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Office of the Mayor
City of San Diego

Independent Accountant's Report on Agreed-Upon Procedures Applied to Proposed Water Rate Increases

We have applied the procedures enumerated below to the City of San Diego's proposed water rate increases. These procedures, which were agreed to by the City of San Diego were performed solely to assist the City in evaluating the proposed water rate increases.

This engagement to apply agreed-upon procedures was performed in accordance with standards established by the American Institute of Certified Public Accountants. The sufficiency of the procedures is solely the responsibility of the specified users of the report. Consequently, we make no representations regarding the sufficiency of the procedures described below either for the purpose for which this report has been requested or for any other purpose.

For purposes of comparisons referenced in this report, amounts are considered to be consistent if the difference between the compared amounts is less than $1 million and also less than 15%.

BACKGROUND

The Water rate model was originally developed by outside consultants and updated and modified by the City's Water Department personnel. The rate model contains projections of future expected revenues, operating costs, and capital costs. The model requires the rate increases to be sufficient to cover net operating costs and 20% of annual capital costs while not violating certain constraints. The model's constraints include maintaining $10 million in unrestricted, undesignated equity and maintaining a debt coverage ratio of at least 150%. The model projects the following rate increases:

Fiscal year ending June 30, 2008	6.5%
Fiscal year ending June 30, 2009	6.5%
Fiscal year ending June 30, 2010	6.5%
Fiscal year ending June 30, 2011	6.5%

PROCEDURES PERFORMED

The procedures performed and the results of those procedures were as follows:

1. We agreed the beginning unrestricted, undesignated equity balance at June 30, 2006 to unaudited accounting system reports.

   Results: The unaudited accounting system reports supported the amounts included in the rate model.

2. The rate model projects revenues based on historical trends and projections of future demand. The rate model includes the following revenue projections (in thousands):

	Fiscal Year Ending June 30,				
	2007	2008	2009	2010	2011
Water sales	$279,832	314,799	346,549	376,356	407,926
Capacity charges	12,457	12,152	12,289	12,394	12,250
Rental income	4,252	4,333	4,416	4,499	4,585
Interest income	8,318	20,804	13,083	21,908	15,210
Charges to other funds	10,762	10,967	11,175	11,388	11,604
Other revenues	9,746	4,609	4,696	4,784	4,875
Total projected revenues	$325,367	367,664	392,208	431,329	456,450

- We agreed the 2003 to 2006 revenues to unaudited accounting system reports. These revenues are used in the model to calculate historical trends.

  Results: For the years ended June 30, 2003 through 2006, the revenues are consistent with unaudited accounting system reports.

- We agreed the 2007 amounts to the 2007 Annual Budget.

  Results: The 2007 Annual Budget is consistent with the projected revenues used in the rate model calculation.

- For *Water Sales*, we analytically compared projected revenues for the years ended June 30, 2007 through 2011 to historical revenue trends.

  Results: The revenue increases from year to year are consistent with the historical water sales plus increases for water rates.

- For *Interest Income*, we calculated the rate of return using unaudited accounting system reports.

  Results: The projected rate of return is consistent with current market interest rates.

- For *Capacity Charges*, *Rental Income*, *Charges to Other Funds*, and *Other Revenues* we compared each projected year to the prior year starting with the fiscal year ended June 30, 2005.

Results: Other revenues decreased significantly from 2007 to 2008 due to known grant funding in 2007 that is unknown for future years. There were no other significant variances from the prior year data that required further investigation.

3. The rate model projects other sources of funding based on long-term budgeting expectations. The rate model includes the following projections of other sources (in thousands):

	Fiscal Year Ending June 30,				
	2007	2008	2009	2010	2011
Bond proceeds	$ 48,275	237,468	-	207,300	-
Rate stabilization fund transfer	-	1,000	-	-	-
Other sources	3,213	115	115	115	115
Total other sources	$ 51,488	238,583	115	207,415	115

- Bond proceeds are issued to fund 70% to 80% of expected capital project expenditures. Water revenues are used to fund the other 20% to 30% of capital projects. We recalculated percentage of the capital project expenditures to determine if the amount of bond proceeds is accurate.

  Results: Bond proceeds received in 2007 are equal to 70% of the 2007 eligible capital project expenditures plus an additional $10 million of reimbursements for the prior year's capital projects that were funded by water revenues in excess of the historical 30% goal. Bond proceeds in 2008 are equal to 80% of eligible capital project expenditures for the years 2008 and 2009 combined. Bond proceeds in 2010 are equal to 80% of eligible capital project expenditures for the years 2010 and 2011.

- The rate stabilization fund transfer is a management tool used to smooth changes in water rates. We inquired with management the reason for the rate stabilization transfer in 2008.

  Results: The $1 million rate stabilization transfer in 2008 represents management's intentions to reduce the required rate increase in 2008.

- We inquired about significant changes in Other Sources.

  Results: Other Sources includes transfers from the City's Capital Outlay Fund. In 2007, the transfer includes proceeds from the sale of property owned by the Water Department.

4. The rate model projects operating expenses based on historical trends and projections of future demand. The rate model includes the following expense projections:

	Fiscal Year Ending June 30,				
	2007	2008	2009	2010	2011
Operating and maintenance	$134,278	151,143	157,333	172,632	180,660
Water purchases	125,340	124,956	131,616	131,244	138,591
Transfers to other funds	3,414	4,717	5,614	5,762	5,915
Debt service	42,623	52,822	61,777	72,875	80,677
Other	1,320	6,234	6,518	7,136	7,463
Total operating expenses	$306,975	339,872	362,858	389,649	413,306

- We agreed the 2003 to 2006 expenses to unaudited accounting system reports. These expenses are used in the model to calculate historical trends.

  Results: For the years ended June 30, 2003 through 2006, expenditures per the unaudited accounting system reports are consistent with expenditures in the rate model.

- We agreed the 2007 amounts to the 2007 Annual Budget.

  Results: The 2007 expenses per the model are consistent with the approved expenses in the 2007 Annual Budget.

- *Operating and Maintenance Costs* did not increase by more than 15% in any year and is consistent with historical amounts. We obtained a detailed listing of what makes up the operating and maintenance expense number. For significant fluctuations between fiscal years, we obtained an explanation from management.

  Results: We noted the following significant fluctuations in the projection:

  - Increase in operating and maintenance expenses for new capital projects - Management reviews the capital program to identify when projects will become operational and to identify whether they will require new staff or add/subtract other operating costs. The amounts in the model represent management's expectations.

  - Increase in management information systems costs – We compared the amounts in the model to information from the department projecting information system costs.

- Decrease in Service Level Agreement (SLA) costs - As a response to the Grand Jury Report, the Mayor has reduced SLA expenditures.

- Increase in Pension Contribution – We agreed the increase to projections provided by the Office of the Mayor.

- Increase in Retirement Heath Benefits – We agreed the increase to projections provided by the Office of the Mayor.

- For *Water Purchases*, we obtained the water rates and charges from the Metropolitan Water District of Southern California ("MWD") and recalculated water purchases in the model based on MWD's water rates.

  Results: No exceptions were noted.

- *Transfers to Other Funds* is for the annual General Governmental Services Allocation. This is an allocation of General Fund charges to other funds of the City. In a separate report dated June 30, 2006, we tested the $3.4 million allocation (2007) to determine if it was equitably charged to the funds of the City. The increase is an estimate based on budgeted cost.

  Results: We obtained detailed spreadsheets by department projecting future increases in the General Governmental Services Allocation. We calculated the percentage of the overall increase for the Water Fund and determined that the increase used in the model was correctly calculated.

- For *Debt Service Expenses*, we agreed principal and interest payments to bond maturity schedules on outstanding debt. We also traced debt service expense to the bond model that projects debt service on bonds that have not yet been issued.

  Results: No exceptions were noted.

5. The rate model projects capital expenses based on specific project start dates and cost estimates. The capital project expenses include a 5% contingency cost and an inflation factor of 4%. We compared the capital project expenses in the rate model to the City's Capital Improvement Budget.

   Results: The capital improvement budget totals $512,825,516. The capital improvement expenses from 2007-2011 in the rate model totals $646,946,000. The capital expenditure budget includes both privately funded resources and debt funded expenditures. The rate model only includes debt funded capital expenditures. We agreed the 2007 capital improvement budget to the rate model, which was reduced by private funding.

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We were not engaged to, and did not, perform an audit, the objective of which would be the expression of an opinion on the subject matter. Accordingly, we do not express such an opinion. Had we performed additional procedures, other matters might have come to our attention that would have been reported to you.

This report is intended solely for the use of the City of San Diego, California and is not intended to be and should not be used by those who have not agreed to the procedures and taken responsibility for the sufficiency of the procedures for their purposes.

Mayer Hoffman McCann P.C.

Irvine, California
November 17, 2006