



Vallecitos Water District
Annual Financial Report
Fiscal Years Ended June 30, 2006 and 2005

Vallecitos Water District
Annual Financial Report
Fiscal Years Ended June 30, 2006 and 2005

Board of Directors as of June 30, 2006:

Darrell Gentry – President
Tim Shell – Vice-President
Margaret E. Ferguson – Director
Patricia Hannan – Director
Vacant – Director

William W. Rucker – General Manager

Vallecitos Water District
Annual Financial Report
For the Years Ended June 30, 2006 and 2005

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Financial Section



Charles Z. Fedak & Company

Certified Public Accountants

An Accountancy Corporation

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Charles Z. Fedak, CPA, MBA
Paul J. Kaymark, CPA

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 years ended June 30, 2006 and 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.

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, 2006 and 2005, and the respective changes in net assets and cash flows for the years 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 30, 2006 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.

Management's discussion and analysis and the Schedule of Funding Progress 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 section 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 30, 2006
Cypress, California

Charles Z. Fedak, CPA
An Accountancy Corporation

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Vallecitos Water District
Management's Discussion and Analysis
For the Years Ended June 30, 2006 and 2005

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, 2006. 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, 2006, increased regulations and the State's budget crisis continued to impact the District's operations and fiscal planning. Although growth in the District's customer base has slowed, the District continues construction on significant projects that will help meet the ultimate demand within District boundaries. The following highlights for the year impacted, or have the potential to impact, the finances of the District.

- The District added 492 active meters during the fiscal year ended June 30, 2006 – a 2.6% percent increase, compared to 1,117 meters (a six percent increase) in the prior year. Growth is expected to continue to slow into next year. The City of San Marcos issued building permits for 1,709 residential units in 2003, 2,321 in 2004, 1,344 in 2005, and 353 through July of 2006.
- During the fiscal year ended June 30, 2006, new development contributed \$11,748,807 in capital assets and cash to be used to fund planned capital facilities, compared to \$20,282,965 in the prior year.
- The District's employer contribution rate for the California Public Employees' Retirement System (PERS) increased from 14.26% in 2004/05 to 19.182% in 2005/06 due to the lack of investment earnings in PERS funds caused by a decline in market rates of interest from June 30, 2002, to June 30, 2003, the actuarial valuation dates for 2004/05 and 2005/06, respectively. Growth in District employment and the increased PERS rate accounted for a \$496,264 increase in PERS contributions. The employer contribution rate for 2006/07 is 19.688%.
- 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 a tax increment of \$742,899 for the 2004/05 fiscal year, \$702,351 for the 2005/06 fiscal year, and is projected to be \$882,000 for the 2006/07 fiscal year.
- On June 30, 2005, 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 (MRF), and to refund existing COPs of \$23 million. The existing COPs were retired on July 1, 2005. As of June 30, 2006, the Reservoir is 15% complete, and MRF is 40% complete.
- Debt service of \$2,011,952 included auction agent and broker fees and auction rate interest. The interest rate averaged 2.9% during 2005/06. The District made a principal payment of \$1,425,000 on July 1, 2006.
- Interest earnings for 2005/06 totaled \$3,485,275 compared to \$1,272,309 in 2004/05 due to increasing yields and the investment of bond proceeds. Bond proceeds will be spent within two years of issuance avoiding arbitrage rebate requirements.
- In July of 2006 the California Supreme Court decided in *Bighorn-Desert View Water verses Verjil (Kelley)* that voters have the right to use the initiative power to reduce a water rate, and agencies must comply with notice and majority protest provisions of Proposition 218. The impact of this ruling is higher administrative costs, longer planning horizons for proposed rate increases, and some uncertainty of the ability of public agencies to recover all costs associated with water delivery and sewer service through user fees.

Vallecitos Water District
Management's Discussion and Analysis
For the Years Ended June 30, 2006 and 2005

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, 2006, and 2005. Assets in excess of liabilities (Net Assets) were \$241,201,935 and \$231,263,462 as of June 30, 2006, and 2005, 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, 2006, and 2005. 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, 2006, of \$4,792,479 is combined with net non-operating revenues of \$2,982,145 and capital contributions of \$11,748,807 to arrive at the change in net assets of \$9,938,473. The increase in net assets is added to beginning net assets of \$231,263,462 to arrive at ending net assets of \$241,201,935 as of June 30, 2006.

Operating income / (loss)	\$ (4,792,479)
Nonoperating revenues / (expenses)	2,982,145
Capital contributions	<u>11,748,807</u>
Change in net assets	9,938,473
Beginning net assets	<u>231,263,462</u>
Ending net assets	<u>\$ 241,201,935</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, 2006, represents the decrease in cash and cash equivalents of \$61,580,741, which is combined with beginning cash and cash equivalents of \$100,396,193, to arrive at ending cash and cash construction of debt-financed projects, and converted debt proceeds in money markets to non-cash-equivalent investments. The \$61.6 million decrease in cash and cash equivalents is made up of the refunding, construction, and conversion of cash to investments. Investments in the California Local Agency Investment Fund, San Diego County Investment Pool, open-ended money market mutual funds, and commercial paper and agency obligations with original maturities of 90 days or less are the only cash equivalents held by the District at June 30, 2006. As of June 30, 2006, the ending cash and cash equivalents are represented on the Statements of Net Assets as follows:

Decrease in cash & cash equivalents	\$ (61,580,741)
Beginning cash & cash equivalents	<u>100,396,193</u>
Ending cash & cash equivalents	<u>\$ 38,815,452</u>

Unrestricted cash & cash equivalents	\$ 15,209,250
Cash & cash equivalents restricted - current	3,746,063
Cash & cash equivalents restricted - noncurrent	<u>19,860,139</u>
Total cash & cash equivalents	<u>\$ 38,815,452</u>

Vallecitos Water District
Management's Discussion and Analysis
For the Years Ended June 30, 2006 and 2005

Analysis of Financial Position and Results of Operations

During the fiscal year ended June 30, 2006, cash and investments decreased by \$41.2 million to refund existing Certificates of Participation (COPs) and fund capital projects. The District expended, out of bond proceeds, \$23.0 million to refund existing COPs for the first Twin Oaks Reservoir, \$9.9 million for the Meadowlark Plant expansion, and \$2.6 million for the second Twin Oaks Reservoir. The District cash funded \$16.4 million for the construction and acquisition of other capital including the Encina Wastewater Authority (EWA) building program and expansion (EWA is a JPA of which the District is a member), Rancho Santa Fe Road improvements, the San Marcos sewer interceptor, a computerized asset management system, outfall sewer pipeline replacement, and the conversion from manual to radio-read meters. These cash funded projects provide for needed capacity, replacement, and operating efficiencies that will result in long-term cost savings to the District.

The District received capital facility fees of \$7.3 million during the fiscal year ended June 30, 2006. Operating activities provided \$4.4 million. The District received \$3.4 million in investment earnings and \$1.4 million in property taxes and assessments. The operating loss of \$4,792,479 includes the non-cash depreciation expense of \$5,248,942. Depreciation is the systematic allocation of a capital asset's cost to expense over a specified period of time.

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 \$23.0 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 2.2 and 4.1% (averaging 2.9%) during the 2005/06 fiscal year, while the District's rate of return on an average invested balance of \$92.2 million averaged 3.8% with a weighted average maturity of 120 days. Debt proceeds are expected to be expended by June 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 decreased by \$41.2 million, or 33.6% over the prior fiscal year. This spend-down along with funds provided by capital facility fees, operations, and property tax provided for the \$30.5 million, or 15.1%, increase in capital assets, and the \$19.5 million, or 19.4% reduction in liabilities (see discussion above under "Analysis of Financial Position and Results of Operations"). Net assets increased by \$9.9 million, or 4.3%, 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				
	2006	2005	Change	
			Amount	%
Cash and investments	\$ 81,547,184	\$ 122,720,954	\$ (41,173,770)	-33.6%
Capital assets	232,425,474	201,886,574	30,538,900	15.1%
Other assets	8,159,886	7,083,517	1,076,369	15.2%
Total Assets	<u>322,132,544</u>	<u>331,691,045</u>	<u>(9,558,501)</u>	-2.9%
Current liabilities	15,929,214	34,093,125	(18,163,911)	-53.3%
Noncurrent liabilities	65,001,395	66,334,458	(1,333,063)	-2.0%
Total Liabilities	<u>80,930,609</u>	<u>100,427,583</u>	<u>(19,496,974)</u>	-19.4%
Net Assets				
Invested in capital assets, net of related debt	196,018,439	178,790,513	17,227,926	9.6%
Restricted	29,527,541	29,133,390	394,151	1.4%
Unrestricted	<u>15,655,955</u>	<u>23,339,559</u>	<u>(7,683,604)</u>	-32.9%
Total Net Assets	<u>\$ 241,201,935</u>	<u>\$ 231,263,462</u>	<u>\$ 9,938,473</u>	4.3%

Vallecitos Water District Selected Financial Ratios		
	2006	2005
Current ratio	3.65	2.91
Quick ratio	3.58	2.88
Capital assets-to-Long-term liabilities	3.58 / 1	3.04 / 1
Debt-to-equity	1 / 2.98	1 / 2.30

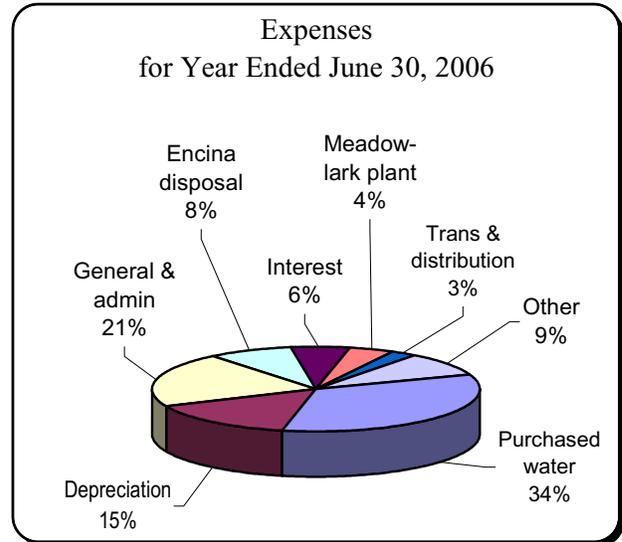
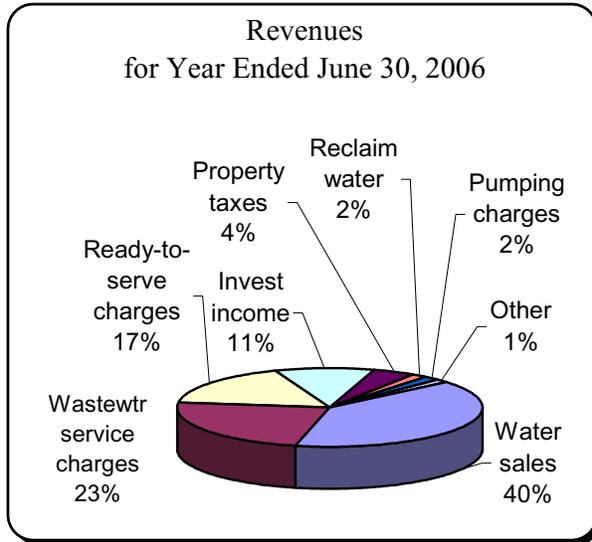
The table at the left illustrates how effectively the District can meet its current obligations, and the margin of safety to creditors. The current ratio (current assets divided by current liabilities) indicates that the District can pay 3.65 times its current debt from current assets. However, some 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 3.58 times its current obligations with assets readily convertible to cash. The District's current ratio of 3.65 indicates a high degree of solvency and a strong current position. The Capital assets-to-Long-term liabilities ratio has increased from the prior year due to increased funding of capital projects such as the Twin Oaks Reservoir and Meadowlark Treatment Plan Expansion. Debt-to-equity ratio increased from more expenditures on projects not financed from debt proceeds.

Vallecitos Water District
Management's Discussion and Analysis
For the Years Ended June 30, 2006 and 2005

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	
	2006	2005	Amount	%
Water sales	\$ 12,987,538	\$ 11,254,578	\$ 1,732,960	15.4%
Wastewater service charges	7,633,921	6,423,244	1,210,677	18.8%
Ready-to-serve charges	5,581,223	4,792,034	789,189	16.5%
Investment income	3,485,275	1,272,309	2,212,966	173.9%
Property taxes	1,416,052	1,078,836	337,216	31.3%
Other revenues	1,579,221	1,521,664	57,557	3.8%
Total Revenues	32,683,230	26,342,665	6,340,565	24.1%
Purchased water	11,650,340	10,358,874	1,291,466	12.5%
Depreciation expense	5,248,942	4,885,666	363,276	7.4%
General and administrative	7,144,693	5,801,955	1,342,738	23.1%
Encina disposal	2,921,237	2,044,835	876,402	42.9%
Interest expense	2,000,800	530,434	1,470,366	277.2%
Meadowlark plant	1,504,519	1,243,025	261,494	21.0%
Transmission and distribution	899,623	676,310	223,313	33.0%
Other expenses	3,123,410	2,287,076	836,334	36.6%
Total Expenses	34,493,564	27,828,175	6,665,389	24.0%
Income / (Loss) before contributions	(1,810,334)	(1,485,510)	(324,824)	21.9%
Capital contributions	11,748,807	20,282,965	(8,534,158)	-42.1%
Change in Net Assets	9,938,473	18,797,455	(8,858,982)	-47.1%
Beginning Net Assets	231,263,462	212,466,007	18,797,455	8.8%
Ending Net Assets	\$ 241,201,935	\$ 231,263,462	9,938,473	4.3%

Vallecitos Water District
Management's Discussion and Analysis
For the Years Ended June 30, 2006 and 2005

Current-to-Prior Year Analysis (Continued)

Analysis of Revenues and Expenses (continued)

The composition of revenues and expenses for the 2005/06 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.

- Increases in water sales, wastewater service charges, ready-to-serve charges, and purchased water were anticipated due to increased customers and rate increases (10.9% in ready-to-serve effective August 1, 2005, eight-cent per-unit wholesale commodity increase passed through January 1, 2006, and an 8.8% sewer service charge increase effective January 1, 2006).
- Investment income increased because of higher yields, increased invested balance, and an increase in fair market value. The 2005/06 yield averaged 3.8% on an average investment balance of \$92.2 million, as opposed to 2.2% in the previous year on an average investment balance of \$53.4 million.
- Increases in property values and property exchanges attributed to the increase in property taxes.
- While the percentage change in other revenues was small, a \$280,379, or 80% decline in annexation fees was offset by a \$200,179, or 66% increase in pumping charges (from higher than anticipated demand within the District's pump zones) and increases in delinquent, lock, unlock, and other charges anticipated from growth and rate increase. The decline in annexation fees was anticipated as there become fewer parcels contiguous to District boundaries likely to annex.
- The increase in general and administrative expenses was due to an anticipated increase in administrative salaries and district-wide benefits of \$1,164,710 due to an increase in the number of employees, scheduled step and COLA increases, and increased benefit costs. The remainder of the increase from the prior year was due to increased property and liability insurance premiums, an increase in outside services, and other inflationary increases.
- The District is a member of the Encina Wastewater Authority (EWA) and pays operating and administrative costs for its share of effluent sent to and processed by EWA. Encina disposal costs also include depreciation of to the District's investment in EWA determined by the change in the allocated share of net assets after backing out capital contributions (\$807,419 in 05/06). Operating costs also include extra time and resources within in the source control program for industries located in the District's boundaries.
- The interest expense increase reflects the June 30, 2005 issuance of \$66.7 million in Certificates of Participation compared to an outstanding balance of \$23.4 million throughout the prior year. The average rate of interest throughout 05/06 was 2.9% compared to 2.2% in the prior year.
- The Meadowlark plant cost increase was mostly anticipated in the budget and mainly due to increased chemical and labor costs
- The Transmission and distribution cost increase was anticipated in the budget and due to nonrecurring projects scheduled for 2005/06.
- The increase in other costs is mainly attributable to a \$546,108 decrease in overhead recorded against capital projects. Overhead is subtracted from operating income and added to the capital costs of projects. Less labor hours were recorded against projects in the 2005/06 fiscal year.
- The 2005/06 decrease in capital contributions (capital facility fees and developer contributed assets and deposits) was caused by a slow-down in growth in the San Marcos area as discussed in the Financial Highlights.

Vallecitos Water District
Management's Discussion and Analysis
For the Years Ended June 30, 2006 and 2005

Restrictions, Commitments, and Limitations

2005 Certificates of Participation

On June 30, 2005, the District issued \$66,700,000 in Certificates of Participation (COPs) to refinance 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 amounts held with the fiscal agent are the weekly interest payment (which averaged \$40,000 during 2005/06), any principle payments deposited for disbursement to bondholders, and any accrued interest. As of June 30, 2006, the fiscal agent held \$1,477,522 to pay the July 1, 2006 principle payment of \$1,425,000, to pay the weekly interest payment of \$52,520, and accrued interest of \$2. 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 was paid July 1, 2006. The next principle payment of \$1,450,000 is due July 1, 2007. 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. The District's 2005/06 net revenue was 5.29 times debt service.

Capital Facility Fees

The District collects capital facility fees from new development and increased demands from existing customers, 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 and fund future construction of facilities identified in the District's Master Plan. As of June 30, 2006, the balances of cash and investments held in the capacity funds were \$16,588,022 for water and \$12,806,464 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 2006 fiscal year end:

Project Description	2006 Budget	Spent	Remaining
Meadowlark treatment plant expansion	\$ 25,985,000	\$ 11,718,156	\$ 14,266,844
Twin Oaks Reservoir #2	21,000,000	2,530,174	18,469,826
San Marcos interceptor sewer line	8,900,000	3,232,001	5,667,999
Encina Wastewater Authority expansion and capitals	5,577,800	2,574,750	3,003,050
Rancho Santa Fe Rd relocations & improvements	3,830,000	1,999,863	1,830,137
Meadowlark Tank #s 3 & 4	3,016,762	196,519	2,820,243
North Twin Oaks Reservoirs 2 and 3	2,300,000	262,206	2,037,794
Automated meter reading conversion	2,178,000	1,198,652	979,348
Wulff Reservoir #2 and 8" pipeline	2,150,000	43,799	2,106,201
Solar car port covers	1,744,200	829,156	915,044
Wulff Pump Station upgrade	1,445,000	775,855	669,145

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, 2006 and 2005

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 during the year ended June 30, 2006, which were largely the result of such development:

Water service lines	\$ 2,166,140
Sewer laterals	1,999,009
Sewer mains	1,761,978
Water meters	1,525,712
Water transmission and distribution mains	1,212,134
Pump stations	846,200

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 2006/07 budget amounts and rates:

- Continued growth - the District anticipates adding 828 meters and six additional employment positions in the 2007 fiscal year,
- The need for improved and expanded facilities,
- Increased costs of employee benefit programs,
- Increases to wholesale water rates,
- The rising costs of medical insurance, and
- Restoration of property tax revenue after losses due to Proposition 1A.

As a result of these factors, the 2006/07 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,
- An eight percent increase in salaries expense due to additional hires, cost of living adjustments, and step increases,
- A ten percent increase in the cost of employee benefits from the increased salary base and increased costs of insurance and retirement benefits, and
- \$78.2 million in budgeted capital expenditures, including \$61,358,100 in expansion costs.

Contacting the District's Financial Management

This financial report is designed to give rate payers, 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, 2006 and 2005

<i>Assets</i>	2006	2005
Current assets:		
Cash and cash equivalents (note 2)	\$ 15,209,250	\$ 17,402,962
Restricted cash and cash equivalents (note 2)	3,746,063	66,382,364
Investments (note 2)	33,362,817	10,177,773
Accounts receivable:		
Water and wastewater sales and services, net (note 3)	3,349,221	2,985,288
Taxes and assessments	831,638	770,686
From other governmental entities	29,801	432,807
Other	452,521	33,652
Accrued interest receivable	440,708	153,672
Current portion of note receivable (note 6)	78,324	74,240
Inventories	507,094	527,158
Prepaid expenses	182,135	146,232
Total current assets	<u>58,189,572</u>	<u>99,086,834</u>
Non-current assets:		
Restricted cash and cash equivalents (note 2)	19,860,139	16,610,867
Restricted investments (note 2)	9,368,915	12,146,988
Restricted accrued interest receivable	307,761	183,067
Note receivable from City of San Marcos, net of current portion (note 6)	1,205,052	1,283,376
Debt issuance costs, net (note 7)	538,214	493,339
Deferred charges from debt retirement, net (note 8)	237,417	-
Investment in Encina Wastewater Authority capital assets (note 5)	16,049,383	13,604,729
Capital assets not being depreciated (note 4)	49,020,447	27,807,797
Net capital assets being depreciated (note 4)	167,355,644	160,474,048
Total non-current assets	<u>263,942,972</u>	<u>232,604,211</u>
Total assets	<u>322,132,544</u>	<u>331,691,045</u>
<i>Liabilities</i>		
Current liabilities:		
Accounts payable	10,317,281	6,250,718
Accounts payable from restricted assets	9,276	7,955
Accrued compensation	1,124,809	901,567
Construction & service deposits	3,000,328	3,487,936
Accrued interest payable from restricted assets	52,520	44,949
Current portion of long term debt (note 9)	1,425,000	23,400,000
Total current liabilities	<u>15,929,214</u>	<u>34,093,125</u>
Non-current liabilities:		
Deposit from San Marcos Unified School District	189,400	189,400
Certificates of participation, net of amortized discount & current portion (note 9)	64,811,995	66,145,058
Total non-current liabilities	<u>65,001,395</u>	<u>66,334,458</u>
Total liabilities	<u>80,930,609</u>	<u>100,427,583</u>
<i>Net Assets</i>		
Invested in capital assets, net of related debt (note 10)	196,018,439	178,790,513
Restricted for future capital facilities	29,527,539	28,932,967
Restricted for debt service	2	200,423
Unrestricted	15,655,955	23,339,559
Total net assets	<u>\$ 241,201,935</u>	<u>\$ 231,263,462</u>

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, 2006 and 2005

	<u>2006</u>	<u>2005</u>
Operating revenues		
Water sales	\$ 12,987,538	\$ 11,254,578
Wastewater service charges	7,633,921	6,423,244
Ready-to-serve charges	5,581,223	4,792,034
Reclaimed water sales	615,158	588,084
Pumping charges	505,073	304,894
Other services and abatements	<u>377,372</u>	<u>277,041</u>
Total operating revenues	<u>27,700,285</u>	<u>23,639,875</u>
Operating expenses:		
Purchased water	11,650,340	10,358,874
General and administrative	7,144,693	5,801,955
Encina disposal	2,921,237	2,044,835
Meadowlark wastewater treatment plant	1,504,519	1,243,025
Transmission and distribution	899,623	676,310
Engineering	631,686	560,565
Customer accounts	510,861	474,699
Pumping	460,047	495,853
Collection and conveyance	669,281	492,896
Buildings and grounds	332,546	377,930
Equipment and vehicles	282,503	261,720
Meter reading and repairs	139,806	138,908
Tanks and reservoirs	196,737	152,886
Water quality and treatment	143,327	121,099
Other wastewater operating expenses	192,248	192,727
Other water operating expenses	<u>177,411</u>	<u>133,203</u>
Total operating expenses	<u>27,856,865</u>	<u>23,527,485</u>
Operating income before overhead absorption	(156,580)	112,390
Overhead absorption	<u>613,043</u>	<u>1,159,151</u>
Operating income before depreciation and amortization	456,463	1,271,541
Depreciation and amortization	<u>(5,248,942)</u>	<u>(4,885,666)</u>
Operating loss	<u>(4,792,479)</u>	<u>(3,614,125)</u>
Non-operating revenues (exepnses):		
Property taxes	1,416,052	1,078,836
Investment income	3,485,275	1,272,309
Annexation fees	71,266	351,645
Interest expense	(2,000,800)	(530,434)
Other, net	<u>10,352</u>	<u>(43,741)</u>
Total non-operating revenues and expenses	<u>2,982,145</u>	<u>2,128,615</u>
Loss before capital contributions	(1,810,334)	(1,485,510)
Capital contributions	<u>11,748,807</u>	<u>20,282,965</u>
Change in net assets	9,938,473	18,797,455
Net assets, beginning of year	<u>231,263,462</u>	<u>212,466,007</u>
Net assets, end of year	<u>\$ 241,201,935</u>	<u>\$ 231,263,462</u>

See accompanying notes to the financial statements

Vallecitos Water District
Statements of Cash Flows
For the Years Ended June 30, 2006 and 2005

	<u>2006</u>	<u>2005</u>
Cash flows from operating activities:		
Receipts from water and wastewater customers	\$ 26,832,881	\$ 24,305,799
Payments for water	(11,763,238)	(9,036,620)
Payments for services and supplies	(578,113)	(2,412,134)
Payments for employee wages, benefits and related costs	<u>(10,137,117)</u>	<u>(8,506,590)</u>
Net cash provided by operating activities	<u>4,354,413</u>	<u>4,350,455</u>
Cash flows from non-capital financing activities:		
Receipts from taxes and assessments	<u>1,362,776</u>	<u>921,381</u>
Net cash provided by non-capital financing activities	<u>1,362,776</u>	<u>921,381</u>
Cash flows from capital and related financing activities		
Receipts from annexation fees	71,266	351,645
Acquisition and construction of utility plant	(28,856,369)	(8,478,655)
Proceeds from certificates of participation	-	66,225,139
Proceeds from disposal of capital assets	2,346	11,504
Principal paid on long term debt	(23,400,000)	(400,000)
Payments for costs of debt issuance	(44,875)	(316,630)
Deferred charges from debt retirement	(237,417)	-
Interest payments on long-term debt	(1,993,229)	(505,897)
Investment in Encina Wastewater Authority	(2,936,042)	(4,245,571)
Capacity fees received	<u>7,253,851</u>	<u>8,801,002</u>
Net cash provided by capital and related financing activities	<u>(50,140,469)</u>	<u>61,442,537</u>
Cash flows from investing activities		
Purchase of investments	(216,097,113)	(16,336,614)
Proceeds from sale, call and maturity of investments	195,789,593	10,006,110
Interest received	3,075,819	1,143,786
Collections on note receivable from City of San Marcos	<u>74,240</u>	<u>70,369</u>
Net cash used by investing activities	<u>(17,157,461)</u>	<u>(5,116,349)</u>
Net increase in cash and cash equivalents	(61,580,741)	61,598,024
Cash and cash equivalents, beginning of year	<u>100,396,193</u>	<u>38,798,169</u>
Cash and cash equivalents, end of year	<u>\$ 38,815,452</u>	<u>\$ 100,396,193</u>
Reconciliation of cash and cash equivalents to statement of net assets:		
Cash and cash equivalents	\$ 15,209,250	\$ 17,402,962
Restricted cash and cash equivalents - current	3,746,063	66,382,364
Restricted cash and cash equivalents - non-current	<u>19,860,139</u>	<u>16,610,867</u>
Total cash and cash equivalents	<u>\$ 38,815,452</u>	<u>\$ 100,396,193</u>
Reconciliation of operating loss to net cash provided by operating activities:		
Net cash provided by operating activities:		
Operating income (loss)	\$ (4,792,479)	\$ (3,614,125)
Adjustments to reconcile operating income to net cash provided by operating activities:		
Depreciation expense	5,248,942	4,885,666
Changes in operating assets and liabilities:		
Accounts receivable from water and wastewater sales and services	(363,933)	(182,187)
Accounts receivable from other governmental entities	403,006	(233,464)
Accounts receivable - other	(418,869)	(13,372)
Inventories	20,064	(83,249)
Prepaid expenses	(35,903)	(8,596)
Investment in Encina Wastewater Authority	807,419	231,508
Accounts payable	3,750,532	2,148,766
Accrued compensation	223,242	124,561
Construction and service deposits	<u>(487,608)</u>	<u>1,094,947</u>
Net cash provided by operating activities	<u>\$ 4,354,413</u>	<u>\$ 4,350,455</u>
Noncash investing, capital and financing activities:		
Contributions of assets by developers	<u>\$ 4,019,555</u>	<u>\$ 11,010,197</u>
Amortization related to long-term debt	<u>\$ 9,708</u>	<u>\$ 9,877</u>
Unrealized appreciation (depreciation) of investments	<u>\$ 60,351</u>	<u>\$ 33,897</u>

See accompanying notes to the financial statements

Vallecitos Water District
Notes to the Basic Financial Statements
For the Years Ended June 30, 2006 and 2005

(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, 2006 and 2005

(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. 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. The District has noted no new restrictions in enabling legislation applicable in fiscal year 2006.

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. There were no voluntary or involuntary termination benefits accounted for in fiscal year 2006.

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, 2006 and 2005

(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 \$831,638 and \$770,686 have been reduced by an allowance for estimated uncollectible taxes of \$11,329 and \$9,340 at June 30, 2006 and 2005, 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 using the FIFO method.

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, 2006 and 2005

(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 construction funds set aside from Certificates of Participation proceeds are restricted for 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. The District's investment in EWA is capitalized as a percentage of ownership of current year capital expenditures incurred 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.

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

Vallecitos Water District
Notes to the Basic Financial Statements, continued
For the Years Ended June 30, 2006 and 2005

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.

Vallecitos Water District
Notes to the Basic Financial Statements, continued
For the Years Ended June 30, 2006 and 2005

(2) Cash and Investments

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

	<u>2006</u>	<u>2005</u>
Cash and cash equivalents	\$ 15,209,250	17,402,962
Restricted cash and cash equivalents – current portion	3,746,063	66,382,364
Investments – current portion	33,362,817	10,177,773
Restricted cash and cash equivalents – noncurrent portion	19,860,139	16,610,867
Restricted investments	9,368,915	12,146,988
Total Cash and Investments	<u>\$ 81,547,184</u>	<u>122,720,954</u>

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

	<u>2006</u>	<u>2005</u>
Cash on hand	\$ 1,700	1,700
Deposits with financial institutions	190,228	205,905
Investments	81,355,256	122,513,349
Total cash and investments	<u>\$ 81,547,184</u>	<u>122,720,954</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, 2006 and 2005

(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 \$642,188 and \$370,551 as of June 30, 2006 and 2005, 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, 2006 and 2005

(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, 2006, 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	\$ 4,974,834	4,974,834	-	-
Federal Home Loan Bank	17,876,015	15,908,515	1,967,500	-
Federal Farm Credit Bank	1,472,345	494,845	977,500	-
Federal Home Loan Mortgage Corporation	3,951,340	3,951,340	-	-
Federal National Mortgage Association	7,899,810	6,928,250	-	971,560
Certificates of Deposit	1,095,097	998,051	97,046	-
Commercial paper	7,980,160	7,980,160	-	-
Local Agency Investment Fund (LAIF)	33,233,355	33,233,355	-	-
San Diego County Investment Pool	1,394,775	1,394,775	-	-
Held by bond trustee:				
Money market funds	1,477,525	1,477,525	-	-
Total	\$ <u>81,355,256</u>	<u>77,341,650</u>	<u>3,042,046</u>	<u>971,560</u>

Vallecitos Water District
Notes to the Basic Financial Statements, continued
For the Years Ended June 30, 2006 and 2005

(2) Cash and Investments, continued

Maturities of investments at June 30, 2005, 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	\$ 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	\$ 122,513,349	116,367,449	3,059,323	3,086,577

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, 2006, 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>AA+</u>	<u>Not Rated</u>
U.S. Treasury bills	\$ 4,974,834	N/A	\$ 4,974,834	-	-	-
Federal Home Loan Bank	17,876,015	AA+	-	17,876,015	-	-
Federal Farm Credit Bank	1,472,345	AA+	-	1,472,345	-	-
Federal Home Loan Mortgage Corporation	3,951,340	AA+	-	3,951,340	-	-
Federal National Mortgage Association	7,899,810	AA+	-	7,899,810	-	-
Certificates of Deposit	1,095,097	N/A	-	1,095,097	-	-
Commercial paper	7,980,160	AA+	-	-	7,980,160	-
Local Agency Investment Fund (LAIF)	33,233,355	N/A	-	-	-	33,233,355
San Diego County Investment Pool	1,394,775	N/A	-	1,394,775	-	-
Held by bond trustee:						
Money market funds	1,477,525	N/A	1,477,525	-	-	-
Total	\$ 81,355,256		\$ 6,452,359	33,689,382	7,980,160	33,233,355

Vallecitos Water District
Notes to the Basic Financial Statements, continued
For the Years Ended June 30, 2006 and 2005

(2) Cash and Investments, continued

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

Investment Types	Total	Minimum Legal Rating	Exempt From Disclosure	Rating as of Year End	
				AAA	Not Rated
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	\$ 122,513,349		\$ 68,370,393	28,493,068	25,649,888

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	2006		2005	
	Reported Amount	Portfolio Percentage	Reported Amount	Portfolio Percentage
Federal Home Loan Bank	\$ 17,876,015	22%	\$ 9,925,000	10%

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

The balance at June 30, consists of the following:

	2006	2005
Accounts receivable – water and wastewater sales and services	\$ 3,357,926	2,991,019
Allowance for uncollectible accounts	(8,705)	(5,731)
Accounts receivable – water sales, net	<u>\$ 3,349,221</u>	<u>2,985,288</u>

Vallecitos Water District
Notes to the Basic Financial Statements, continued
For the Years Ended June 30, 2006 and 2005

(4) Capital Assets

Changes in capital assets for the year were as follows:

	<u>Balance 2005</u>	<u>Additions/ Transfers</u>	<u>Deletions/ Transfers</u>	<u>Balance 2006</u>
Non-depreciable assets:				
Land	\$ 4,674,034	-	-	4,674,034
Construction-in-process	23,133,763	37,081,281	(15,868,631)	44,346,413
Total non-depreciable assets	<u>27,807,797</u>	<u>37,081,281</u>	<u>(15,868,631)</u>	<u>49,020,447</u>
Depreciable assets:				
Water transmission and distribution system	120,985,099	6,310,383	(14,363)	127,281,119
Wastewater system	72,228,428	4,435,739	-	76,664,167
Buildings	13,770,844	61,735	-	13,832,579
Transportation equipment	2,281,791	274,661	(131,458)	2,424,994
Field and shop equipment	5,840,943	1,032,991	-	6,873,934
Office equipment	1,017,447	48,055	(22,910)	1,042,592
Total depreciable assets	<u>216,124,552</u>	<u>12,163,564</u>	<u>(168,731)</u>	<u>228,119,385</u>
Accumulated depreciation and amortization:				
Water transmission and distribution system	(25,740,471)	(2,504,700)	12,793	(28,232,378)
Wastewater system	(21,494,096)	(1,708,710)	-	(23,202,806)
Buildings	(2,181,941)	(288,989)	-	(2,470,930)
Transportation equipment	(1,043,888)	(249,474)	102,504	(1,190,858)
Field and shop equipment	(4,509,614)	(415,695)	-	(4,925,309)
Office equipment	(680,494)	(81,374)	20,408	(741,460)
Total accum depr. and amort.	<u>(55,650,504)</u>	<u>(5,248,942)</u>	<u>135,705</u>	<u>(60,763,741)</u>
Total depreciable assets, net	<u>160,474,048</u>	<u>6,914,622</u>	<u>(33,026)</u>	<u>167,355,644</u>
Total capital assets, net	<u>\$ 188,281,845</u>	<u>43,995,903</u>	<u>(15,901,657)</u>	<u>216,376,091</u>

In 2006, major capital assets additions during the year include the North Twin Oaks Reservoir #2 and the Meadowlark Treatment Plant Expansion along with rehabilitation of the District's transmission and distribution systems mains and pipelines. A significant portion of the District's transmission and distribution systems mains and pipelines rehabilitation 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, 2006 and 2005

(4) Capital Assets, continued

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, 2006 and 2005

(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:

Project Name	2004	2005	2006
<i>District Financed</i>			
SM interceptor - SM Blvd/Discovery	\$ 1,614,711	1,869,431	1,013,633
Meadowlark Plant expansion design	1,323,177	1,765,027	3,270,011
Deer Springs pump station replacement	1,064,029	1,474,017	1,569,387
Radio read meters	333	1,317,582	900,669
Land outfall replacement 24" & 54" Laurels to Carillo Ranch	140,043	1,250,083	775,855
South Lake Pump Station improvement project	630,111	900,536	-
Slip lining for outfall under I-5	647,222	849,480	-
Water wastewater reclamation FY 2000-2001 master plan update	623,030	690,899	335,650
Facility/Maintenance data management system	-	303,753	-
Sewer flow monitoring stations	154,114	277,187	1,600,260
Rancho Santa Fe Road Phase I	-	-	254,973
City of San Marcos water/sewer plan check - Rancho Santa Fe Rd	252,707	276,562	-
North Twin Oaks Pump Station Upgrade	-	-	1,112,420
Wulff Pump Station - Upgrade	195,094	261,555	262,978
Sewer main replacement- Linda Vista/Pacific	175,425	234,702	2,520,785
Meadowlark Plant Expansion	-	-	13,067,765
North Twin Oaks reservoir 2 & 3 San Marcos Mtn / Merriam Mtn	73,340	228,366	1,602,679
Meadowlark Tank #3	-	-	196,519
Los Posas Road Improvements	-	-	570,642
Lift Station #3	-	-	220,570
Twin Oaks Reservoir	-	-	868,874
Twin Oaks Reservoir #2	-	-	2,086,649
Gravity portion of Montiel Lift Station	-	216,777	-
Miscellaneous Road Improvements	-	-	280,847
Automated Meter Reading Conversion	-	-	1,168,433
Solar Carport Covers	-	-	829,156
Emergency Replacement 24" RPM	-	-	295,795
Subtotal - District Financed	<u>\$ 6,893,336</u>	<u>11,915,957</u>	<u>34,804,550</u>
<i>Developer Financed</i>			
Univ. Commons, San Elijo Hills Rd. improvement water/sewer plan check	\$ 21,922	1,259,517	1,198,823
Euston Homes water/sewer grading plan check	294,131	1,195,082	-
Rancho Coronado Village B-4 water/sewer plan check Twin Oaks Valley Rd	5,611	525,626	217,761
TSM 430 water/sewer plan check	13,339	363,800	-
San Marcos track 432 water/sewer plan check, Mission Rd	9,286	254,786	-
University Commons, TSM 421 unit 11, Shadetree DR	2,180	213,650	-
Las Posas widening - Las Posas drainage Grand to Mission	200,591	213,633	-
University Commons, Unit 3, San Elijo Rd, water/sewer plan check	2,905	212,451	310,216
Oceanside-Escondido rail project-railroad right of way & CSUSM loop	201,267	210,048	1,278,108
University Commons TSM 421, Unit 1 water/sewer plan check	4,388	206,607	304,005
University Commons Unit 5	-	-	115,465
KB Home water/sewer plan check Paloma A6 U4	209,869	-	-
Rose Ranch Estates water/sewer plan check	453,172	-	-
Subtotal - Developer Financed	<u>\$ 1,418,661</u>	<u>4,655,200</u>	<u>3,424,378</u>
Various Other Projects	<u>\$ 4,250,275</u>	<u>6,562,606</u>	<u>6,117,485</u>
Total	<u><u>\$ 12,562,272</u></u>	<u><u>23,133,763</u></u>	<u><u>44,346,413</u></u>

Vallecitos Water District
Notes to the Basic Financial Statements, continued
For the Years Ended June 30, 2006 and 2005

(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, 2006, 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, 2005 and 2004, are available directly from EWA (6200 Avenida Encinas, Carlsbad, California 92009), and show the following:

	2005	2004
Total assets	\$ 66,487,445	55,482,902
Total liabilities	3,649,739	3,417,513
Total net assets	\$ 62,837,706	52,065,389
Increase(decrease) in net assets	\$ 10,772,317	6,294,747

(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, 2006, the following amounts are due to the District:

Fiscal Year	Principal Amount
2007	\$ 783,234
2008	82,631
2009	87,176
2010	91,971
2011	97,029
2012-2016	571,311
2017-2018	274,934
Total	1,988,286
Current portion	(783,234)
Non-current portion	\$ 1,205,052

Vallecitos Water District
Notes to the Basic Financial Statements, continued
For the Years Ended June 30, 2006 and 2005

(7) Debt Issuance Costs

The debt issuance costs balance relates to the issuance costs of the 2005A Refunding Certificates of Participation. The balance is being amortized over a thirty-two year period. The debt issuance costs, net balances are as follows:

The balance at June 30, consists of the following:	<u>2006</u>	<u>2005</u>
Debt issuance costs	\$ 555,576	493,339
Accumulated amortization	<u>(17,362)</u>	<u>-</u>
Debt issuance costs, net	<u>\$ 538,214</u>	<u>493,339</u>

(8) Deferred Charges from Debt Retirement

The deferred charges from debt retirement balance relates to the defeasance costs of the District's 1998 Twin Oaks Certificates of Participation. The balance is being amortized over a twenty-six year period. The deferred charges from debt retirement, net balances are as follows:

The balance at June 30, consists of the following:	<u>2006</u>	<u>2005</u>
Deferred charges from debt retirement	\$ 246,914	-
Accumulated amortization	<u>(9,497)</u>	<u>-</u>
Deferred charges from debt retirement, net	<u>\$ 237,417</u>	<u>-</u>

(9) Long-term Debt

Long-term debt:	<u>Balance 2005</u>	<u>Additions</u>	<u>Principal Payments</u>	<u>Balance 2006</u>
1998 Certificates of Participation	\$ 23,400,000	-	(23,400,000)	-
2005A Certificates of Participation	66,700,000	-	-	66,700,000
Less: Unamortized discounts	<u>(554,942)</u>	<u>-</u>	<u>91,937</u>	<u>(463,005)</u>
Total long-term debt	89,545,058	<u>-</u>	<u>(23,308,063)</u>	66,236,995
Less: Current portion	<u>(23,400,000)</u>			<u>(1,425,000)</u>
Long-term portion	<u>\$ 66,145,058</u>			<u>64,811,995</u>

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 \$23,000,000 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.

Vallecitos Water District
Notes to the Basic Financial Statements, continued
For the Years Ended June 30, 2006 and 2005

(9) Long-term Debt

2005 Certificates of Participation

On June 30, 2005, the District issued \$66,700,000 in Water and Wastewater Enterprise Certificates of Participation (Series 2005A COPs). The proceeds of the issue are being used to prepay the 1998 Twin Oaks Reservoir Certificates of Participation and to complete 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.

A total of \$23,000,000 from the Series 2005A COPs was used to pay off the outstanding principal, and call premium on the 1998 Twin Oaks Reservoir Certificates of Participation. As a result, the 1998 Twin Oaks Reservoir Certificates of Participation are considered retired and the liability for those obligations has been removed from the financial statements. The District completed the advance refunding to reduce the District's total debt service payments over the next 25 years by \$1,506,316 and to obtain an economic gain of approximately \$1,111,076.

The Series 2005A COPs are payable solely from the net revenues of the District's water and sewer systems as defined in the 2005 Certificates of Participation. The Certificates bear interest at a fixed rate of 3.50% with principal maturities from 2007 to 2036.

Annual debt service payments are as follows:

<u>Fiscal Year</u>	<u>Principal</u>	<u>Interest</u>	<u>Total</u>
2007	\$ 1,425,000	2,310,287	3,735,287
2008	1,450,000	2,259,119	3,709,119
2009	1,500,000	2,206,341	3,706,341
2010	1,550,000	2,151,664	3,701,664
2011	1,625,000	2,134,614	3,759,614
2012-2016	9,025,000	9,567,747	18,592,747
2017-2021	10,850,000	7,747,437	18,597,437
2022-2025	12,950,000	5,639,013	18,589,013
2026-2031	15,550,000	3,069,235	18,619,235
2032-2036	10,775,000	799,206	11,574,206
Total	\$ 66,700,000	<u>37,884,663</u>	<u>104,584,663</u>
Less: current portion	<u>(1,425,000)</u>		
Non-current portion	<u>\$ 65,275,000</u>		

Vallecitos Water District
Notes to the Basic Financial Statements, continued
For the Years Ended June 30, 2006 and 2005

(10) Net Investment in Capital Assets

Net investment in capital assets:

The balance at June 30, consists of the following:	<u>2006</u>	<u>2005</u>
Investment in Encina Wastewater Authority capital assets	\$ 16,049,383	13,604,729
Capital assets not being depreciated	49,020,447	27,807,797
Net capital assets being depreciated	167,355,644	160,474,048
Debt issuance costs net of amortization	538,214	493,339
Deferred charges from debt retirement	237,417	-
Certificates of participation – current portion	(1,425,000)	(23,400,000)
Deposit from San Marcos Unified School District	(189,400)	(189,400)
Portion of COPs attributable to spent proceeds	<u>(35,568,266)</u>	<u>-</u>
Net investment in capital assets	<u>\$ 196,018,439</u>	<u>178,790,513</u>

(11) 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, 2006 and 2005 amounted to \$1,140,062 and \$964,485, 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.

(12) 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 years 2006 and 2005 was 19.182% and 14.260%, 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.

Vallecitos Water District
Notes to the Basic Financial Statements, continued
For the Years Ended June 30, 2006 and 2005

(12) Defined Benefit Pension Plan, continued

Annual Pension Cost

For fiscal year 2006 and 2005, the District's annual pension cost was \$1,072,497 and \$633,679, 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, 2004 and 2003, respectively, 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>
2004	416,013	100%	-
2005	633,679	100%	-
2006	1,072,497	100%	-

(13) 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, 2006 and 2005 was \$98,500 and \$77,938, respectively.

Vallecitos Water District
Notes to the Basic Financial Statements, continued
For the Years Ended June 30, 2006 and 2005

(14) 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, 2006, 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 \$1,000,000, combined single limit at \$1,000,000 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, 2006 and 2005. 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, 2006 and 2005.

Vallecitos Water District
Notes to the Basic Financial Statements, continued
For the Years Ended June 30, 2006 and 2005

(15) Segment Information

Condensed Statement of Net Assets

	2006			2005
	Water	Wastewater	Total	Total
Assets:				
Current assets	\$ 38,576,592	19,612,980	58,189,572	99,086,834
Non-current assets	17,884,235	13,633,263	31,517,498	30,717,637
Capital assets, net	128,158,578	104,266,896	232,425,474	201,886,574
Total assets	184,619,405	137,513,139	322,132,544	331,691,045
Liabilities:				
Current liabilities	9,974,297	5,954,917	15,929,214	34,093,125
Non-current liabilities	42,257,421	22,743,974	65,001,395	66,334,458
Total liabilities	52,231,718	28,698,891	80,930,609	100,427,583
Net assets:				
Investment in capital assets, net of related debt	103,380,942	92,637,497	196,018,439	178,790,513
Restricted for future capital facilities	16,686,751	12,840,788	29,527,539	28,932,967
Restricted for debt service	1	1	2	200,423
Unrestricted	12,319,993	3,335,962	15,655,955	23,339,559
Total net assets	132,387,687	108,814,248	241,201,935	231,263,462
Total liabilities and net assets	\$ 184,619,405	137,513,139	322,132,544	331,691,045

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

	2006			2005
	Water	Wastewater	Total	Total
Revenues:				
Operating revenues	\$ 19,431,125	8,269,160	27,700,285	23,639,875
Non-operating revenues	2,898,521	2,084,424	4,982,945	2,702,790
Total revenues	22,329,646	10,353,584	32,683,230	26,342,665
Expenses:				
Operating expenses	18,404,373	8,839,449	27,243,822	22,368,334
Depreciation and amortization	3,198,479	2,050,463	5,248,942	4,885,666
Non-operating expenses	1,300,520	700,280	2,000,800	574,175
Total expenses	22,903,372	11,590,192	34,493,564	27,828,175
Net income (loss) before capital contributions	(573,726)	(1,236,608)	(1,810,334)	(1,485,510)
Capital contributions	6,785,915	4,962,892	11,748,807	20,282,965
Change in net assets	6,212,189	3,726,284	9,938,473	18,797,455
Net assets, beginning of year	124,887,938	106,375,524	231,263,462	212,466,007
Net assets, end of year	\$ 131,100,127	110,101,808	241,201,935	231,263,462

Condensed Statement of Cash Flows

	2006			2005
	Water	Wastewater	Total	Total
Net Cash Provided (Used) by:				
Operating activities	\$ 2,189,459	2,164,954	4,354,413	4,350,455
Noncapital financing activities	748,616	614,160	1,362,776	921,381
Capital and related financing activities	(29,250,503)	(20,889,966)	(50,140,469)	61,442,537
Investing activities	(8,230,338)	(8,927,123)	(17,157,461)	(5,116,349)
Net cash provided (used)	(34,542,766)	(27,037,975)	(61,580,741)	61,598,024
Cash and cash equivalents, beginning of year	63,489,090	36,907,103	100,396,193	38,798,169
Cash and cash equivalents, end of year	\$ 28,946,324	9,869,128	38,815,452	100,396,193

Vallecitos Water District
Notes to the Basic Financial Statements, continued
For the Years Ended June 30, 2006 and 2005

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

The Governmental Accounting Standards Board (GASB) has issued several pronouncements prior to June 30, 2006, that have effective dates that may impact future financial presentations.

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.

(17) 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 \$31,238,171 in open construction contracts as of June 30, 2006. 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>
Meadowlark Reclamation Facility Expansion	\$ 23,284,700	9,083,852	14,200,848
Twin Oaks No. 2 Reservoir	15,618,497	695,313	14,923,184
PV Solarport	2,792,462	1,911,948	880,514
Twin Oaks Reservoir Mass Grading	2,197,551	1,866,848	330,703
North Twin Oaks Pump Station	1,118,000	827,078	290,922
Wulff Pump Station	875,671	273,204	602,467
Linda Vista Sewer Replacement Project	619,575	610,042	9,533
	<u>\$ 46,506,456</u>	<u>15,268,285</u>	<u>31,238,171</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.

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Required Supplementary Information

**Vallecitos Water District
Schedule of Funding Progress – CalPERS Pension Plan
For the Years Ended June 30, 2006 and 2005**

Required Supplementary Information – Funded Status of the District’s CalPERS Pension Plan

Following the creation of risk pools pursuant to Section 20840 of the Government Code, any existing contracting agency with a rate plan of less than 100 active members on any annual actuarial valuation date shall be required to participate in a risk pool. Participation shall be effective as of the valuation date for all members of that rate plan, but no earlier than June 30, 2003. Risk pool valuations will be used to set employer contribution rates for future fiscal years.

Rate Plan belonging to the Miscellaneous Employee 3.0% at 60 Risk Pool Retirement Plan

The Schedule of Funding Progress below shows the recent history of the CalPERS Miscellaneous Employee 3.0% at 60 Risk Pool Retirement Plan actuarial value of assets, actuarial accrued liability, their relationship, and the relationship of the unfunded actuarial accrued liability (UAAL) to payroll.

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, 2003	\$ 2,596,966,545	2,372,879,034	224,087,511	91.4%	725,020,458	30.9%
June 30, 2004	426,958,282	334,956,019	92,002,263	78.5%	90,667,029	101.5%
June 30, 2005	499,323,280	405,480,805	93,842,475	81.2%	108,618,321	86.4%

Supplementary Information Section

Vallecitos Water District
Combining Schedule of Revenue, Expenses, and Changes in Net Assets
For the Year Ended June 30, 2006 with Comparative Totals for the Year Ended June 30, 2005

	2006			2005 Total
	Water	Wastewater	Total	
Operating revenue	\$ 19,431,125	8,269,160	27,700,285	23,639,875
Operating expenses:				
Water division	18,404,373	-	18,404,373	15,480,861
Wastewater division	-	8,839,449	8,839,449	6,887,473
Depreciation	3,198,479	2,050,463	5,248,942	4,885,666
Total operating expenses	21,602,852	10,889,912	32,492,764	27,254,000
Operating loss	(2,171,727)	(2,620,752)	(4,792,479)	(3,614,125)
Non-operating revenue(expense)				
Property taxes	766,483	649,569	1,416,052	1,078,836
Interest and investment earnings	2,103,042	1,382,233	3,485,275	1,272,309
Annexation fees	13,102	58,164	71,266	351,645
Interest expense – long-term debt	(1,300,520)	(700,280)	(2,000,800)	(530,434)
Other non-operating revenues/(expenses), net	15,894	(5,542)	10,352	(43,741)
Total nonoperating revenues and expenses	1,598,001	1,384,144	2,982,145	2,128,615
Net loss before capital contributions	(573,726)	(1,236,608)	(1,810,334)	(1,485,510)
Capital contributions	6,785,915	4,962,892	11,748,807	20,282,965
Change in net assets	6,212,189	3,726,284	9,938,473	18,797,455
Net assets, beginning of year	124,887,938	106,375,524	231,263,462	212,466,007
Net assets, end of year	\$ 131,100,127	110,101,808	241,201,935	231,263,462

Vallecitos Water District
Schedule of Operating Expenses – Water Division
For the Years Ended June 30, 2006 and 2005

	<u>2006</u>	<u>2005</u>
Purchased water	\$ 11,650,340	10,358,875
Transmission and distribution:		
Labor	579,623	421,893
Materials and supplies	158,124	87,366
Outside repair	121,593	116,169
Telemetry and power	40,283	50,882
Total transmission and distribution	<u>899,623</u>	<u>676,310</u>
Engineering:		
Labor	579,581	427,148
Outside repair	41,388	120,319
Materials and supplies	10,717	13,098
Allocated to wastewater division	<u>(243,069)</u>	<u>(204,527)</u>
Total engineering	<u>388,617</u>	<u>356,038</u>
Customer accounts:		
Labor	313,655	293,354
Materials and supplies	63,779	59,599
Uncollectible accounts	<u>16,980</u>	<u>12,030</u>
Total customer accounts	<u>394,414</u>	<u>364,983</u>
Pumping:		
Labor	76,317	71,981
Materials and supplies	26,051	36,379
Outside repair	7,459	22,413
Power	<u>350,220</u>	<u>365,080</u>
Total pumping	<u>460,047</u>	<u>495,853</u>
Building and grounds:		
Labor	120,713	125,277
Outside repair	79,364	131,660
Power	98,947	91,651
Materials and supplies	33,522	29,342
Allocated to wastewater division	<u>(129,838)</u>	<u>(151,172)</u>
Total building and grounds	<u>202,708</u>	<u>226,758</u>
Equipment and vehicles:		
Materials and supplies	160,149	121,311
Labor, fuel and repairs	93,391	110,699
Allocated to wastewater division	<u>(96,833)</u>	<u>(92,722)</u>
Total equipment and vehicles	<u>156,707</u>	<u>139,288</u>

Continued on next page

Vallecitos Water District
Schedule of Operating Expenses – Water Division, continued
For the Years Ended June 30, 2006 and 2005

	<u>2006</u>	<u>2005</u>
Meter reading and repairs:		
Labor	\$ 112,167	119,146
Materials and supplies	23,979	16,448
Outside repair	3,660	3,314
Total meter reading and repairs	<u>139,806</u>	<u>138,908</u>
Tanks and reservoirs:		
Labor	135,285	101,704
Outside repairs	26,802	22,242
Materials and supplies	32,396	26,227
Telemetry and power	2,254	2,713
Total tanks and reservoirs	<u>196,737</u>	<u>152,886</u>
Water quality and treatment:		
Labor	85,807	64,445
Outside repair	34,316	26,399
Materials and supplies	15,768	16,965
Power	7,436	13,290
Total water quality and treatment	<u>143,327</u>	<u>121,099</u>
Other water operating expenses:		
Labor	117,927	109,603
Material and supplies	41,580	22,699
Outside repairs	39,618	23,962
Allocated to wastewater division	(21,714)	(23,061)
Total other water operating expenses	<u>177,411</u>	<u>133,203</u>

Continued on next page

Vallecitos Water District
Schedule of Operating Expenses – Water Division, continued
For the Years Ended June 30, 2006 and 2005

	<u>2006</u>	<u>2005</u>
General and administrative:		
Salaries	\$ 2,052,713	1,651,562
Group insurance	1,070,617	979,128
Public employees' retirement	1,327,389	901,824
Social security	826,777	687,623
Worker's compensation insurance	138,412	140,273
Legal	123,120	134,130
District insurance	219,085	124,498
Director's expense	81,523	82,722
Office supplies	106,278	81,443
Outside services	124,455	64,694
Director's fees	61,650	61,200
Meetings and seminars	53,625	56,791
Dues and subscriptions	63,884	52,288
Other taxes/benefits	32,237	35,542
Telephone	41,396	30,866
Auditing	25,694	22,897
Travel	8,308	19,504
Office equipment repair	11,846	12,738
Computer consulting	4,800	7,053
Postage	10,319	6,299
Public awareness	85,797	75,363
Election and annexations	4,692	3,287
Other	34,643	53,282
Allocated to wastewater division	(2,448,386)	(2,137,920)
Overhead allocation	(466,238)	(830,427)
	<u>3,594,636</u>	<u>2,316,660</u>
Total general and administrative		
Total water division operating expenses	\$ <u>18,404,373</u>	<u>15,480,861</u>

Vallecitos Water District
Schedule of Operating Expenses – Wastewater Division
For the Years Ended June 30, 2006 and 2005

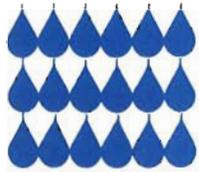
	<u>2006</u>	<u>2005</u>
Encina disposal	\$ <u>2,921,237</u>	<u>2,044,835</u>
Meadowlark wastewater treatment plant:		
Materials and supplies	809,790	662,717
Labor	361,659	270,789
Power	230,662	207,149
Outside repair	100,469	100,173
Telephone	1,939	2,087
Telemetry	<u>-</u>	<u>110</u>
Total Meadowlark wastewater treatment plant	<u>1,504,519</u>	<u>1,243,025</u>
Engineering:		
Allocated from water division	<u>243,069</u>	<u>204,527</u>
Customer accounts:		
Labor	79,293	76,318
Materials and supplies	21,689	20,563
Uncollectible accounts	<u>15,465</u>	<u>12,835</u>
Total customer accounts	<u>116,447</u>	<u>109,716</u>
Collection and conveyance:		
Labor	373,844	296,788
Outside repair	68,469	43,243
Materials and supplies	225,778	152,290
Power	<u>1,190</u>	<u>575</u>
Total collection and conveyance	<u>669,281</u>	<u>492,896</u>
Buildings and grounds:		
Allocated from water division	<u>129,838</u>	<u>151,172</u>
Equipment and vehicles:		
Allocated from water division	96,833	92,722
Labor, fuel and repairs	<u>28,963</u>	<u>29,710</u>
Total equipment and vehicles	<u>125,796</u>	<u>122,432</u>
Other wastewater operating expenses:		
Labor	88,463	86,773
Materials and supplies	46,372	35,207
Outside repairs	4,850	7,858
Power	30,359	38,027
Telemetry	490	1,800
Allocated from water division	<u>21,714</u>	<u>23,061</u>
Total other wastewater operating expenses	<u>192,248</u>	<u>192,726</u>

Continued on next page

Vallecitos Water District
Schedule of Operating Expenses – Wastewater Division, continued
For the Years Ended June 30, 2006 and 2005

	<u>2006</u>	<u>2005</u>
General and administrative:		
Allocated from water division	\$ 2,448,386	2,137,920
Salaries	127,353	121,375
Group insurance	138,323	126,946
Public employees' retirement	178,820	108,130
Social security	128,207	104,760
Worker's compensation insurance	30,505	29,810
Other	15,804	13,736
Outside services	163	163
Meetings and seminars	10,618	7,336
Dues and subscriptions	2,283	2,312
Other taxes/benefits	2,598	2,127
Travel	759	253
Overhead allocation	<u>(146,805)</u>	<u>(328,724)</u>
Total general and administrative	<u>2,937,014</u>	<u>2,326,144</u>
Total wastewater division operating expenses	\$ <u><u>8,839,449</u></u>	<u><u>6,887,473</u></u>

Report on Compliance and Internal Controls



Charles Z. Fedak, CPA, MBA
Paul J. Kaymark, CPA

Charles Z. Fedak & Company

Certified Public Accountants

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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, 2006, and have issued our report thereon dated September 30, 2006. 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 30, 2006
Cypress, California

Charles Z. Fedak, CPA
An Accountancy Corporation