

December 23, 2009

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) for the fiscal year ended June 30, 2009 (FY 2008-2009), 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. Since the cost of internal control should not exceed anticipated benefits, the objective is to provide reasonable, rather than absolute, 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 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 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, and 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, the San Francisco Finance Corporation, and the San Francisco Parking Authority. The reason for this is that these component units have the same governing body as the primary government or provides services exclusively to the City. In other instances, namely, for the San Francisco Redevelopment Agency and the Treasure Island Development Authority, financial reporting is shown separately. Supplemental combining statements and schedules for non-major 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

The national recession which started in December 2007 finally began to affect the San Francisco economy in October 2008, in the wake of the financial crisis following the collapse of Lehman Brothers. The depth of the local recession can most clearly be seen in the number of unemployed, which has nearly doubled from June 2008 to June 2009. The City's unemployment rate rose to an average rate of 7.4% during FY 2008-2009, the highest annual rate in over 10 years. In addition to higher unemployment, the recession of FY 2008-2009 has led to lower retail sales, declining consumer prices, housing and commercial real estate price drops, and higher vacancies and lower rates in hotels and commercial real estate.

Nonetheless, San Francisco's economy has continued to outperform most other jurisdictions in California, and the State itself, during the recession. To place San Francisco's economic performance in context, the State of California's economy has continued to worsen since 2006. The clearest indication of this distress is the state's employment situation. During FY 2008-2009, California's unemployment rate increased by over 50%, to a rate of 11.6% in June 2009.

San Francisco did not feel the national recession until well into FY 2008-2009. The recession initially formed in areas of the State that suffered severe housing price declines and construction industry contractions. These declines occurred with the collapse of a housing bubble built on speculative overbuilding and an excessive spread of high-risk mortgages. The housing bubble in California was significant, but for the most part did not spread to coastal counties such as San Francisco, where rates of housing construction have remained low by State standards.

The housing market downturn broadened into an economy-wide credit and financial crisis in the fall of 2008. San Francisco businesses were not immune, and immediately curtailed investment and shed jobs. Almost every sector of the City's economy lost jobs during FY 2008-2009. Job losses were led, in percentage terms, by the construction, retail trade, and financial service sectors. Only health care and educational services have maintained employment during the recession.

Nevertheless, San Francisco's long-term economic fundamentals – the quality of its workforce, environment, technological base, and cultural amenities – remain among the strongest of any city in the United States. These competitive advantages are likely to secure the City's continued prosperity after the current recession ends.

Significant Economic Outcomes

Several aspects of San Francisco's recent economic performance over the past several years are discussed in more detail in the following section.

Population: Rising through 2008

Since 2000, the California Department of Finance and the U.S. Census Bureau have released significantly different estimates of San Francisco's population. For both calendar years 2007 and 2008, both sources indicated a rise in San Francisco's population over the prior years' levels. According to the Census Bureau, San Francisco had 808,976 residents as of July 1, 2008, a 1.2% increase over July 1, 2007. The Department of Finance reported San Francisco's population as 835,364 as of January 1, 2008, a 0.7% increase over the same date in 2007. In addition, the Department of Finance has estimated San Francisco's population to be 845,559 as of January 1, 2009, a 1.2% increase over the same date in 2008.

Employment Base: Severe Job Losses, But Outperforming the State

The wage and salaried employment base of San Francisco fell by 17,000 jobs between March 2008 and March 2009, based on the latest preliminary data available from the Bureau of Labor Statistics. This 3.0% drop is the largest annual change since 2003, and partially reverses a 4.0% increase in employment during the prior year. To put the recent job loss into context, San Francisco lost 94,000 jobs between 2000 and 2004, or 16% of its total wage and salary employment base, according to the Employment Development Department. Although that represents four consecutive years of job losses, each of the first three years of the 2000-2004 recession featured annual job losses that were greater than what San Francisco experienced between March 2008 and March 2009.

San Francisco's average monthly unemployment rate for FY 2008-2009 rose to 7.4%, an increase of nearly two-thirds over the average annual figure for the prior fiscal year. Despite the significant increase in local joblessness, San Francisco had a lower unemployment rate than most California counties, as of the end of June 2009. The State's unemployment rate rose from 7.6% to 11.6% during this same fiscal year.

Taxable Sales: Significant Declines Late in the Fiscal Year

Unlike most of the State of California, San Francisco's taxable sales base grew through most of 2008, even as the national economy entered a severe recession. However, as of the second quarter of FY 2008-2009, the City saw annual declines in taxable sales and its associated sales tax revenue. Actual taxable sales declined by 11.2% in the second quarter of FY 2008-2009, 17.6% in the third quarter, and 20.5% in the fourth quarter, all versus the same quarter in the prior fiscal year. Overall, taxable sales declined by 11.3% in FY 2008-2009, versus the prior year.

San Francisco's Major Industries

San Francisco's economy is dependent on the global competitiveness of two primary sets of industry clusters: knowledge-based businesses centered around professional, financial, and information services, and experience-based businesses centered on tourism. San Francisco's continued economic growth has been, and will in the future be, due to the competitiveness of these key elements of its economy. In addition, a new set of emerging technology-based industries has helped diversify San Francisco's economy in recent years. Nevertheless, almost all major segments of the local economy have suffered employment declines during FY 2008-2009.

Financial, Professional, and Business Services

The core of San Francisco's knowledge-based economy is its large downtown concentration of corporate headquarters, banks and financial services companies, and professional services such as law firms and consultants. The competitiveness of these industry clusters is important to San Francisco's long-term economic outlook.

In March 2008, San Francisco held over 173,000 private sector jobs in financial activities and business and professional services, according to the Bureau of Labor Statistics. As a group, employment in these

industries declined by 11,000 jobs between March 2008 and March 2009, a 6.1% overall reduction. In California, employment in these sectors declined by 7.1% during the same period, while nationally they declined by 5.7%.

The commercial real estate market in downtown San Francisco provides another indicator of the challenges facing the City's knowledge-based industries during the current recession. In the April to June 2009 period, the City's commercial vacancy rate increased by approximately 30%. Average commercial lease rates experienced a corresponding decline of 30.6% during the same period, with an average annual asking lease rate of \$32.67 per square foot.

Tourism and Hospitality

The other major segment of San Francisco's economic base is the tourism and hospitality industry. Like the downtown office sector, tourism experienced a strong recovery after the recession of the early 2000s, but experienced declines during FY 2008-2009.

There were approximately 73,000 people working in arts, recreation, cultural services, accommodation, and food services in San Francisco in March 2009, according to the latest preliminary data from the Bureau of Labor Statistics. This represents a loss of over 3,400 jobs, or a 4.7% decrease, versus the prior year. After several years of growth that exceeded State and national levels, San Francisco's loss in FY 2008-2009 exceeded the State's decline of 4.2% and the national decline of 3.1%.

Like most of the rest of the local economy, San Francisco's hotel sector entered FY 2008-2009 with strength, only to see rapid declines in the second quarter which continued until the end of the fiscal year. Both occupancy rates and average daily rates declined, resulting in a combined reduction in revenue per available room-night of 11.5% during the fiscal year.

Emerging Industries: Biotechnology and Clean Technology

Recombinant genetic engineering, the central innovation that created the biotechnology industry, was co-invented by a researcher at the University of California, San Francisco (UCSF) in the 1970s. Between UCSF, Stanford University, the University of California at Berkeley, and other local research institutions, the Bay Area is the leading biomedical research region in the world.

Until recently, however, few biotechnology companies were located in San Francisco itself. This has begun to change with the growth of the Mission Bay redevelopment area. Mission Bay now houses a new UCSF campus, and growing amounts of lab and incubator space for researchers and start-up companies. Today, San Francisco is home to 52 life sciences companies and has 6% of the Bay Area's occupied space for biotechnology, up from just 1% in 2003. As Mission Bay continues to develop, it is expected that San Francisco's biotechnology industry will continue to grow.

San Francisco also has a growing clean technology industry, with over 200 firms located within the City, including Suntech America, the world's largest solar manufacturer, that has located their North American headquarters in San Francisco.

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 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 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.

In November 2009, City voters approved a change to the City's Charter which requires the City to adopt a host of financial planning tools, including a two-year budget, a five-year financial plan, and a series of financial policies. The Charter amendment phases these changes in over a four year period, beginning in FY 2010-2011.

Key Government Initiatives

San Francisco's industry competitiveness and overall prosperity are underpinned by a number of local economic foundations that benefit City residents, visitors, and businesses. Improvement affecting core City infrastructure, to proceeding with key redevelopment and land-use projects, to initiatives aimed at improving the quality of life for those that live, work, and visit the City. The City government is taking steps to strengthen these advantages, and thereby helping to secure the City's continued prosperity. Some important initiatives are described below.

Key Initiatives: Housing and Commercial Development

San Francisco's recovery and future economic growth depends on developing new residential and commercial areas. Despite the recession, the City continued to make significant progress on these objectives in FY 2008-2009.

Treasure Island Redevelopment Project

The City has proceeded during the past year with planning for the redevelopment of Treasure Island, a former military base in the San Francisco Bay. By leveraging private capital and the City's entitlement power, the City plans to develop the closed base into a green, sustainable community. The Treasure Island Plan will add 6,000 new residential units, including 1,800 at below-market rate. The planned project also includes 250,000 square feet of retail and commercial space, 450 hotel rooms, entertainment venues and cultural exhibitions, and a 300-acre park.

Bayview and Hunters Point Redevelopment Projects

A similar development opportunity exists along San Francisco's southern waterfront, at Candlestick Point and the Hunters Point Shipyard. Current plans include up to 10,000 housing units, over two million square feet of research and development space, and over 350 acres of open space and waterfront park land. A new 49ers stadium could be an element of that revitalization effort; plans are proceeding with, and without, a stadium alternative. Revitalizing these waterfront sites will create badly-needed jobs, affordable housing and parks and open space for the Hunters Point community, and the broader region.

In June 2008, City voters approved Proposition G, supporting the combined Hunters Point Shipyard Candlestick Point redevelopment project. This measure affirmed the actions of both the Redevelopment Agency Commission and the Board of Supervisors, who in 2007 endorsed the conceptual framework to plan for an integrated, mixed-use project in the southeast corner of the City. In addition, the Navy's cleanup and transfer of the Shipyard parcels to the City are accelerating, including an \$82 million federal appropriation for the Navy's clean-up of the site during FY 2008-2009, a significant increase over appropriations in prior years.

Key Initiatives: Transportation Infrastructure

San Francisco's economic recovery and future development will raise demand for transportation and create a need for increased infrastructure investment. The City is planning for this growth across all modes, including bus, rail, and air.

The Transbay Transit Center

Rising freeway congestion in the Bay Area make it critical for the region to have the ability to rapidly bring large numbers of workers into a transit-accessible employment center. Downtown San Francisco can serve this function better than any other area in the region, and the Transbay Center will significantly strengthen this capacity. Plans for a multi-modal hub located in the City's core – the Transbay Transit Center – are targeted to meet this need.

In 2006, the Transbay Transit Center project obtained Federal and State environmental approvals. The Center will initially feature an expanded terminal for buses to and from surrounding counties, and is planned to include a terminal for commuter rail from San Mateo County, high speed rail from Southern California, and pedestrian connections to both Bay Area Rapid Transit (BART) and City Municipal Transportation Agency (MTA) subways. Plans for the Transbay Center include a mixed use transit tower, where development will fund much of the transit infrastructure.

The project is scheduled for completion in 2014, followed by completion of an extension of the Caltrain rail line to the site in 2018. Once completed, the Center is expected to serve more than 100,000 people per day through nine different transportation systems.

Expanded Capacity at San Francisco International Airport

The San Francisco International Airport (SFO) is nearing completion of a \$383 million renovation of Terminal 2 from a 10-gate international terminal to a 14-gate domestic terminal. As a result of the international economic slowdown, U.S. airports have experienced an average decline of 7.7% in air traffic. In contrast, air traffic at SFO has decreased by only 0.8% as a result of additional flights being offered by low-cost carriers. Virgin America and American Airlines are the anticipated tenants of the new Terminal 2, which is scheduled to open in early 2011.

Improved Municipal Transit Planning

The City has recently completed a comprehensive review of current and projected transit travel patterns and produced a series of recommended changes to the City's mass transit system designed to improve reliability and reduce travel times. The analytical and planning phase of this project concluded during FY 2008-2009.

The City is currently developing a five-year implementation plan for these recommendations. The plan will include goals and target outcomes, a phasing plan for route updates and service changes, a detailed list of required capital projects and funding strategies, and a master schedule with critical path steps to deliver the five-year program. Concurrently, the City will commence required environmental assessment processes during spring 2010.

Subway System Expansion

In 2007 the City completed an extension of its light-rail system from the edge of the City's financial district to the City's southeast sector through completion of the Third Street Light Rail Project. The next phase of this project, titled the Central Subway Project, will extend this light rail line underneath the City's financial district to Chinatown. The City is now completing preliminary engineering work and anticipates receiving federal approval to enter into the final design of the project late in FY 2009-2010.

Key Initiatives: Health and Human Services

Public health and human services are important to the long-run productivity of the 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.

Access to Healthcare

The City launched the Healthy San Francisco program in 2007 with the goal of increasing access to healthcare for San Francisco residents. The program creates a mandate for many businesses in San Francisco to either provide employer-paid health insurance for their employees or to pay into an expansion of the City's public health network. The program is funded with a mix of grants, employer-paid fees, and through a redirection of local funds allocated for public health services.

During this past fiscal year, the City's Department of Public Health has focused on expanding enrollment and broadening the medical provider network participating in the program. The provider network now includes a number of private and nonprofit community health care associations and hospitals. By the end of FY 2008-2009, over 43,000 uninsured adult residents had enrolled in the program, or approximately 72% of the City's estimated uninsured population.

Rebuilding the City's Public Hospitals

The City is in the process of replacing and modernizing both of its public hospitals, Laguna Honda Rehabilitation Center and San Francisco General Hospital.

The replacement of Laguna Honda is scheduled for completion during the coming fiscal year. The \$585 million project has been funded with a mix of General Obligation bonds, tobacco settlement revenues, and certificates of participation. Three new seismically-safe buildings, which will be home to 780 residents, will open in April 2010.

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 existing 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. Preliminary excavation and utility work on the site has already commenced, with completion expected in 2015.

Key Initiatives: Quality of Life

In recent years the City has completed renovation and expansion of a number of recreational and cultural facilities that serve those that live, work, and visit the City. The experience generated by these institutions is one of the keys to the maintaining the high quality of life that, in turn, serves to attract and retain the City's many visitors and residents.

New Museums

Several museums have recently opened, broadening the base of available cultural amenities. During the past three years, the California Academy of Sciences and de Young Museum have reopened in new and expanded facilities. The Contemporary Jewish Museum, Museum of the African Diaspora, and Walt Disney Family Museum and Library have all opened during this same period. And work is underway to relocate the Exploratorium Museum to a larger, more central waterfront location.

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, most recently with the approval of a \$185 million General Obligation bond for improvements to neighborhood parks in February 2008. This most-recent parks improvement measure includes funds for seismic improvement, disability access, and facility renovation at key facilities and parks throughout the City, and is scheduled for completion by FY 2013-2014.

A comprehensive capital improvement program intended to renovate the City's branch library system is proceeding, with planned improvements at over half of the City's branches now complete. 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. The program is scheduled for completion in FY 2010-2011.

SUMMARY:**Short Term Weakness, Long Term Strength**

The economic recession that had begun earlier elsewhere in the State had significant impacts on San Francisco's economy in FY 2008-2009. Unemployment rates increased, consumer prices declined, retail sales weakened, housing and commercial real estate price declined, and vacancy rates in commercial real estate and hotels increased.

Corresponding tax revenue declines forced reductions in general government services and resulted in the need for mid-year budget corrections to maintain a Charter-required balanced budget. These pressures on the City's General Fund budget are expected to continue into FY 2009-2010 and FY 2010-2011.

As discussed above, however, San Francisco is positioned to maintain its historic strength after the current recession ends. Significant investments in key infrastructure and land-use projects will provide needed jobs and economic stimulus in the short-term, with long-term benefits resulting to the City and region's economic competitiveness. These investments are complemented by a number of key initiatives aimed at improving the quality of life of those who live in and visit the City. In the longer term, the City and region's longstanding advantages in workforce educational attainment, research and development, entrepreneurial talent, venture capital financing, and quality of life are likely to ensure it remains among the most competitive regional economies in the world.

Certificate of Achievement Award

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, 2008. This was the 27th consecutive year (fiscal years ended June 30, 1982 – 2008) 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.

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,

A handwritten signature in black ink, appearing to read 'B. Rosenfield', with a long horizontal flourish extending to the right.

Ben Rosenfield
Controller