. Planning efforts are underway to identify longer-term revenue sources to extend the program.
The City completed a $383 million renovation of Terminal 2 at San Francisco International Airport (SFO) in fiscal year 2010-11, and has an approved capital plan of over $700 million over the next five years, which includes the planned work on runway safety improvements, a new air traffic control tower, and renovations to Terminal 3. Additional long-term capital projects that are in the early review and planning stages include planned improvements to Terminal 1 and various boarding areas with a total cost likely in excess of $1 billion and anticipated phased completion dates through 2023. These projects are necessitated by the continued growth in passenger volumes at SFO, which accounts for 97% of international air travel and 71% of all air travel into the Bay Area.

Continuing Critical Infrastructure Upgrades for Water, Power, and Sewer Services

The City is more than half-way complete with a $4.6 billion program to upgrade the City’s local and regional water system, known as the Water System Improvement Program (WSIP). The WSIP delivers capital improvements that enhance the system’s ability to provide reliable, affordable, high-quality drinking water to the system’s wholesale and regional retail customers in Alameda, Santa Clara and San Mateo counties, collectively serving some 1.8 million people outside of San Francisco, as well as another 800,000 retail customers in San Francisco. The program is structured to cost effectively meet water quality requirements, improve seismic and delivery reliability, and meet long-term water supply objectives. Construction is completed on 74 of 81 projects, with some new facilities already in operation. The WSIP is projected to be fully completed by the middle of 2016.

The Public Utilities Commission endorsed a phased Sewer System Improvement Program (SSIP), a $6.9 billion dollar program, after an extensive planning process, which included 18 months of public workshops. The SSIP will upgrade to the City’s wastewater system, a system predominantly built out over the past century. Although significant investment occurred in the mid 1970s through the mid 1990s to comply with the Clean Water Act, today many of the existing facilities are in need of upgrade and major improvement to prepare San Francisco for the future. The sewer system includes nearly 1,000 miles of collection and transmission mains, four treatment plants, a solids handling system, and major force mains and interceptors.

Hetch Hetchy Power completed the installation of two additional municipal solar arrays at a Municipal Railway maintenance yard and Chinatown Public Health Center, for an additional 164 MWh of clean, solar energy. Hetch Hetchy Water is in the fifth year of a 20-year rehabilitation program for its aging reservoirs, powerhouses, switchyards and pipelines and tunnels. Funding for the program is $14.2 million and $14.8 million in fiscal years 2011-12 and 2012-13, respectively.

Expanding Access to Healthcare

Public health and human services are important to the long-term health and well-being of City residents, and to the overall productivity of the City’s workforce. The City offers a host of health and safety net services, including operation of two public hospitals, the administration of federal, state, and local entitlement programs, and a vast array of community-based health and human services.

In 2007, the City passed the Health Care Security Ordinance, which increases access to healthcare for uninsured adult San Francisco residents through the Healthy San Francisco Program, and creates a mandate for many businesses in San Francisco to make health care expenditures on behalf of their employees. By the end of fiscal year 2011-12, nearly 47,000 uninsured adult residents were enrolled in Healthy San Francisco, or approximately 73% of the City’s estimated adult uninsured population. At the end of calendar year 2011, 3,652 businesses and nonprofit organizations employing over 220,000 persons had made $1.19 billion in health care expenditures.

During this past fiscal year, the City began preparation for implementation of the Affordable Care Act. It launched SF PATH, a federally-supported Low Income Health Program, designed to transition uninsured adults into either Medi-Cal or the California Health Benefits Exchange in January 2014. By the end of fiscal year 2011-12, over 10,000 San Franciscans were enrolled in the program.
Amidst these changes, the City is on schedule to replace and modernize the City’s two public hospitals. The voters approved a general obligation bond measure to fund the replacement of San Francisco General Hospital in November 2008. This $887 million project is required given changes to state law governing seismic requirements for hospitals. It will replace the current facility with a new nine-story building on the existing hospital campus. The hospital is the only trauma center in San Francisco, and also acts as the safety net hospital for our residents. Construction of the project is underway, with completion expected in fiscal year 2014-15. This project follows substantial completion of the reconstruction of the City’s skilled nursing facility, Laguna Honda Hospital, in fiscal year 2011-12.

**Modernizing the City’s Parks and Libraries**

San Francisco voters have approved a number of bond measures to fund capital improvements to the City’s parks and libraries during the past decade, including the most recent approval in November 2012 of a $195 million general obligation bond for improvements to neighborhood parks. This most-recent parks improvement measure includes funds to improve 15 neighborhood parks and renovations to the parks’ support infrastructure.

A comprehensive capital improvement program intended to renovate the City’s branch library system is nearly complete, with planned improvements in 22 of the 24 branch libraries included within the capital program now finished. The $187 million program, funded with a mix of general obligation and lease-revenue bonds, focuses on seismic safety, accessibility, and modernization of facilities for current uses. Final completion of the improvement program is scheduled by fiscal year 2013-14. The 2012 San Francisco Clean and Safe Neighborhood Parks bond builds upon over $300 million worth of Park capital projects completed over the past decade.

**Planning for the City’s Growth**

San Francisco’s economic recovery has stimulated the demand for new residential and commercial space. After years of planning, development accelerated during fiscal year 2011-12 in several areas of the city where new growth has been planned. At the end of the fiscal year, over 43,000 housing units and 14 million square feet of commercial office space was in the planning or construction stages. 4,220 housing units were under construction, along with 830,000 square feet of commercial space. In recent years the City has completed major area planning efforts in the Eastern Neighborhoods, Market-Octavia, and Park Merced areas, as well as large-scale redevelopment projects in Hunters Point, Treasure Island, and the Transbay Transit Center area. While private construction slowed in San Francisco during the recession, the activity seen in the last fiscal year equals or surpasses what was seen during the previous upswing in the business cycle.

**OTHER INFORMATION:**

**Independent Audit**

The City’s Charter requires an annual audit of the Controller’s records. These records, represented in the basic financial statements included in the CAFR have been audited by the nationally recognized certified public accounting firm, Macias Gini & O’Connell LLP. The various enterprise funds, the Health Service System, the Employees’ Retirement System, the San Francisco County Transportation Authority, the San Francisco Finance Corporation, the former Redevelopment Agency through January 31, 2012 and the Successor Agency to the San Francisco Redevelopment Agency from February 1, 2012, have been separately audited. The Independent Auditor’s Report on our current year’s financial statements is presented in the Financial Section.
Award for Financial Reporting

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 Financial Report (CAFR) for the fiscal year ended June 30, 2011. This was the 30th consecutive year, beginning with the fiscal year ended June 30, 1982, that the City has achieved this prestigious award. A Certificate of Achievement is valid for a period of one year only. 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.

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 in the preparation of the CAFR. 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,

Ben Rosenfield
Controller