

EXHIBIT P



Finance

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June 14, 2006

Mr. Eric Reimer
1022 Douglas Street
Modesto, Ca. 95350

Dear Eric:

Thank you for your letter dated May 2, 2006 in which you have expressed your concerns regarding the issues that were covered during our meeting held on May 1, 2006 and also during the public meeting held on April 11, 2006. I would like to address several of the concerns that were listed in your letter to provide some clarification on these issues.

With regard to the discussion held on April 11th at the public meeting, staff from the City did not disagree then, nor do they disagree now that there were errors contained in Table 7-1 from the Foresight Water Rate Study. I apologize if you were unable to cover this point during our meeting held on May 1st, but I trust that you would agree we did cover a lot of information that was relevant and enlightening to the topic of analyzing the water rate study.

With respect to your discussion about the interpretation of the term, "Revenue Requirement" I would like to refer you to the following information:

Pages 16 & 17 of the Foresight Study (copy attached). As you can see, starting with the first paragraph, the consultant clearly intended to include the capital improvement costs for the new pay-as-you-go and Tier 2 downstream improvement projects in the annual Revenue Requirement calculation by reference to the fact that the proposed rate adjustment is intended to build the reserves that will be used to eventually construct these facilities. Further, on page 17 the text indicates that the "net revenue requirements shown in Table 4-1 do not directly show how much is spent on "cash-funded" CIP projects, but they illustrate the need to collect additional revenue from ratepayers when compared to the current annual rate revenue of approximately \$28 million per year."

With regard to your statement regarding Foresight's recommendation that the creation of reserves for capital expenditures should be initiated after 2010, I again refer you to Table 7-3. It is here that the revenues remaining after payment of operating expenditures and debt service are distributed for use in either paying the costs of capital projects or building the various reserve levels to the target values that are shown (see the section labeled, "Balances of Reserves." As you can see, by the end of fiscal '08-09, the reserves that

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are listed are just beginning to reach the target levels that are shown. It is because of this that Foresight makes the recommendation to set aside additional capital reserves after 2010, because it is during that timeframe that monies are assumed to become available for that purpose.

Thank you for your interest in the city's evaluation of the water rate study. I hope that once you've had the chance to review this information you will find it useful in conducting your own evaluation of the study.

Respectfully,



Wayne Padilla
Finance Director

cc K. Olsen
R. Rudnansky ✓

4. Projected Revenue Requirements

The process of setting water rates is often focused on meeting the utility's annual revenue requirements. However, in the City's case, the rate study objectives are broader than this; in addition to meeting the annual revenue requirements, water rates also need to fund the costs of significant capital improvements allocated to existing customers.

As seen later in the proposed financial plan (Section 7), the proposed rate adjustments are used to fund new capital projects in two ways: (1) by paying the annual debt service on new debt for capital improvements, and (2) by building the City's reserve funds, which are then used to pay for additional capital projects on a pay-as-you-go basis. These new capital facilities include:

- The new MID Regional Water Treatment Plant, which has been the subject of extensive study and engineering analysis by the City's capital projects group (\$37.6 million – funded with new debt)
- Tier 1 Downstream Improvements (\$34 million – new debt)
- Tier 2 Downstream Improvements (\$26.7 million – of which \$15 million is debt-funded and \$11.7 million is cash-funded from reserves)
- Cash-funded Capital Improvements (\$43.15 million – cash-funded from reserves)

In order to construct the MID Plant and downstream improvements, it is critical for the City be able to support the issuance of the additional \$86.6 million of debt funding shown here. This requires rate adjustments that are sufficient enough to improve the City's financial outlook and enable the City to demonstrate that it can meet its current and future bond coverage requirements. The additional debt would then be repaid over a 20-year period through water rates (the estimated time to reach buildout).

It is also important to note that funding for these future capital improvements has been allocated between existing customers and future growth based on an engineering study prepared by West Yost & Associates. This study looked at a total of \$152.8 in capital improvement projects and found that 74.2% of those costs should be born by existing customers and 25.8% by growth. Although actual funding is discussed in more detail in the financial plan (Section 7), rate revenue from existing customers may be used to initially cover growth's capital expenditures if connection fee revenue is not received in a timely manner. However, the City is currently evaluating water system connection fees and expects the new, higher water connection fees to ultimately cover the costs allocated to growth.

Table 4-1 summarizes the projected operating expenditures. The new debt-service payments include:

- \$4.1 million fund the new MID treatment plant
- \$3.6 million beginning in 2007-08 are for the Tier 1 downstream improvements

- \$1.6 million beginning in 2008-09 are for the \$15-million of Tier 2 downstream improvements that are debt-funded

The net revenue requirements shown in Table 4-1 do not directly show how much is spent on "cash-funded" CIP projects, but they illustrate the need to collect additional revenue from ratepayers when compared to the current annual rate revenue of approximately \$28 million per year.

Table 4-1
Projected Water Utility Budgets (From 10-Year Proforma)
 City of Modesto

Agency/Org.	Description	Estimate	Adopted	Projected				
		7/14/04 2003-04	2004-05 Year 1	2005-06 Year 2	2006-07 Year 3	2007-08 Year 4	2008-09 Year 5	
Operating Expenses								
440/5015	Capital Planning	\$766,000	\$998,000	\$1,018,000	\$1,039,000	\$1,059,000	\$1,081,000	
440/509x	Billing & Collection	\$1,243,000	\$1,393,000	\$1,422,000	\$1,450,000	\$1,479,000	\$1,508,000	
480/5009	Water Admin.	\$594,000	\$866,000	\$883,000	\$901,000	\$919,000	\$937,000	
480/50xx	Construction/Repairs	\$7,489,000	\$7,882,000	\$8,040,000	\$7,918,000	\$8,034,000	\$8,153,000	
480/50xx	Meter & Service Install.	\$1,366,000	\$1,582,000	\$1,614,000	\$1,647,000	\$1,679,000	\$1,713,000	
480/5017	Water Conservation	\$361,000	\$372,000	\$379,000	\$387,000	\$395,000	\$403,000	
480/50xx	Well Site Improvement	\$4,526,000	\$5,856,000	\$5,912,000	\$6,335,000	\$6,461,000	\$6,590,000	
480/50xx	Water Quality/Lab	\$411,000	\$780,000	\$796,000	\$812,000	\$828,000	\$845,000	
	Remainder of Operating Expen.	-\$778,000	-\$2,596,000	\$431,000	\$504,000	\$532,000	\$585,000	
	Subtotal - Operating Expenses	\$15,978,000	\$17,133,000	\$20,495,000	\$20,993,000	\$21,386,000	\$21,815,000	
480/5013	Treatment (MID T&DA O&M) (a)	\$4,052,000	\$4,853,000	\$4,998,000	\$5,148,000	\$6,795,000	\$8,536,000	
N.A.	New Meter Reading & Billing (b)	\$0	\$338,000	\$516,000	\$531,480	\$547,424	\$563,847	
N.A.	New Meter & Service O&M (c)	\$0	\$0	\$721,000	\$466,796	\$480,800	\$495,224	
	Total Operating Expenditures	\$20,030,000	\$22,324,000	\$26,730,000	\$27,139,276	\$29,209,224	\$31,410,071	
Debt Service Payments								
	1997 COPs/CDWR Loan	\$2,045,000	\$2,044,944	\$2,049,564	\$2,055,314	\$2,058,776	\$2,056,586	
	MID T&DA Debt Service	\$6,724,000	\$7,124,000	\$7,124,000	\$7,124,000	\$7,124,000	\$7,124,000	
	New MID Treatment Plant (\$37.6 mil.) (d, e)	\$0	\$0	\$0	\$0	\$4,110,000	\$4,110,000	
	Tier 1 Downstream Imprvmnts (\$34 mil.) (d)	\$0	\$0	\$0	\$0	\$3,618,000	\$3,618,000	
	Tier 2 Downstream Imprvmnts (\$15 mil.) (d)	\$0	\$0	\$0	\$0	\$0	\$1,619,000	
	Subtotal - Debt Service	\$8,769,000	\$9,168,944	\$9,173,564	\$9,179,314	\$16,910,776	\$18,527,586	
	Capital & Other Uses	\$1,869,000	\$2,001,000	\$2,010,000	\$2,012,000	\$1,907,000	\$1,869,000	
	Total Revenue Requirements	\$30,668,000	\$33,493,944	\$37,913,564	\$38,330,590	\$48,027,000	\$51,806,657	

Unless otherwise noted, source of data is the City Water Utility Budgets and Finance Dept.'s 10-Year Proforma (7-26-04).

- Assumes the MID Treatment Plant will be completed in the 1st quarter of 2008, therefore, additional O&M costs in '07-08 are for 6 months of operations.
- Estimate of personnel and O&M costs for new meter reading and billing operations, provided by Cheryl Detmar.
- Includes \$260,000 in one-time costs and \$440,000 in ongoing costs for meter installation and maintenance, from Judith Ray, 7-26-04.
- Financing assumption: 6% interest rate, 20-year repayment period, and 12 months of capitalized interest. Source: Peter Miller, Public Financial Mngmt, 9/1/04.
- Assumes the MID Treatment Plant will be completed in the 1st quarter of 2008, that interest is capitalized, and debt service payments start in 2007-08.

Table 7-3

Projected Reserve Levels (in \$000's)

City of Modesto Water Fund

	Estimated '03-04	Year 1 '04-05	Year 2 '05-06	Year 3 '06-07	Year 4 '07-08	Year 5 '08-09	Total Cash-Funded CIP (Years 1-5)
Available Working Capital							
Net Revenues (from Table 7-2)		(\$67)	(\$2,767)	(\$2,694)	(\$4,275)	(\$5,980)	
Add'l Revenue from Rate Increases (From Table 7-1)		\$3,855	\$17,841	\$25,230	\$28,401	\$31,806	
Debt Service Payments							
1997 COPs/CDWR Loan		(\$2,045)	(\$2,050)	(\$2,055)	(\$2,059)	(\$2,057)	
New MID Plant Debt Ser.		\$0	\$0	\$0	(\$4,110)	(\$4,110)	
Tier 1 CIP Debt Service		\$0	\$0	\$0	(\$3,618)	(\$3,618)	
Tier 2 CIP Debt Service		\$0	\$0	\$0	\$0	(\$1,619)	
Available for Reserves & Cash-funding		\$1,743	\$13,024	\$20,481	\$14,339	\$14,423	
Reserve Contributions & Cash-Funding							
Beginning Working Capital (a)	\$17,642	\$5,377	\$0	\$0	\$0	\$0	
Available for Reserves & Cash-funding	--	\$1,743	\$13,024	\$20,481	\$14,339	\$14,423	
Cash-Funded CIP (b)	(\$4,926)	(\$5,330)	(\$9,456)	(\$9,456)	(\$9,456)	(\$9,456)	(\$43,153)
Cash-Funded Tier 2 COP Projects (c)	\$0	\$0	\$0	(\$3,900)	(\$3,900)	(\$3,900)	(\$11,700)
New Contrib. to Rate Stabilization	--	\$1,000	\$0	(\$158)	\$0	\$0	
New Contrib. to Operating Reserve	--	\$0	(\$1,313)	(\$2,000)	\$0	\$0	
New Contrib. to R&R Reserve	--	\$0	\$0	(\$3,700)	\$297	\$226	
less Connection Fee Revenues (d)	(\$1,159)	(\$1,243)	(\$1,255)	(\$1,268)	(\$1,280)	(\$1,293)	
Existing Restricted Reserves (e)	(\$3,673)	--	--	--	--	--	
Adjustments (f)	(\$2,507)	(\$1,547)	\$0	\$0	\$0	\$0	
Ending Working Capital After CIP (g)	\$5,377	\$0	\$0	\$0	\$0	\$0	(\$54,853)
Balance of Reserves							
Ending Working Capital After CIP	\$5,377	\$0	\$0	\$0	\$0	\$0	
Rate Stabilization Reserve	\$2,847	\$1,847	\$1,847	\$2,004	\$2,004	\$2,004	
Target Balance (h) 20%	\$2,100	\$2,200	\$2,200	\$2,300	\$2,300	\$2,300	
Operating Reserve	\$0	\$0	\$1,313	\$3,313	\$3,313	\$3,313	
Target Balance (i) 25%	\$4,000	\$4,300	\$5,100	\$5,200	\$5,300	\$5,500	
Repair & Replacement Reserve	\$0	\$0	\$1,000	\$4,700	\$4,403	\$4,177	
Target Balance (j) 5%	\$4,900	\$4,900	\$4,900	\$4,900	\$4,900	\$4,900	
Balance of Reserves	\$8,224	\$1,847	\$4,160	\$10,018	\$9,720	\$9,494	
Target Balance - Operating Reserves	\$11,000	\$11,400	\$12,200	\$12,400	\$12,500	\$12,700	

a. FY '03-04 is from Finance Department, 10-year proforma.

b. Currently planned cash-funded CIP projects for existing users totaling \$41.8 million plus from 2005-06 through 2008-09, plus \$1.353 mil. carryover from '04-05.

c. Cash-funded portion of existing users share of Tier 2 CIP projects. Remainder of \$15 million is debt funded (see Tables 4-1 and 7-1).

d. Connection fee revenues are included in the Net Revenues, but will not be used to pay for CIP projects for existing customers.

e. Includes existing balance in Rate Stabilization fund as of June 30, 2003 (from p. 117 of CAFR) and restricted cash (p.28).

f. Includes Balance Sheet & Non-Cash adjustments plus annual Surplus/Deficit from 10-Year Proforma, 7-26-04, plus Net Revenues of \$2.453 mil from Table 7-2.

g. Prior year CIP carryover exceeds ending working capital in FY'03-04.

h. Rate Stabilization Fund target balance = 20% of rate revenues from metered customers (from Table 7-1).

i. Operating Reserve target balance = 25% of Operating Expenses (from Table 7-1). Excludes MID O&M, debt service, etc.

j. Repair & Replacement Reserve target balance = 5% of next 5-years of cash- and debt-funded CIP projects (approximately \$100 million).

Reserve Funds

In the past, the City has had to contend with the loss of wells due to contamination and increasingly strict water quality standards. Now it has to fund the new MID surface water treatment plant and a number of new transmission, storage, and related downstream capital improvements. Given these significant funding requirements and other uncertainties in future plans, including actual population growth, COP interest rates, the revenue impacts of higher rates, metering program, and future yet un-funded capital projects, the City needs to re-examine how it will maintain adequate operating and capital reserve funds.

The following is a brief description of each of the recommended reserve funds and their target ending balances.

Working Capital Reserves – A water utility typically needs a certain amount of cash on hand carried over from the previous year to ensure smooth financial operations. In