



**Vallecitos Water District
Annual Financial Report
Fiscal Years Ended June 30, 2005 and 2004**



Vallecitos Water District
Annual Financial Report
Fiscal Years Ended June 30, 2005 and 2004

Board of Directors as of June 30, 2005:

Margaret E. Ferguson – President

Paul A. Davy – Vice-President

Darrell Gentry – Director

Patricia Hannan – Director

Timothy Shell – Director

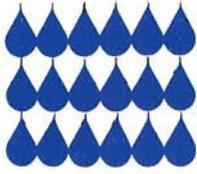
William W. Rucker – General Manager

Vallecitos Water District
Annual Financial Report
For the Years Ended June 30, 2005 and 2004

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Financial Section



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Independent Auditor's Report

Board of Directors
Vallecitos Water District
San Marcos, California

We have audited the accompanying financial statements of the Vallecitos Water District (District) as of and for the year ended June 30, 2005, which collectively comprise the District's basic financial statements as listed in the table of contents. These basic financial statements are the responsibility of the District's management. Our responsibility is to express an opinion on these basic financial statements based on our audit. The comparative financial information as of June 30, 2004, was audited by other auditors whose report dated November 10, 2004, expressed an unqualified opinion on that financial information.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the basic financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the basic financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall basic financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the basic financial statements referred to above present fairly, in all material respects, the respective financial position of the Vallecitos Water District as of June 30, 2005, and the respective changes in net assets and cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

In accordance with *Government Auditing Standards*, we have also issued a report dated September 28, 2005, on our consideration of the District's internal control over financial reporting and our tests of its compliance with certain provisions of laws, regulations, contracts, grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be read in conjunction with this report in considering the results of our audit. This report can be found on page 41.

Management's discussion and analysis on pages 2 through 9 and the Schedule of Funding Progress on page 34 are not required parts of the basic financial statements but are supplementary information required by the Governmental Accounting Standards Board. We have applied certain limited procedures, which consisted primarily of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit this information and express no opinion on it.

Our audits were conducted for the purpose of forming an opinion on the financial statements that collectively comprise the District's basic financial statements. The supplementary information on pages 35 through 40 is presented for purposes of additional analysis and is not a required part of the basic financial statements. The supplementary information has not been subjected to the auditing procedures applied in the audit of the basic financial statements and, accordingly, we express no opinion on it.

September 28, 2005
Cypress, California

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Vallecitos Water District
Management's Discussion and Analysis
For the Years Ended June 30, 2005 and 2004

Our discussion and analysis of the Vallecitos Water District's financial performance provides an overview of the District's financial activities for the fiscal year ended June 30, 2005. Management's Discussion and Analysis (MD&A) presents financial highlights; an overview of the accompanying financial statements; an analysis of financial position and results of operations; a current-to-prior year analysis; a discussion on restrictions, commitments, and limitations; and a discussion on significant activity involving capital assets and long-term debt.

Financial Highlights

During the fiscal year ended June 30, 2005, growth in housing development, increased regulations, and the State's budget crisis continued to impact the District's operations and fiscal planning. The District has responded to increased demands from residential and commercial growth by adopting plans to build more reservoirs and expand the District's wastewater treatment plant. Negative impacts on revenue from the voluminous rainfall were offset by record high water use in the first four months of the fiscal year and conservative budgeting. The following highlights for the year impacted, or have the potential to impact, the finances of the District.

- The District added 1,117 active meters during the fiscal year ended June 30, 2005 – a six percent increase. Growth is expected to continue into next year but at a slower pace. As of June 30, 2005, 3,040 meters were in plan check or inspection, an increase of 110 meters since last year. The City of San Marcos issued building permits for 883 residential units in 2002, 1,709 in 2003, 2,321 in 2004, and 1,115 in 2005 through September.
- During the fiscal year ended June 30, 2005, new development contributed \$20,282,965 in capital assets and cash to be used to fund planned capital facilities – a \$4,630,397 increase from the prior year.
- The District's employer contribution rate for the California Public Employees' Retirement System (PERS) increased from 9.666% in 2003/04 to 14.26% in 2004/05 due to the lack of investment earnings in PERS funds caused by a decline in market rates of interest. Growth in District employment and the increased PERS rate accounted for a \$263,141 increase in PERS contributions. The employer contribution rate for 2005/06 is 19.182%. The required contribution was based on rates determined as part of the June 30, 2003, actuarial valuation using the entry age normal actuarial cost method.
- Proposition 1A passed in November of 2004 and resulted in a loss of property tax revenue of \$947,173 in the 2004/05 fiscal year, and another \$947,173 in the 2005/06 fiscal year. However, the pass-through of Redevelopment Agency tax increment from the City of San Marcos continues to increase. The District received \$555,363 for the 2003/04 fiscal year, \$742,899 for the 2004/05 fiscal year, and is projected to be \$780,000 for the 2005/06 fiscal year.
- On June 30, 2005, the last day of the fiscal year, the District issued \$66.7 million in Certificates of Participation (COPs) to fund the construction of a 40 million gallon reservoir, fund expansion of the Meadowlark Reclamation Facility, and to refund existing COPs of \$23 million. The existing COPs were retired on July 1, 2005.
- The wholesale water commodity rate continues to increase (by seven percent, effective January 1, 2006). Wholesale water rates are expected to increase by eight percent in 2007. These increases will pay for acquisition of alternative sources of water (desalinization, transfers from Imperial Valley, and new local treatment facilities). The District's Board adopted ready-to-serve and sewer rate increases effective August 1, 2005, to restore replacement reserves above the adopted floor, narrow the gap between fixed revenue and fixed expenses, and provide revenues adequate to meet debt service covenants from net revenues without considering capital facility fees.

Vallecitos Water District
Management's Discussion and Analysis
For the Years Ended June 30, 2005 and 2004

Overview of the Financial Statements

The financial statements present the financial position, results of operations, and changes in cash flow from the economic resources measurement focus using the accrual basis of accounting, which is similar to the accounting basis used by for-profit entities. Each financial statement is identified and defined in this section and analyzed in subsequent sections of this MD&A.

Statements of Net Assets

The Statements of Net Assets present the District's financial position (assets and liabilities) as of June 30, 2005, and 2004. Assets in excess of liabilities (Net Assets) were \$231,263,462 and \$212,466,007 as of June 30, 2005, and 2004, respectively. In accordance with generally accepted accounting principles, capital assets are recorded at historical cost.

Statements of Revenues, Expenses, and Changes in Net Assets

The Statements of Revenues, Expenses, and Changes in Net Assets present the District's results of operations for the years ended June 30, 2005, and 2004. Revenues are recognized (recorded) when water or services are provided, and expenses are recognized when incurred. Operating revenues and expenses are related to the District's core activities (providing water and related services, wastewater services, and processing and delivering recycled water). Non-operating revenues and expenses (e.g. interest income, interest expenses, etc.) are not directly related to the core activities of the District. The operating loss for the year ended June 30, 2005, of \$3,614,125 is combined with net non-operating revenues of \$2,128,615 and capital contributions of \$20,282,965 to arrive at the change in net assets of \$18,797,455. The increase in net assets is added to beginning net assets of \$212,466,007 to arrive at ending net assets of \$231,263,462 as of June 30, 2005.

Operating income / (loss)	\$ (3,614,125)
Nonoperating revenues / (expenses)	2,128,615
Capital contributions	<u>20,282,965</u>
Change in net assets	18,797,455
Beginning net assets	<u>212,466,007</u>
Ending net assets	<u><u>\$ 231,263,462</u></u>

Statements of Cash Flows

The Statements of Cash Flows presents the amounts of cash provided or used by the District's operating, financing, and investing activities. Every cash flow has been categorized into one of the following activities: operating, non-capital financing, capital and related financing, or investing. The total of these categories for the year ended June 30, 2005, represents the increase in cash and cash equivalents of \$61,598,024, which is combined with beginning cash and cash equivalents of \$38,798,169, to arrive at ending cash and cash equivalents of \$100,396,193. The increase and ending balance in cash and cash equivalents are materially larger than in prior years because of the \$66.2 million (\$66.7 less issue costs and discount) in debt proceeds received on June 30, 2005. Investments in the California Local Agency Investment Fund, San Diego County Investment Pool, and open-ended money market mutual funds are the only cash equivalents held by the District at June 30, 2005. As of June 30, 2005, the ending cash and cash equivalents are represented on the Statements of Net Assets as follows:

Increase in cash & cash equivalents	\$ 61,598,024
Beginning cash & cash equivalents	<u>38,798,169</u>
Ending cash & cash equivalents	<u><u>\$ 100,396,193</u></u>

Unrestricted cash & cash equivalents	\$ 17,402,962
Cash & cash equivalents restricted - current	66,382,364
Cash & cash equivalents restricted - noncurrent	<u>16,610,867</u>
Total cash & cash equivalents	<u><u>\$ 100,396,193</u></u>

Vallecitos Water District
Management's Discussion and Analysis
For the Years Ended June 30, 2005 and 2004

Analysis of Financial Position and Results of Operations

During the fiscal year ended June 30, 2005, the District accelerated cash funding of projects, including the Encina Wastewater Authority (EWA) flow equalization and expansion (EWA is a JPA of which the District is a member), the conversion from manual to radio-read meters, replacing the outfall sewer pipeline, expanding the District's Meadowlark Reclamation Facility, replacing pumping facilities, and implementing a computerized asset management system. The District expended \$12.7 million in EWA and other capital assets while still increasing cash and investments by \$2.7 million (plus \$66.2 million from debt proceeds). These cash funded projects provide for needed capacity, replacement, and operating efficiencies that will result in long-term cost savings to the District. Operating activities provided \$1,271,541 for transfer to a separate fund to be used for replacement of existing capital facilities. (The District maintains separate funds for specific purposes. Funds are combined for financial statement presentation.)

The operating loss of \$3,614,125 includes the non-cash depreciation expense of \$4,885,666. Depreciation is the systematic allocation of a capital asset's cost to expense over a specified period of time. The District expended \$12.7 million for the acquisition and construction of capital assets. The District received \$8,801,002 in capacity fees to offset this financial burden and future capital costs of expansion.

On June 30, 2005, the District issued \$66.7 million in COPs to fund the construction of a 40 million gallon buried pre-stressed concrete reservoir, fund expansion of the Meadowlark Reclamation Facility, and refund COPs of \$23 million issued in 1998. The 1998 COPs funded construction of a 33 million gallon reservoir and were retired on July 1, 2005. The District obtained a AA rating from Fitch Inc., a AA- from Standard & Poor's Rating Group, and purchased insurance to a AAA rating. Rating agencies cited the following reasons for the favorable ratings: local residential and commercial growth, strong and stable financial performance, ample liquidity, high debt service coverage levels, strong financial flexibility given above-average income levels and low rates, and a manageable capital plan. The rating agencies expressed concerns because of the District's reliance on the San Diego County Water Authority for all water purchased, and moderate reliance on capital facility fees to cover debt payments. The COPs are seven-day auction rate certificates offered initially at 2%. The rate varied between 1.9 and 2.3% through September 2005, while the District's rate of return on \$98 million in investments averaged 3.2% with a weighted average maturity of 128 days. The \$43 million of debt proceeds included in the June 30, 2005, investments is expected to be expended by April 2007. Federal arbitrage rebate rules do not apply because all COP proceeds will be spent within two years of issuance. Management monitors the percentage of debt hedged and other economic indicators and assesses alternatives to the variable rate financing.

Current-to-Prior Year Analysis

Analysis of Net Assets

As noted in the table on the following page, cash and investments have increased by \$68 million, or 124% over the prior fiscal year. The increase includes \$66.2 million in debt proceeds. The District also provided improvements and additions to capital facilities. Capital assets increased by \$17.5 million, or 9.5%. Total assets and total liabilities increased materially because of the debt issuance on June 30, 2005. Net assets increased by \$18.8 million, or 8.8%, from the prior year.

Vallecitos Water District
Management's Discussion and Analysis
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Current-to-Prior Year Analysis (Continued)

Analysis of Net Assets (continued)

Vallecitos Water District's Net Assets				
	2005	2004	Change	
			Amount	%
Cash and investments	\$ 122,720,954	\$ 54,763,275	\$ 67,957,679	124.1%
Capital assets	201,886,574	184,413,396	17,473,178	9.5%
Other assets	7,083,517	6,097,958	985,559	16.2%
Total assets	<u>331,691,045</u>	<u>245,274,629</u>	<u>86,416,416</u>	35.2%
Current liabilities	34,093,125	9,299,303	24,793,822	266.6%
Noncurrent liabilities	66,334,458	23,509,319	42,825,139	182.2%
Total liabilities	<u>100,427,583</u>	<u>32,808,622</u>	<u>67,618,961</u>	206.1%
Net assets				
Invested in capital assets, net of related debt	178,790,513	160,680,786	18,109,727	11.3%
Restricted	29,133,390	26,179,870	2,953,520	11.3%
Unrestricted	23,339,559	25,605,351	(2,265,792)	-8.8%
Total net assets	<u>\$ 231,263,462</u>	<u>\$ 212,466,007</u>	<u>\$ 18,797,455</u>	8.8%

Vallecitos Water District Selected Financial Ratios		
	2005	2004
Current ratio	2.91	3.56
Quick ratio	2.88	3.48
Capital assets-to-Long-term liabilities	8.62 / 1	7.84 / 1
Debt-to-equity	1 / 6.78	1 / 6.48

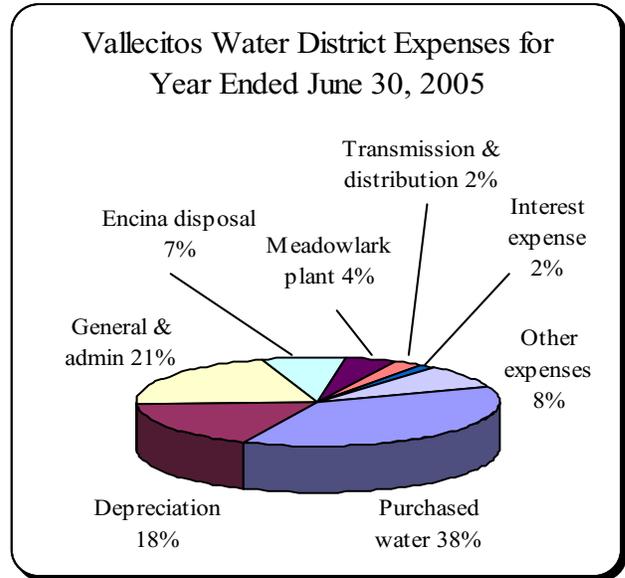
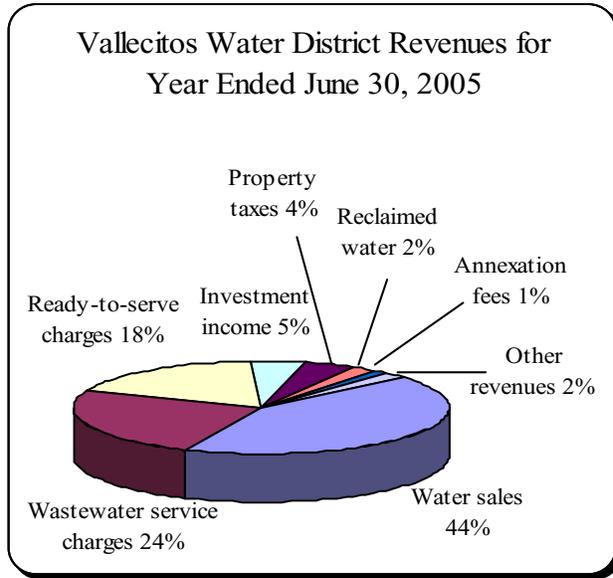
The table at the left illustrates how effectively the District can meet its current obligations, and the margin of safety to creditors. The current ratio (current assets divided by current liabilities) indicates that the District can pay 2.91 times its current debt from current assets. However, some current assets are not easily, or will never be, converted to cash (e.g. inventories and prepaid insurance). The quick

ratio, quick assets (cash, liquid investments, accounts receivable) divided by current liabilities, measures how effectively the District can meet current obligations with assets that are readily convertible to cash. The District can pay 2.88 times its current obligations with assets readily convertible to cash. The District's current ratio of 2.91 indicates a high degree of solvency and a strong current position. The decline in the current ratio results from accelerated cash funding of capital projects as indicated by the increase in the capital assets-to-liabilities ratio. The current ratio increased to 6.9 on July 1, 2005, when the District paid \$23 million to refund existing COPs reclassified to current liabilities on the last day of the year. The 2005 capital assets-to-liabilities and debt-to-equity ratios are shown without the effect of the June 30, 2005, COP issuance so that the numbers from year-to-year are comparable. The capital asset ratio has been steadily increasing over recent years (6.93/1 in 2002 and 7.26/1 in 2003) because of increased capital investment without increased borrowing. The debt-to-equity ratio indicates that for every dollar of debt the District has \$6.78 of net assets (equity). The debt-to-equity ratio dropped to 1/2.3 on the last day of the fiscal year and increased to 1/3.5 the next day after the existing COPs were refunded.

Vallecitos Water District
Management's Discussion and Analysis
For the Years Ended June 30, 2005 and 2004

Current-to-Prior Year Analysis (Continued)

Analysis of Revenues and Expenses



A comparative analysis of revenues and expenses is presented below. Significant and unanticipated variances from the prior year are discussed on the following page.

Vallecitos Water District's Revenues and Expenses				
	For Fiscal Year:		Change	
	2005	2004	Amount	%
Water sales	\$ 11,254,578	\$ 11,293,918	\$ (39,340)	-0.3%
Wastewater service charges	6,423,244	6,056,679	366,565	6.1%
Ready-to-serve charges	4,792,034	4,447,240	344,794	7.8%
Investment income	1,272,309	567,244	705,065	124.3%
Property taxes	1,078,836	1,619,214	(540,378)	-33.4%
Other revenues	1,521,664	1,759,199	(237,535)	-13.5%
Total revenues	<u>26,342,665</u>	<u>25,743,494</u>	599,171	2.3%
Purchased water	10,358,874	9,522,203	836,671	8.8%
Depreciation expense	4,885,666	4,504,507	381,159	8.5%
General and administrative	5,801,955	5,055,950	746,005	14.8%
Encina disposal	2,044,835	1,934,460	110,375	5.7%
Meadowlark plant	1,243,025	1,344,189	(101,164)	-7.5%
Transmission and distribution	676,310	677,873	(1,563)	-0.2%
Other expenses	2,817,510	2,742,694	74,816	2.7%
Total expenses	<u>27,828,175</u>	<u>25,781,876</u>	2,046,299	7.9%
Income / (Loss) before contributions	(1,485,510)	(38,382)	(1,447,128)	3770.3%
Capital contributions	20,282,965	15,652,568	4,630,397	29.6%
Change in net assets	18,797,455	15,614,186	3,183,269	20.4%
Beginning net assets	212,466,007	196,851,821	15,614,186	7.9%
Ending net assets	<u>\$ 231,263,462</u>	<u>\$ 212,466,007</u>	18,797,455	8.8%

Vallecitos Water District
Management's Discussion and Analysis
For the Years Ended June 30, 2005 and 2004

Current-to-Prior Year Analysis (Continued)

Analysis of Revenues and Expenses (continued)

The composition of revenues and expenses for the 2004/05 fiscal year is graphically illustrated on the preceding page. Water sales, ready-to-serve charges, and wastewater service charges continue to be the main sources of revenue funding District operations. Water sales are commodity charges assessed to cover the variable costs of purchasing and delivering water to customers. Ready-to-serve charges are intended to cover fixed costs in the wholesale water rate, and costs related to being able to provide water to customers.

- Investment income increased because of higher yields, little change in fair market value, and an increase in the invested balance. The 2004/05 yield averaged 2.23% on an average investment balance of \$53.4 million, as opposed to 1.68% in the previous year on an average investment balance of \$52 million. The District records unrealized gains and losses on holdings as part of investment income as required by accounting pronouncements. The 2004/05 change in fair market value was a \$33,897 increase from the previous year, as opposed to the \$385,160 decline included in the prior year's investment income.
- As discussed in the Financial Highlights of this MD&A, property tax revenue declined due to the \$947,173 taken away from the District's allocation in accordance with Proposition 1A. This decline was partially offset by an increase in assessable values and Redevelopment Agency tax increment passed through by the City of San Marcos.
- While the percentage change in general and administrative expenses (G&A) was small, group insurance and the District's PERS contribution (as discussed in the Financial Highlights) expenses included in G&A increased significantly. These increases were offset by the recapture of G&A in construction in progress which increased because of accelerated developer activity and procurement of District capital projects.
- Interest expense is the largest component of the increase in other expenses. The 1998 COPS were variable rate debt obligation with an average rate of 2.15% through 2004/05 compared to 1.28% in the previous year.
- The 2004/05 increase in capital contributions (capital facility fees and developer contributed assets and deposits) was caused by growth in the San Marcos area as discussed in the Financial Highlights.

Restrictions, Commitments, and Limitations

1998 Certificates of Participation

In March of 1998, the District issued \$23,865,000 COPS to finance the acquisition, installation, and construction of the first Twin Oaks Reservoir and related facilities. Proceeds were held with the fiscal agent and pledged as security. All construction was funded at the beginning of fiscal year 2001/02. Installment payments were payable from Water Systems net revenue. The District was required to have net revenues at least equal to 1.15 times the annual debt service payment. Net revenues are all revenues, including capital facility fees, less operating expenditures. The debt service coverage ratio in 2004/05 was 2.42 without including capital facility fees, and 7.59 with capital facility fees. The 1998 COPS were refunded on July 1, 2005.

Vallecitos Water District
Management's Discussion and Analysis
For the Years Ended June 30, 2005 and 2004

Restrictions, Commitments, and Limitations (continued)

2005 Certificates of Participation

On June 30, 2005, the District issued \$66,700,000 in Certificates of Participation (COPs) to refinance the 1998 COPs, construct an additional 40 million gallon buried pre-stressed concrete reservoir at the Twin Oaks site, and expand and improve the Meadowlark Reclamation Facility. Any funds held with the fiscal agent are pledged as security. The only funds held with the fiscal agent, aside from the weekly interest payment of approximately \$33,000 and the initial deposit of proceeds, were for issuance costs and have already been expended. As of June 30, 2005, the fiscal agent held \$23,444,949 to refund existing COP principal and pay accrued interest, \$270,000 for issuance costs, and \$42,666,731 of bond proceeds transferred to LAIF and other investments one week after year-end. The 2005 COPs are auction rate certificates with the rate changing and interest payments due weekly. The District is required to prepay principal amounts before the maturity date of July 1, 2035. The first principal payment for \$1,425,000 is due July 1, 2006. The 2005 COPs are payable from the net combined water and sewer revenues of the District. The net revenue requirement is 1.15 times debt service.

Capital Facility Fees

The District collects capital facility fees from new development, maintains the collected fees in separate funds (one for water and one for wastewater), and uses the funds exclusively to provide capacity to serve new development, increased demands from existing customers and fund future construction of facilities identified in the District's Master Plan. As of June 30, 2005, the balances of cash and investments held in the capacity funds were \$16,413,221 for water and \$12,406,743 for wastewater. (The District maintains separate funds for specific purposes. Funds are combined for financial statement presentation.)

Capital Projects

The following budgeted projects have been contracted for at least the design phase before the 2005 fiscal year end:

Project Description	2005 Budget	Spent	Remaining
Meadowlark treatment plant expansion	\$ 24,735,000	\$ 1,767,230	\$ 22,967,770
San Marcos interceptor sewer line	8,900,000	1,825,800	7,074,200
Rancho Santa Fe Road relocations & improvements	3,830,000	432,000	3,398,000
San Marcos Mountain tank	3,750,000	247,800	3,502,200
Meadowlark tank no. 3 & 4	3,000,000	116,300	2,883,700
Wulff reservoir no. 2 and 8" pipeline	2,150,000	26,300	2,123,700
Land outfall replacement	1,748,000	746,900	1,001,100
Linda Vista and Pacific sewer line	1,000,000	231,600	768,400
Wulff pump station upgrade	850,000	250,400	599,600

The budget amounts above indicate the amount anticipated for completion of the projects. For some of these projects the District has only committed to the design phase through contractual obligations, and the construction has not yet been through the bidding process.

Vallecitos Water District
Management's Discussion and Analysis
For the Years Ended June 30, 2005 and 2004

Capital Assets and Long-Term Debt

Accelerated development in the San Elijo Hills and other areas has resulted in significant contributions to the District's infrastructure. The following represents the most significant additions to capital assets which were largely the result of such development:

Water transmission and distribution mains	\$ 2,062,186
Sewer mains	1,265,092
Water service lines	1,228,648
Sewer laterals	1,058,555
Manholes and clean outs	539,995

The \$66.7 million in COPs issued to refinance 1998 COPs, construct a 40 million gallon reservoir, and expand the Meadowlark Reclamation Facility is the only long-term debt owed by the District.

Economic Factors and Next Year's Budget and Rates

The District considered the following economic factors in establishing 2005/06 budget amounts and rates:

- Continued growth - the District anticipates adding 1,100 meters and four additional employment positions in the 2006 fiscal year,
- The need for improved and expanded facilities,
- Results of an independent classification and compensation study,
- Increased sewer and ready-to-serve water rates to cover rising costs from increased regulation,
- Increased costs of the District retirement program,
- Material increases to wholesale water rates,
- The rising costs of medical insurance, and
- Property tax revenue loss due to Proposition 1A of \$947,173.

As a result of these factors, the 2005/06 budget includes:

- Increased water sales and water purchases from growth and wholesale rate increases offset by decreased water demand per customer due to higher projected rainfall,
- A sixteen percent increase in salaries expense due to additional hires, cost of living adjustments, step increases, and the adoption of the classification and compensation study,
- A thirty-two percent increase in the cost of employee benefits from the increased salary base and increased costs of insurance and retirement benefits, and
- \$85.4 million in budgeted capital expenditures, including \$71,379,500 in expansion costs.

Contacting the District's Financial Management

This financial report is designed to give ratepayers, customers, investors, and creditors a general overview of the District's finances and to demonstrate the District's accountability for the money it receives and the stewardship of the facilities it maintains. If you have questions about this report or need additional information, contact the Vallecitos Water District's Finance Department, 201 Vallecitos de Oro, San Marcos, CA 92069, call (760) 744-0460, or visit our website at www.vwd.org.

Basic Financial Statements

Vallecitos Water District
Statements of Net Assets
June 30, 2005 and 2004

<i>Assets</i>	2005	2004
Current assets:		
Cash and cash equivalents (note 2)	\$ 17,402,962	\$ 18,271,476
Restricted cash and cash equivalents (note 2)	66,382,364	1,430,826
Investments	10,177,773	8,997,042
Accounts receivable:		
Water and wastewater sales and services (note 3)	2,985,288	2,803,101
Taxes and assessments	770,686	639,618
From other governmental entities	432,807	199,343
Other	33,652	20,280
Accrued interest receivable	153,672	134,072
Current portion of note receivable (note 6)	74,240	70,370
Inventories	527,158	443,909
Prepaid expenses	146,232	137,636
Total current assets	99,086,834	33,147,673
Non-current assets:		
Restricted cash and cash equivalents (note 2)	16,610,867	19,095,867
Restricted investments (note 2)	12,146,988	6,968,064
Restricted accrued interest receivable	183,067	103,295
Restricted capital facility fees receivable	-	12,010
Note receivable from City of San Marcos, net of current portion (note 6)	1,283,376	1,357,615
Debt issuance costs net of amortization (note 7)	493,339	176,709
Investment in Encina Wastewater Authority capital assets (note 5)	13,604,729	10,187,830
Capital assets not being depreciated (note 4)	27,807,797	17,240,910
Net capital assets being depreciated (note 4)	160,474,048	156,984,656
Total non-current assets	232,604,211	212,126,956
Total assets	331,691,045	245,274,629
<i>Liabilities</i>		
Current liabilities:		
Accounts payable	6,250,718	4,699,116
Accounts payable from restricted assets	7,955	1,009,780
Accrued compensation	901,567	777,006
Construction & service deposits	3,487,936	2,392,989
Accrued interest payable from restricted assets	44,949	20,412
Current portion of long term debt (note 8)	23,400,000	400,000
Total current liabilities	34,093,125	9,299,303
Non-current liabilities:		
Deposit from San Marcos Unified School District	189,400	189,400
Certificates of participation, net of amortized discount & current portion (note 8)	66,145,058	23,319,919
Total non-current liabilities	66,334,458	23,509,319
Total liabilities	100,427,583	32,808,622
<i>Net Assets</i>		
Invested in capital assets, net of related debt	178,790,513	160,680,786
Restricted for future capital facilities	28,932,967	26,179,236
Restricted for debt service	200,423	634
Unrestricted	23,339,559	25,605,351
Total net assets	\$ 231,263,462	\$ 212,466,007

See accompanying notes to the financial statements

Vallecitos Water District
Statements of Revenues, Expenses and Changes in Net Assets
For the Years Ended June 30, 2005 and 2004

	<u>2005</u>	<u>2004</u>
Operating revenues		
Water sales	\$ 11,254,578	\$ 11,293,918
Wastewater service charges	6,423,244	6,056,679
Ready-to-serve charges	4,792,034	4,447,240
Reclaimed water sales	588,084	588,719
Pumping charges	304,894	342,778
Other services and abatements	<u>277,041</u>	<u>296,831</u>
Total operating revenues	<u>23,639,875</u>	<u>23,026,165</u>
Operating expenses:		
Purchased water	10,358,874	9,522,203
General and administrative	5,801,955	5,055,950
Encina disposal	2,044,835	1,934,460
Meadowlark wastewater treatment plant	1,243,025	1,344,189
Transmission and distribution	676,310	677,873
Engineering	560,565	466,371
Customer accounts	474,699	441,081
Pumping	495,853	413,800
Collection and conveyance	492,896	350,362
Buildings and grounds	377,930	319,300
Equipment and vehicles	261,720	213,331
Meter reading and repairs	138,908	158,039
Tanks and reservoirs	152,886	143,346
Water quality and treatment	121,099	136,065
Other wastewater operating expenses	192,727	184,576
Other water operating expenses	<u>133,203</u>	<u>119,710</u>
Total operating expenses	<u>23,527,485</u>	<u>21,480,656</u>
Operating income before overhead absorption	112,390	1,545,509
Overhead absorption	<u>1,159,151</u>	<u>598,724</u>
Operating income before depreciation and amortization	1,271,541	2,144,233
Depreciation and amortization	<u>(4,885,666)</u>	<u>(4,504,507)</u>
Operating loss	<u>(3,614,125)</u>	<u>(2,360,274)</u>
Non-operating revenues (expenses):		
Property taxes	1,078,836	1,619,214
Investment income	1,272,309	567,244
Annexation fees	351,645	530,871
Interest expense	(530,434)	(331,049)
Other, net	<u>(43,741)</u>	<u>(64,388)</u>
Total non-operating revenues and expenses	<u>2,128,615</u>	<u>2,321,892</u>
Loss before capital contributions	(1,485,510)	(38,382)
Capital contributions	<u>20,282,965</u>	<u>15,652,568</u>
Change in net assets	18,797,455	15,614,186
Net assets, beginning of year	<u>212,466,007</u>	<u>196,851,821</u>
Net assets, end of year	<u>\$ 231,263,462</u>	<u>\$ 212,466,007</u>

See accompanying notes to the financial statements

Vallecitos Water District
Statements of Cash Flows
For the Years Ended June 30, 2005 and 2004

	<u>2005</u>	<u>2004</u>
Cash flows from operating activities:		
Receipts from water and wastewater customers	\$ 22,947,183	\$ 22,052,542
Other receipts	1,358,616	368,471
Payments for water	(9,036,620)	(10,079,226)
Payments for services and supplies	(2,412,134)	(1,796,548)
Payments for employee wages, benefits and related costs	<u>(8,506,590)</u>	<u>(7,247,851)</u>
Net cash provided by operating activities	<u>4,350,455</u>	<u>3,297,388</u>
Cash flows from non-capital financing activities:		
Receipts from taxes and assessments	<u>921,381</u>	<u>1,511,912</u>
Net cash provided by non-capital financing activities	<u>921,381</u>	<u>1,511,912</u>
Cash flows from capital and related financing activities		
Receipts from annexation fees	351,645	530,871
Acquisition and construction of utility plant	(8,478,655)	(7,178,664)
Proceeds from certificates of participation	66,225,139	-
Proceeds from disposal of capital assets	11,504	1,365
Principal paid on long term debt	(400,000)	(400,000)
Payments for costs of debt issuance	(316,630)	-
Interest payments on long-term debt	(505,897)	(329,798)
Investment in Encina Wastewater Authority	(4,245,571)	(678,000)
Capacity fees received	<u>8,801,002</u>	<u>8,685,871</u>
Net cash provided by capital and related financing activities	<u>61,442,537</u>	<u>631,645</u>
Cash flows from investing activities		
Purchase of investments	(16,336,614)	(20,352,920)
Proceeds from sale, call and maturity of investments	10,006,110	16,249,170
Interest received	1,143,786	961,123
Collections on note receivable from City of San Marcos	<u>70,369</u>	<u>66,702</u>
Net cash used by investing activities	<u>(5,116,349)</u>	<u>(3,075,925)</u>
Net increase in cash and cash equivalents	61,598,024	2,365,020
Cash and cash equivalents, beginning of year	<u>38,798,169</u>	<u>36,433,149</u>
Cash and cash equivalents, end of year	<u>\$ 100,396,193</u>	<u>\$ 38,798,169</u>
Reconciliation of cash and cash equivalents to statement of net assets:		
Cash and cash equivalents	\$ 17,402,962	\$ 18,271,476
Restricted cash and cash equivalents - current	66,382,364	19,095,867
Restricted cash and cash equivalents - non-current	<u>16,610,867</u>	<u>1,430,826</u>
Total cash and cash equivalents	<u>\$ 100,396,193</u>	<u>\$ 38,798,169</u>
Reconciliation of operating loss to net cash provided by operating activities:		
Net cash provided by operating activities:		
Operating income (loss)	\$ (3,614,125)	\$ (2,360,274)
Adjustments to reconcile operating income to net cash provided by operating activities:		
Depreciation expense	4,885,666	4,504,507
Changes in operating assets and liabilities:		
Accounts receivable from water and wastewater sales and services	(182,187)	(629,418)
Accounts receivable from other governmental entities	(233,464)	(47,373)
Accounts receivable - other	(13,372)	(6,504)
Inventories	(83,249)	(192,544)
Prepaid expenses	(8,596)	(10,678)
Investment in Encina Wastewater Authority	231,508	339,505
Accounts payable	2,148,766	1,573,307
Accrued compensation	124,561	48,716
Construction and service deposits	<u>1,094,947</u>	<u>78,144</u>
Net cash provided by operating activities	<u>\$ 4,350,455</u>	<u>\$ 3,297,388</u>
Noncash investing, capital and financing activities:		
Contributions of assets by developers	<u>\$ 11,010,197</u>	<u>\$ 7,027,796</u>
Amortization related to long-term debt	<u>\$ 9,877</u>	<u>\$ 9,877</u>
Unrealized appreciation (depreciation) of investments	<u>\$ 33,897</u>	<u>\$ (385,160)</u>

See accompanying notes to the financial statements

Vallecitos Water District
Notes to the Basic Financial Statements
For the Years Ended June 30, 2005 and 2004

(1) Reporting Entity and Summary of Significant Accounting Policies

A. Organization and Operations of the Reporting Entity

The Vallecitos Water District was organized in March of 1955 under the provisions of the California Water Code. By Board action in 1989, the District's name changed from the San Marcos County Water District to the Vallecitos Water District. The District was organized to finance, construct, operate, and maintain a water and wastewater system serving portions of northern San Diego County. Currently, the District services approximately 29,000 acres and provides water and wastewater service to the City of San Marcos, portions of the cities of Escondido and Carlsbad, and portions of surrounding unincorporated areas.

The criteria used in determining the scope of the financial reporting entity is based on the provisions of Governmental Accounting Statements No. 14, *The Financial Reporting Entity*, and No. 39, *Determining Whether Certain Organizations Are Component Units* (an amendment of No. 14). The District is the primary governmental unit based on the foundation of a separately elected governing board that is elected by the citizens in a general popular election. Component units are legally separate organizations for which the elected officials of the primary government are financially accountable. The District is financially accountable if it appoints a voting majority of the organization's governing body and: 1) It is able to impose its will on that organization, or 2) There is a potential for the organization to provide specific financial benefits to, or impose specific financial burdens on, the primary government.

The Vallecitos Water District Financing Corporation (Corporation) was incorporated in March 1998. The Corporation is a California nonprofit public benefit corporation formed to assist the District by acquiring, constructing, operating and maintaining facilities, equipment, or other property needed by the District and leasing or selling such property to the District and as such has no employees or other operations. Although the Corporation is legally separate, it is included as a blended component unit of the District, as it is in substance part of the District's operations. No separate financial statements are prepared for the Corporation.

B. Basis of Accounting and Measurement Focus

The District reports its activities as an enterprise fund and accounts for operations that are financed and operated in a manner similar to a private business enterprise. The intent of the District is to provide water, wastewater and recycled water services to its customers on a continuing basis and finance or recover costs of providing services primarily through user charges (water and wastewater sales and services). Revenues and expenses are recognized on the full accrual basis of accounting. Revenues are recognized in the accounting period in which they are earned and expenses are recognized in the period incurred, regardless of when the related cash flows take place.

Operating revenues, such as water and wastewater sales and services, result from exchange transactions associated with the principal activity of the District. Exchange transactions are those in which each party receives and gives up essentially equal values. Non-operating revenues, such as investment income, result from non-exchange transactions, in which, the District gives or receives value without directly receiving or giving value in exchange.

C. Financial Reporting

The District's basic financial statements are presented in conformance with the provisions of Governmental Accounting Standards Board (GASB) Statement No. 34, *Basic Financial Statements – and Management's Discussion and Analysis – for State and Local Governments* (GASB No. 34). This statement established revised financial reporting requirements for state and local governments throughout the United States for the purpose of enhancing the understandability and usefulness of financial reports.

Vallecitos Water District
Notes to the Basic Financial Statements, continued
For the Years Ended June 30, 2005 and 2004

(1) Reporting Entity and Summary of Significant Accounting Policies, continued

C. Financial Reporting, continued

GASB No. 34 and its related GASB pronouncements provide for a revised view of financial information and restructure the format of financial information provided prior to its adoption. A statement of net assets replaces the balance sheet and reports assets, liabilities, and the difference between them as net assets, not equity. A statement of revenues, expenses and changes in net assets replaces both the income statement and the statement of changes in retained earnings and contributed capital. GASB No. 34 also requires that the statement of cash flows be prepared using the direct method. Under the direct method, cash flows from operating activities are presented by major categories.

Under GASB No. 20, enterprise funds, such as the District, have the option of consistently following or not following pronouncements issued by the Financial Accounting Standards Board (FASB) subsequent to November 30, 1989. The District has elected not to follow FASB standards issued after that date, unless such standards are specifically adopted by GASB.

D. Implementation of New Governmental Accounting Standards Board Statements

Governmental Accounting Standards Board Statement No. 40

As of July 1, 2003, the District adopted the provisions of Governmental Accounting Standards Board (GASB) Statement No. 40, *Deposit and Investment Risk Disclosures, an amendment of GASB No 3*. This statement modifies the Deposit and Investment Risk Categorization Disclosures and requires additional information on an entity's cash and investment portfolio. Accordingly, certain footnote disclosures have been revised to conform to the provisions of GASB Statement No. 40.

Governmental Accounting Standards Board Statement No. 41

In May 2003, the GASB issued Statement No. 41, *Budgetary Comparison Schedules- Perspective Differences, an amendment of GASB No. 34*. This statement established guidance for governments with significant budgetary perspective differences to report budgetary comparison schedules within the GASB Statement No. 34 reporting model. Budgetary comparison schedules are required only for General and Special Revenue Funds. Accordingly, this statement has no effect on the District's reports.

Governmental Accounting Standards Board Statement No. 42

In November 2003, the GASB issued Statement No. 42, *Accounting and Financial Reporting for Impairment of Capital Assets and for Insurance Recoveries*. This statement requires governmental agencies to measure, recognize, and disclose the effects of capital asset impairments in their financial statements when it occurs. Also, this statement clarifies and establishes accounting requirements for insurance recoveries, including those associated with capital asset impairment. Accordingly, the District has analyzed its capital assets that may be impaired or in need of an insurance recovery provision as of June 30, 2005, and determined that none of its assets are impaired or in need of an insurance recovery provision.

E. Assets, Liabilities, and Net Assets

1. Use of Estimates

The preparation of the basic financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities at the date of the financial statements and the reported changes in net assets during the reporting period. Actual results could differ from those estimates.

Vallecitos Water District
Notes to the Basic Financial Statements, continued
For the Years Ended June 30, 2005 and 2004

(1) Reporting Entity and Summary of Significant Accounting Policies, continued

E. Assets, Liabilities, and Net Assets, continued

2. Cash and Cash Equivalents

Substantially all of the District's cash is invested in interest bearing accounts. The District considers all highly liquid investments with an original maturity of three months or less to be cash equivalents.

3. Investments and Investment Policy

The District has adopted an investment policy directing the Treasurer to deposit funds in financial institutions.

Changes in fair value that occur during a fiscal year are recognized as investment income reported for that fiscal year. Investment income includes interest earnings, changes in fair value, and any gains or losses realized upon the liquidation or sale of investments.

4. Accounts Receivable and Allowance for Uncollectible Accounts

The District extends credit to customers in the normal course of operations. When management deems customer accounts uncollectible, the District uses the allowance method for the reservation and write-off of those accounts.

5. Federal and State Capital and Operating Grants

If a grant agreement were approved and eligible expenditures were incurred, the amount is recorded as a capital or operating grant receivable on the statement of net assets and as capital grant contribution or operating grant revenue, as appropriate, on the statement of revenues, expenses and changes in net assets.

6. Property Taxes and Assessments

Property taxes and assessments are billed by the County of San Diego to property owners. The District's property tax calendar is as follows:

Lien date	January 1
Levy date	July 1
Due date	
First installment	November 1
Second installment	February 1
Delinquent date	
First installment	December 10
Second installment	April 10

Taxes and assessments receivable of \$770,686 and \$639,618 have been reduced by an allowance for estimated uncollectible taxes of \$9,340 and \$6,291 at June 30, 2005 and 2004, respectively.

7. Water-In-Storage Inventory

The District owns the water within its transmission and distribution system. This water has been recorded on the District's books at the cost at which the water was purchased.

8. Materials and Supplies Inventory

Materials and supplies inventory consists primarily of water meters, pipe and pipefittings for construction and repair to the District's water transmission and distribution system and wastewater system. Inventory is valued at cost using a weighted average cost method. Inventory items are charged to expense or work-in-process at the time that individual items are withdrawn from inventory or consumed.

Vallecitos Water District
Notes to the Basic Financial Statements, continued
For the Years Ended June 30, 2005 and 2004

(1) Reporting Entity and Summary of Significant Accounting Policies, continued

E. Assets, Liabilities, and Net Assets, continued

9. Prepaid Expenses

Certain payments to vendors reflects costs or deposits applicable to future accounting periods and are recorded as prepaid items in the basic financial statements.

10. Restricted Assets

Certain assets of the District are restricted in use by law or debt covenant and, accordingly are shown as restricted assets on the accompanying statement of net assets. Certificates of Participation reserve funds and construction funds set aside from Certificates of Participation proceeds are restricted for future debt service payments and construction projects. The District uses restricted resources, prior to using unrestricted resources, to pay expenditures meeting the criteria imposed on the use of restricted resources by a third party.

11. Capital Assets

Capital assets acquired and/or constructed are capitalized at historical cost. District policy has set the capitalization threshold for reporting capital assets at \$2,500. Donated assets are recorded at estimated fair market value at the date of donation. Upon retirement or other disposition of capital assets, the cost and related accumulated depreciation are removed from the respective balances and any gains or losses are recognized. Depreciation is recorded on a straight-line basis over the estimated useful lives of the assets as follows:

Transmission and distribution system	10 - 75 years
Wastewater system	5 - 50 years
Buildings	50 years
Transportation equipment	8 - 15 years
Field and shop equipment	5 - 20 years
Office equipment	5 - 10 years

12. Encina Wastewater Authority

The District's participation in the Encina Wastewater Authority (EWA) is included in the accompanying financial statements. Plant and equipment is capitalized as a percentage of ownership of accumulated capital expenditures made by EWA. Ownership percentages are determined by joint agreements at the time the assets are acquired.

13. Deferred Charges

The deferred charges are from bond issuance costs that will be amortized using the straight-line method over the remaining life of the respective debt service.

14. Compensated Absences

The District's personnel policies provide for accumulation of vacation and sick leave. Liabilities for vacation and sick leave are recorded when benefits are earned. Cash payment equal to 100% of unused vacation and 25% or 50% of sick leave, depending on length of service, is available upon retirement or termination.

15. Construction Advances and Deposits

Construction advances represent deposits received in aid of construction, which are refundable if the applicable construction does not take place. Construction advances are transferred to contributed capital when the applicable construction project is completed.

Vallecitos Water District
Notes to the Basic Financial Statements, continued
For the Years Ended June 30, 2005 and 2004

(1) Reporting Entity and Summary of Significant Accounting Policies, continued

E. Assets, Liabilities, and Net Assets, continued

16. Net Assets

The financial statements utilize a net assets presentation. Net assets are categorized as follows:

- **Net Investment in Capital Assets** – This component of net assets consists of capital assets, net of accumulated depreciation and reduced by any debt outstanding against the acquisition, construction or improvement of those assets.
- **Restricted Net Assets** – This component of net assets consists of constraints placed on net assets use through external constraints imposed by creditors, grantors, contributors, or laws or regulations of other governments or constraints imposed by law through constitutional provisions or enabling legislation.
- **Unrestricted Net Assets** – This component of net assets consists of net assets that do not meet the definition of *restricted* or *net investment in capital assets*.

F. Water and Wastewater Sales and Services

Water and wastewater sales and services are billed on a monthly cyclical basis. Estimated unbilled water revenue through June 30 has been accrued at year-end.

G. Capital Contributions

Capital contributions represent cash and capital asset additions contributed to the District by property owners, granting agencies or real estate developers desiring services that require capital expenditures or capacity commitment.

H. Economic Dependency

The District purchases virtually all of its water from the San Diego County Water Authority. A sustained interruption of this source could impact the District negatively.

I. Budgetary Policies

The District adopts an annual budget for planning, control, and evaluation purposes. Budgetary control and evaluation are affected by comparisons of actual revenues and expenses with planned revenues and expenses for the period. Encumbrance accounting is not used to account for commitments related to unperformed contracts for construction and services.

J. Reclassification

The District has reclassified certain prior year information to conform to current year presentations.

Vallecitos Water District
Notes to the Basic Financial Statements, continued
For the Years Ended June 30, 2005 and 2004

(2) Cash and Investments

Cash and investments as of June 30, are classified in the accompanying financial statements as follows:

	<u>2005</u>	<u>2004</u>
Cash and cash equivalents	\$ 17,402,962	18,271,476
Restricted cash and cash equivalents – current portion	66,382,364	1,430,826
Investments – current portion	10,177,773	8,997,042
Restricted cash and cash equivalents – noncurrent portion	16,610,867	19,095,867
Restricted investments	<u>12,146,988</u>	<u>6,968,064</u>
Total Cash and Investments	<u>\$ 122,720,954</u>	<u>54,763,275</u>

Cash and investments as of June 30, consist of the following:

	<u>2005</u>	<u>2004</u>
Cash on hand	\$ 1,700	1,700
Deposits with financial institutions	205,905	73,276
Investments	<u>122,513,349</u>	<u>54,688,299</u>
Total cash and investments	<u>\$ 122,720,954</u>	<u>54,763,275</u>

Investments Authorized by the California Government Code and the District's Investment Policy

The table below identifies the investment types that are authorized by the District in accordance with the District's investment policy, which is more restrictive than the California Government Code. The table also identifies certain provisions of the District's investment policy that address interest rate risk, credit risk, and concentration of credit risk. This table does not address investments of debt proceeds held by bond trustees that are governed by the provisions of debt agreements of the District, rather than the general provisions of the District's investment policy.

<u>Authorized Investment Type</u>	<u>Maximum Maturity</u>	<u>Maximum Percentage Of Portfolio</u>	<u>Maximum Investment in One Issuer/Institution</u>
U.S. Treasury Obligations	5 years	75%	None
U.S. Agency Securities	5 years	40%	25%
Commercial Paper	270 days	10%	10%
Negotiable Certificates of Deposit	4 years	5%	5%
Non-negotiable Certificates of Deposit	1 year	20%	20%
Repurchase Agreements	1 year	10%	10%
San Diego County Pooled Investment Funds	N/A	20%	20%
Local Agency Investment Fund (LAIF)	N/A	65%	None
Savings Accounts	N/A	10%	10%

Vallecitos Water District
Notes to the Basic Financial Statements, continued
For the Years Ended June 30, 2005 and 2004

(2) Cash and Investments, continued

Investments Authorized by Debt Agreements

Investment of debt proceeds are governed by provisions of the debt agreements, rather than the general provisions of the California Government Code or the District's investment policy. Appendix B of the official statements note the investment types that are authorized for investments and identifies certain provisions of these debt agreements that address interest rate risk, credit risk and concentration of credit risk. The debt agreement for the 1998 Twin Oaks Certificates of Participation authorizes the bond trustee to invest in money market funds. The District maintains and invests the 2005 Certificates of Participation debt proceeds in accordance with debt covenants.

Custodial Credit Risk

Custodial credit risk for *deposits* is the risk that, in the event of the failure of a depository financial institution, a government will not be able to recover its deposits or will not be able to recover collateral securities that are in the possession of an outside party. The custodial credit risk for *investments* is the risk that, in the event of the failure of the counterparty (e.g., broker-dealer) to a transaction, a government will not be able to recover the value of its investment or collateral securities that are in the possession of another party. With respect to investments, custodial credit risk generally applies only to direct investments in marketable securities. Custodial credit risk does not apply to a local government's indirect investment in securities through the use of mutual funds or government investment pools (such as LAIF).

The District's investment policy considers aversion to custodial credit risk by requiring all participants in the investment process to invest no more than 25% of the portfolio with one financial institution, with the exception of LAIF, the U.S. Treasury and funds advanced or in trustee accounts for project construction. The California Government Code requires that a financial institution secure deposits made by state or local governmental units by pledging securities in an undivided collateral pool held by a depository regulated under state law (unless so waived by the governmental unit). The market value of the pledged securities in the collateral pool must equal at least 110% of the total amount deposited by the public agencies. California law also allows financial institutions to secure District deposits by pledging first trust deed mortgage notes having a value of 150% of the secured public deposits. The District had deposits with bank balances of \$357,878 and \$370,551 as of June 30, 2005 and 2004, respectively. Of the bank balances, up to \$100,000 is federally insured and the remaining balance is collateralized in accordance with the Code; however, the collateralized securities are not held in the District's name.

Investment in State Investment Pool

The District is a voluntary participant in the Local Agency Investment Fund (LAIF) that is regulated by the California Government Code under the oversight of the Treasurer of the State of California. The fair value of the District's investment in this pool is reported in the accompanying financial statements at amounts based upon the District's pro-rata share of the fair value provided by LAIF for the entire LAIF portfolio (in relation to the amortized cost of that portfolio). The balance available for withdrawal is based on the accounting records maintained by LAIF, which are recorded on an amortized cost basis.

Vallecitos Water District
Notes to the Basic Financial Statements, continued
For the Years Ended June 30, 2005 and 2004

(2) Cash and Investments, continued

San Diego County Pooled Investment Fund

The San Diego County Pooled Investment Fund (SDCPIF) is a pooled investment fund program governed by the County of San Diego Board of Supervisors, and administered by the County of San Diego Treasurer and Tax Collector. Investments in SDCPIF are highly liquid as deposits and withdrawals can be made at anytime without penalty. SDCPIF does not impose a maximum investment limit; however, the District's investment policy limits investment in SDCPIF to 20% of the District's total portfolio.

The County of San Diego's bank deposits are either Federally insured or collateralized in accordance with the California Government Code. Pool detail is included in the County of San Diego Comprehensive Annual Financial Report (CAFR). Copies of the CAFR may be obtained from the County of San Diego Auditor-Controller's Office – 1600 Pacific Coast Highway – San Diego, CA 92101.

Interest Rate Risk

Interest rate risk is the risk that changes in market interest rates will adversely affect the fair value of an investment. Generally, the longer the maturity of an investment, the greater the sensitivity of its fair value to changes in market interest rates. The District manages interest rate risk by limiting terms of investment as noted in the Authorized Investment Type on page 18. The District also manages its exposure to interest rate risk by purchasing a combination of shorter term and longer term investments and by timing cash flows from maturities so that a portion of the portfolio matures or comes close to maturity evenly over time as necessary to provide requirements for cash flow and liquidity needed for operations. Information about the sensitivity of the fair values of the District's investments to market interest rate fluctuations is provided by the following table that shows the distribution of the District's investments by maturity date:

Maturities of investments at June 30, 2005, are as follows:

Investment Type	Total	Remaning Maturity (in Months)		
		12 Months Or Less	13 to 24 Months	25-60 Months
U.S. Treasury bills	\$ 1,988,029	1,988,029	-	-
Federal Home Loan Bank	9,925,000	6,955,630	1,979,060	990,310
Federal Farm Credit Bank	3,979,070	2,984,070	-	995,000
Federal Home Loan Mortgage Corporation	986,590	986,590	-	-
Federal National Mortgage Association	1,983,440	-	980,940	1,002,500
Certificates of Deposit	497,102	299,012	99,323	98,767
General Electric commercial paper	2,965,530	2,965,530	-	-
Money market funds – bond proceeds	42,936,731	42,936,731	-	-
Local Agency Investment Fund (LAIF)	25,649,888	25,649,888	-	-
San Diego County Investment Pool	8,156,336	8,156,336	-	-
Held by bond trustee:				
Money market funds	23,445,633	23,445,633	-	-
Total	\$ <u>122,513,349</u>	<u>116,367,449</u>	<u>3,059,323</u>	<u>3,086,577</u>

Vallecitos Water District
Notes to the Basic Financial Statements, continued
For the Years Ended June 30, 2005 and 2004

(2) Cash and Investments, continued

Maturities of investments at June 30, 2004, are as follows:

<u>Investment Type</u>	<u>Total</u>	<u>Remaning Maturity (in Months)</u>		
		<u>12 Months Or Less</u>	<u>13 to 24 Months</u>	<u>25-60 Months</u>
U.S. Treasury bills	\$ 2,989,765	2,989,765	-	-
Federal Home Loan Bank	8,923,150	-	6,942,520	1,980,630
Federal Farm Credit Bank	1,987,820	-	1,987,820	-
Federal Home Loan Mortgage Corporation	985,060	-	985,060	-
Federal National Mortgage Association	980,310	-	-	980,310
Certificates of Deposit	99,000	99,000	-	-
Local Agency Investment Fund (LAIF)	30,309,226	30,309,226	-	-
San Diego County Investment Pool	7,992,921	7,992,921	-	-
Held by bond trustee:				
Money market funds	421,047	421,047	-	-
Total	<u>\$ 54,688,299</u>	<u>41,811,959</u>	<u>9,915,400</u>	<u>2,960,940</u>

Credit Risk

Generally, credit risk is the risk that an issuer of an investment will not fulfill its obligation to the holder of the investment. This is measured by the assignment of a rating by a nationally recognized statistical rating organization. Presented below is the minimum rating required by (where applicable) the California Government Code, the District's investment policy, or debt agreements, and the actual rating as of year end for each investment type.

Credit ratings of investments as of June 30, 2005, were as follows:

<u>Investment Types</u>	<u>Total</u>	<u>Minimum Legal Rating</u>	<u>Exempt From Disclosure</u>	<u>Rating as of Year End</u>	
				<u>AAA</u>	<u>Not Rated</u>
U.S. Treasury bills	\$ 1,988,029	N/A	\$ 1,988,029	-	-
Federal Home Loan Bank	9,925,000	AA+	-	9,925,000	-
Federal Farm Credit Bank	3,979,070	AA+	-	3,979,070	-
Federal Home Loan Mortgage Corporation	986,590	AA+	-	986,590	-
Federal National Mortgage Association	1,983,440	AA+	-	1,983,440	-
Certificates of Deposit	497,102	N/A	-	497,102	-
General Electric commercial paper	2,965,530	AA+	-	2,965,530	-
Money market funds – bond proceeds	42,936,731	N/A	42,936,731	-	-
Local Agency Investment Fund (LAIF)	25,649,888	N/A	-	-	25,649,888
San Diego County Investment Pool	8,156,336	N/A	-	8,156,336	-
Held by bond trustee:					
Money market funds	23,445,633	N/A	23,445,633	-	-
Total	<u>\$ 122,513,349</u>		<u>\$ 68,370,393</u>	<u>28,493,068</u>	<u>25,649,888</u>

Vallecitos Water District
Notes to the Basic Financial Statements, continued
For the Years Ended June 30, 2005 and 2004

(2) Cash and Investments, continued

Credit ratings of investments as of June 30, 2004, were as follows:

Investment Types	Total	Minimum Legal Rating	Exempt From Disclosure	Rating as of Year End	
				AAA	Not Rated
U.S. Treasury bills	\$ 2,989,765	N/A	\$ 2,989,765	-	-
Federal Home Loan Bank	8,923,150	AA+	-	8,923,150	-
Federal Farm Credit Bank	1,987,820	AA+	-	1,987,820	-
Federal Home Loan Mortgage Corporation	985,060	AA+	-	985,060	-
Federal National Mortgage Association	980,310	AA+	-	980,310	-
Certificates of Deposit	99,000	N/A	-	99,000	-
Local Agency Investment Fund (LAIF)	30,309,226	N/A	-	-	30,309,226
San Diego County Investment Pool	7,992,921	N/A	-	7,992,921	-
Held by bond trustee:					
Money market funds	421,047	N/A	421,047	-	-
Total	\$ 54,688,299		\$ 3,410,812	20,968,261	30,309,226

Concentration of Credit Risk

The investment policy of the District limits the amount that can be invested in any one issuer to 25% of the portfolio, other than U.S. Treasury securities. Investments in any one issuer, other than U.S. Treasury securities, that represent 5% or more of the total District investments are as follows:

Issuer	2005		2004	
	Reported Amount	Portfolio Percentage	Reported Amount	Portfolio Percentage
Federal Home Loan Bank	\$ 9,925,000	10%	\$ 8,923,150	16%

(3) Accounts Receivable – Water and Wastewater Sales and Services, Net

The balance at June 30, consists of the following:

	2005	2004
Accounts receivable – water and wastewater sales and services	\$ 2,991,019	2,809,312
Allowance for uncollectible accounts	(5,731)	(6,211)
Accounts receivable – water sales, net	<u>\$ 2,985,288</u>	<u>2,803,101</u>

Vallecitos Water District
Notes to the Basic Financial Statements, continued
For the Years Ended June 30, 2005 and 2004

(4) Capital Assets

Changes in capital assets for the year were as follows:

	<u>Balance 2004</u>	<u>Additions/ Transfers</u>	<u>Deletions/ Transfers</u>	<u>Balance 2005</u>
Non-depreciable assets:				
Land	\$ 4,674,034	-	-	4,674,034
Construction-in-process	12,562,272	19,048,081	(8,476,590)	23,133,763
District formation costs	4,604	-	(4,604)	-
Total non-depreciable assets	<u>17,240,910</u>	<u>19,048,081</u>	<u>(8,481,194)</u>	<u>27,807,797</u>
Depreciable assets:				
Water transmission and distribution system	116,040,060	4,977,631	(32,592)	120,985,099
Wastewater system	69,291,719	2,936,709	-	72,228,428
Buildings	13,770,844	-	-	13,770,844
Transportation equipment	2,313,190	270,119	(301,518)	2,281,791
Field and shop equipment	5,652,309	201,032	(12,398)	5,840,943
Office equipment	1,003,627	13,820	-	1,017,447
Total depreciable assets	<u>208,071,749</u>	<u>8,399,311</u>	<u>(346,508)</u>	<u>216,124,552</u>
Accumulated depreciation and amortization:				
Water transmission and distribution system	(23,382,906)	(2,365,904)	8,339	(25,740,471)
Wastewater system	(19,832,555)	(1,661,541)	-	(21,494,096)
Buildings	(1,897,945)	(283,996)	-	(2,181,941)
Transportation equipment	(1,110,476)	(234,930)	301,518	(1,043,888)
Field and shop equipment	(4,266,174)	(255,838)	12,398	(4,509,614)
Office equipment	(597,037)	(83,457)	-	(680,494)
Total accum depr. and amort.	<u>(51,087,093)</u>	<u>(4,885,666)</u>	<u>322,255</u>	<u>(55,650,504)</u>
Total depreciable assets, net	<u>156,984,656</u>	<u>3,513,645</u>	<u>(24,253)</u>	<u>160,474,048</u>
Total capital assets, net	<u>\$ 174,225,566</u>	<u>22,561,726</u>	<u>(8,505,447)</u>	<u>188,281,845</u>

In 2005, major capital assets additions include the rehabilitation of the District's transmission and distribution systems mains and pipelines. A significant portion of these additions were constructed by the District and transferred out of construction-in-process upon completion.

Vallecitos Water District
Notes to the Basic Financial Statements, continued
For the Years Ended June 30, 2005 and 2004

(4) Capital Assets, continued

	<u>Balance 2003</u>	<u>Additions/ Transfers</u>	<u>Deletions/ Transfers</u>	<u>Balance 2004</u>
Non-depreciable assets:				
Land	\$ 4,674,034	-	-	4,674,034
Construction-in-process	7,488,900	16,032,742	(10,959,370)	12,562,272
District formation costs	4,604	-	-	4,604
Total non-depreciable assets	<u>12,167,538</u>	<u>16,032,742</u>	<u>(10,959,370)</u>	<u>17,240,910</u>
Depreciable assets:				
Water transmission and distribution system	111,236,354	5,093,740	(290,034)	116,040,060
Wastewater system	66,425,757	3,017,725	(151,763)	69,291,719
Buildings	13,569,516	402,231	(200,903)	13,770,844
Transportation equipment	2,036,279	311,302	(34,391)	2,313,190
Field and shop equipment	5,016,301	637,713	(1,705)	5,652,309
Office equipment	943,080	143,469	(82,922)	1,003,627
Total depreciable assets	<u>199,227,287</u>	<u>9,606,180</u>	<u>(761,718)</u>	<u>208,071,749</u>
Accumulated depreciation and amortization:				
Water transmission and distribution system	(21,472,328)	(2,109,111)	198,533	(23,382,906)
Wastewater system	(18,251,348)	(1,581,207)	-	(19,832,555)
Buildings	(1,651,431)	(246,514)	-	(1,897,945)
Transportation equipment	(956,970)	(153,506)	-	(1,110,476)
Field and shop equipment	(3,934,204)	(331,970)	-	(4,266,174)
Office equipment	(589,536)	(82,199)	74,698	(597,037)
Total accum depr. and amort.	<u>(46,855,817)</u>	<u>(4,504,507)</u>	<u>273,231</u>	<u>(51,087,093)</u>
Total depreciable assets, net	<u>152,371,470</u>	<u>5,101,673</u>	<u>(488,487)</u>	<u>156,984,656</u>
Total capital assets, net	<u>\$ 164,539,008</u>	<u>21,134,415</u>	<u>(11,447,857)</u>	<u>174,225,566</u>

In 2004, major capital assets additions during the year include the rehabilitation of the District's transmission and distribution systems mains and pipelines. A significant portion of these additions were constructed by the District and transferred out of construction-in-process upon completion of these various projects.

Vallecitos Water District
Notes to the Basic Financial Statements, continued
For the Years Ended June 30, 2005 and 2004

(4) Capital Assets, continued

Construction-In-Process

The District has been involved in various construction projects throughout the year. The balances of the various construction projects that comprise the construction-in-process balances at June 30 are as follows:

<u>Project Name</u>	<u>2003</u>	<u>2004</u>	<u>2005</u>
<i>District Financed</i>			
SM interceptor - SM Blvd/Discovery	\$ 1,612,444	1,614,711	1,869,431
Meadowlark Plant expansion design	681,934	1,323,177	1,765,027
Deer Springs pump station replacement	201,978	1,064,029	1,474,017
Radio read meters	-	333	1,317,582
Land outfall replacement 24" & 54" Laurels to Carillo Ranch	76,547	140,043	1,250,083
South Lake Pump Station improvement project	97,972	630,111	900,536
Slip lining for outfall under I-5	40,197	647,222	849,480
Water wastewater reclamation FY 2000-2001 master plan update	564,924	623,030	690,899
Facility/Maintenance data management system	-	-	303,753
Sewer flow monitoring stations	8,809	154,114	277,187
City of San Marcos water/sewer plan check - Rancho Santa Fe Rd	131,703	252,707	276,562
Wulff Pump Station - Upgrade	62,187	195,094	261,555
Sewer main replacement- Linda Vista/Pacific	129,834	175,425	234,702
North Twin Oaks reservoir 2 & 3 San Marcos Mtn / Merriam Mtn	21,339	73,340	228,366
Gravity portion of Montiel Lift Station	-	-	216,777
GIS implementation project	130,493	-	-
Subtotal - District Financed	<u>\$ 3,760,361</u>	<u>6,893,336</u>	<u>11,915,957</u>
<i>Developer Financed</i>			
Univ. Commons, San Elijo Hills Rd. improvement water/sewer plan check	\$ 12,797	21,922	1,259,517
Euston Homes water/sewer grading plan check	20,376	294,131	1,195,082
Rancho Coronado Village B-4 water/sewer plan check Twin Oaks Valley Rd	-	5,611	525,626
TSM 430 water/sewer plan check	3,780	13,339	363,800
San Marcos track 432 water/sewer plan check, Mission Rd	2,463	9,286	254,786
University Commons, TSM 421 unit 11, Shadetree DR	600	2,180	213,650
Las Posas widening - Las Posas drainage Grand to Mission	65,258	200,591	213,633
University Commons, Unit 3, San Elijo Rd, water/sewer plan check	475	2,905	212,451
Oceanside-Escondido rail project-railroad right of way & CSUSM loop	1,968	201,267	210,048
University Commons TSM 421, Unit 1 water/sewer plan check	852	4,388	206,607
Kaufman Broad water/sewer plan check TSM 401	400,512	-	-
HNB San Marcos LLC water/sewer plan check	201,566	-	-
KB Home water/sewer plan check Paloma A6 U4	1,714	209,869	-
Rose Ranch Estates water/sewer plan check	29,680	453,172	-
San Elijo Hills planning area R offsite sewer siphon plan check	311,329	-	-
Rancho Coronado Village H, Unit 4, water/sewer plan check	101,515	-	-
Subtotal - Developer Financed	<u>\$ 1,154,885</u>	<u>1,418,661</u>	<u>4,655,200</u>
Various Other Projects	<u>\$ 2,573,654</u>	<u>4,250,275</u>	<u>6,562,605</u>
Total	<u>\$ 7,488,900</u>	<u>12,562,272</u>	<u>23,133,762</u>

Vallecitos Water District
Notes to the Basic Financial Statements, continued
For the Years Ended June 30, 2005 and 2004

(5) Encina Wastewater Authority

The Revised Basic Agreement is a joint exercise of powers agreement by and among the cities of Carlsbad, Vista, and Encinitas, the Buena Sanitation District, the Vallecitos Water District, and the Leucadia Wastewater District for the ownership and operation of a joint sewerage system. The Encina Wastewater Authority (EWA) board is composed of representatives of these Member Agencies. Each Member Agency has an investment in EWA's assets and owns a corresponding proportion of the capacity of the joint system. As of June 30, 2005, the Member Agencies have the following approximate ownership interest:

City of Vista	22%
City of Carlsbad	25%
Buena Sanitation District	8%
Vallecitos Water District	20%
Leucadia Wastewater District	20%
City of Encinitas	5%

The latest available financial statements of EWA, dated June 30, 2004 and 2003, are available directly from EWA (6200 Avenida Encinas, Carlsbad, California 92009), and show the following:

	2004	2003
Total assets	\$ 55,482,902	47,194,922
Total liabilities	3,417,513	1,424,280
Total net assets	\$ 52,065,389	45,770,642
Increase(decrease) in net assets	\$ 6,294,747	(99,476)

(6) Note Receivable from City of San Marcos

In February 1998, the District sold 23.6 acres of excess land to the City of San Marcos for \$1,829,520. The District received \$50,000 and an installment note of \$1,779,520. The note is payable in twenty annual installments of \$148,909 including interest of 5.5%. As of June 30, 2005, the following amounts are due to the District:

Fiscal Year	Principal Amount
2006	\$ 74,240
2007	78,323
2008	82,631
2009	87,176
2010	91,971
Thereafter	943,275
	\$ 1,357,616

Vallecitos Water District
Notes to the Basic Financial Statements, continued
For the Years Ended June 30, 2005 and 2004

(7) Deferred Charges

The deferred charges balance relates to the issuance costs of the 2005 Refunding Certificates of Participation along with the defeasance costs of the District's 1998 Twin Oaks Certificates of Participation. The balance is being amortized over a thirty year period. The deferred charges net balances are as follows:

The balance at June 30, consists of the following:

	2005	2004
Deferred charges	\$ 493,339	203,910
Accumulated amortization	-	(27,201)
Deferred charges, net	493,339	176,709

(8) Long-term Debt

Changes in long-term debt amounts for the year ended June 30, 2005 were as follows:

	Balance 2004	Additions	Principal Payments	Balance 2005
Long-term debt:				
1998 certificates of participation	\$ 23,800,000	-	(400,000)	23,400,000
2005A certificates of participation	-	66,700,000	-	66,700,000
Less: unamortized discounts	(80,081)	(477,941)	3,080	(554,942)
Total long-term debt	23,719,919	66,222,059	(396,920)	89,545,058
Less: current portion	(400,000)			(23,400,000)
Long-term portion	\$ 23,319,919			66,145,058

1998 Certificates of Participation

In March 1998, the District issued \$24,865,000 in 1998 Twin Oaks Reservoir Certificates of Participation. The proceeds of the issue were used to finance the acquisition, installation and construction of the Twin Oaks Reservoir and related facilities. The Certificates are payable solely from "Net Revenues" of its water system and certain funds and accounts created under the Trust Agreement dated March 1, 1998. "Net Revenues" are defined as District revenues less maintenance and operating costs for a given period. Initially, the Certificates have the benefit of an irrevocable direct pay letter of credit. The letter of credit expired on June 30, 2005. On July 1, 2005, the District used \$23,400,000 of the \$66,700,000 in 2005 Refunding Certificates of Participation to refund the Certificates in full.

As of June 30, 2005, the District has recorded the balance of the 1998 Twin Oaks Certificates of Participation of \$23,400,000 as a current portion of long-term debt payable since the refunding takes place on July 1, 2005.

2005 Certificates of Participation

On June 30, 2005, the District issued \$66,700,000 in Water and Wastewater Enterprise Certificates of Participation (Series 2005A). The proceeds of the issue are being used to prepay the 1998 Twin Oaks Reservoir Certificates of Participation (this was paid on 7/1/05), the construction of a second buried pre-stressed concrete reservoir at the Twin Oaks Reservoir site, including related grating and earthwork, and the upgrade of the District's Meadowlark Water Reclamation Facility, including the installation of new primary clarifiers, two new filter beds, the reconstruction of the operations and laboratory building, the installation of odor control systems throughout the site, and the addition of a larger emergency generator. The Certificates are payable solely from "Net Revenues" of its water and sewer system as defined in the 2005 Certificates of Participation. The Certificates bear interest at a variable rate (2.0% at June 30, 2005) with principal maturities from 2007 to 2036.

Vallecitos Water District
Notes to the Basic Financial Statements, continued
For the Years Ended June 30, 2005 and 2004

(8) Long-term Debt, continued

Annual debt service payments are as follows:

<u>Fiscal Year</u>	<u>Principal</u>	<u>Interest</u>	<u>Total</u>
2006	\$ -	1,334,000	1,334,000
2007	1,425,000	1,305,500	2,730,500
2008	1,450,000	1,276,500	2,726,500
2009	1,500,000	1,246,500	2,746,500
2010	1,550,000	1,215,500	2,765,500
2011-2015	8,725,000	5,566,500	14,291,500
2016-2020	10,450,000	4,593,500	15,043,500
2021-2024	12,475,000	3,429,000	15,904,000
2025-2030	15,000,000	2,034,000	17,034,000
2031-2035	11,800,000	662,500	12,462,500
2036	2,325,000	-	2,325,000
Total	<u>\$ 66,700,000</u>	<u>22,663,500</u>	<u>89,363,500</u>

(9) Net Investment in Capital Assets

Net investment in capital assets:

	<u>2005</u>	<u>2004</u>
The balance at June 30, consists of the following:		
Investment in Encina Wastewater Authority capital assets	\$ 13,604,729	10,187,830
Capital assets not being depreciated	27,807,797	17,236,306
Net capital assets being depreciated	160,474,048	156,989,260
Debt issuance costs net of amortization	493,339	176,709
Certificates of participation – current portion	(23,400,000)	(400,000)
Deposit from San Marcos Unified School District	(189,400)	(189,400)
Certificates of participation – non-current portion	-	(23,319,919)
Net investment in capital assets	<u>\$ 178,790,513</u>	<u>160,680,786</u>

(10) Deferred Compensation Savings Plan

For the benefit of its employees, the District participates in two 457 Deferred Compensation Programs (Programs). The purpose of these Programs is to provide deferred compensation for public employees that elect to participate in the Program. Generally, eligible employees may defer receipt of a portion of their salary until termination, retirement, death or unforeseeable emergency. Until the funds are paid or otherwise made available to the employee, the employee is not obligated to report the deferred salary for income tax purposes.

Federal law requires deferred compensation assets to be held in trust for the exclusive benefit of the participants. Accordingly, the District is in compliance with this legislation. Therefore, these assets are not the legal property of the District, and are not subject to claims of the District's general creditors. Market value of all plan assets held in trust by the District's two deferred compensation plans at June 30, 2005 and 2004 amounted to \$964,485 and \$893,548, respectively.

The District has implemented GASB Statement No. 32, *Accounting and Financial Reporting for Internal Revenue Code Section 457 Deferred Compensation Plans*. Since the District has little administrative involvement and does not perform the investing function for this plan, the assets and related liabilities are not shown on the statement of net assets.

Vallecitos Water District
Notes to the Basic Financial Statements, continued
For the Years Ended June 30, 2005 and 2004

(11) Defined Benefit Pension Plan

Plan Description

The District contributes to the California Public Employees Retirement System (CalPERS), an agent multiple-employer public employee defined benefit pension plan. CalPERS provides retirement and disability benefits, annual cost-of-living adjustments, and death benefits to plan members and beneficiaries. CalPERS acts as a common investment and administrative agent for participating public agencies within the State of California. Benefit provisions and all other requirements are established by state statute and the District. Copies of CalPERS annual financial report may be obtained from their executive Office: 400 P Street, Sacramento, CA, 95814.

Funding Policy

The contribution rate for participants is 8% of their annual covered salary. The District makes these contributions required of District employees on their behalf and for their account. Also, the District is required to contribute the actuarially determined remaining amounts necessary to fund the benefits for its members. The required employer contribution rate for fiscal year 2005 and 2004 was 14.260% and 9.666%, respectively. The contribution requirements of the plan members are established by State statute, and the employer contribution rate is established and may be amended by CalPERS.

Annual Pension Cost

For fiscal year 2005 and 2004, the District's annual pension cost was \$633,679 and \$416,013, respectively, for CalPERS and was equal to the District's required and actual contributions. The required contribution was determined as part of the June 30, 2003, actuarial valuation using the entry age normal actuarial cost method. The actuarial assumptions included (a) 7.75% investment rate of return (net of administrative expense), (b) projected annual salary increases that vary by duration of service, and (c) 3.25% per year cost of living adjustments to 14.45% depending on age. Both (a) and (b) included an inflation component of 3.00% and a payroll growth rate of 3.25%. The actuarial value of CalPERS assets was determined using techniques that smooth the effects of short-term volatility in the market value of investment over a three-year period (smoothed market value). Initial unfunded liabilities are amortized over a closed period that depends on the plan's date of entry into CalPERS. Subsequent plan amendments are amortized as a level percentage of pay over a closed 20-year period.

Gains and losses that occur in the operation of the plan are amortized over a rolling period, which results in an amortization of 10% of unamortized gains and losses each year. If the plan's accrued liability exceeds the actuarial value of plan assets, then the amortization payment on the total unfunded liability may not be lower than the payment calculated over a 30 year amortization period.

Trend information gives an indication of the progress made in accumulating sufficient assets to pay benefits when due. The District presents the most recent available three-year Annual Pension Cost (APC) information for the plan, along with required supplementary information as follows:

Three-Year Trend Information for CalPERS

<u>Fiscal Year</u>	<u>Annual Pension Cost (APC)</u>	<u>Percentage of APC Contributed</u>	<u>Net Pension Obligation</u>
2003	-	100%	-
2004	416,013	100%	-
2005	633,679	100%	-

Vallecitos Water District
Notes to the Basic Financial Statements, continued
For the Years Ended June 30, 2005 and 2004

(12) Post Employment Benefits

The District provides post-employment health benefits in accordance with a resolution approved by the Board of Directors, to all employees who retire from the District under the retirement criteria established by CalPers, up to age 65. Currently, there are nine retired employees who meet these eligibility requirements and are therefore receiving the benefits. The post-retirement health care benefits are financed on a pay as you go basis.

The total expense incurred for these benefits for retired employees for the year ended June 30, 2005 and 2004 was \$77,938 and \$51,742, respectively.

(13) Risk Management

The District is exposed to various risks of loss related to torts, theft of, damage to and destruction of assets; errors and omissions; injuries to employees; and natural disasters. The District is a member of the Association of California Water Agencies/Joint Powers Insurance Authority (ACWA/JPIA), an intergovernmental risk sharing joint powers authority created to provide self-insurance programs for California water agencies. The purpose of the ACWA/JPIA is to arrange and administer programs of self-insured losses and to purchase excess insurance coverage. At June 30, 2005, the District participated in the liability and property programs of the ACWA/JPIA as follows:

- General and auto liability, public officials and employees' errors and omissions: Total risk financing self-insurance limits of \$500,000, combined single limit at \$500,000 per occurrence. The District purchased additional excess coverage layers: \$45 million for general, auto and public officials liability, which increases the limits on the insurance coverage noted above.

In addition to the above, the District also has the following insurance coverage:

- Employee dishonesty coverage up to \$100,000 per loss includes public employee dishonesty, forgery or alteration and theft, disappearance and destruction coverage.
- Property loss is paid at the replacement cost for property on file, if replaced within two years after the loss, otherwise paid on an actual cash value basis, to a combined total of \$50 million per occurrence, subject to a \$10,000 deductible per occurrence.
- Boiler and machinery coverage for the replacement cost up to \$50 million per occurrence, subject to various deductibles depending on the type of equipment.
- Public officials personal liability up to \$15 million each occurrence, with an annual aggregate of \$45 million per each elected/appointed official to which this coverage applies, subject to the terms, with a deductible of \$1,000 per claim.
- Workers' compensation insurance up to California statutory limits for all work related injuries/illnesses covered by California law.

Settled claims have not exceeded any of the coverage amounts in any of the last three fiscal years and there were no reductions in the District's insurance coverage during the years ending June 30, 2005 and 2004. Liabilities are recorded when it is probable that a loss has been incurred and the amount of the loss can be reasonably estimated net of the respective insurance coverage. Liabilities include an amount for claims that have been incurred but not reported (IBNR). There were no IBNR claims payable as of June 30, 2005 and 2004.

Vallecitos Water District
Notes to the Basic Financial Statements, continued
For the Years Ended June 30, 2005 and 2004

(14) Governmental Accounting Standards Board Statements Issued, Not Yet Effective

The Governmental Accounting Standards Board (GASB) has issued several pronouncements prior to June 30, 2005, that have effective dates that may impact future financial presentations.

Governmental Accounting Standards Board Statement No. 43

In April 2004, the GASB issued Statement No. 43, *Financial Reporting for Postemployment Benefit Plans Other Than Pension Plans*. This statement establishes accounting and financial reporting standards for plans that provide postemployment benefits other than pension benefits (known as other postemployment benefits or OPEB). This statement is not effective until June 30, 2007. This statement is not expected to have a significant impact on the presentation of the District's financial statements.

Governmental Accounting Standards Board Statement No. 44

In May 2004, the GASB issued Statement No. 44, *Economic Condition Reporting: The Statistical Section-an amendment of NCGA Statement No.1*. This statement amends the portions of NCGA Statement 1, *Governmental Accounting and Financial Reporting Principles*, that guide the preparation of the statistical section of a Comprehensive Annual Financial Report (CAFR). The statistical section presents detailed information, typically in ten-year trends, that assists users in utilizing the basic financial statements, notes to basic financial statements, and required supplementary information to assess the economic condition of a government. This statement is not effective until June 30, 2006. This statement will not have an effect on the financial statement presentation as the District does not prepare a CAFR.

Governmental Accounting Standards Board Statement No. 45

In June 2004, the GASB issued Statement No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions*. This Statement establishes standards for the measurement, recognition, and display of OPEB expense/expenditures and related liabilities (assets), note disclosures, and, if applicable, required supplementary information (RSI) in the financial reports of state and local government employers. This statement is not effective until June 30, 2009. The District has not determined the effect this statement will have on its financial statement presentation.

Governmental Accounting Standards Board Statement No. 46

In December 2004, GASB issued Statement No. 46, *Net Assets Restricted by Enabling Legislation, an amendment of GASB Statement No. 34*. GASB Statement No. 34 requires that limitations on the use of net assets imposed by enabling legislation be reported as restricted net assets. In the process of applying this provision, some governments have had difficulty interpreting the requirement that those restrictions be "legally enforceable." The confusion over this phrase has resulted in a diversity of practice that has diminished comparability. This statement clarifies that a legally enforceable enabling legislation restriction is one that a party external to a government – such as citizens, public interest groups, or the judiciary – can compel the government to honor. This statement also specifies the accounting and financial reporting requirements if new enabling legislation replaces existing enabling legislation or if legal enforceability is reevaluated. Finally, this statement requires governments to disclose the portion of net assets that are restricted by enabling legislation. This statement is not effective until June 30, 2006. The District has not determined the effect this statement will have on its financial statement.

Governmental Accounting Standards Board Statement No. 47

In June 2005, GASB issued Statement No. 47, *Accounting for Termination Benefits*. This statement establishes accounting standards for *voluntary* and *involuntary* termination benefits. This statement is not effective until June 30, 2006. The District has not determined the effect this statement will have on its financial statement presentation.

Vallecitos Water District
Notes to the Basic Financial Statements, continued
For the Years Ended June 30, 2005 and 2004

(15) Segment Information

Condensed Statement of Net Assets

	2005			2004
	Water	Wastewater	Total	Total
Assets:				
Current assets	\$ 60,857,192	38,229,642	99,086,834	33,147,673
Non-current assets	17,465,897	13,251,740	30,717,637	27,713,560
Capital assets, net	120,275,962	81,610,612	201,886,574	184,413,396
Total assets	198,599,051	133,091,994	331,691,045	245,274,629
Liabilities:				
Current liabilities	30,534,866	3,558,259	34,093,125	9,299,303
Non-current liabilities	43,176,247	23,158,211	66,334,458	23,509,319
Total liabilities	73,711,113	26,716,470	100,427,583	32,808,622
Net assets:				
Investment in capital assets, net of related debt	97,256,684	81,533,829	178,790,513	160,680,786
Restricted for future capital facilities	16,435,532	12,497,435	28,932,967	26,179,236
Restricted for debt service	200,423	-	200,423	634
Unrestricted	10,995,299	12,344,260	23,339,559	25,605,351
Total net assets	\$ 124,887,938	106,375,524	231,263,462	212,466,007

Condensed Statement of Revenues, Expenses, and Changes in Net Assets

	2005			2004
	Water	Wastewater	Total	Total
Revenues:				
Operating revenues	\$ 16,609,924	7,029,951	23,639,875	23,026,165
Non-operating revenues	1,397,740	1,305,050	2,702,790	2,717,329
Total revenues	18,007,664	8,335,001	26,342,665	25,743,494
Expenses:				
Operating expenses	15,480,861	6,887,473	22,368,334	20,881,932
Depreciation and amortization	2,961,202	1,924,464	4,885,666	4,504,507
Non-operating expenses	549,816	24,359	574,175	395,437
Total expenses	18,991,879	8,836,296	27,828,175	25,781,876
Net income before capital contributions	(984,215)	(501,295)	(1,485,510)	(38,382)
Capital contributions	11,168,068	9,114,897	20,282,965	15,652,568
Change in net assets	10,183,853	8,613,602	18,797,455	15,614,186
Net assets, beginning of year	114,704,085	97,761,922	212,466,007	196,851,821
Net assets, end of year	\$ 124,887,938	106,375,524	231,263,462	212,466,007

Condensed Statement of Cash Flows

	2005			2004
	Water	Wastewater	Total	Total
Net Cash Provided (Used) by:				
Operating activities	\$ 2,271,720	2,078,735	4,350,455	3,297,388
Noncapital financing activities	488,822	432,559	921,381	1,511,912
Capital and related financing activities	41,477,591	19,964,946	61,442,537	631,645
Investing activities	(1,071,700)	(4,044,649)	(5,116,349)	(3,075,925)
Net cash provided	43,166,433	18,431,591	61,598,024	2,365,020
Cash and cash equivalents, beginning of year	20,322,657	18,475,512	38,798,169	36,433,149
Cash and cash equivalents, end of year	\$ 63,489,090	36,907,103	100,396,193	38,798,169

Vallecitos Water District
Notes to the Basic Financial Statements, continued
For the Years Ended June 30, 2005 and 2004

(16) Commitments and Contingencies

Construction Contracts

The District has a variety of agreements with private parties relating to the installation, improvement or modification of water facilities and distribution systems within its service area. The financing of such construction contracts is being provided primarily from the District's replacement reserves and advances for construction. The District has committed to approximately \$41,148,476 in open construction contracts as of June 30, 2005. These include the following:

<u>Project Name</u>	<u>Total Approved Contract[s]</u>	<u>Contract Payments To Date</u>	<u>Outstanding Contract Balance</u>
Lift Station No. 1 Truck Offloading Station	144,595	64,392	80,203
Land Outfall Sewer Replacement Project	1,891,860	949,587	942,273
Linda Vista Sewer Replacement Project	701,225	-	701,225
Meadowlark Reclamation Facility Expansion	23,284,700	-	23,284,700
Twin Oaks No. 2 Reservoir	15,757,302	93,113	15,664,189
San Marcos Interceptor	670,000	202,923	467,077
VWD Slip Lining for Outfall under I-5	687,000	678,191	8,809
	<u>43,136,682</u>	<u>1,988,206</u>	<u>41,148,476</u>

Grant Awards

Grant funds received by the District are subject to audit by the grantor agencies. Such audit could lead to requests for reimbursements to the grantor agencies for expenditures disallowed under terms of the grant. Management of the District believes that such disallowances, if any, would not be significant.

Litigation

In the ordinary course of operations, the District is subject to claims and litigation from outside parties. After consultation with legal counsel, the District believes the ultimate outcome of such matters, if any, will not materially affect its financial condition.

(17) Subsequent Event

On July 1, 2005, the District used \$23,400,000 of the \$66,700,000 2005 Revenue Refunding Certificates of Participation to defease the 1998 Twin Oaks Certificates of Participation.

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Required Supplementary Information

**Vallecitos Water District
Schedule of Funding Progress
For the Years Ended June 30, 2005 and 2004**

Required Supplementary Information – *Funded Status of the CalPERS Plan*

Actuarial Valuation Date	Entry Age Normal Accrued Liability [A]	Actuarial Value of Assets [B]	Unfunded Liability (Excess Assets) [A-B]	Funded Status [B/A]	Annual Covered Payroll [C]	UAAL/ (Excess Assets) as a % of Payroll [(A-B)/C]
June 30, 2001	14,781,704	15,274,287	(492,583)	103.3%	3,630,313	(13.6%)
June 30, 2002	15,706,233	14,475,448	1,230,785	92.2%	3,997,572	30.8%
June 30, 2003	18,722,327	15,160,182	3,562,145	81.0%	4,168,402	85.5%

The Schedule of Funding Progress above shows the District's recent history of its PERS Plan actuarial value of assets, actuarial accrued liability, their relationship, and the relationship of the unfunded actuarial accrued liability to payroll.

Supplementary Information

Vallecitos Water District
Combining Schedule of Revenue, Expenses, and Changes in Net Assets
For the Year Ended June 30, 2005 with Comparative Totals for the Year Ended June 30, 2004

	2005			2004 Total
	Water	Wastewater	Total	
Operating revenue	\$ 16,609,924	7,029,951	23,639,875	23,026,165
Operating expenses:				
Water division	15,480,861	-	15,480,861	14,495,413
Wastewater division	-	6,887,473	6,887,473	6,386,519
Depreciation	2,961,202	1,924,464	4,885,666	4,504,507
Total operating expenses	18,442,063	8,811,937	27,254,000	25,386,439
Operating loss	(1,832,139)	(1,781,986)	(3,614,125)	(2,360,274)
Non-operating revenue(expense)				
Property taxes	558,136	520,700	1,078,836	1,619,214
Interest and investment earnings	789,175	483,134	1,272,309	567,244
Annexation fees	50,429	301,216	351,645	530,871
Interest expense – long-term debt	(530,434)	-	(530,434)	(331,049)
Other non-operating revenues/(expenses), net	(19,382)	(24,359)	(43,741)	(64,388)
Total nonoperating revenues and expenses	847,924	1,280,691	2,128,615	2,321,892
Net loss before capital contributions	(984,215)	(501,295)	(1,485,510)	(38,382)
Capital contributions	11,168,068	9,114,897	20,282,965	15,652,568
Change in net assets	10,183,853	8,613,602	18,797,455	15,614,186
Net assets, beginning of year	114,704,085	97,761,922	212,466,007	196,851,821
Net assets, end of year	\$ 124,887,938	106,375,524	231,263,462	212,466,007

Vallecitos Water District
Schedule of Operating Expenses – Water Division
For the Years Ended June 30, 2005 and 2004

	<u>2005</u>	<u>2004</u>
Purchased water	\$ 10,358,874	9,522,203
Transmission and distribution:		
Labor	465,344	485,750
Materials and supplies	86,125	111,651
Outside services	114,687	70,389
Telemetry and power	10,154	10,083
Total transmission and distribution	<u>676,310</u>	<u>677,873</u>
Engineering:		
Labor	427,145	388,242
Materials and supplies	13,098	19,909
Outside services	120,322	58,220
Allocated to wastewater division	(204,527)	(186,548)
Total engineering	<u>356,038</u>	<u>279,823</u>
Customer accounts:		
Labor	293,354	278,162
Materials and supplies	59,599	59,023
Uncollectible accounts	12,030	8,433
Total customer accounts	<u>364,983</u>	<u>345,618</u>
Pumping:		
Labor	71,942	58,287
Materials and supplies	36,380	21,569
Outside services	22,451	9,237
Power	365,080	324,707
Total pumping	<u>495,853</u>	<u>413,800</u>
Building and grounds:		
Labor	125,277	131,459
Materials and supplies	29,342	26,697
Outside repair	131,660	81,953
Power	91,651	79,191
Allocated to wastewater division	(151,172)	(127,720)
Total building and grounds	<u>226,758</u>	<u>191,580</u>
Equipment and vehicles:		
Materials and supplies	121,311	98,902
Labor, fuel and repairs	110,699	89,116
Allocated to wastewater division	(92,722)	(75,156)
Total equipment and vehicles	<u>139,288</u>	<u>112,862</u>

Continued on next page

Vallecitos Water District
Schedule of Operating Expenses – Water Division, continued
For the Years Ended June 30, 2005 and 2004

	<u>2005</u>	<u>2004</u>
Meter reading and repairs:		
Labor	\$ 119,147	107,381
Materials and supplies	16,447	37,699
Outside repair	3,314	12,959
Total meter reading and repairs	<u>138,908</u>	<u>158,039</u>
Tanks and reservoirs:		
Labor	101,704	54,618
Outside repairs	22,242	49,722
Materials and supplies	26,227	36,412
Telemetry and power	2,713	2,594
Total tanks and reservoirs	<u>152,886</u>	<u>143,346</u>
Water quality and treatment:		
Labor	64,445	71,125
Outside repair	26,399	27,670
Materials and supplies	16,965	20,063
Power	13,290	17,207
Total water quality and treatment	<u>121,099</u>	<u>136,065</u>
Other water operating expenses:		
Labor	109,604	96,014
Material and supplies	22,698	20,687
Outside repairs	23,962	25,207
Allocated to wastewater division	(23,061)	(22,198)
Total other water operating expenses	<u>133,203</u>	<u>119,710</u>

Continued on next page

Vallecitos Water District
Schedule of Operating Expenses – Water Division, continued
For the Years Ended June 30, 2005 and 2004

	<u>2005</u>	<u>2004</u>
General and administrative:		
Salaries	\$ 1,651,600	1,549,836
Group insurance	979,128	806,918
Public employees' retirement	901,824	654,625
Social security	687,623	641,034
Worker's compensation insurance	140,273	106,193
Legal	134,130	86,239
Other	127,407	63,597
District insurance	124,498	113,882
Director's expense	82,722	70,504
Office supplies	81,443	102,119
Outside services	64,657	58,667
Director's fees	61,200	64,228
Meetings and seminars	56,791	42,601
Dues and subscriptions	52,288	51,869
Other taxes/benefits	32,221	21,031
Telephone	30,866	29,489
Auditing	22,897	17,525
Travel	19,504	15,269
Office equipment repair	12,738	17,912
Computer consulting	7,053	9,862
Postage	6,299	7,235
Public awareness	4,559	54,765
Election and annexations	3,287	17,300
Allocated to wastewater division	(2,137,920)	(1,842,900)
Overhead allocation	(830,427)	(365,307)
	<u>2,316,661</u>	<u>2,394,493</u>
Total general and administrative		
Total water division operating expenses	\$ <u>15,480,861</u>	<u>14,495,412</u>

Vallecitos Water District
Schedule of Operating Expenses – Wastewater Division
For the Years Ended June 30, 2005 and 2004

	<u>2005</u>	<u>2004</u>
Encina disposal	\$ 2,044,835	1,934,460
Meadowlark wastewater treatment plant:		
Labor	270,791	279,006
Materials and supplies	662,717	791,682
Outside repair	100,172	74,674
Power	207,148	194,651
Other	2,197	4,176
Total Meadowlark wastewater treatment plant	<u>1,243,025</u>	<u>1,344,189</u>
Engineering:		
Allocated from water division	<u>204,527</u>	<u>186,548</u>
Customer accounts:		
Labor	76,318	71,567
Materials and supplies	20,563	19,662
Uncollectible accounts	12,835	4,234
Total customer accounts	<u>109,716</u>	<u>95,463</u>
Collection and conveyance:		
Labor	296,788	249,602
Materials and supplies	173,659	16,441
Outside repair	21,874	81,525
Power	575	2,794
Total collection and conveyance	<u>492,896</u>	<u>350,362</u>
Buildings and grounds:		
Allocated from water division	<u>151,172</u>	<u>127,720</u>
Equipment and vehicles:		
Allocated from water division	92,722	75,156
Labor, fuel and repairs	29,710	25,313
Total equipment and vehicles	<u>122,432</u>	<u>100,469</u>
Other wastewater operating expenses:		
Labor	86,773	88,266
Materials and supplies	35,208	32,537
Outside repairs	7,858	4,830
Power	38,027	34,085
Telemetry	1,800	2,660
Allocated from water division	23,061	22,198
Total other wastewater operating expenses	<u>192,727</u>	<u>184,576</u>

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Vallecitos Water District
Schedule of Operating Expenses – Wastewater Division, continued
For the Years Ended June 30, 2005 and 2004

	<u>2005</u>	<u>2004</u>
General and administrative:		
Allocated from water division	\$ 2,137,920	1,842,900
Salaries	121,375	102,461
Group insurance	126,946	110,077
Public employees' retirement	108,130	92,188
Social security	104,760	104,219
Worker's compensation insurance	29,810	24,031
Other	13,736	12,128
Outside services	163	-
Meetings and seminars	7,336	3,946
Dues and subscriptions	2,312	2,121
Other taxes/benefits	2,127	2,079
Travel	252	-
Overhead allocation	(328,724)	(233,417)
Total general and administrative	<u>2,326,143</u>	<u>2,062,733</u>
Total wastewater division operating expenses	\$ <u><u>6,887,473</u></u>	<u><u>6,386,520</u></u>

Report on Compliance and Internal Controls



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Independent Auditor's Report on Compliance and on Internal Control Over Financial Reporting Based on an Audit of Financial Statements Performed in Accordance with *Government Auditing Standards*

Board of Directors
Vallecitos Water District
San Marcos, California

We have audited the financial statements of the Vallecitos Water District (District) as of and for the year ended June 30, 2005, and have issued our report thereon dated September 28, 2005. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

Compliance

As part of obtaining reasonable assurance about whether the District's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts and grants, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit and, accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance that are required to be reported under *Government Auditing Standards*.

Internal Control Over Financial Reporting

In planning and performing our audit, we considered the District's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide assurance on the internal control over financial reporting. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control over financial reporting that might be material weaknesses. A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We noted no matters involving the internal control over financial reporting and its operation that we consider to be material weaknesses.

This report is intended solely for the information and use of the Board of Directors and management and is not intended to be and should not be used by anyone other than these specified parties. This restriction is not intended to limit the distribution of this letter, which is a matter of public record.

September 28, 2005
Cypress, California