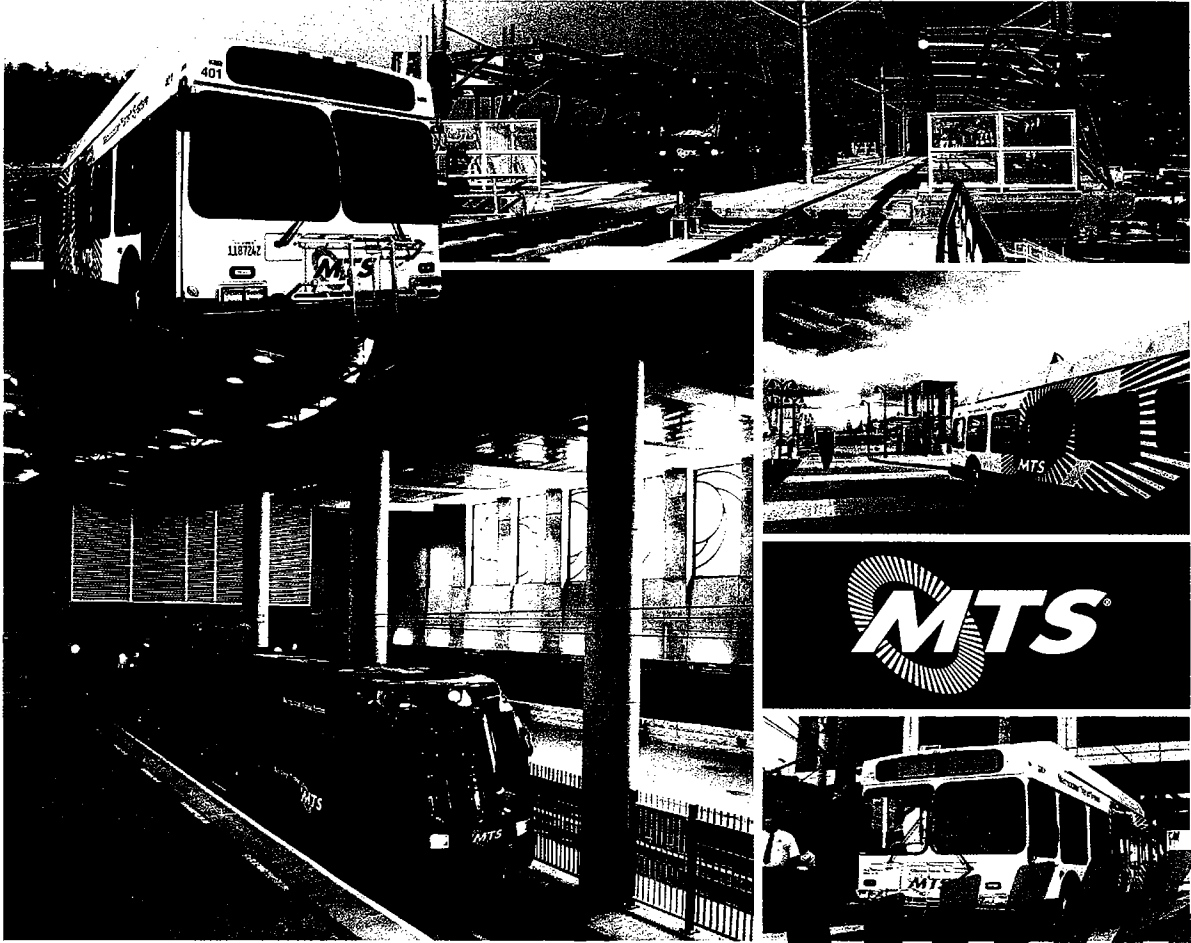


COMPREHENSIVE
ANNUAL FINANCIAL REPORT



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

Table of Contents

	Page
INTRODUCTORY SECTION (UNAUDITED):	
Letter of Transmittal	1
Listing of Board of Directors and Management	6
Organization Chart	7
FINANCIAL SECTION:	
Independent Auditors' Report	9
Management's Discussion and Analysis (Required Supplementary Information-Unaudited)	11
Basic Financial Statements:	
Government-Wide Financial Statements:	
Statement of Net Assets	28
Statement of Activities	30
Fund Financial Statements:	
<i>Governmental Fund Financial Statements:</i>	
Balance Sheet and Reconciliation of the Governmental Funds Balance Sheet to the Government-Wide Statement of Net Assets	34
Statement of Revenues, Expenditures, and Changes in Fund Balances	36
Reconciliation of the Governmental Funds Statement of Revenues, Expenditures, and Changes in Fund Balances to the Government-Wide Statement of Activities	37
<i>Proprietary Fund Financial Statements:</i>	
Statement of Net Assets	41
Statement of Revenues, Expenses, and Changes in Fund Net Assets	42
Statement of Cash Flows	43
Notes to Basic Financial Statements	45
Required Supplementary Information (Unaudited):	
Budgetary Information	82
Schedule of Revenues, Expenditures, and Changes in Fund Balances – Budget and Actual – General Fund	83

SAN DIEGO METROPOLITAN TRANSIT SYSTEM

Comprehensive Annual Financial Report

Year ended June 30, 2006

Table of Contents

	Page
FINANCIAL SECTION, Continued:	
Required Supplementary Information (Unaudited), Continued:	
Schedule of Revenues, Expenditures, and Changes in Fund Balances – Budget and Actual – Subsidy Pass-Through Fund	84
Schedule of Revenues, Expenditures, and Changes in Fund Balances – Budget and Actual – TransNet Fund	85
Schedule of Funding Progress of Defined Pension Plans	87
Supplementary Information:	
Non-Major Proprietary Funds, Combining Schedules	
Statement of Net Assets	90
Statement of Revenues, Expenses, and Changes in Net Assets	91
Statements of Cash Flows	92
STATISTICAL SECTION (UNAUDITED):	
Fund Information:	
Net Assets by Component	95
Changes in Net Assets	96
Fund Balances of Governmental Funds	97
Changes in Fund Balances of Governmental Funds	98
Fare Structure	99
Farebox Recovery Percentages – Component Units and Major Proprietary Fund	100
Ratios of Outstanding Debt by Type	101
Demographic and Economic Statistics	102
Full-time and Part-time Employees by Function	103
Operating Indicators by Function	104
Capital Asset Statistics by Function	105

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

issued certificates of participation (COPs), and MTS services the debt through lease payments. The other is a lease purchase agreement for the acquisition of telecommunications equipment.

On the COP issue which related to the construction of the MTS Tower, the rating, which was based on the strength of the joint venture and the primary lessor (the County of San Diego), was Aaa by Moody's Investors Service and AAA by Standard & Poor's Corporation.

Finance Obligations – MTS has four finance obligations. Total debt service for FY 06 was \$14 million. Two finance obligations are the result of Light Rail Vehicle (LRV) sale/leaseback and lease/leaseback transactions. Proceeds from these transactions were placed into various investments that mature at values sufficient to cover all remaining obligations as well as amounts necessary to exercise the repurchase options where applicable. In addition, MTS issued Certificates of Participation to fund the automated fare collection project in 2003 and the regional transit management project in 2002.

Pension Obligation Bonds – MTS issued Taxable Pension Obligation Bonds in 2004 to reduce the unfunded liability in the SDTC retirement plan. This obligation is reported by SDTC.

Cash Management

To facilitate optimum management of MTS' resources, cash in all the individual funds is combined to form a pool of cash for short-term investment, except for restricted funds, which are generally held by outside custodians on behalf of capital projects and enterprise funds. MTS' funds are invested in accordance with its written policy which is consistent with the California Government Code 53600. MTS uses the services of an outside investment management firm to handle the daily investment activities. Further details of MTS' cash and investments at June 30, 2006 are set forth in Note 4 to the financial statements.

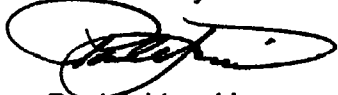
Risk Management

MTS (including Taxicab Administration, SD&AE, and Other Contracted Services), SDTI, and SDTC are protected against the adverse consequences of material or financial loss through a balanced program of risk retention and the purchase of commercial insurance. MTS, SDTI, and SDTC are insured for liability, property, and workers' compensation claims under a combined insurance program. Claims in excess of the various deductibles and self-insured retention amounts which range from \$50,000 to \$2,000,000 are insured with commercial carriers up to \$75,000,000 for liability and up to \$600,000,000 for property damage.

Acknowledgments

The preparation of this report was accomplished with the cooperation of MTS' management and staff. We express our appreciation to the staff members who contributed to the preparation of this report.

Respectfully submitted,



Paul Jablonski
Chief Executive Officer



Cliff Telfer
Chief Financial Officer

November 30, 2006

SAN DIEGO METROPOLITAN TRANSIT SYSTEM

Year ended June 30, 2006

BOARD OF DIRECTORS

<u>Members</u>	<u>Board position (elected position)</u>
Harry Mathis	Chairman, since 1/06
Jerry Rindone	Vice Chairman, since 7/91 (Councilmember, City of Chula Vista)
Toni Atkins	Board Member, since 12/02 (Deputy Mayor, City of San Diego)
Thomas E. Clabby	Board Member, since 6/96 (Councilmember, City of Lemon Grove)
Robert Emery	Chair, Pro Tem, since 7/85 (Councilmember, City of Poway)
Ernest Ewin	Board Member, since 03/05 (Councilmember, City of La Mesa)
Kevin Faulconer	Board Member, since 1/06 (Councilmember, City of San Diego)
Mark Lewis	Board Member, since 12/98 to 4/00, 12/02 (Mayor, City of El Cajon)
Brian Maienschein	Board Member, since 12/00 (Councilmember, City of San Diego)
Fred McLean	Board Member, since 1/06, (Councilmember, City of Imperial Beach)
Phil Monroe	Board Member, since 4/02 (Councilmember, City of Coronado)
Ron Morrison	Board Member, since 6/04 (Councilmember, National City)
Ron Roberts	Board Member, since 12/89 (County Board of Supervisors)
Hal Ryan	Board Member, since 1/04 (Councilmember, City of Santee)
Tony Young	Board Member, since 1/05 (Councilmember, City of San Diego)

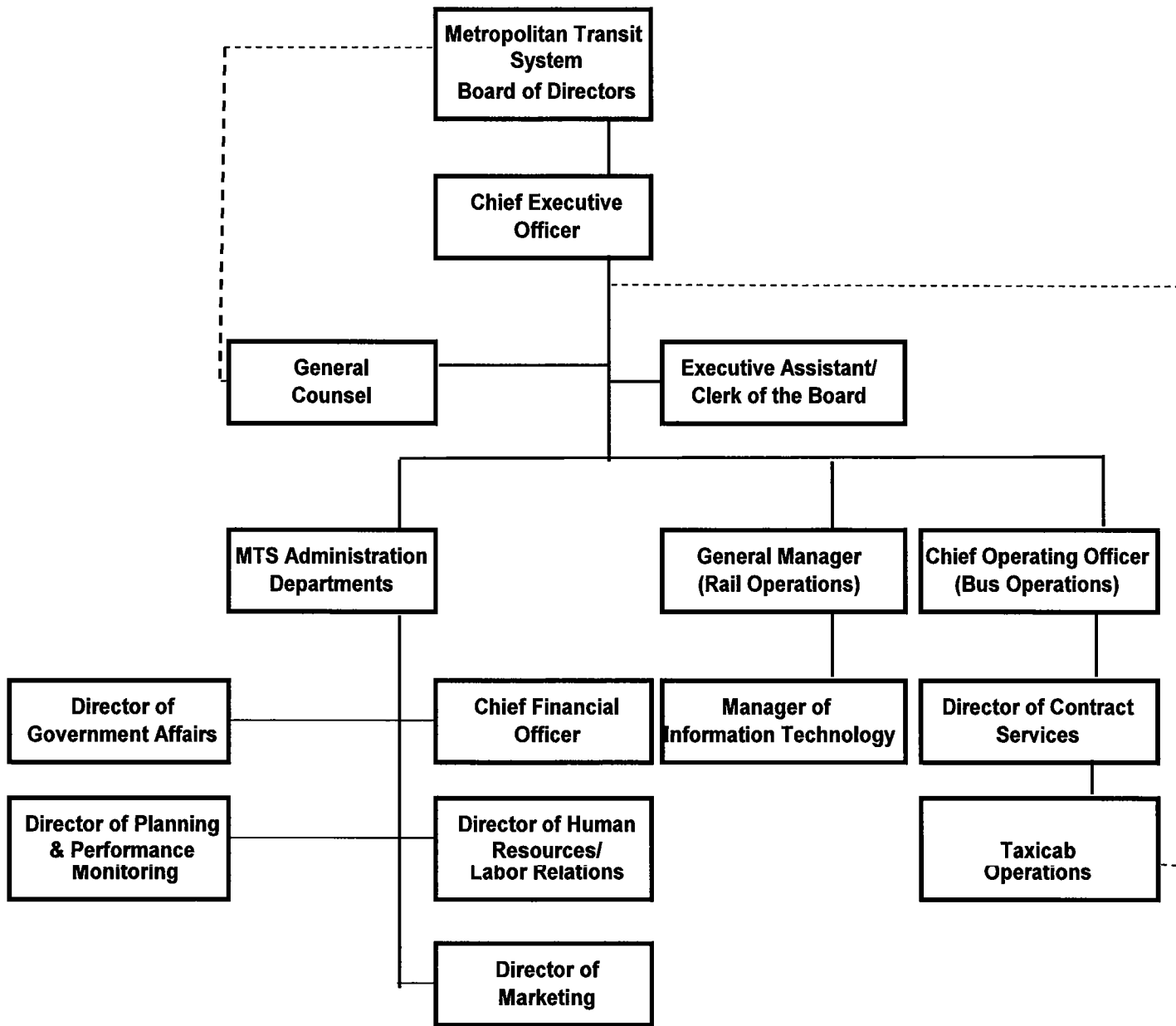
MTS MANAGEMENT

<u>Staff</u>	<u>Position</u>
Paul Jablonski	Chief Executive Officer, as of January 2004
Tiffany Lorenzen	General Counsel
Cliff Telfer	Chief Financial Officer
Claire Spielberg	Chief Operations Officer, Bus (SDTC)
Peter Tereschuck	President-General Manager, Rail (SDTI)
Conan Chung	Director, Planning and Performance Monitoring
Sharon Cooney	Director, Government Affairs and Community Relations
Susan Hafner	Director, Multimodal Operations City of San Diego
Robert Schupp	Director, Marketing and Communications
Jeff Stumbo	Director, Human Resources and Labor Relations

SAN DIEGO METROPOLITAN TRANSIT SYSTEM

Executive Level Organization Chart

Fiscal Year 2006



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FINANCIAL SECTION

INDEPENDENT AUDITORS' REPORT

To the Board of Directors
of the San Diego Metropolitan Transit System
San Diego, California

We have audited the accompanying financial statements of the governmental activities, the business-type activities, each major fund, and the aggregate remaining fund information of the San Diego Metropolitan Transit System (MTS), as of and for the year ended June 30, 2006, which collectively comprise MTS' basic financial statements as listed in the table of contents. These financial statements are the responsibility of MTS' management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards in the United States 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 financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the 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 governmental activities, the business-type activities, each major fund, and the aggregate remaining fund information of MTS as of June 30, 2006, and the respective changes in financial position and cash flows, where applicable, thereof for the year then ended in conformity with generally accepted accounting principles in the United States.

In accordance with *Government Auditing Standards*, we have also issued our report dated November 30, 2006, on our consideration of MTS' internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grants. 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 considered in assessing the results of our audit.

As described in Note 1 to the basic financial statements, MTS adopted the Governmental Accounting Standards Board Statements No. 44, *Economic Condition Reporting: the Statistical Section (an amendment of NCGA Statement 1)*, No. 46, *Net Assets Restricted by Enabling Legislation (an amendment of GASB Statement No. 34)*, and No. 47, *Accounting for Termination Benefits*.

The accompanying Required Supplementary Information, such as Management's Discussion and Analysis, Budgetary Information and Schedule of Funding Progress of Defined Pension Plans, as listed in the table of contents is not a required part of the basic financial statements but is supplementary information required by the Governmental Accounting Standards Board. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the Required Supplementary Information. However, we did not audit the information and express no opinion on it.

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9 Corporate Park, Suite 100
Irvine, California 92606

Sacramento

777 Campus Commons Rd., Suite 200
Sacramento, California 95825

San Diego

4858 Mercury, Suite 106
San Diego, California 92111

To the Board of Directors
of the San Diego Metropolitan Transit System
San Diego, California

Our audit was conducted for the purpose of forming opinions on the financial statements that collectively comprise MTS' basic financial statements. The accompanying Supplementary Information is presented for purpose of additional analysis and is not a required part of the basic financial statements. The Supplementary Information has been subjected to the auditing procedures applied in the audit of the basic financial statements and, in our opinion, is fairly stated in all material respects in relation to the basic financial statements taken as a whole. The Introductory and Statistical Sections have not been subjected to the auditing procedures applied in the audit of the basic financial statements and, accordingly, we express no opinion on them.

Capricci & Carlson

San Diego, California
November 30, 2006

SAN DIEGO METROPOLITAN TRANSIT SYSTEM

Management's Discussion and Analysis

June 30, 2006

The following discussion and analysis of the financial performance of the San Diego Metropolitan Transit System (MTS) is intended to provide an overview of MTS' financial activities for the fiscal year ended June 30, 2006. This information should be used in conjunction with the Letter of Transmittal, which can be found on pages 1 through 6 of this report.

Financial Highlights

- Net assets, as reported in the statement of net assets, totaled \$1,248 million as of June 30, 2006. Of this amount, \$2.1 million is unrestricted. Total net assets decreased by \$17.4 million.
- As of June 30, 2006, MTS' governmental funds reported combined ending fund balances of \$182.5 million, a decrease of \$5.3 million in comparison with an increase of \$9.6 million the prior year. Of this amount, \$4.1 million is unreserved.
- For the year ended June 30, 2006, the combined farebox recovery ratio (the measure of the ability to recover operating costs through fare revenue) for San Diego Trolley, Inc., San Diego Transit Corporation, and MTS Contracted Services was 37.0%, compared to 35.5% for the previous year. A number of factors have brought about this increase, principally increased ridership and lower operating costs at San Diego Transit Corporation.

Overview of the Financial Statements

This discussion and analysis is intended to serve as an introduction to MTS' financial statements. MTS' financial statements comprise three components: 1) government-wide financial statements, 2) fund financial statements, and 3) notes to financial statements. This report also contains other supplementary information in addition to the financial statements themselves.

Government-wide financial statements. The government-wide financial statements are designed to provide readers with a broad overview of MTS' finances, in a manner similar to a private-sector business.

The statement of net assets presents information on all of MTS' assets and liabilities, with the difference between the two reported as net assets. Over time, increases or decreases in net assets may serve as a useful indicator of whether the financial position of MTS is improving or deteriorating.

The statement of activities presents information showing how the government's net assets changed during the most recent fiscal year. All changes in net assets are reported as soon as the underlying event giving rise to the change occurs, regardless of the timing of related cash flows. Thus, revenues and expenses are reported in this statement for some items that will only result in cash flows in future fiscal periods (e.g., earned but unused vacation leave).

Both of the government-wide financial statements distinguish functions of MTS that are principally supported by grant revenue and subsidies (*governmental activities*) from other functions that are intended to recover all or a significant portion of their costs through user fees and charges (*business-type activities*). The governmental activities of MTS include general government and transit operations funding. The business-type activities of MTS include transit services that are operated on a contracted basis with third parties and the taxicab regulatory function. In addition, the government-wide financial statements include not only MTS itself (*known as the primary government*), but also two legally separate transit operators and one legally separate freight railway, for which MTS is financially accountable: San Diego and Arizona Eastern Railway Company (SD&AE).

Fund financial statements. A fund is a grouping of related accounts that is used to maintain control over resources that have been segregated for specific activities or objectives. MTS uses fund accounting to ensure and demonstrate compliance with finance-related legal requirements. All of the funds of MTS can be divided into two categories: governmental funds and proprietary funds.

SAN DIEGO METROPOLITAN TRANSIT SYSTEM

Management's Discussion and Analysis

June 30, 2006

Governmental funds. Governmental funds are used to account for essentially the same functions reported as governmental activities in the government-wide financial statements. However, unlike the government-wide financial statements, governmental fund financial statements focus on *near-term inflows and outflows* of spendable resources, as well as on *balances of spendable resources available* at the end of the fiscal year. Such information may be useful in evaluating a government's near-term financing requirements.

Because the focus of governmental funds is narrower than that of the government-wide financial statements, it is useful to compare the information presented for *governmental funds* with similar information presented for governmental activities in the government-wide financial statements. By doing so, readers may better understand the long-term impact of the government's near-term financing decisions. Both the governmental fund balance sheet and the governmental fund statement of revenues, expenditures, and changes in fund balances provide a reconciliation to facilitate this comparison between *governmental funds* and *governmental activities*.

MTS maintains five individual governmental funds. Information is presented separately in the governmental fund balance sheet and in the governmental fund statement of revenues, expenditures, and changes in fund balances for the General Fund, the Subsidy Pass-Through Special Revenue Fund, the TransNet Special Revenue Fund, the Capital Projects Fund, and the Debt Service Fund, all of which are considered to be major funds.

MTS adopts an annual appropriated budget for the General Fund, the Special Revenue Funds, and the Capital Projects Fund. A budgetary comparison statement has been provided for the General Fund and major Special Revenue Funds to demonstrate compliance with the budget.

Proprietary funds. *Enterprise funds* (a proprietary fund type) are used to report the same functions presented as *business-type activities* in the government-wide financial statements. MTS uses enterprise funds to account for its Taxicab Administration and Other Contracted Services, as well as SDTI, SDTC, and SD&AE

Proprietary funds provide the same type of information as the government-wide financial statements, only in more detail. The proprietary fund financial statements provide separate information for SDTI, SDTC, and Other Contracted Services, a major fund of MTS. Taxicab Administration and SD&AE are reported together as nonmajor proprietary funds of MTS. In addition, MTS prepares individual financial statements for SDTI and SDTC.

Notes to basic financial statements. The notes provide additional information that is essential to a full understanding of the data provided in the government-wide and fund financial statements.

Other information. In addition to the financial statements and accompanying notes, this report also presents certain required supplementary information concerning MTS' progress in funding its obligation to provide pension benefits to its employees.

Government-Wide Financial Analysis

As noted earlier, net assets may serve over time as a useful indicator of a government's financial position. In the case of MTS, assets exceeded liabilities by \$1,248 million at the close of the most recent fiscal year.

The largest portion of MTS' net assets reflects the investment in capital assets, net of related debt. Most of the investment in capital assets is comprised of trolley system assets, buses, and construction-in-progress totaling \$119.5 million, of which the largest projects currently under construction are the Automated Fare Collection System and the San Ysidro Intermodal Transit Center (currently \$31.2 million and \$27.5 million respectively). The capital assets that are represented by the construction-in-progress will be used to provide services to citizens; consequently, these assets

SAN DIEGO METROPOLITAN TRANSIT SYSTEM

Management's Discussion and Analysis

June 30, 2006

are *not* available for future spending. In FY 2006 MTS transferred completed projects worth \$483 million to SDTC, SDTI and Other Contracted Services Fund.

MTS has recorded prior period adjustments totaling \$27,461,021 to properly state unearned revenue in Capital Projects and Debt Service Funds, and to properly state TransNet revenue in the TransNet Fund (see Note 15). SDTC has recorded a prior period adjustment totaling \$704,362 to properly state the liability for compensated absences (see Note 15). All comparative schedules will be presented as restated by the prior period adjustment.

	Governmental Activities June 30, 2006	Governmental Activities (restated) June 30, 2005	Change
Current and other assets	\$ 198,054,162	\$ 257,977,676	\$ (59,923,514)
Capital assets	154,290,529	615,618,669	(461,328,140)
Total assets	352,344,691	873,596,345	(521,251,654)
Long-term liabilities outstanding	173,812,181	220,449,815	(46,637,634)
Other liabilities	30,704,556	47,363,292	(16,658,736)
Total liabilities	204,516,737	267,813,107	(63,296,370)
Net assets (deficit):			
Invested in capital assets, net of related debt	111,959,506	420,667,651	(308,708,145)
Unrestricted	35,868,448	185,115,587	(149,247,139)
Total net assets	\$ 147,827,954	\$ 605,783,238	\$ (457,955,284)
	Business-Type Activities June 30, 2006	Business-Type Activities (restated) June 30, 2005	Change
Current and other assets	\$ 87,280,767	\$ 94,064,838	\$ (6,784,071)
Capital assets	1,134,242,639	695,486,022	438,756,617
Total assets	1,221,523,406	789,550,860	431,972,546
Long-term liabilities outstanding	95,630,429	97,828,047	(2,197,618)
Other liabilities	25,411,482	31,799,826	(6,388,344)
Total liabilities	121,041,911	129,627,873	(8,585,962)
Net assets (deficit):			
Invested in capital assets, net of related debt	1,134,242,639	695,486,022	438,756,617
Unrestricted	(33,761,144)	(35,563,034)	1,801,890
Total net assets	\$ 1,100,481,495	\$ 659,922,988	\$ 440,558,507

SAN DIEGO METROPOLITAN TRANSIT SYSTEM

Management's Discussion and Analysis

June 30, 2006

Governmental Activities. Governmental activities decreased MTS' net assets by \$458 million. Key elements of this decrease are as follows:

	<u>2006</u>	<u>2005</u>	
	<u>Governmental</u>	<u>Governmental</u>	<u>Change</u>
	<u>Activities</u>	<u>Activities</u>	
Revenues:			
Program revenues:			
Operating grants and contributions	\$ 124,018,111	\$ 86,270,079	\$ 37,748,032
Capital grants and contributions	31,727,904	55,623,439	(23,895,535)
General revenues:			
Interest income	6,966,330	11,638,987	(4,672,657)
Indirect cost recovery	1,685,026	2,827,481	(1,142,455)
Total revenues	<u>164,397,371</u>	<u>156,359,986</u>	<u>8,037,385</u>
Expenses:			
General government	10,144,463	10,429,104	(284,641)
Transit operations funding	85,352,004	73,905,584	11,446,420
Transit capital funding	-	261,775	(261,775)
Misc office/other expense	34,502	-	34,502
Interest on long-term debt	8,136,111	8,669,729	(533,618)
Total expenses	<u>103,667,080</u>	<u>93,266,192</u>	<u>10,400,888</u>
Increase (decrease) in net assets before capital contributions and transfers	60,730,291	63,093,794	(2,363,503)
Capital contributions - SANDAG	895,826	946,278	(50,452)
Capital contributions - MTS	(483,169,381)	(21,679,153)	(461,490,228)
Transfers	(36,412,020)	(626,720)	(35,785,300)
Increase (decrease) in net assets	<u>(457,955,284)</u>	<u>41,734,199</u>	<u>(499,689,483)</u>
Net assets – Beginning of year as restated	605,783,238	564,049,039	41,734,199
Net assets – End of year	<u>\$ 147,827,954</u>	<u>\$ 605,783,238</u>	<u>\$ (457,955,284)</u>

Capital and operating grants and contributions continue to be a major portion of the revenue used to fund transit operations and capital projects. Variances between FY 2006 and FY 2005 governmental activities are largely attributable to the \$483 million contribution of completed capital projects to SDTC, SDTI and Other Contracted Services. The largest portion of this contribution, \$481 million, consisted of the completed Mission Valley East project contributed to San Diego Trolley. In addition, there was a decrease in the current year subsidy for capital projects.

SAN DIEGO METROPOLITAN TRANSIT SYSTEM

Management's Discussion and Analysis

June 30, 2006

Variations between FY 2006 and 2005 business-type activities are due primarily to capital assets totaling \$505 million contributed by MTS, SANDAG and others.

	<u>2006</u>	<u>2005</u>	
	<u>Business-Type</u>	<u>Business-Type</u>	
	<u>Activities</u>	<u>Activities, as</u>	<u>Change</u>
		<u>restated</u>	
Revenues:			
Program revenues:			
Charges for services	\$ 70,183,914	\$ 66,055,549	\$ 4,128,365
Operating grants and contributions	<u>73,349,516</u>	<u>101,128,154</u>	<u>(27,778,638)</u>
Total revenues	<u>143,533,430</u>	<u>167,183,703</u>	<u>(23,650,273)</u>
Expenses:			
Transportation	<u>244,673,515</u>	<u>224,969,714</u>	<u>19,703,801</u>
Total expenses	<u>244,673,515</u>	<u>224,969,714</u>	<u>19,703,801</u>
Increase (decrease) in net assets before capital contributions and transfers	(101,140,085)	(57,786,011)	(43,354,074)
Capital contributions-other	22,117,191	29,061,061	(6,943,870)
Capital contributions-MTS	483,169,381	21,679,153	461,490,228
Transfers	<u>36,412,020</u>	<u>626,720</u>	<u>35,785,300</u>
Increase in net assets	<u>440,558,507</u>	<u>(6,419,077)</u>	<u>446,977,584</u>
Net assets – beginning of year as restated	<u>659,922,988</u>	<u>666,342,065</u>	<u>(6,419,077)</u>
Net assets – end of year	<u>\$1,100,481,495</u>	<u>\$ 659,922,988</u>	<u>\$ 440,558,507</u>

