



JERRY SANDERS
MAYOR

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COUNTY GRAND JURY

July 2, 2007

Honorable Janis Sammartino
Presiding Judge
San Diego County Superior Court
Main Courthouse, Third Floor
220 West Broadway
San Diego, California 92101

Dear Judge Sammartino:

Subject: 2006-2007 Grand Jury Report entitled "Water for the City of San Diego Revisited"

Pursuant to California Penal Code Section 933.05(a), (b), and (c), the City of San Diego provides the following responses to the findings and recommendations in the above-entitled Grand Jury Report.

Below, I have provided a response to each and every finding and recommendation outlined in your report.

Finding: The City is in jeopardy of defaulting on the promise to the federal government to reuse beneficially 50% of the reclaimed water from the North City Water Reclamation plant by 2010.

Disagree. The agreement with the United States Environmental Protection Agency specifies the City will attempt to achieve a goal of 50% beneficial use. If the City falls short of this value despite good efforts, it does not constitute 'defaulting on a promise'.

Finding: The City has not responded on research concerning desalinization as a potential resource for potable city water.

Disagree. The San Diego City Council adopted the Long-Range Water Resources Plan (2002 – 2030) on December 9, 2002. This water resource planning document provides the framework for the development of local water supplies including brackish groundwater desalination and seawater desalination. Since approval of the Water Resource Plan, the City has moved forward to assess

and develop the most promising local water supply, groundwater, with an emphasis on brackish groundwater desalination in the following groundwater basins:

- Mission Valley: A monitoring well was constructed in Mission Valley in 2006. This project, a joint effort by the City and United States Geologic Survey (USGS), was undertaken to collect and analyze the water supply potential of the basin. The well has provided the City with data that will assist in determining the potential for a potable water desalination project.
- San Diego Formation: A monitoring well was constructed and completed in the San Diego Formation in March 2007 to determine the water quality and quantity of this large groundwater basin. State grants funds from Prop 50 paid for 50% of project costs (\$249,000).
- San Pasqual Valley: Several projects are underway in the San Pasqual Valley, one of the City owned basins which appears to have the greatest groundwater development potential. The preparation of a Groundwater Management Plan is scheduled to be completed later this calendar year. Additionally, a 205 acre-foot (AF) groundwater desalination demonstration project to evaluate the feasibility of building a 5,000 AF desalination facility in the western portion of the basin was recently approved by City Council and is being implemented. The City received Prop 50 grant funds totaling \$1.5 million for this demonstration project.
- Balboa Park: Working with USGS, a monitoring well is being drilled in Balboa Park to assess the water quality and quantity within the northern portion of the San Diego Formation.

Funds for \$30 million in groundwater development projects are included in the water rate case approved by the City Council in February of this year and comprise 5% of the total FY 08-11 Water CIP.

The City continuously works with both the San Diego County Water Authority (CWA) and the Metropolitan Water District of Southern California (MWD) to further the development of desalination within the region. There is currently a plant under development by Poseidon Resources Corporation in Encina. City Water Department staff has met with Poseidon executives on a number of occasions and have directly expressed interest in pursuing a second plant in the south county once Encina is operational.

Finding: The Coachella Canal and All-American Canal projects are working their way through the construction phase and legal system.

Agree.

Finding: The City did terminate water and wastewater SLAs by the end of 2006. The terminations resulted in reimbursement of approximately \$3 million to the Water Department.

Agree.

Finding: The City directed increases in rates resulted in a rise in income of more than \$77 million through fiscal years 2002-2004. During the period of the rate increases operating and capital expenses incurred by the Water Enterprise Fund exceeded revenues generated from rate increases by almost \$98 million. As a result, little, if any effort was directed to upgrade the failing water infrastructure. Between the years 2000-2006, there were 999 water main breaks in the City.

Partially Agree. This condition was reviewed by outside auditors and is consistent with the City's policy to fund CIP projects with both cash and financing. During this period, the City's inability to access the bond market because of other financial issues diminished the Water Department's ability to upgrade the water infrastructure.

Finding: The City is struggling to meet that goal (DHS compliance order to replace 10 miles of cast iron water pipe each year), even though the numbers of breaks have decreased. In 2006, there were 104 breaks.

Agree. The City's inability to access the bond market reduced the cast iron replacement program as all projects had to be cash funded.

Finding: The rate increases provided more than \$108 million in additional revenues from 2001 to 2005. Direction from the City to increase sewer replacements resulted in sewer spill reduction. At the same time, retirement expenses increase from \$3.5 million to nearly \$5.5 million, resulting from a 21% growth due to staff additions, salary increases and an increase in retirement contribution rate from 6.68% to 10.94% of salaries.

Partially Agree. Metropolitan Wastewater Department (MWWD) streamlining and efficiency initiatives have resulted in staff reductions, which have limited the growth of retirement expenses.

Finding: There are no apparent actions being taken by the City to proceed with recommendations of the (*City of San Diego Water Reuse*) study. It has (been) met with mixed reviews. The approval of this report is pending.

Agree. Policy discussions surrounding the Water Reuse Study continue.

Finding: There were two Cost of Service rate studies prepared by Raftelis Financial Consultants, Inc.; one for Water and one for Wastewater. The percentage of increase applied to different groups of water users has been challenged. The City approved the rate increases on February 26, 2007.

Agree. The challenges were refuted, which allowed the rate increases to be passed by a vote of the San Diego City Council.

Finding: The current plan is to submit a request for an additional five year waiver

Disagree. The City is evaluating the issue of secondary treatment at Point Loma and will decide whether to submit a request for an additional five year waiver in late 2007, after study by the scientific and other applicable communities.

Recommendation 07-39: Endorse the City of San Diego Water Reuse Study and proceed with the next steps as proposed.

Response: Recommendation requires further analysis. As noted above, the policy discussions on the Water Reuse Study are continuing. Outreach efforts with citizen and stakeholder groups will be conducted over the next 2-3 years to determine the optimal implementation alternatives and strategies.

Funds for pipeline extensions to provide recycled water service to additional customers are included in the new rates. As noted in the public outreach materials for the rate case, the primary short-term (four year) goals of the Water Department are to: meet ongoing operation and maintenance needs of the water system; replace aging infrastructure to reduce the number of pipeline breaks and emergency repairs; comply with Federal Safe Drinking Water Act and the DHS Compliance Order; and repair and replace infrastructure to maintain system reliability.

Recommendation 07-40: Implement the plan for upgrade of the water and wastewater systems infrastructure.

Response: This recommendation has been implemented. On February 26, 2007 the City of San Diego Council approved four years of water rate increases which will fund \$585 million of water capital improvements (CIP). Specific project budgets were identified to upgrade the Water Department treatment plants, reservoirs, pump station and pipelines, and other operational requirements. Currently the Water Department is obtaining the financing to implement this plan. The major part of the four year CIP plan is mandated by the State of California Department of Health Services (DHS), and for that reason, City Personnel met with DHS representatives and requested Amendment 11 to the Compliance Order that was issued on May 11, 2007, that is supported by the four year CIP plan for 2008 – 2011.

On February 26, 2007 the City of San Diego Council also approved four years of wastewater rate increases which will fund \$648 million of wastewater capital improvements (CIP). These projects focus on collection systems improvements supporting the Final Consent Decree.

Recommendation 07-41: Attempt to streamline the water and wastewater systems, organization and procedures. This should include outsourcing where feasible.

Response: This recommendation has been implemented. Almost 80% of the Water Department is currently under "Bid to Goal" (Operations Division with 498 personnel is completing their third year of a five year contract and Customer Support Division is finishing their first year of a five year contract). The rest of the Department has undergone a Business Process Reengineering review within the last six months. While City Council has not yet approved the recommendations of this review, we recognize that organizational change is a constantly evolving process and will implement efficiency improvements whenever they are available.

MWWD has completed the City's first department wide Business Process Reengineering/Bid to Goal process, with MWWD matching an independent estimate of private industry costs to operate and maintain the wastewater system. This has resulted in a planned reduction of over 10% of personnel in FY08. MWWD will continue to evaluate further organizational and process improvements.

Recommendation 07-42: Work closely with the San Diego County Water Authority to generate a plan for the development of desalination as an alternate source of water for San Diego.

Response: This recommendation has been implemented. The SDCWA, and its member agencies including the City of San Diego, are supportive of the private development of the Carlsbad Desalination Project by Poseidon Resources Group. This project will provide 56,000 acre-feet per year of new local water supply to meet the needs of 300,000 county residents. Several SDCWA member agencies have signed contracts with Poseidon for the water to be produced from the Carlsbad desalination plant including: City of Carlsbad, Valley Center Water District, Sweetwater Authority, Olivenhain Municipal Water District, and Rincon Water District.

Recommendation 07-43: Implement new procedures to ensure that enterprise funds of the Water and Wastewater Departments are not misused.

Response: This recommendation has not yet been implemented, but will be in the future, with implementation completed by August 31, 2007. The City is establishing an Independent Rates Oversight Committee (IROC) for Water and Wastewater Departments that will monitor use of enterprise funds. The primary responsibilities for the IROC will be to:

Review reports on the expenditure of rate and bond proceeds;

- Review independent performance audits on the City's water and wastewater systems;
- Provide advice on the efficiency and performance of both systems on a regular basis;
- Oversee departmental savings efforts and deposits to the "Dedicated Reserve from Efficiency and Savings" (DRES) to be established as another element of the safeguard plan;
- Provide an annual public report on these issues to the Mayor and City Council. That report will be announced in the City's water and wastewater billing, through announcements to local media, via placement on the City's website and through notices on CityTV;
- Assume all duties now assigned to the Public Utilities Advisory Commission related to the review of policy, proposals and advice sought by the water and wastewater systems. The subject areas to be addressed by the IROC will include budget and finance, environmental issues, technology innovations, public outreach and education efforts.

Recommendation 07-44: Ensure that funds obtained from the approved rate increases for both water and wastewater systems are properly utilized for infrastructure upgrade.

Response: This recommendation has not yet been implemented, but will be in the future, with implementation completed by August 31, 2007.

Mayor Sanders has already put in place a number of safeguards to assure that rate increases are used appropriately. Before proposing the rate increases approved by the City Council in February 2007, Mayor Sanders set several preconditions as requirements for considering any new rate recommendations:

- Completion of a comprehensive examination of the budgets and rate structures.
- A review by outside auditors of past practices regarding the use of previous rate increases and bond proceeds.
- A detailed report regarding whether the water system had raised rates for projects that have not been, or never will be, completed.
- An analysis of the various operational and capital demands on the cash flow.
- A complete accounting of any funds that have been transferred out and for what purpose.
- A study of how San Diego's water rates compare with surrounding agencies, and
- A thorough report of what administrative expenses can be trimmed.

Several reports were prepared to ensure that these requirements were met, including the reports of reviews of the following:

- Use of revenues generated by a series of water rate increases approved by the City Council for fiscal years 2003, 2004, and 2005.
- Use of the proceeds from the Series 2002 Water Revenue Bonds.

- Transfers and interfund charges (including Service Level Agreement charges) paid by the Water Fund to other City Funds (including the General Fund) for the fiscal year ending June 30, 2003.

An independent review was also completed for the proposed rate increases. The results of these reviews were documented in the Report to the City Council No. 07-039, "Water Revenue Increase and Capacity Fee Increase", dated February 21, 2007 and which propose the most recent rate increases. In summary, based on an independent review done by the accounting firm of Mayer Hoffman and McCann P.C., it was found that the revenues generated by previous rate increases were appropriately expended; that with minor exceptions bond funds were appropriately expended and recommendations were made for improved procedures which have been implemented; that there were some instances of inappropriate fund transfers and that the City's use of SLA should be reviewed. The Mayor directed the repayment of certain transfers and the review of SLA has been completed and new procedures adopted.

Looking forward, in order to ensure the appropriate use of funds derived from rate increases, the Mayor proposed and the City Council has adopted the Independent Rates Oversight Committee (IROC) as described above. The IROC will assume and expand on the role currently played by the City's Public Utilities Advisory Commission. The IROC will replace that commission as the venue used to review changes in budgets and the scope of projects being proposed for the water and wastewater systems. The primary responsibilities of the IROC are described in the response to Recommendation 07-43.

In summary, the Mayor's plan to safeguard revenues from rate increases include creation of a new oversight committee with expanded and clearly defined responsibilities; creation of the DRES to protect and preserve savings from increased efficiencies or changed priorities to decrease the need for future rate increases; annual independent audits in addition to the City's regular financial audits to focus on use of ratepayer funds and bond proceeds; regular performance audits to identify methods to reduce costs; and a limitation of future bid-to-goal contracts to one year in anticipation of managed competition.

Recommendation 07-45: Develop or update plans for the upgrade of the Point Loma Wastewater Treatment Plant to a secondary treatment level facility in accordance with the EPA's requirements.

Response: This recommendation requires further scientific analysis and policy decisions.

Recommendation 07-46: Exercise caution in increasing retirement benefits which will take funds from ratepayers who have been promised that increases are for infrastructure maintenance and repair.

Response: This recommendation has been implemented. In November 2006, San Diego voters overwhelmingly passed Proposition B requiring a public vote for any future

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pension benefit increases for City employees. On December 5, 2006 the City Council voted unanimously to approve the ordinance amending Chapter 2, Article 4, of the San Diego Municipal Code by adding Division 19, Titled "Voter Approval of Retirement System Benefit Increases" relating to the implementation of the Charter Section 143.1.

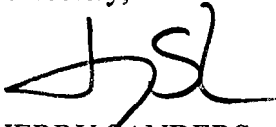
The Water and Wastewater Departments do not negotiate compensation packages for City employees, rather, those negotiations are conducted the Mayor and labor unions representing specific employee classifications. Any increases to employee retirement benefits would have to be negotiated through a meet and confer process and voted on by the citizens of San Diego.

Recommendation 07-47: Direct the Water Department to aggressively replace aging infrastructure, particularly the cast iron water pipe, in accordance with the State DHS mandate. The "fix as it breaks" philosophy is costly and inefficient.

Response: This recommendation has been implemented. The Water Department has replaced more than 90 miles of cast iron water pipe in the past eight years. The DHS mandate in the Compliance Order is to replace ten miles of cast iron annually; however, the Water Department voluntarily decided to adopt a more aggressive cast iron main replacement program. The four year CIP plan (2008 – 2011) includes replacing 15 miles of cast iron mains for fiscal year 2008, and 20 miles per year thereafter until the remaining 190 miles are replaced.

Please contact Richard Haas, Deputy Chief of Public Works, at (619) 236-6750 if you have any questions.

Sincerely,



JERRY SANDERS
Mayor

Cc: San Diego County Grand Jury
San Diego City Council
Chief Operating Officer
Deputy Chief of Public Works
City Clerk
City Attorney
Business Operations/Administration Director