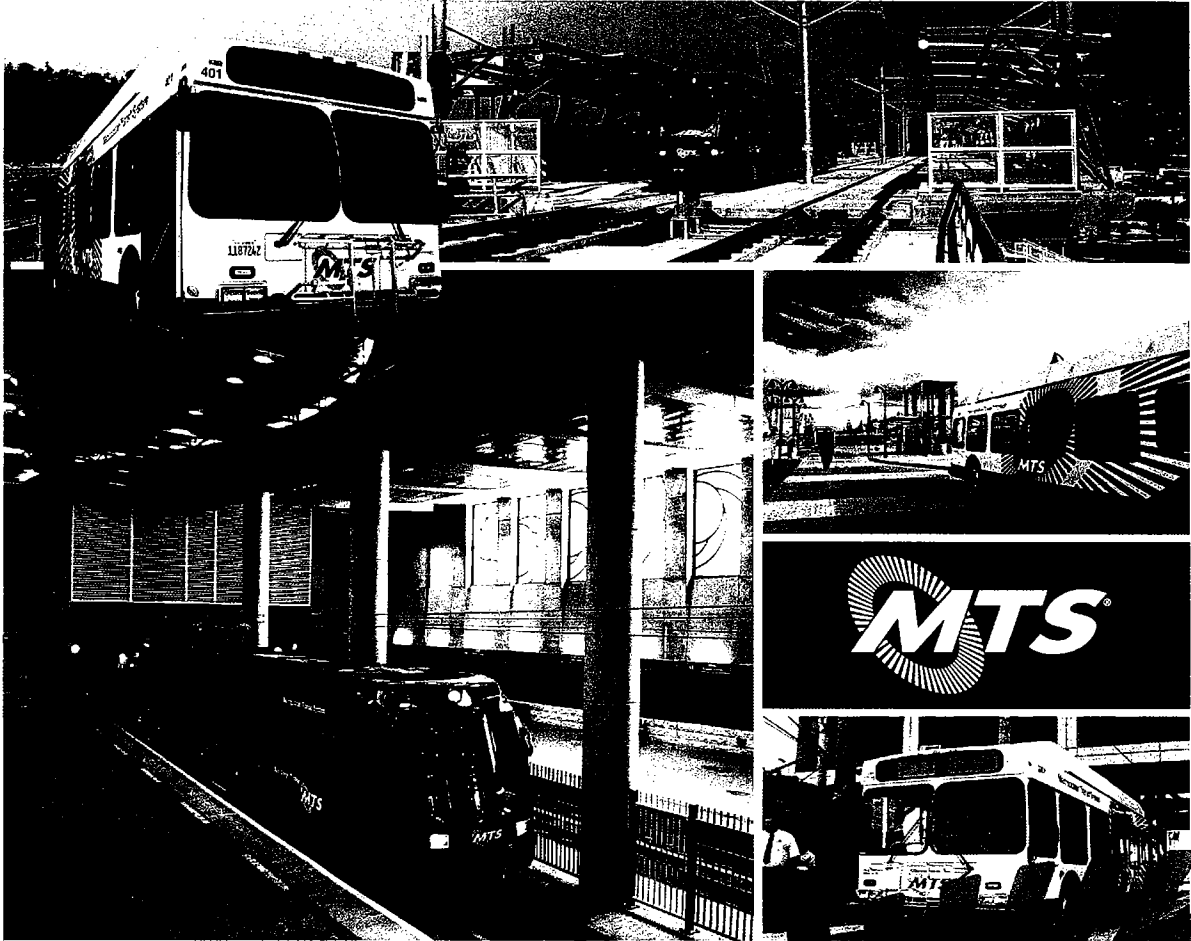


COMPREHENSIVE
ANNUAL FINANCIAL REPORT



FOR THE FISCAL YEAR ENDED JUNE 30, 2006
SAN DIEGO METROPOLITAN TRANSIT SYSTEM
SAN DIEGO, CALIFORNIA



SAN DIEGO METROPOLITAN TRANSIT SYSTEM

SAN DIEGO, CALIFORNIA

Comprehensive Annual Financial Report

Year ended June 30, 2006

(With Independent Auditors' Report Thereon)

Prepared by Finance Department

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SAN DIEGO METROPOLITAN TRANSIT SYSTEM

Comprehensive Annual Financial Report

Year ended June 30, 2006

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INTRODUCTORY SECTION



Metropolitan Transit System

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**San Diego Metropolitan Transit System
Board of Directors and Transit Riders:**

The comprehensive annual financial report of the San Diego Metropolitan Transit System (MTS) for the fiscal year ended June 30, 2006 is hereby submitted. Responsibility for both the accuracy of the data and the completeness and fairness of the presentation, including all disclosures, rests with management. Management of MTS is responsible for establishing and maintaining an internal control structure designed to ensure that the assets of MTS are protected from loss, theft, or misuse, and to ensure that adequate accounting data are compiled to allow for the preparation of financial statements in conformity with generally accepted accounting principles in the United States of America (GAAP). The internal control structure is designed to provide reasonable, but not absolute, assurance that these objectives are met. The concept of reasonable assurance recognizes that (1) the cost of a control should not exceed the benefits likely to be derived and (2) the valuation of costs and benefits requires estimates and judgments by management. As management, we assert that, to the best of our knowledge and belief, this financial report is complete and reliable in all material respects.

State statutes require an annual audit by independent certified public accountants. The firm of Caporicci & Larson has been retained to meet this requirement. The goal of the independent audit was to provide reasonable assurance that the financial statements of MTS for the fiscal year ended June 30, 2006 are free of material misstatement. The independent audit involved examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements; assessing the accounting principles used and significant estimates made by management; and evaluating the overall financial statement presentation. The independent auditors concluded, based upon the audit, that there was a reasonable basis for rendering an unqualified opinion that MTS' financial statements for the fiscal year ended June 30, 2006 are fairly presented, in all material respects, in conformity with GAAP. The independent auditors' report is presented as the first component of the financial section of this report.

The independent audit was also designed to meet the requirements of a broader, federally mandated "Single Audit" to meet the special needs of federal grantor agencies. The standards governing Single Audit engagements require the independent auditor to report not only on the fair presentation of the financial statements, but also on the audited government's internal controls and compliance with legal requirements, with special emphasis on internal controls and legal requirements involving the administration of federal awards. The reports related specifically to the Single Audit are issued under separate cover.

MTS maintains budgetary controls, the objective of which is to ensure compliance with the provisions embodied in the annual appropriated budget approved by the board of directors. Activities of the General Fund, Special Revenue Funds, Debt Service Funds, and Capital Projects Fund are included in the annual appropriated budgets. Comprehensive multi-year financial plans, adopted when major projects are approved for the final design and construction phase, provide project-length budgetary control in the Capital Projects Fund. The portion of costs expected to be incurred on each project during the fiscal year is included in the annual operating budget. The level of budgetary control (that is, the level at which expenditures cannot legally exceed the appropriated amount) is established by line item within an individual fund. The Chief Executive Officer has the authority to transfer up to \$25,000 between line items. MTS also maintains an encumbrance accounting system as one technique of

accomplishing budgetary control. Encumbered amounts lapse at year-end. However, encumbrances are evaluated and may be reappropriated as part of the following year's budget.

GAAP require that management provide a narrative introduction, overview, and analysis to accompany the financial statements in the form of Management's Discussion and Analysis (MD&A). This letter of transmittal is designed to complement the MD&A and should be read in conjunction with it. The MD&A can be found immediately following the report of the independent auditors.

REPORTING ENTITY

The San Diego Metropolitan Transit System was created effective January 26, 1976 to provide the policy setting and overall management coordination of the public transportation system in the San Diego metropolitan service area. This service area encompasses approximately 2.19 million people residing in a 570 square mile area of San Diego County, including the cities of Chula Vista, Coronado, El Cajon, Imperial Beach, La Mesa, Lemon Grove, National City, Poway, Santee, and San Diego and the unincorporated area of the County of San Diego. A number of fixed-route operating entities provide the service and have banded together to form a federation of transit service providers called the Metropolitan Transit System (MTS). The purpose of the MTS is to provide coordinated routes, fares, and transfers among the different operating entities.

MTS' mission statement, adopted by the Board of Directors, is to enhance the personal mobility of San Diego metropolitan area residents and visitors by:

- Obtaining maximum benefit for every dollar spent.
- Being the community's major public transportation advocate.
- Increasing public transportation usage per capita.
- Taking a customer-oriented approach.
- Offering high-quality public transportation services.
- Responding to the community's socio-economic interests.

Effective January 1, 2003, Senate Bill 1703 (SB 1703) took effect which consolidated the planning, programming, project development, and construction activities of the San Diego Association of Governments (SANDAG), MTS, and North San Diego County Transit Development Board (NCTD) within SANDAG. The legislation called for an initial transfer of the planning and programming functions from MTS to SANDAG by July 1, 2003 and a subsequent transfer of the project development and construction functions by January 30, 2004. Now that the consolidation is complete, MTS' focus has shifted to transit service operations, as SANDAG, in its newly configured role, is responsible for all other facets of transportation planning, programming, and development. MTS has one voting member on the nine-member Transportation Committee within SANDAG. The Transportation Committee assumed the responsibility and decision-making for all transportation-related planning, programming, and development activities. In accordance with the legislation, the planning and programming functions were transferred to SANDAG on July 1, 2003, and the project development and construction activities were transferred to SANDAG on October 13, 2003.

MTS is effectively an umbrella agency. MTS owns the assets of San Diego Trolley, Inc. (SDTI) and San Diego Transit Corporation (SDTC), the area's two largest transit operators. These two transit units were formed under California law as not-for-profit public corporations and function as operating subsidiaries of MTS. SDTI and SDTC are considered component units and are blended component units for financial reporting purposes. SDTI operates three Light Rail Transit (LRT) routes, the Blue Line from the Mission San Diego Station to San Ysidro at the International Border, the Orange Line

from the Imperial and 12th Bayside Platform through Centre City and then east to Santee, and the Mission Valley Extension, known as the Green Line, which began service in July 2005. With this addition of 5.8 miles of track, SDTI now operates on a total of 54.3 miles of track. SDTC operates 29 routes with an active fleet of 274 buses.

The relationship between MTS and the transit operating subsidiaries, SDTI and SDTC, is formally established through operating agreements and MTS-adopted corporate policies. These agreements and corporate policies specify the roles and responsibilities of each of the organizations and outline the procedures in numerous functional areas including auditing and budgeting, fare setting, marketing and public information, revenue-producing advertising, service contracts, and programming of federal, state and local subsidies. The MTS Board of Directors has the policy-setting responsibility for the operation and development of MTS' transit operating subsidiaries as well as for the planning and approval of capital expenditures by or on behalf of these entities. The day-to-day operating functions, labor matters and maintenance of facilities are managed by the individual transit operators.

Starting in July of 2004 and continuing forward, MTS has begun to centralize and consolidate many functions within SDTI and SDTC. These include Planning, Human Resources, Finance, and Purchasing. This is a gradual process that has been on-going and will continue for some time.

In addition, MTS owns the San Diego and Arizona Eastern Railway Company (SD&AE), a not-for-profit railroad holding company entrusted with assets which include 108 miles of rail line and over 2,000 acres of property. MTS has a contract with the San Diego and Imperial Valley Railway Co. (SDIV) for the operation of freight rail services over the SD&AE rail line. MTS provides no subsidy to SDIV, but does receive a portion of its gross revenue. SD&AE is considered a component unit and a blended component unit for financial reporting purposes.

In addition to the bus routes operated by SDTC, MTS is financially accountable for the operation of certain other bus routes. MTS contracts with an outside party for the operation of these bus routes. The contracts require full operation and maintenance of the bus services. These contract services are accounted for in the Other Contracted Services Enterprise Fund for financial reporting purposes. Effective July 1, 2002, the responsibility for operating the County Transit System (CTS) was transferred from the County of San Diego to MTS. CTS operating services are combined with the Other Contracted Services Enterprise Fund for financial reporting purposes.

MTS also is financially accountable for the operation of Taxicab Administration services, which includes regulating the issuance of taxi and jitney service permits in the Cities of San Diego, El Cajon, Imperial Beach, Lemon Grove, National City, Poway, and Santee. Taxicab Administration is accounted for in an Enterprise Fund for financial reporting purposes.

The MTS Board of Directors is comprised of 15 members with four appointed from the San Diego City Council, one appointed from the San Diego County Board of Supervisors, one appointed from each city council of Chula Vista, Coronado, El Cajon, Imperial Beach, La Mesa, Lemon Grove, National City, Poway, and Santee, and one elected by other Board members to serve as Chairman.

ECONOMIC CONDITION AND OUTLOOK

Operations

Historically, the San Diego region has enjoyed strong economic expansion, outpacing both the state and national economies. San Diego's gross regional product (GRP), the estimated total value of the regions' economy was estimated at \$151.1 billion for FY 2005 (most recent estimate available). This was a growth of 6.6% percent, better than the state and national averages. MTS-area fixed-route

ridership increased during FY 2006. The opening of the Mission Valley East line in July 2005 has added a large component of daily ridership.

The principal local source of operating subsidy for MTS' transit programs is Transportation Development Act (TDA) funding. One-fourth percent of the local sales tax in each California County is dedicated to transportation purposes.

On a local level, area voters approved a one-half cent transportation sales tax in 1987, called TransNet. One-third of the sales tax proceeds is allocated for transit purposes which is further divided between MTS and North County Transit District (MTS' counterpart in North San Diego County) based on the proportion of the population within the area of each jurisdiction. Prior to FY 2004, 80% of the transit TransNet funds had to be used for expansion of the light rail system. The remaining 20% could be used for operations after funding a reduced price pass program for seniors, disabled, and youth, which is capped at \$5.5 million. As a result of operating budget pressures, the ratio was changed in June 2003 so that up to 40% of the TransNet program can be used for operations (increased from 20%). The current TransNet sales tax expires in 2008. A reauthorization measure was approved by voters in November 2004 extending the TransNet sales tax for 40 additional years. This has removed a major potential funding problem that would have occurred in 2008 and beyond.

Major initiatives

With the changes brought about by SB 1703, the MTS focus is now clearly on operations rather than development. Specifically, this is providing quality, efficient, and reliable service to customers using resources to maximum effect. Two major challenges are to align operating costs with recurring revenues and rebuild the capital program in order to be able to replace aging infrastructure.

One of the tools MTS is currently using is a Comprehensive Operational Analysis (COA), the first in MTS history. The purpose of the COA is to assess its ridership and route structure on a comprehensive basis. This assessment is allowing MTS to better align its operations in all areas. The benefits are at least two fold. First it better matches riders with where they want to go offering opportunities for increased ridership and better service to customers and the larger community. Second, it acts as a priority guide for providing service. In doing so, various service levels can be effectively evaluated to coincide with available recurring revenues. Matching the proper service level to available recurring revenues eliminates structural deficits that have produced challenges for MTS for the last few years.

The Mission Valley East (MVE) LRT Line opened in July 2005. It extends 5.8 miles from Interstate 15 in Mission Valley to Baltimore Drive in La Mesa primarily along the I-8 corridor. It has added four stations and the first tunnel for MTS. In opening Mission Valley East, a new green line service was initiated, which consists of previous blue line stations from Old Town to Mission San Diego and the four new stations.

FINANCIAL MANAGEMENT

Pension Funds

MTS and SDTI contract with the California Public Employees Retirement System (PERS) to provide retirement plans for their employees. The employees of SDTC participate in the San Diego Transit Corporation Employee Retirement Plan, a single-employer public employee retirement plan.

Debt Administration

Capital Leases – MTS has two capitalized lease obligations with current year debt service of \$450 thousand. One lease obligation is the result of a joint venture arrangement whereby the joint venture

