

FY2010 IROC ANNUAL REPORT
FINANCE SUBCOMMITTEE
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FINANCE SUBCOMMITTEE

The intent of the Finance Subcommittee is to assist IROC with oversight of the Public Utilities Department (Department) water and sewer rates, efficiency, financial management, budgets, and rate payer funds to ensure services are provided to rate payers in the most efficient and affordable manner possible. The subcommittee also tracks and reviews the use of rate proceeds and project schedules to advance the capital improvement program related to the rate packages adopted by the City Council. The subcommittee performs its work in a manner which considers and balances the interests of both the Department and the rate payers with the goal that a high level of public confidence in utility services be maintained by ensuring that services are provided, and investments made, in the most cost efficient and transparent way possible at the most affordable cost to the rate payers.

To perform this function, and working through the full IROC Committee, the subcommittee utilizes the following methods and tools: (1) performance and financial oversight; (2) meetings and investigations of timely and relevant financial issues; (3) written advisory letters to communicate issues of a financial nature to the Mayor, City Council and Department management; (4) testimony at City Council meetings and Council Committee hearings; and (5) written reports on salient water and sewer financial issues. The subcommittee diversifies its information sources to promote objectivity and independence; and solicits information from other City departments, City Council offices and outside sources to supplement Departmental information.

Members. The membership of the Finance Subcommittee includes:

- Andy Hollingworth - The Auditing/Accounting representative to IROC who serves as the Finance Subcommittee Chair as well as IROC's Vice Chair.
- Jim Peugh (Ex Officio) - The Environmental representative to IROC who serves as IROC's Chair.
- Gail Welch - The Commercial and Industrial representative to IROC who serves as the Chair of the Public Outreach, Education, and Customer Service subcommittee.
- Don Billings – The Finance/Municipal Finance Representative to IROC who served as the first Chairperson of IROC.

2010 FINANCE SUBCOMMITTEE OVERSIGHT ACTIVITIES AND ISSUES

During FY2010, the Finance Subcommittee conducted monthly meetings and evaluated special studies in pursuit of its mission of providing oversight of the Departments water rates, efficiency, financial management, budgets, and rate payer funds in conjunction with the full IROC. These included monthly reviews of the Department's operational finances, and a quarterly review of the capital improvement program progress and costs. The subcommittee also evaluated the causes

for the Metropolitan Water District (MWD) and San Diego County Water Authority (CWA) pass-through water rate increases and held two special meetings with the full IROC to seek explanations from the MWD and CWA CFO's, and the CWA General Council. During FY2010 the Subcommittee found the following issues in the course of its oversight activities:

Financial and Capital Improvement Program (CIP) Reporting

The San Diego County Grand Jury filed a report on April 25, 2006 titled "Service Level Agreements Equal Back Door Funding". In response, on February 15, 2007 the Mayor issued a press release entitled "Mayor Sanders Details Plan to Safeguard Water and Wastewater Ratepayer Funds". The plan was offered to the City Council in advance of a vote on new rate increases for both the water and wastewater systems and called for installation of five safeguards for protecting ratepayer funds used by the City's water and wastewater systems. The first of these safeguards was the establishment of the Independent Rates Oversight Committee. The document specified that "Under the Mayor's Plan, the City will form a new Independent Rates Oversight Committee charged with reviewing and analyzing finances and efficiency measures in both systems. IROC will advise the City regarding budgets, project priorities and financial management of the Water and Wastewater Departments".

To fulfill this mission, adequate, accurate and timely financial and CIP reporting is critical. Therefore, in June 2009 the Finance Subcommittee requested the following financial reports be submitted to the subcommittee on a regular basis to provide adequate reporting for operational and maintenance finances and the CIP program to ensure that water and sewer rates were sufficient to fund necessary operational and capital costs, but not excessive.

- Monthly actual expenditures versus budget reports for year-to-date and forecasted revenues and expenditures for the water and wastewater funds -- with explanations of significant variances. This is a standard report from the SAP enterprise reporting system and helps determine whether current year water and sewer rate structures are sufficient to fund current year expenditures, but not excessive.
- A monthly reserve balance and analysis report for all Departmental reserve funds. This is a standard report from the SAP enterprise reporting system and helps determine the adequacy of reserves and whether they are increasing or being depleted, which is another indicator of the adequacy of current water and sewer rate structures.
- A quarterly report of Full Time Equivalent position transfers, service level agreements, and overhead charges from the non-enterprise funds to the Department water, sewer and bond funds. This would help determine whether cost shifting is occurring between the General Fund and the Enterprise Funds.
- Capital Improvement Program Actual versus Baseline schedule; and Actual versus Budget expenditures reporting at the project level.

These reports are meant to ensure that rates are neither too high (resulting in a fund surplus); nor too low (resulting in a fund deficit), and sufficient to cover current and projected operating and

capital expenses. The reporting was also meant to ensure that funds were not being shifted to the General Fund from the Utility Enterprise Funds via position transfers or overhead charges, beyond the cost of legitimate services. Such a situation would result in water and sewer rates subsidizing general government operations, which should be funded from the General Fund. Finally, they were meant to ensure that the CIP program is on schedule and on budget, as program delays can result in major deficits.

Without adequate financial and CIP reporting, IROC cannot assure the Mayor, City Council and the public that water and wastewater ratepayer funds are adequately safeguarded.

Since June 2009, in response to IROC verbal and written information requests, IROC found the following problems involving Department financial and CIP reporting:

- Problems receiving financial reports on a consistent basis.
- Problems with the accuracy and completeness of the financial reports as many were incomplete and calculated on a cash accounting, rather than accrual basis, and were therefore inaccurate.
- Problems getting accurate and comprehensive reports on FTE position transfers and new overhead charges.

Much of these problems may have been related to the problems the City is experiencing with the overall SAP financial reporting system - particularly the problems the City is having closing the FY2010 books which are now several months late. Department staff, however, stated that such problems have not affected their review and tracking other than those involving labor charge allocations. IROC inquired of other interested parties - such as the Utility Consumer Action Network - whether or not they experienced similar problems obtaining information from the Department. They indicated they had experienced similar disclosure problems and had filed a Public Records Act request filed in an attempt to gain access to information.

Department management did respond in October 2010 to the June 2009 IROC requests involving CIP actual versus baseline schedule reports and actual vs. budget Expenditure reports which has improved as a result. The 2nd Qtr. CIP report also met most of IROC's needs. However, the 3rd Qtr. report omitted several important previously requested information items included in "Management Advisory Letter #1 – CIP reporting" sent to Department management on October 20, 2010. The missing items of information include:

- (1) The baseline schedule by project. This is needed so IROC can determine if the CIP program is falling behind schedule and where so problems areas can be identified and remedial action taken in a timely manner. Schedule slippage can be a major cause of program deficits.
- (2) Forecasted total costs by project. This enables IROC to determine whether the program is fully funded and the extent of any developing deficits.
- (3) Major change orders by project. This helps IROC determine if major project scope changes are being approved which could affect either program progress or cost.

The Department did include this information in the 2nd Qtr. report but not the 3rd Qtr. report. It should be noted, however, that previously requested program level “dashboard” reporting and increased project definition was included in the 3rd Qtr. report. But the previously requested, but omitted, information is important to providing oversight of the CIP program and is indicative of the problems IROC has experienced getting accurate and comprehensive reports on a consistent basis. The Department has indicated that the reporting problems stem from the delay in issuance of the FY2010 Comprehensive Annual Financial Report and will be resolved once it is finalized which the City’s Chief Financial Officer previously indicated that will occur in July or August 2011.

However, a delay in issuing the FY2010 CAFR should not hinder responding to financial reporting requests if the financial reporting system is operating properly as the Department budget officer currently represents. Furthermore, most private companies issue monthly comprehensive financial reports to their Board of Directors and management that are not dependent upon completion of their annual audit; and there is no financial reason Department management cannot do the same if the system is operating properly as represented; or unless management is constrained by an internal City policy restricting such distributions. Department management has not presented written evidence of such a policy. Significant improvements therefore need to occur in operational financial reporting which is currently not adequate to allow oversight of finances.

IROC, therefore, concludes that reporting is better in the CIP area but still inconsistent from quarter to quarter. IROC also believes some of this may be due to problems reported in the Engineering and Capital Projects Department as discussed in Finding #5 in the July 2011 City Auditors Office report entitled “Capital Improvement Program – Better Planning and Oversight Are Needed to Effectively Identify Capital Infrastructure Needs and Manage Projects”.

Conclusions and Recommendations. In view of these problems IROC concludes that financial reporting continues to be an ongoing problem with management, with important, but inconsistent, improvement in the CIP area. This continues to be a hindrance to IROC fulfilling its oversight mission as charged by the Mayor and City Council. IROC therefore cannot render an opinion at this time regarding whether water and wastewater ratepayer funds are being safeguarded and whether rates are necessary and adequate to finance operations and the capital program.

IROC recommends Department management address these reporting issues prior to the next rate case, as this will be needed to assure the public and City Council that any proposed rate increases are necessary. Among the reports needed are:

- An annual and comprehensive forecasted Statement of Cash Flows for the water, sewer and bond funds encompassing the following elements: (a) a five-year forecast period, (b) separate line items for forecasted operations, CIP and debt service expenditures, (c) separate line items for forecasted water/sewer rate, bond sale, and grant revenues, (d) forecasted cash and fund balances for the water, sewer, and bond funds, (e) the forecast should include the current CIP schedule and forecasted CIP expenditures based on that

schedule, (f) forecasted debt coverage ratios, and (g) a list of assumptions upon which the forecast is based.

- Quarterly detailed actual versus budget statement of revenues, expenses, and changes in fund net assets for year-to-date and forecasted year-end revenues and expenditures for both funds; with an explanation of significant variances similar in quality to the report provided in May 2011. An example of an adequate report is the one included on page 54 of the Public Facilities Finance Authority of the City of San Diego Water Revenue Bonds, Series 2009B prospectus booklet as amended to include columns for YTD actual and forecasted year-end data; and YTD actual and forecasted year-end budget data.
- Quarterly detailed actual versus budget statement of net assets for the both funds. An example of an adequate report format is the report included on page 58 of the 2009 Comprehensive Annual Financial Report as amended to include a column for budget data.
- Semi-annual forecasted statement of revenues, expenses, and changes in fund net assets for both the CIP program and the water and sewer funds for a five year forecast period. An example of an acceptable format is on page 59 of the 2008 Comprehensive Annual Financial Report forecasted out for five years.
- Quarterly comprehensive current versus baseline schedule report for all projects for the wastewater and water CIP program; as the prior reports include only some, but not all, projects.
- Quarterly reports of FTE position transfers, and the detailed charges comprising the payments for inter-fund services used line item included in the Statement of Cash Flows for the Water and Sewer Funds (See page 60 of the 2008 Comprehensive Annual Financial Report for an example of the inter-fund payments line item). Alternatively, Department management indicates that ratepayer assurance could be provided by mandating that the annual audit plan overseen by IROC include both a review of FTE position transfers and payments for inter-fund services – This can be used to ensure they don't represent a subsidy from Enterprise Funds to the General Fund. This would meet both the concerns expressed in the 2006 Grand Jury report as well as concerns expressed by outside constituencies regarding FTE transfers. IROC concurs with this compromise solution.

The Department states it is taking steps to improve both its CIP and financial reporting, and has shown some evidence of this. IROC stands ready to work closely with Department management to address the reporting issues and will report progress to the Mayor and Council by December 2011. Once provided, IROC will be able to render an opinion to the Mayor and City Council regarding whether water and wastewater ratepayer funds are properly safeguarded and whether rates are necessary and adequate to finance operations, maintenance and the capital improvement program.

Capital Improvement Program

The Subcommittee is pleased to report that CIP reporting has improved, even though problems were still noted in the 3Q2010-11 report. In response to the subcommittee's June 2009 information request, the Department instituted quarterly actual versus budget expenditure reporting in October 2010 for both the FY2010 and the 1st Quarter of 2011 water and wastewater CIP programs; and partial actual versus baseline schedule reporting for the same programs and periods. IROC therefore conducted a detailed review of the CIP program utilizing these documents, and now reports the following:

Wastewater CIP Program

IROC observed that the number of sewer spills have significantly improved over the past ten years with total spills declining from 365 in 2000 to 41 in 2010 while the number of the sewer spills into public waterways - i.e. beaches and bays - decreased from 33 in 2000 to 13 in 2010. Infrastructure improvements resulting from the CIP have contributed to this improvement. IROC considers this a significant success for which the Department is congratulated.

Wastewater (Muni Fund) Rate Case FY08-11 CIP Program.

Review of the Muni Capital Improvement Program "Planned to Actual" expenditures report indicates the following financial status for this program as of December 2010.

Wastewater Muni Fund CIP Expenditures

Project Status	Count	Rate Case Funds Budgeted FY 08-11	Expend. FY08-FY11 (Nov 30)	Expend. Actual + Planned FY08-11	Expend. Actual + Planned FY08-13	Project Balance
Active	22	436,137,861	145,835,264	217,576,907	418,367,501	17,770,360
Completed	11	7,540,820	6,374,971	6,374,971	6,374,971	1,165,849
Cancelled	4	19,854,075	803,074	803,074	803,074	19,051,001
Contingency	1	14,368,855	-	-	-	14,368,855
Total	38	477,901,611	153,013,309	224,754,952	425,545,546	52,356,065

Project Status	No.	Rate Case Funds Budgeted FY 08-11	Expend. FY08-FY11 (Nov 30)	Expendi. Actual+Planned FY08-11	Expend. Actual+Planned FY08-13	Project Balance
Active	22	100.0%	33.4%	49.9%	95.9%	4.1%
Completed	11	100.0%	84.5%	84.5%	84.5%	15.5%
Cancelled	4	100.0%	4.0%	4.0%	4.0%	96.0%
Contingency	1	100.0%	0.0%	0.0%	0.0%	100.0%
Total		100.0%	32.0%	47.0%	89.0%	11.0%

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Source: Public Utilities Department Report, Wastewater (Muni Fund) Rate Case FY08-11, Capital Improvement Program
 “Planned to Actual” 12/15/2010

IROC also reviewed the partial schedule information the Department and E&CP Departments provided for both the Muni and Metro Wastewater CIP programs to determine whether on-going capital projects are ahead, behind, or on schedule; and whether capital projects were ultimately finished ahead, behind, or on schedule. The results are as follows:

Muni and Metro Wastewater Program Partial CIP Schedule

Project Current Progress Compared to Baseline Schedule	No of Projects
Ahead of Schedule	1
Behind Schedule	9
On Schedule	6
Total Projects Reported	16
Total Projects in Muni and Metro Wastewater CIP program	69

Source: FY2011 Capital Improvement Projects (CIP) – 1st Quarter Report to IROC

Review of the expenditure information implies that the program is behind schedule as only 47% of FY2008-11 program funds are projected to be expended by the end of FY2011, with 89% expended by the end of 2013. Eleven (11) out of 38 total projects have been completed for the Muni program as of December 2011. Review of the partial schedule information provided for 16 wastewater projects for both programs indicates that 9 out of 16 (56%) were between 0.5 to 1.25 years behind schedule. The E&CP Department reported that the reason for the program delay is the following:

“The City was out of the public bond market during 2003 to 2008 due to the lack of audited financial statements....this had a significant impact on the City’s capital program and ultimately resulted in the loss of city engineers and other necessary staff for executing the CIP program. During this timeframe, water and wastewater funds were forced to reduce their capital program and finance only legally mandated projects with cash and private financing. Although Water and Wastewater funds had access to private financing in 2008, CIP execution was hampered by the necessary ramp-up of E&CP in addition to City transition issues due to the Business Process Reengineering. Also, when the rate case was prepared back in 2007, design and construction cost were significantly higher than today. It was anticipated that design and construction cost would gradually increase from 2007 through 2011. However, the opposite has happened. Design and construction cost have dramatically reduced due to the weak economy. These factors have led to significant CIP execution variances between actual expenditures for Water and Wastewater funds and projected CIP expenditures in the Water and Wastewater 2007 rate cases.” According to the Department “Some project schedules have slipped, but all Consent Decree projects are projected to be completed on schedule, prior to June 30, 2013.”

The Department contends that “The bulk of the Muni rate case is the replacement of 165 miles of sewer mains at a cost of \$365 million between FY08-FY11. Actual expenditures for this same period (FY08-FY11) are projected to be \$191 million and 162.5 miles will be completed. For pipeline replacement projects, we are on schedule. Based upon the Department’s schedule and expenditure data, the majority of its projects won’t be completed until 2013 rather than 2011. Review of the expenditures report indicates the program is funded from \$477.9 of projected

sewer rate revenues and bond funds on a 20% to 80% split. Only \$224.7 million (47%) will be expended by the close of FY2011, with \$425.5 million (89%) expended by the close of FY2013 and result in a 52.4 million (11%) reduction of expenditures. All of this evidence points to a program behind schedule.

Further review of the program indicates that as of December 2010, four projects budgeted at \$19.8 million have been cancelled. However, \$800,000 was expended on these projects which therefore did not cost the ratepayers a significant amount of sunken cost. Eleven projects have been completed, but analysis indicates only three of the eleven appear to be major projects. The remaining eight completed projects involved only minor fund expenditures and most did not appear to have been included in the rate case since they had no rate case funds listed in the report for them.

The program appears to need enhanced project scope definition and cost/budgetary controls, particularly in certain “annual allocation” projects, where scope definition is vague and continually being added, and where actual costs vary significantly from budget. Therefore rate payers cannot be sure what project scope their rate dollars are actually buying and at what cost. This is illustrated by the Department’s statement “Annual Allocations are used to fund numerous projects within a certain asset class. The scopes are generally broad and include all projects related to that asset class.”

Some vagueness in scope definition in construction programs can be considered normal; but the degree present in the Departmental CIP program can make oversight difficult. For example, six of the 31 projects in the FY08-11 Wastewater (Metro Fund) Rate Case CIP report; 11 of the 38 projects in the Wastewater (Muni Fund) Rate Case FY08-11 CIP report; and 12 of the 65 projects in the FY08 Water Rate Case -11 CIP report were “Annual Allocation” projects. Within the Muni Fund, nine of the eleven annual allocation projects are classified as “active”, one as “cancelled”, and one as “contingency”.

An example of the scope and budgetary control issues which can arise with the use of annual allocations is Project 44-001.0 Annual Allocation – Sewer Main Replacements which is going significantly over its original budget due to additional scope being added to the project. The rate case included \$134.8 million in the Annual Allocation -Sewer Main Replacement project for the replacement of 50 miles of sewer pipe between FY08-FY11. Actual costs are expected at \$83 million with 60.37 miles of pipeline replaced, with the expanded scope being completed at significantly lower cost. Due to favorable economic conditions, however, the scope of this project was expanded to include the replacement of an additional 50 miles of pipe with expenditures expected to total \$180 million by 2013 versus the \$134.8 million included in the original rate case for this project. Therefore, total 2008-13 expenditures exceed the original budget by \$45.2 million due to the significant project scope expansion.

In this example, IROC does not have a problem with the scope expansion since it fulfills the original purpose of the program, and because the original scope was completed under budget. However, IROC requests that it be informed of material scope changes (i.e. more than 10%), as IROC may not agree with future project scope expansions and their associated costs. This is why IROC wishes to be informed of such scope expansions and their budgets.

IROC recommends that program Change Order logs be included in each quarterly CIP report -- which were included in the 2nd but not the original 3rd Qtr. report. This is why IROC recommends that program Change Order logs be included in each quarterly CIP report.

IROC has noted some other significant successes, but also some problems, with other projects including the following:

- Project 46-050.0 Sewer Rehabilitation project is coming in on scope and significantly under budget - a significant success story. 115 miles of rehabilitation was planned between FY08-11 with 116 miles projected for completion. The scope of work was funded at \$106.8 million, but is projected to end up costing \$82.9 million for a \$23.9 million (22%) savings. This is because bids have been coming in at \$500,000 per mile versus the \$800,000 plus inflation originally anticipated.
- Under an EPA consent decree 45 miles of sewer main was agreed to be either replaced or rehabilitated in FY2011 with the Department establishing a 60 mile goal for rehabilitation/replacement. As of March 2011 18.45 miles of sewer main were completed which was short of the 40.66 miles target for March. The Department still projects goal achievement by year-end, which appears uncertain given progress to date.

The above discussion indicates that, even in the face of some significant successes, program scope and budgeting controls appear weak which can lead to ratepayers not knowing what program scope they are actually buying with their rate dollars and what it will cost. The Department has been fortunate to have been conducting this program in a particularly weak construction market which has led to additional scope being added to the program with projects completed at significant savings. However, in other non-city construction programs, vague scope definitions and budgets have led to scope being cut for projects going over budget; or scope being added to programs which wasn't originally intended, which led to large program deficits. This is why project scope and budgets need to be defined to the greatest extent practical in order to mitigate future risk to ratepayers.

Conclusions and Recommendations: The Muni Wastewater CIP program appears to be behind schedule but significantly under budget, with some of the savings being redirected to augment sewer replacement and rehabilitation project scope. IROC supports this scope augmentation in view of the city's remaining antiquated sewer infrastructure and due to the significant reduction in sewer spills which have occurred over the past ten years. IROC, however, is troubled by the program being behind schedule and by apparent weakness in program scope, budget, schedule controls, and other barriers to implementing CIP Projects on time. Inability to do this could result in funding deficits and program scope deductions due to lack of funds under more normal construction market conditions as has occurred in other non-city construction programs. IROC is also concerned that the other City Departments that support the CIP Program may not have adequate engineering and management resources to implement the Metro CIP on schedule.

The Department has shown it is agreeable to enhancing its project level scope, schedule, budgetary reporting and controls. The Department has agreed to better define the scope of the CIP program by breaking out and reporting separately on all the subprojects within the "annual

allocation” projects. They have also agreed that all projects in the program (including all subprojects in its “annual allocation projects” will have individual actual versus baseline schedule reporting included in a comprehensive schedule report; and actual versus budget versus forecast total project cost financial reporting for all projects, including all subprojects in the annual allocation projects.

IROC has seen recent evidence the Department is moving in this direction in their program reporting, and the additional information should provide additional clarity regarding the current progress and financial condition of the program. To provide the Department the additional time necessary to accomplish this, IROC is postponing until December 2011 its opinion regarding the current state of program progress, financing, and whether a remedial action is required to implement the project on schedule and will report to the City Council and Mayor its opinion at that time.

Wastewater (Metro fund) Rate Case FY08-11 CIP Program. Review of the Capital Improvement Program “Planned to Actual” expenditure report indicates the following status of the Metro CIP program as of December 2010.

Wastewater Metro Fund CIP Expenditures

Project Status	No.	Rate Case Funds Budgeted FY08-11	Expend. FY08-FY11 (Nov 30)	Expendi. Actual+Planned FY08-11	Expend. Actual+Planned FY08-13	Project Balance
Active	19	89,640,585	16,169,122	28,219,402	79,690,575	9,950,010
Completed	4	489,569	776,701	776,701	776,701	(287,132)
Cancelled	5	6,483,886	20,091	20,091	20,091	6,463,795
On-Hold	1	8,299,188	-	-	-	8,299,188
Contingency	2	2,551,105	-	-	-	2,551,105
Total	31	107,464,333	16,965,914	29,016,194	80,487,367	26,976,966

Project Status	No.	Rate Case Funds Budgeted FY 08-11	Expend. FY08-FY11 (Nov 30)	Expend. Actual + Planned FY08-11	Expend. Actual + Planned FY08-13	Project Balance
Active	19	100.0%	18.0%	31.5%	88.9%	11.1%
Completed	4	100.0%	158.6%	158.6%	158.6%	-58.6%
Cancelled	5	100.0%	0.3%	0.3%	0.3%	99.7%
On-Hold	1	100.0%	0.0%	0.0%	0.0%	100.0%
Contingency	2	100.0%	0.0%	0.0%	0.0%	100.0%
Total	31	100.0%	15.8%	27.0%	74.9%	25.1%

Source: Public Utilities Department Report, Wastewater (Metro Fund) Rate Case FY08-11, Capital Improvement Program “Planned to Actual”

Review of the expenditure information showed that four out of 31 projects (13%) have been completed as of December 2010 with five having been cancelled and one project placed on-hold. Six of the 31 projects in the above numbers are Annual Allocation projects, five of which are classified as active, and one as cancelled. \$107.4 million of funds were allocated to this program from the 2007 rate case of which \$29 million (27%) are projected to be expended by the end of FY2011 and \$80.5 million (74.9%) by the end of FY2013. A \$26.9 million (25.1%) reduction in expenditures is expected by the end of FY2013. Therefore, like the Muni CIP program, based on the expenditure report, the Metro program appears to be behind schedule, but will come in significantly under budget due to the same factors alluded to in the discussion of the Muni program.

The four completed projects appear to be relatively minor capital outlay projects with only \$489,569 of rate case funds allocated to them. Five projects were cancelled after it was determined they weren't needed, resulting in a \$6.4 million program savings. The remaining 19 projects are still in progress.

The following comments are made regarding specific projects:

Department reports indicate that funding for three projects are being moved to project 42-913.0 Annual Allocation Metro Treatment Plants which is projected to come in significantly over budget by FY2013 (\$3.4 million budget versus projected expenditures of \$12.9 million). The transferred funds come from projects 46.119.0 Annual Allocation Pt. Loma Treatment Plant (\$3.4 million budget), 42.926.0 Annual Allocation North City Water Reclamation Plant (\$1.685 million budget) and 45-32.0 Annual Allocation – South Bay Water Reclamation Plant (\$0.6 million budget). Even with the funding transfers, the project would still come in at least \$4.5 million over budget.

The Treatment Plant Annual Allocations were used to fund numerous enhancement and improvement projects at each of the individual plants that are identified during the course of the year due to operational needs and condition assessments. When the rate case was developed, some projects were identified. Funding was based on the known, identified projects plus a placeholder for future unidentified projects. The funding for the unidentified projects was based on historical data of what was spent in prior years. In FY2010, all of the Treatment Plant Annual Allocations were consolidated into CIP 42-913.0. The rate case estimated \$8.4 million would be expended between FY2008-FY2011. Actual expenditures during that same period were \$4.4 million. In FY2012 and FY2013, expenditures are expected to increase by \$8.4 million, mainly due to the addition of the Point Loma Sedimentation Basin Refurbishment, a \$6.6 million project that was not included in the rate case. Therefore, due to the project scope expansion, a project originally estimated to cost \$8.4 million is now expected to cost \$16.8 million.

Project 45-915.0 Pump Station 2 onsite standby power (\$9.0 million budget) appears to be significantly behind schedule. The Department indicates that "A feasibility study is expected in FY12 with design completed by FY14; but the project cannot be completed until electrical upgrades at the pump station are completed".

Conclusions and Recommendations: Much like the Muni Wastewater CIP program, the Metro Wastewater CIP program appears to be behind schedule, but significantly under budget, with some of the funding being redirected to the annual allocation Metro Treatment Plant which appears to be significantly over its original budget due to scope expansion. The same program scope, schedule, and budgetary reporting and control issues present in the Wastewater Muni CIP program also appear present in the Wastewater Metro CIP program. IROC is also troubled by the program appearing behind schedule as this could result in funding deficits under more normal construction market conditions.

It is requested that IROC be informed of CIP scope changes when the changes amount to an increase of 10% or more than existing project budget.

The Department is including the Metro Wastewater CIP program projects in the same enhanced scope, schedule, and financial reporting it is instituting for the Muni CIP program as described in that section. IROC is therefore postponing until December 2011 its opinion regarding the current state of Metro program progress, financing, and whether a remedial action is required to implement the project on schedule and will report to the City Council and the Mayor its opinion at that time.

Water Rate Case FY08-11 CIP Program

Review of the water Capital Improvement Program “Planned to Actual” expenditure report indicates the following status of the Water CIP program as of December 2010.

Water Fund CIP Expenditures

Project Status	Count	Rate Case Funds Budgeted FY 08-11	Expend. FY08-FY11 (Nov 30)	Expend. Actual + Planned FY08-11	Expend. Actual + Planned FY08-13	Project Balance
Active	53	427,800,000	225,469,064	270,298,513	410,908,109	16,891,891
Completed	7	122,300,000	106,496,402	106,496,402	106,496,402	15,803,598
Cancelled	3	16,400,000	885,221	885,224	885,221	15,514,779
Contingency	2	18,700,000	0	0	0	18,700,000
Total	65	585,200,000	332,850,687	377,680,139	518,289,732	66,910,268

Project Status	Count	Rate Case Funds FY 08-11	Expend. FY08-FY11 (Nov 30)	Expend. Actual + Planned FY08-11	Expend. Actual + Planned FY08-13	Project Balance
Active Total	53	100.0%	52.7%	63.2%	96.1%	3.9%
Completed Total	7	100.0%	87.1%	87.1%	87.1%	12.9%
Cancelled Total	3	100.0%	5.4%	5.4%	5.4%	94.6%
Contingency Total	2	100.0%	0.0%	0.0%	0.0%	100.0%

Grand Total	65	100.0%	56.9%	64.5%	88.6%	11.4%
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Source: Public Utilities Department Report, Water Rate Case FY08-11, Capital Improvement Program “Planned to Actual” 12/15/2010

Water Program Partial CIP Schedule

Project Current Progress Compared to Baseline Schedule	No of Projects
Ahead of Schedule	3
Behind Schedule	9
On Schedule	12
Total Projects Reported	24
Total Projects in Water CIP program	65

Source: DEPARTMENT FY2011 Capital Improvement Projects (CIP) – 1st Quarter Report to IROC

Review of the expenditure information showed that seven out of 65 projects (11%) have been completed as of December 2010 with 53 still active and three having been cancelled. Twelve of the 65 projects in the previous schedule are “Annual Allocation” projects – eight of which are classified as “active”, one as “completed”, one as “cancelled”, and two as “contingency”. \$585.2 million of funds were allocated to this program from the 2007 rate case of which \$377.7 million (65%) are projected to be expended by the end of FY2011 and \$518.3 million (89%) by the end of FY2013. A \$66.9 million (11.4%) reduction in expenditures is expected by the CIP completion date at the end of FY2013.

Review of an updated water CIP actual vs. baseline schedule report released this month in response to this study showed that 43 out of 163 water projects (26%) were six or more months behind schedule. Six projects (4%) were six or more months ahead of schedule, and 114 projects (70%) were within six months of their scheduled completion data. This is based upon a comparison of the forecasted completion date for all project phases vs. the scheduled completion date.

Progress on this program appears to be significantly better than the wastewater program (even though it still appears behind schedule) since 70% of projects are forecasted to be completed with six months of schedule and because 65% of the budgeted funds will be expended by the end of FY2011 based on the information provided. Like the wastewater program, it is projected to come in under budget due to more favorable market conditions than expected when the current rate case was enacted; which is projected to result in a \$66.9 million savings.

The following comments are reported for certain specific projects:

- Under a State Department of Public Health (DPH) Compliance order 10 miles of cast iron water main replacements are scheduled to be awarded in FY 2011 with the Department establishing a 35 mile departmental award goal for the entire year. As of March 2011 15.55 miles of main replacement has been awarded versus the 10 mile DPH goal; with 38 miles forecasted to be awarded by June verses the 35 mile departmental goal. This will meet both the DPH and Departmental goals. As of March 2011 18.21 miles of water main replacements has actually been completed, with no goals having been established for actual completed miles. Seven projects were completed at a cost of \$106.4 million versus the \$122.3 million budgeted for a \$15.8 million (12.9%) savings due to bids

coming in lower than budgeted. These were significant capital outlay projects which included the upgrade to the Miramar water treatment plant which expanded plant capacity from 140 to 215 mgd.

- Three projects budgeted at \$16.4 million were cancelled with \$800,000 having been expended prior to cancellation. They were cancelled mainly because another CIP project provided the necessary redundancies.
- Five projects with a total budget of \$27.2 million appear to have been significantly delayed or postponed indefinitely. This include: (1) No. 732624 Alvarado Water Treatment Plant Upgrade (Budget - \$4.5M; project delayed); (2) No. 709590 El Capitan Pipeline#2 (Budget - \$7.7M; delayed condition assessment); (3) No 709631 Alvarado Service Area Improvement (Budget - \$5M; priority changed based on water master plan); (4) No 709632 Otay Service Area Improvements (Budget - \$5M; priority changed based on water master plan), (5) No. 709633 Miramar Service Area Improvements (Budget - \$5M; priority changed based on water master plan).
- The following projects show significant variances from budget:

CIP No	Project Title	Rate Case Budget FY08-11	Exp Act.+ Planned FY08- 13	Var\$	Var%
732630	AA - Water Pump Station Rehabilitation	\$2.0M	\$14.8M	+\$12.8M	+640%
730830	AA – Water Main Replacements	\$137.4M	\$187.6M	+\$50.2M	+37%
732621	Alvarado WTP Ozone Improv.	\$65.8M	\$56.0M	-\$9.8M	-15%
732850	Otay WTP Ph1.	\$19.0	\$26.0	+7.0M	+37%

Source: Public Utilities Department Report, Water Rate Case FY08-11, Capital Improvement Program “Planned to Actual” 12/15/2010

In the case of project 730830 – AA Water Main Replacements, the Department indicated “the rate case programmed \$137.4 million for the replacement of 75 miles of pipeline between FY08-FY11. The cost increase of \$50.2 million through FY2013 is due to the addition of another 45 miles of pipeline for a total of 120 miles between FY2008-FY2013. It is not a cost overrun but rather an increase in the scope of work.” Explanations were not included in the Department’s report for the other two projects with cost overruns; however, the cost savings on the Alvarado Plant was caused by the bid coming in lower than estimate.

Conclusions and Recommendations: The water CIP program appears to be adequately managed as of December 2010 as it is coming in much closer to schedule than the wastewater program and is projected to realize an 11% budget savings. However the Department needs to explain why five projects with a combined \$27.2M budget were significantly delayed or indefinitely postponed, and how the Department intends to get them back on schedule. The Department is including the Water CIP program projects in the same enhanced scope, schedule, and financial reporting it is instituting for the Wastewater CIP program as described in that section. IROC is therefore postponing until December 2011 its opinion regarding the current state of Water CIP program progress and financing, and will report its opinion to the council and mayor at the same time it reports its opinion regarding the Wastewater program based on the additional information.

Water Rates Analysis

In recent years the Department has been the subject of considerable controversy over both the level of its water rates and their pace of increase. The Department cites the main drivers affecting retail water rate increases as being increased wholesale water rates, reduced retail water supplies over which department fixed costs are spread, and the cost of their CIP program. Non-departmental observers cite departmental overhead and staffing costs as a major cost driver. To shed an independent view on some of the conflicting claims, the subcommittee reviewed water rate, water supply, wholesale water charge, and staffing/compensation statistics to shed additional light on some of the factors which various parties cite as driving department costs and water rates.

Due to previously mentioned financial reporting problems, IROC's review was limited to publicly available documents including current and past budgets, water bond prospectuses, and the City's audited Comprehensive Annual Financial Report all of which are publicly available on the city's website. The sources of the data are cited in each section.

Water Rates

The following table shows the history of how both retail and wholesale water rates changed over the five years between July 1, 2005 and July 1, 2010:

Five-Year Water Service Charge History For Single Family Residential, Multi-Family, Commercial, Industrial, Irrigation, and Construction

Base Fees: Meter Size	Increase Amount	Rate 7/1/2005	Rate 7/1/2010	Total % Change	Annual % Change
	5/8 Inch	14.310	18.860	31.8%	6.4%
	¾ Inch	14.310	18.860	31.8%	6.4%
	1 Inch	15.290	27.660	80.9%	16.2%
	1 ½ Inch	68.410	47.790	-30.1%	-6.0%
	2 Inch	105.310	72.950	-30.7%	-6.1%
	3 Inch	377.980	132.040	-65.1%	-13.0%
	4 Inch	630.590	216.300	-65.7%	-13.1%
	6 Inch	1,407.450	425.080	-69.8%	-14.0%
	8 Inch	1,896.360	676.600	-64.3%	-12.9%
	10 Inch	2,542.760	970.890	-61.8%	-12.4%
	12 Inch	3,537.060	1,808.470	-48.9%	-9.8%
	16 Inch	5,903.130	3,150.360	-46.6%	-9.3%
Commodity Charge					
Customer Type "1":					
Single Family Residence					
Tier 1	0-7 HCF	1.609	3.399	111.2%	22.2%
Tier 2	8-14 HCF	2.023	3.686	82.2%	16.4%
Tier 3	Over 14 HCF	2.223	4.139	86.2%	17.2%
Multifamily	All Volume ¹	1.870	3.686	97.1%	19.4%

¹ According to department documents, these rate classes were charged on a per HCF basis in 7/1/05 which was changed to "All Volume" in 7/1/2010.

Commercial	All Volume	1.870	3.536	89.1%	17.8%
Industrial	All Volume	1.870	3.536	89.1%	17.8%
Irrigation Temporary	All Volume	-	3.778	NA	NA
Construction	All Volume	-	3.778	NA	NA

The most important rate for residential customers is the commodity charge which reflects actual water usage. The table indicates average single family residential rate has increased between 16.4% - 22.2% per year since 7/1/2005; while the multifamily rate has increased an average of 19.4%, the commercial rate 17.8%, and the industrial rate 17.8%. Therefore there has been a substantial increase in both residential and commercial water rates during the five year period

Water Cost Drivers

Water Supplies and Wholesale Water Costs. The following tables show recent history of the City of San Diego water supplies:

**Water Supplies the City of San Diego
Fiscal Years 2007 thru 2011
(In AF)**

Water Supplies (In AF)	FY2007	FY2008	FY2009	FY2010	FY2011
Local Supplies	18,709	25,911	24,460	NA	NA
CWA Water Supplies	229,682	219,323	202,225	NA	NA
Total Supplies	248,391	245,234	226,685	-	-

Source: Public Facilities Financing Authority of the City of San Diego: Water Revenue Bonds, Series 2010A Prospectus page 29

Data was only available for FY 2007, 2008, and 2009 for the five year analysis period. Review of the data shows that there was a 7.6% reduction in supply between FY2008 and FY2009, but that supplies were elevated in both FY2007 and FY2008. Therefore supply constraints did not appear to be a major driver of water rate increases resulting from Department overhead costs being spread over significantly reduced supply since there wasn't a major reduction in water supplies during the study period.

The Department cites increased wholesale water costs as a cause of increasing retail water rates since they were automatically being passed through to retail customers in addition to the Department's water rate increases. The following shows the recent history of those rates.

**CWA Water Supply Rates
Fiscal Years 2005 through 2010
(Per AF)**

	Municipal & Industrial (M&I) Rates	Transport Rates
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Source: Public Facilities Financing Authority of the City of San Diego: Water Revenue Bonds, Series 2010A Prospectus page 52, 53

Fiscal Year	Untreated	Treated	
2005	\$349	\$461	\$55
2006	\$360	\$485	\$60
2007	\$365	\$512	\$60
2008	\$390	\$554	\$60
2009	\$463	\$631	\$64
2010	\$532	\$747	\$67
Total Percent Change	52.4%	62.0%	21.8%
Avg Annual Percent Change	10.5%	12.4%	4.4%

Source: Public Facilities Financing Authority of the City of San Diego: Water Revenue Bonds, Series 2010A Prospectus page 29

CWA untreated and treated rates to Municipal and Industrial users increased an average of 10.5% and 12.4% per year respectively during FY2005 to FY2010, while the transportation rate increased an average of 4.4%. The water supply table shows that the Department relies heavily on imported CWA water purchases with about 88% of its supply coming from this source versus 12% from local sources. Therefore, this is a major cost driver and could be a cause of increased retail rates.

The cause of the rising CWA water rates were discussed in a previous paper, and found to reside in rising rates changed by the super regional water wholesaler – the Metropolitan Water District. IROC’s financial analysis indicates MWD’s increases were most probably driven by a combination of:

- Reductions in the amount of water sold.
- MWD’S compensation structure - specifically the levels of wages and benefits they are paying their labor force under agreements negotiated with their public employee unions which inflated their overhead costs.
- MWD’s scheduling of their CIP program and the increased use of pay-as-you-go funding from current year water rate revenues to pay for long term capital project costs which are usually financed from long term bond funds.
- MWD’s alleged misallocation of water supply costs to their transportation rate which adversely affects the costs paid by SDCWA and ultimately San Diego ratepayers. This is currently the subject of litigation.

Staffing and Compensation Overhead Costs. Some non-departmental parties contend that increased departmental staffing costs are a major cost driver and a cause of rising water rates. We therefore examined staffing, compensation, and fringe benefit trends to see if this could be a contributing cause. The following shows departmental staffing levels. The sewer fund is also included in the analysis to correct for any position shifts and reorganizations which occurred during the review period.

**Public Utilities Department Staffing Levels
FY 2007 to 2011**

	FY 2007	FY 2008	FY 2009	FY 2010	FY 2011	Change
FTE by Fund	Budget	Budget	Budget	Budget	Budget	2007-2011
Muni Sewer Revenue Fund				238	442	
Metropolitan Sewer Utility Fund	1,052	916	841	590	480	

Subtotal Sewer System	1,052	916	841	828	922	(130)
Water Fund	914	851	779	786	704	(210)
Total Staffing	1,966	1,767	1,619	1,613	1,626	(339)

Source: City of San Diego 2011 and 2009 DEPARTMENT Department Budget

The table shows that water fund staffing decreased from 914 in 2007 to 704 in 2011 due to a departmental reorganization which merged the previously separate water and wastewater departments, and business process reengineering which occurred during that time period.

The following table shows the compensation and fringe benefit costs associated with these staffing levels during the period.

**Public Utilities Department Wage and Fringe Benefit Levels
FY 2007 to 2011**

Compensation by Fund	FY 2007 Budget	FY 2008 Budget	FY 2009 Budget	FY 2010 Budget	FY 2011 Adopted	Ann. \$ Chg 2007-11	Ann. % Chg 2007-11
Metro and Muni Sewer Utility Fund							
Salaries and Wages	63,231,152	59,837,143	53,688,994	51,186,936	54,291,853	(2,234,825)	-4%
Fringe Benefits	29,997,715	29,859,113	26,569,395	23,906,027	34,485,020	1,121,826	4%
Total Pers. Exp	93,228,867	89,696,256	80,258,389	75,092,963	88,776,873	(1,112,999)	-1%
Fringe Benefit Ratio	47%	50%	49%	47%	64%		
Water Utility Operating Fund							
Salaries and Wages	50,372,788	50,268,860	44,576,486	44,269,273	38,611,408	(2,940,345)	-6%
Fringe Benefits	23,824,420	25,727,728	23,106,270	21,676,569	24,703,636	219,804	1%
Total Pers. Exp	74,197,208	75,996,588	67,682,756	65,945,842	63,315,044	(2,720,541)	-4%
Fringe Benefit Ratio	47%	51%	52%	49%	64%		
Total Public Utilities Department							
Salaries and Wages	113,603,940	110,106,003	98,265,480	95,456,209	92,903,261	(5,175,170)	-5%
Fringe Benefits	53,822,135	55,586,841	49,675,665	45,582,596	59,188,656	1,341,630	2%
Total Pers. Exp	167,426,075	165,692,844	147,941,145	141,038,805	152,091,917	(3,833,540)	-2%
Fringe Benefit Ratio	47%	50%	51%	48%	64%		
Water Utility Operating Fund Cost Per FTE							
Salaries and Wages	55,109	59,077	57,259	56,358	54,825	(71)	0%
Fringe Benefits	26,064	30,236	29,681	27,596	35,077	2,253	9%
Total Pers. Exp	81,173	89,313	86,940	83,954	89,902	2,182	3%
Fringe Benefit Ratio	47%	51%	52%	49%	64%		
Total Public Utilities Department Cost Per FTE							
Salaries and Wages	57,790	62,300	60,695	59,179	57,121	(167)	0%
Fringe Benefits	27,379	31,452	30,683	28,260	36,392	2,253	8%
Total Pers. Exp	85,169	93,753	91,378	87,439	93,513	2,086	2%
Fringe Benefit Ratio	47%	50%	51%	48%	64%		

Source: City of San Diego 2011 and 2009 Budget

Wage and fringe benefit data for the Water Fund shows that wage cost decreased from \$50.3 million to \$38.6 million from FY2007 to FY2011 for a cumulative savings of \$11.7 million - \$2.9 million per year (on average). This was roughly in line with the 210 position staffing reduction since the salary and wage cost per FTE within the water fund remained relatively constant over the four year period at approximately \$55,000 per position. Fringe benefit costs, however, stayed relatively constant over the period at around \$24-\$25 million and did not decrease in line with salary and wage costs or staffing levels with the result that the fringe benefit cost per FTE actually increased about 9% a year from \$26,000 to \$35,000 per FTE due mainly to retirement benefit costs. As a consequence, the ratio of fringe benefits to base salary cost increased from 47% in FY2007 to 64% by FY2011 which is substantially higher than the fringe benefit ratio for many private sector companies. As a result, the cost of an average FTE within the Water Fund increased from \$81,000 in FY2007 to \$90,000 in FY2011, which appears excessive compared to private sector compensation levels. The Department has indicated that direct salary and wages are typically higher in the private sector with the fringe benefit rates tending to be lower, thus producing the lower private sector ratio. They also state the average tenure of Department employees are longer, and therefore tend to have high costs per FTE over time. The Department, however, did not produce any evidence to support this statement

In spite of this aggregate wage and fringe benefit costs declined within the water fund from \$74 million to \$63 million due to the staffing reductions and therefore probably weren't a major cause of the water rate increases even though per FTE costs appear elevated.

Revenues, Costs, Cash and Net Assets - Their Impact On Water Rates

One of the best ways to determine the drivers of a public sector organization's cost structure, and therefore the drivers of its rates is to review its overall revenue, cost, cash and net asset levels and trends. The following tables show: (1) the audited Statement of Revenues, Expenses and Changes in Fund Net Assets in the Water Fund from FY2005 to FY2009 - the public sector equivalent to a private sector organization's Profit and Loss Statement; and (2) the Water Fund's audited Statement of Net Assets from FY2005 to FY2009 - the public sector equivalent to a private sector organization's balance sheet. FY2010 data is unavailable since the City has not released its FY2010 Comprehensive Annual Financial Report.

Statement of Revenues, Expenses, and Changes in Fund Net Assets Water Utility Fund Fiscal Years 2005 through 2009 (000s) (Audited)

	2005	2006	2007	2008	2009	\$ Chg. 2005-09	\$ Yrly Chg.	Ann. % Chg from 2005
Operating Revenues								
Sales of Water	245,287	258,900	289,127	297,225	324,772	79,485	19,871	8.1%
Charges for Services	1,027	1,031	1,147	33	-	(1,027)	(257)	-25.0%
Revenues from Property Use	4,701	4,833	6,162	6,115	5,418	717	179	3.8%
Usage Fees	1,756	1,943	1,594	1,235	1,272	(484)	(121)	-6.9%
Other	14,878	13,860	12,262	14,018	11,257	(3,621)	(905)	-6.1%
Subtotal	267,649	280,567	310,292	318,626	342,719	75,070	18,768	7.0%

Operating Expenses								
Maint. & Oper.	92,959	94,433	97,821	100,360	95,979	3,020	755	0.8%
Purchased Water Cost	102,096	110,263	124,880	121,186	133,499	31,403	7,851	7.7%
Taxes	1,457	570	163	162	162	(1,295)	(324)	-22.2%
Administration	37,762	35,370	30,964	36,722	33,258	(4,054)	(1,126)	-3.0%
Depreciation	27,277	29,230	27,644	29,870	39,627	12,350	3,088	11.3%
Subtotal	261,551	269,866	281,472	288,300	302,525	40,974	10,244	3.9%
Operating Inc/(Loss)	6,098	10,701	28,820	30,326	40,194	34,096	8,524	139.8%
Nonoper. Rev - (Exp)								
Invest Earnings	7,258	6,966	11,461	15,536	12,478	5,220	1,305	18.0%
Federal Grants	640	424	283	1,427	192	(448)	(112)	-17.5%
Other Agency Grants	694	359	284	272	1,070	376	94	13.5%
Gain (Loss) Sale-Ret Assets	(26,141)	(9,819)	(5,076)	(3,494)	(2,436)	23,705	5,926	-22.7%
Debt Service Interest	(12,737)	(23,935)	(26,370)	(29,919)	(28,081)	(15,344)	(3,836)	30.1%
Other	32	(67)	175	980	751	719	180	561.7%
Subtotal	(30,254)	(26,072)	(19,243)	(15,198)	(16,026)	14,228	3,557	-12%
Inc – (Loss) Before Contrib. & Transfers	(24,156)	(15,371)	9,577	15,128	24,168	48,324	12,081	-50.0%
Capital Contribution	41,954	44,262	80,859	31,526	30,277	(11,677)	(2,919)	-7.0%
Trans. from other Funds	3,377	220	352	578	439	(2,938)	(735)	-21.8%
Trans. from Govt Funds	27	-	84	3,867	3,443	3,416	854	3,163.0%
Trans. to Other Funds	(319)	(158)	(234)	(93)	(99)	220	55	-17.2%
Trans. to Govt Funds	(1,046)	(1,481)	(1,713)	(834)	(530)	516	129	-12.3%
Subtotal	43,993	42,843	79,348	35,044	33,530	(10,463)	(2,616)	-5.9%
Chg in Net Assets	19,837	27,472	88,925	50,172	57,698	37,861	9,465	47.7%
Net Assets Beg of Yr	1,179,114	1,198,951	1,226,423	1,315,348	1,365,520	186,406	46,602	4.0%
Net Assets End of Yr	1,198,951	1,226,423	1,315,348	1,365,520	1,423,218	224,267	56,067	4.7%

Source: San Diego City Audited Comprehensive Annual Financial Report FY 2005 -2009

Review of the Departments revenues and costs indicates that operating expenses grew by about \$40.9 million from FY2005 to FY2009 with the major driving factors being increased purchased water costs and depreciation. Maintenance, operating and administrative costs, while a major part of the Water Fund’s overall cost structure, stayed relatively stable during the period and were not major factors in the increase. Operating revenues, however, increased \$75 million during the period compared to the \$40.9 million increased operating costs, due to a \$79.4 million increase in water sale revenues. Therefore, the Department realized a \$34 million increase in net operating revenues (i.e. operating revenues minus operating expenses) during the period.

However, net non-operating expenses, as well as net capital contributions and inter-fund transfers, also have to be considered to get a clear view of department finances. Net non-

operating expenses decreased \$14 million during the period while net capital contributions and inter-fund transfers also decreased \$10.4 million. The result was a net \$37.8 million increase in the change in net assets. By year, there were \$24.1 million and 15.4 million losses before capital contributions and transfers in FY2005 and FY2006 which resulted in a \$19.8 million and \$27.4 million increase in net assets when non-cash capital contributions and transfers are subsequently added-in. In FYs 2007, 2008 and 2009 there was \$9.6 million, \$15.1 million and \$24.2 million of net income before capital contributions and transfers which resulted in a \$88.9 million, \$50.2 million and \$57.7 million increase in Net Assets each year when non-cash capital contributions and transfers are added in. This resulted in a \$224 million growth in ending net assets from FYs 2005 to 2009, which is equivalent to a \$224 million growth in retained earnings and capital in a private sector firm. Capital contributions represent the market value of developer financed water connections transferred to the Department by developers each year. Therefore the increase in water sale revenues more than compensated for the increase in purchased wholesale water costs as well as any other growth in Department operating costs

The following is the Water Funds Statement of Net Assets from FYs 2005 to 2009. FY2010 data is not available since the City has not released its Comprehensive Annual Financial report that fiscal year.

**Statement of Net Assets
Water Utility Fund
Fiscal Years 2005 through 2009 (000s) (Audited)**

	2005	2006	2007	2008	2009	Tot \$ Chg 2005-09	\$ Yrly Chg	% Yrly Chg From 2005
ASSETS								
Current Assets:								
Cash & Invest.	117,892	154,889	196,510	212,932	225,556	107,664	26,916	22.8%
Receivables								
Accounts – Net of allow.	42,973	36,385	42,697	43,854	43,573	600	150	0.3%
Claims – Net								
Contributions								
Accrued Interest	1,110		2,291	2,040	604	(506)	(127)	-11.4%
Grants	2,319	1,723	1,202	1,572	1,822	(497)	(124)	-5.4%
From other Funds		1,655			-	-	-	NA
Invent. Of Water in Storage	28,923	26,546	27,556	36,593	36,974	8,024	2,006	6.9%
Inventories	478	539	414	463	620	142	36	7.4%
Prepaid Exp.	5	690	737	446	456	451	113	2255.0%
Total Current Assets	193,700	222,316	271,407	297,900	309,578	115,878	28,970	15.0%
Non-Current Assets:								
Restrict. Cash & Investments	87,070	53,240	77,587	196,304	263,883	176,813	44,203	50.8%
Advances to Other Funds	644	644				(644)	(161)	-25.0%
Deferred Charges	4,989	4,792	4,704	4,515	6,988	1,999	500	10.0%

Interfund Int. Rec.	668	773		-		(668)	(167)	-25.0%
Interfund Loan Rec.	2,386	2,386				(2,386)	(597)	-25.0%
Capital Assets – Non	354,052	285,466	216,124	134,738	240,760	(113,292)	(28,323)	-8.0%
Capital Assets – Deprec.	1,204,453	1,321,237	1,452,843	1,584,365	1,611,573	407,120	101,780	8.5%
Total Current Non-Assets	1,654,262	1,668,538	1,751,258	1,919,922	2,123,204	468,942	117,236	7.1%
Total Assets	1,847,962	1,890,854	2,022,665	2,217,822	2,432,782	584,820	146,205	7.9%

LIABILITIES

Current Liabilities:

Accounts Payable	31,130	32,392	30,125	37,556	32,367	1,237	309	1.0%
Accrued Wage & Benefits	3,835	1,923	1,925	1,817	2,145	(1,690)	(423)	-11.0%
Int. Accrued on L	11,139	11,133	11,772	13,236	11,598	459	115	1.0%
LTD Due within one	11,652	17,577	18,776	76,962	19,705	8,053	2,013	17.3%
Due to Other Funds				1,242	558	558	140	NA
Due to other agencies	2,380	3,937	4,502	2,571	1,046	(1,334)	(334)	-14.0%
Unearned Revenue	3,618	3,289	1,004	1,143	817	(2,801)	(700)	-19.4%
Contract Deposits	5,647	5,151	5,569	4,519	4,756	(891)	(223)	-3.9%
Curr. Liab Pay – Rest. Assets:						-	-	NA
Customer Dep. Payable	3,321	3,849	4,265	4,331	4,566	1,245	311	9.4%
Total Current Liabilities	72,722	79,251	77,938	143,377	77,558	4,836	1,209	1.7%

Non-Current Liabilities:	2005	2006	2007	2008	2009	Tot \$ Chg 2005-09	\$ Yrly Chg	% Yrly Chg From 2005
Arbitrage Liability	187	176	193	429		(187)	(47)	-25.0%
Compensated Absences	2,624	2,359	2,202	2,027	2,036	(588)	(147)	-5.6%
Liability Claims	2,313	3,642	5,340	5,534	1,576	(737)	(184)	-8.0%
Loans Payable	-	20,257	19,385	18,490	17,573	17,573	4,393	NA
Notes Payable			57,000	150,000		-	-	NA
Net Revenue Bonds Payable	561,732	548,964	535,470	521,510	895,146	333,414	83,354	14.8%
Pollution Remediation Oblig.					620	620	155	NA
Obligation				2,659	6,578	6,578	1,645	NA
Net Pension Payable	9,433	9,782	9,789	8,276	8,477	(956)	(239)	-2.5%
Total Non-Current Liabilities	576,289	585,180	629,379	708,925	932,006	355,717	88,929	15.4%
Total Liabilities	649,011	664,431	707,317	852,302	1,009,564	360,553	90,138	13.9%

Net Assets:

Invest. in Capital Assets, Net of Related Debt	1,073,719	1,075,851	1,175,384	1,151,511	1,186,697	112,978	28,245	2.6%
Restricted for Debt Srvc.	2,833	2,395	2,260	2,164	3,622	789	197	7.0%
Unrestricted	122,399	148,177	137,704	211,845	232,899	110,500	27,625	22.6%

Total Net Assets	1,198,951	1,226,423	1,315,348	1,365,520	1,423,218	224,267	56,067	4.7%
Total Liab. & Net Assets	1,847,962	1,890,854	2,022,665	2,217,822	2,432,782	584,820	146,205	7.9%
Financial Ratios	2005	2006	2007	2008	2009			
Unrest. Net Assets/Total Assets	6.6%	7.8%	6.8%	9.6%	9.6%			
Total Net Assets/Total Assets	64.9%	64.9%	65.0%	61.6%	58.5%			
Unrest. Cash & Inv./Total Assets	6.4%	8.2%	9.7%	9.6%	9.3%			
Total Cash & Inv./Total Assets	11.1%	11.0%	13.6%	18.5%	20.1%			

Source: San Diego City Comprehensive Annual Financial Report FY 2005 -2009

Review of the Statement of Net Assets shows that Total Net Assets grew by \$224 million from FYs 2005 to 2009, inclusive of unrestricted net assets (i.e. those assets free for water use) which grew by \$110 million. There was also a substantial build-up of cash and investment funds. Unrestricted cash and investments increased \$107.6 million while total cash and investments (both unrestricted and restricted) increased by \$284 million. The growth in cash and investments, and the growth in unrestricted net assets more than outpaced total asset growth in the Water Fund as shown by the financial ratios. The ratio of unrestricted net assets to total assets increased from 6.6% in FY2005 to 9.6% in FY2009, while the ratio of unrestricted cash and investments to total assets grew from 6.4% in FY2005 to 9.3% in FY2009. The increase in cash and investments did not appear to be attributable to increased bond sales since these were used to finance an increase in depreciable net assets. Depreciable net assets increased \$407.1 million while net revenue bonds payable increased \$333 million. Therefore the bond financing was totally used to finance the capital asset growth, not the cash and investment build-up.

The Department contends that reserves such as the Rate Stabilization Fund, Secondary Purchase Reserve, Capital Reserve, Operating Reserve, and the DRES reserve must be backed out from unrestricted net assets to determine “assets available for water utility use”. The evidence, however, does not support this assertion since the use of these funds is not legally restricted by the city charter or statute. Instead, their use is subject to administrative policy governed by city management discretion. The use of the DRES Fund, as an example, was changed by administrative action in FY2010.

These ratios, plus the aggregate growth in cash and investments and unrestricted net assets, imply that water sales revenues were more than needed to cover any growth in wholesale water and retail operating costs from FYs 2005 to 2009 as evidenced by the growth in unrestricted net assets and unrestricted cash and investments. This could possibly be explained if the Department was building cash from water rates to fund its CIP program or to mitigate operating risk. However, management has not provided long term cash flow forecasts for the Department or its CIP program demonstrating a need to build cash for either its CIP program or to mitigate operating risk in the immediate future, or that these needs won’t be met through the current water rate levels. Furthermore, as was noted in the CIP section, the Water Rate Case FY2008-FY2011 CIP Program appears to be behind schedule. The FY2007 water rates also included a 4% construction cost inflation assumption which did not materialize which has contributed to the forecasted 11.4% cost savings in the water CIP program. Therefore, the financial data implies that water rates may be more than needed to fund current operations and the CIP program, unless

the Department can produce conclusive evidence indicating a need to build cash to fund CIP expenditures, to maintain debt coverage ratios to comply with bond covenants, or to mitigate operating risk within the next three years.

Conclusions and Recommendations. Water Fund cash, investments, and net assets have been growing steadily over the past five years thereby constituting an increasing percentage of total assets. The Department therefore needs to demonstrate a need to retain the cash and investment growth to finance forecasted operations and CIP expenditures within the next three years, taking into account future forecasted revenues from the next rate case and forecasted inflation rates, operating costs, debt levels, and proposed debt retirements. This should be based on the current construction schedule and forecasted costs to fund CIP expenditures.

IROC therefore recommends that the Department revalidate their water rates by producing the long term cash flow forecast recommended in the Financial and CIP Reporting Section taking into account current and forecasted inflation rates, costs, and schedules for the Department and its CIP program. The forecast specifically needs to validate the buildup and retention of the higher cash, investment, and unrestricted net asset levels by demonstrating a use for these assets within in the next three years to finance operating and capital expenditures, mitigate operating risk, or maintain debt coverage ratios to comply with bond covenants. We recommend a three year horizon be used since it is consistent with the time horizon used in IRS arbitrage regulations used to determine whether tax exempt bond funds have been retained too long by public agencies.