FISCAL YEAR 2003 ANNUAL REPORT

WATER RESOURCES FOR A DESERT COMMUNITY

TUCSON WATER

CITY OF TUCSON WATER DEPARTMENT

ON THE COVER:

Sam Hughes Elementary School (shown) is one of 40 schools irrigated with reclaimed water. Reclaimed water, a growing resource, will play an important role in meeting the future water needs of our community.

TUCSON WATER

provides water service to approximately 690,000 people (about 85% of the greater Tucson metropolitan area's total population) within a 300 square-mile area. During Fiscal Year 2003, Tucson Water delivered 36 billion gallons of potable water. Additionally, Tucson Water delivered 3.5 billion gallons of reclaimed water for turf irrigation.

Reclaimed water keeps community schoolyards green and inviting while saving precious drinking water.

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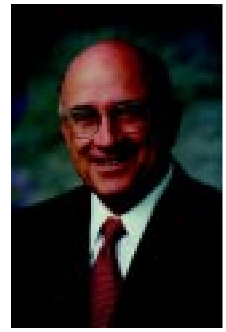

Letter from
Robert E. Walkup
Mayor

Once again, the citizens of Tucson and Tucson Water, their water utility, have done a great job in meeting the water challenges that face our desert community.

Despite a prolonged drought and increasingly hot summers, our customers continue to demonstrate a strong water conservation ethic. Encouraged by outstanding public outreach, education, and conservation programs at Tucson Water, our community has achieved one of the lowest per capita water use rates in the southwestern United States. We can be very proud of our conservation achievements and we know that becoming even more water efficient will be critical as our community grows and the demand for water increases.

Conservation efforts in Tucson are enhanced by our outstanding reclaimed water system, one of the largest in the nation. We have led the way in this area of water re-use. Our community reduces its reliance on groundwater with each new customer added to the reclaimed system.

During Fiscal Year 2003, we also expanded our use of Colorado River water via our Clearwater Renewable Resource Facility. Additional wells in the central city were shut off to allow the water table in our community to be naturally replenished. Groundwater levels beneath Tucson are rising, and the threat of additional land subsidence has retreated for now.

You will gain a greater understanding of the balancing act required in managing the water resources in our community as you review this annual report. Our community will need to utilize all of the valuable water resources available to us to meet the water demands of the future, and make sure that we use those resources in the most efficient and effective ways possible. All of us must work together to make the sometimes complex choices that will ensure that we have sufficient supplies of high quality water for today and for generations to come.

Robert E. Walkup
Mayor

Council, City of Tucson

José J. Ibarra
Ward 1

Carol W. West
Ward 2

Kathleen Dunbar
Ward 3

Shirley C. Scott
Ward 4

Steve Leal
Ward 5

Fred Ronstadt
Ward 6

James R. Keene, Jr.
City Manager

Letter from
David V. Modeer
Director

Continuous self-improvement has been the theme for Tucson Water over the past year. We've worked to become more efficient with the implementation of the Maintenance Management Pilot Program, our major re-engineering effort in 2003. We also began developing a long-range water resource plan that will help us make timely decisions about future water supplies and capital improvements needed to serve customers in the decades ahead.

The Maintenance Management Pilot program, the testing ground for our reengineered approaches to the Utility's maintenance functions, has provided important information to allow the Utility to move forward with major efficiency improvements. The Pilot Program will be completed in June 2004, with a full roll out to all maintenance functions of Tucson Water scheduled in Fiscal Year 2005. The full-scale implementation of the Maintenance Program will be applied to over 4,000 miles of water mains, more than 200 active wells, 125 boosters, 15,000 fire hydrants, and 62,000 valves.

Tucson Water is also developing a long-range integrated water resource plan. This involves evaluating the water supply, water quality, and water delivery issues facing our community and developing a water resource plan to guide the Utility through 2050. Many complex factors must be considered in developing the long-range plan. These include the assessment of potentially available water sources, including groundwater, Colorado River water and wastewater effluent, in relation to projected growth and the ever- increasing demand for water.

Reclaimed water, our current method of utilizing wastewater effluent, contributed nearly 9% of water delivered in Fiscal Year 2003. We have one of the oldest and largest reclaimed water systems in the nation. We expect our current customer base of 670 to grow to over 1,000 by 2008. Our ability to expand the ways we use this vital resource is critical in meeting the future water needs of our community.

We look forward to talking with our customers about the long-range plan as well as all of the options we may have and the decisions that we need to work on together. We want all of our customers to provide input as we move forward together to ensure our water needs are met today and in the future.

David Modeer
Director

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WATER RESOURCES

FOR A DESERT COMMUNITY

FOCUS ON

RECLAIMED WATER

INTRODUCTION

As a southwestern city, Tucson is challenged to create innovative methods of ensuring the availability of quality drinking water. Our Tucson community is fortunate to have three distinct water resources that can be used to meet the needs of its citizens: groundwater, Colorado River water, and reclaimed water. Whereas our groundwater and our allotment of Colorado River water are finite resources, reclaimed water is often considered a renewable resource, in that as long as the population is using water, there will be wastewater. Maximizing the utilization of reclaimed water is especially valuable for our ever-growing desert community.

TUCSON'S WATER HISTORY

When people first entered the Tucson basin, flowing river water was a source of life around which the community developed. By the year 1881, the residents of Tucson could no longer rely on the surface water that had been readily available since the earliest settlers arrived. The stress on the aquifer from the growing population lowered the water table, causing rivers like the Santa Cruz River to become dry streambeds, flowing only during periods of heavy rain. Tucson's continuous and dramatic growth in the next 100 years outpaced nature's ability to replenish the annual draw on groundwater, and by the mid-1970's major water conservation campaigns were set in motion. At the same time, city and county planners and water experts were looking into the viable uses of effluent. In 1984, Tucson Water delivered reclaimed water to the first customer on our reclaimed water system: a golf course. Our system was one of the first of its kind in the United States, and remains one of the largest.

WHAT IS RECLAIMED WATER?

When we produce reclaimed water, we are simply speeding up a process that our ecosystem has always performed: we are recycling water. Reclaimed water is the final product of a multiple-stage advanced treatment process that cleans wastewater. This treatment process produces water ideal for plant irrigation and other commercial and industrial uses, such as use in cooling towers, but not suitable for human or house pet consumption. The residual nitrogen and phosphorous in the water provide excellent fertilizers for ornamental plants and turf grass.

HOW IS RECLAIMED WATER TREATED?

Our reclaimed water treatment process begins with secondary effluent produced at Pima County's Roger Road Wastewater Treatment Facility. The County treats effluent to standards required by State and Federal agencies, and Tucson Water treats the secondary effluent to meet ADEQ's more stringent Class "A" reclaimed water standards. We currently utilize two processes for treating the secondary effluent.

ROGER ROAD RECLAIMED WATER TREATMENT PLANT

Some of the wastewater from Pima County's treatment facility is piped into Tucson Water's nearby Reclaimed Water Treatment Plant for further cleansing. In the filtration plant, the water is filtered through pressure filters containing anthracite coal and sand, and is then disinfected with chlorine. The final product is mixed with water that has been recharged and recovered to produce a tertiary-quality water that is stored in reservoirs until it is pumped through a separate system of infrastructure to reclaimed water customers throughout the Tucson region.

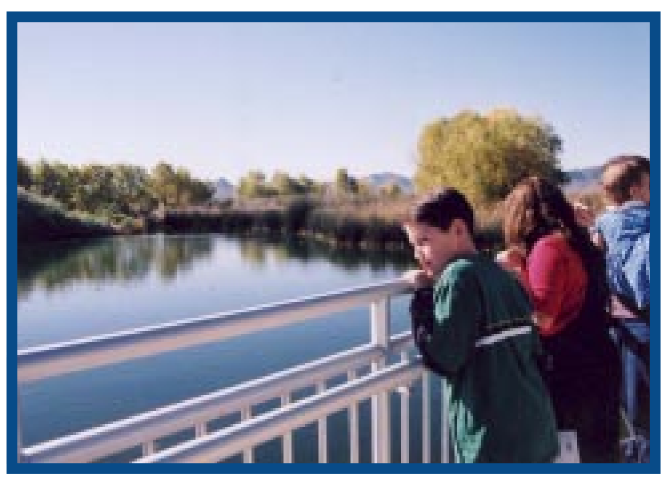
RECHARGE AND RECOVERY

Recharge and recovery is an important part of the reclaimed water system. Some of the wastewater treated at Pima County Wastewater treatment plant is piped directly to Tucson Water's constructed recharge basins where the earth acts as a natural filter as the water seeps into the ground. This water is recovered through wells and is chlorinated and mixed with filtered water produced at the City's treatment plant.

The remainder of the secondary effluent that is not piped to Tucson Water's Reclaimed Water Treatment Plant or the constructed recharge facilities is discharged into the Santa Cruz River to be passively recharged to the aquifer through natural stream channel processes. One well currently recovers recharged effluent and other wells are planned for the future. This recovered water is chlorinated, mixed with filtered and/or other recovered water and delivered to customers throughout the Tucson region.

SWEETWATER WETLANDS

Another component of our reclaimed water treatment system is the Sweetwater Wetlands, a constructed facility which functions primarily as a marsh ecosystem to further treat wastewater for recharge and reuse. The facility was developed with community-wide participation to be an experimental wetland/recharge facility, which includes an associated wildlife habitat and educational and passive recreational amenities. The water entering the Sweetwater



Wetlands actually comes from two sources: secondary effluent from Pima County's treatment facility or backwash water, water produced from cleaning the mechanical filters, from Tucson Water's filtration plant. The water is introduced to densely vegetated sedimentation, or settling, ponds where certain compounds are transformed and undesirable substances and solids are removed from the water. The water flows from the sedimentation ponds to polishing ponds where biological processes further reduce harmful substances that then become available as chemical building blocks. Next, in the recharge basins, the earth acts as a natural filter as the water seeps into the ground, replenishing the local aquifer. This naturally filtered water is recovered through wells and piped to the chlorine contact chamber where it is chlorinated and mixed with filtered water produced at the plant.

In addition to increasing capacity for production of reclaimed water, the Sweetwater Wetlands facility serves as a wildlife and riparian habitat, attracting many various species of birds, mammals, reptiles and insects. Built with looping trails and informational signs, the facility provides an environmental and educational experience where visitors can learn about the importance of establishing and enhancing wildlife populations and habitats in harmony with Tucson's urban environment.

WHO USES RECLAIMED WATER?

By the end of fiscal year 2003, our average annual reclaimed water service connections numbered 670. Since the first customer was served in 1984, our reclaimed system has been expanded to include 14 public and private golf courses, 40 schools including the University of Arizona and Pima Community College, and 33 area parks, in addition to industrial sites and residences. During FY 2003, we delivered nearly 3.5 billion gallons of reclaimed water to these customers, comprising nearly 9% of our total water sales volume.

The use of reclaimed water for turf irrigation is a key component of Tucson's campaign to conserve groundwater. Tucson Water has worked collaboratively with many larger property owners, such as school districts and city and county parks departments, to connect existing potable irrigation systems to groundwater-saving reclaimed systems. Converting large turf irrigation users from potable to reclaimed water systems is critical for Tucson Water as we work to achieve maximization of our renewable water resources.

FUTURE EXPANSION

City voters have supported the expansion of the reclaimed water system at the polls during the past two water revenue bond elections held in 1994 and 2000. Proceeds from the bond sales have allowed us to expand the reclaimed system's storage capacity, with six booster stations to distribute the water through 104 miles of pipeline. Our current 5-year reclaimed water capital improvement plan will add an additional 9 million gallons of storage capacity along with another 17 miles of mains to be completed by 2008. These expansions of the system are meant to accommodate a projected customer base of over 1,000 sites by 2008.

In addition to the sale of bonds, Tucson Water also expects to receive a $3 million dollar loan during FY 2005 to help fund construction of the Forty Niners' Country Club Golf Course reclaimed transmission main. The loan, from the Water Infrastructure Finance Authority of Arizona (WIFA), will be repaid at a subsidized interest rate. The 8-mile long transmission main will deliver reclaimed water for irrigation of the golf course, which currently uses approximately 500 acre feet of groundwater annually, and will connect several additional schools that lie in proximity of the new line.

LONG RANGE WATER RESOURCE PLAN

Tucson Water is working to develop a long-range water resource plan. This plan involves evaluating our community's future water demands, available water supply and water quality outlook through 2050. Reclaimed water already is an important component of our water supply and it plays an increasingly important role in the ongoing studies included in the long-range plan. The long-range planning studies will include the evaluation of options that may allow Tucson Water to expand the use of reclaimed water.

NARROWING THE GAP

For decades, Tucson Water has emphasized water conservation as a primary factor in the sustainability of our water supply to support our current and future population. As public awareness of water issues has increased, the benefits of using reclaimed water for turf irrigation purposes have become evident to the community. In less than 20 years, our reclaimed system has grown from irrigating one golf course to reducing the potable water usage of over 600 customers by more than 3 billion gallons annually. Without a doubt, use of reclaimed water narrows the gap between our limited supply and our growing population's demand for water. Tucson Water is committed to decreasing the community's reliance on groundwater for a whole range of commercial, recreational and environmental purposes that can be met with reclaimed water. In the future, our ability to effectively recycle wastewater and produce quality reclaimed water is certain to play a vital role in the management of Tucson's water resources.

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WATER RESOURCES

FOR A DESERT COMMUNITY

FINANCIAL SECTION

HEINFELD, MEECH & CO., P.C.
CERTIFIED PUBLIC ACCOUNTANTS

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INDEPENDENT AUDITORS' REPORT

Honorable Mayor and Members of the City Council
City of Tucson, Arizona

We have audited the accompanying financial statements of Tucson Water, an enterprise fund of the City of Tucson, Arizona, as of and for the year ended June 30, 2003, as listed in the table of contents. These financial statements are the responsibility of the management of Tucson Water and the City of Tucson. Our responsibility is to express an opinion on these 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 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 financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

As discussed in Note 2, the financial statements present only Tucson Water and do not purport to, and do not, present fairly the financial position of the City of Tucson, Arizona, as of June 30, 2003, and the changes in its financial position for the year then ended in conformity with accounting principles generally accepted in the United States of America.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Tucson Water, an enterprise fund of the City of Tucson, Arizona, as of June 30, 2003, and the changes in financial position and cash flows, where applicable, thereof for the year then ended in conformity with accounting principles generally accepted in the United States of America.

Our audit was conducted for the purpose of forming an opinion on the financial statements taken as a whole. The Management's Discussion and Analysis and supplementary information included in Schedules I and II are presented for purposes of additional analysis and are not a required part of the financial statements. The supplementary information included in Schedules I and II has been subjected to the auditing procedures applied in the audit of the financial statements and, in our opinion, is fairly stated in all material respects in relation to the financial statements taken as a whole. The Management's Discussion and Analysis has not been subjected to the auditing procedures applied in the audit of the financial statements and, accordingly, we express no opinion on it.

Heinfeld, Meech & Co., P.C.

HEINFELD, MEECH & CO., P.C.
Certified Public Accountants

December 10, 2003

2003 ANNUAL REPORT

WATER RESOURCES

FOR A DESERT COMMUNITY

MANAGEMENT'S DISCUSSION

AND ANALYSIS

Overview

Tucson Water is an enterprise fund of the City of Tucson, Arizona. This means we operate similar to a private business, covering all costs of doing business with revenues from operations. Our fiscal year runs from July 1 through June 30. Our authority and responsibility is derived from the City's Charter and ordinances and resolutions of the Mayor and Council. We provide water service to approximately 690,000 people (about 85% of the greater Tucson metropolitan area's total population) within a 300 square-mile service area that lies within Pima County. We ended fiscal year 2003 with over 205,000 customer connections to our water system, and during the year delivered enough potable water to fill nearly 2.2 million residential swimming pools (35.4 billion gallons) Additionally, we delivered 3.5 billion gallons of reclaimed water for turf irrigation.

Tucson Water Statistics: FY 2003

Customer Connections	205,369
FY 2003 Customer Growth	2.25
Miles of Pipeline	4,200
Wells	221
Reservoirs	51
Reservoir Storage Capacity	286 million gallons

Units of Measure:
1 Acre foot = 325,851 gallons
1 Ccf = 748 gallons

Operations

Potable Water:

During FY 2003, we obtained our municipal potable water (water meeting or exceeding all federal, state, and local drinking water standards) from our groundwater well fields and a facility where we recharge and recover Colorado River water.

Our groundwater is supplied from four well fields (Central, Avra Valley, Santa Cruz, and Southside). These four well fields had an aggregate capacity of 201 million gallons per day during the year.

Our surface water source contract with the United States Department of the Interior and the Central Arizona Water Conservation District ("CAWCD") provides us access to 134,466 acre-feet annually of Colorado River water, delivered via the Central Arizona Project (CAP). The CAP consists of 335 miles of waterworks and associated facilities designed to deliver water from Lake Havasu on the Colorado River to Maricopa, Pinal, and Pima Counties in central/southern Arizona.

In FY 2003, our Clearwater Renewable Resource Facility, (CRRF), an $81 million project completed during the year, pumped 27,100 acre-feet of blended recharged/recovered CAP water and groundwater into our distribution system. The facility's recharge and recovery production will increase to approximately 50,000 acre-feet during FY 2004. CRRF, constructed northwest of the City of Tucson, is composed of recharge basins, recovery well fields, storage and transmission facilities. The facility permits the recharge of 54 million gallons per day (60,000 acre-feet/year) of Colorado River water, a renewable source. Meeting approximately fifty percent of our customers' current demand for potable water with Colorado River water enables us to reduce groundwater pumpage from the central well field, over which the majority of the City of Tucson lies, thereby easing concerns related to land subsidence.

Production from Clearwater Facility

FY	Acre-Feet
2001	3,300
2002	26,000
2003	27,100
2004*	52,800
2005*	60,000

* Projected

RECLAIMED WATER:

Although only 9% of our total FY 2003 water sales, reclaimed water will play an increasingly important role in our future water supply program. Tucson Water has the right to use over half of the effluent produced at the metropolitan wastewater treatment facilities owned and operated by Pima County. Planning for use of this water resource was initiated in 1982 and we began delivering reclaimed water to customers for turf irrigation in 1984. The reclaimed water we produce meets the State of Arizona standards for Class A water (water suitable for: irrigation of sites having unrestricted public access, cooling towers, use on vegetable gardens and orchards, and for toilet flushing).

Our reclaimed system currently includes a treatment plant which filters secondary effluent, a wetlands which biologically treats the backwash water from the filtration plant, constructed basins for the recharge of secondary effluent, and wells to recover the recharged water. This recovered water is blended with water produced at our filtration plant and distributed to customers throughout the reclaimed system.

We plan to obtain our next increment of reclaimed water supply from a managed in-channel recharge and recovery project which will recover, via wells, some of the effluent that has been discharged by the Pima County Wastewater treatment plants into the nearby Santa Cruz River. This project will produce 2,500 acre-feet of reclaimed water annually.

We will continue to work with our customers and other agencies to identify additional reclaimed water uses, thereby transferring the demand from potable to reclaimed water.

DISCUSSION OF BASIC FINANCIAL STATEMENTS

We account for our activity on the accrual basis of accounting, in conformance with all applicable Governmental Accounting Standards Board (GASB) Statements, including GASB Statement No. 34, *Basic Financial Statements and Management's Discussion and Analysis for State and Local Governments*, and the related statement numbers 36 (Recipient Reporting for Certain Shared Nonexchange Revenue), 37 (Basic Financial Statements-and Management's Discussion and Analysis-for State and Local Governments: Omnibus), and 38 (Certain Financial Statement Note Disclosures.)

Our annual financial reporting includes three basic financial statements (and accompanying notes) and two supplemental schedules.

Statement/Schedule	Description/Purpose
Statement of Net Assets	A summary of our current and long-term obligations and our assets available to meet those obligations. The difference between total assets and total obligations represents our net assets.
Statement of Revenues, Expenses and Changes in Net Assets	A summary of our revenues and our operating and non-operating expenses, and the resulting change in net assets.
Statement of Cash Flows	A summary of our cash sources, including proceeds from the sale of water revenue bonds, and our use of cash.
Supplemental Schedule of Net Revenue Available for Debt Service	Calculation of the percentage by which revenues, after meeting operational expenses, exceed revenue bond debt service. Bond covenants require maintaining debt service coverage of 1.75.
Supplemental Schedule of Flow of Funds	A summary of our FY 2003 results commensurate with the methodology we use in establishing water rates.

FINANCIAL HIGHLIGHTS/CONDENSED FINANCIAL STATEMENTS

Net Assets: Our total assets exceeded our total liabilities at the close of the fiscal year by $574.0 million, an increase from FY 2002 of $20.3 million. Of this amount, $.1 million was restricted for capital projects or debt service. At June 30, 2003 we had capital assets, net of depreciation, of $870.7 million, and outstanding long-term debt of $325.0 million.

Tucson Water Summarized Statement of Net Assets as of June 30 ($ in thousands)

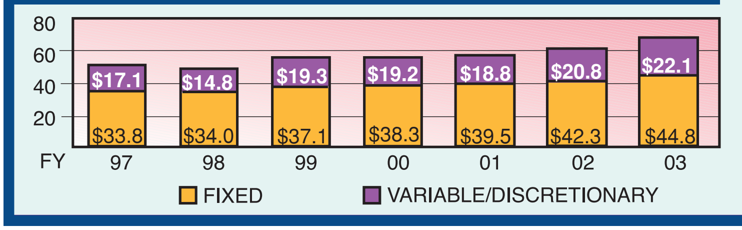
	2003	2002 (unaudited)
Current Assets	$ 40,906	$ 38,998
Restricted Assets	20,579	45,179
Other Assets	6,652	6,969
Capital Assets	870,684	827,353
Total Assets	938,821	918,499
Current Liabilities	18,860	19,198
Liabilities from Restricted Assets	21,037	18,903
Long-term Debt Outstanding	324,951	326,688
Total Liabilities	364,848	364,789
Net assets		
Invested in capital assets net of debt	538,391	515,706
Restricted	100	5,763
Unrestricted	35,482	32,241
Total Net Assets	$ 573,973	$ 553,710

Revenues –Potable and reclaimed water sales revenues, including the Central Arizona Project surcharge on potable water sales, make up approximately 90% of our annual revenues. During FY 2003 we set a record for water sales *revenues* ($99.5 million), while water sales *volume* was slightly down from FY 2002 record level (52 million Ccf in FY 2003 versus 53 million Ccf in FY 2002). Revenues increased by $1.0 million from FY 2002.

FY 2003 other revenues decreased from FY 2002 by $4.4 million. The decrease resulted largely from a FY 2002 settlement with Oro Valley under which outstanding water issues were resolved. Under the settlement agreement, Oro Valley agreed to remit to Tucson Water, over a ten-year period that began during FY 2002, approximately $5.4 million. The settlement amount was recorded as FY 2002's revenue. Partially offsetting this decrease were $1.2 million in new fees for plan review and inspection of developer projects that began in July 2002.

Expenses - The majority of our operating costs are fixed, at least in the twelve months of our fiscal year. Approximately 65%-70% of our annual operating expenses will not vary as a result of the quantity of water we sell. Staff related expenses, payments to the City of Tucson for administrative support, and CAP capital payments are our most significant fixed items. The remaining 30%-35% of our operating expenses are made up of expenses that *vary* with the quantity of water produced (power, CAP water, chemicals) or are of a *discretionary* nature, for example, community relations, training, and consultant services.

FIXED VS. VARIABLE/DISCRETIONARY OPERATING EXPENSES ($ IN MILLIONS)



Excluding depreciation and a FY 2002 discount ($920,000) granted on receipt of an early payoff of a legal settlement, FY 2003 operating costs were $3.8 million higher than FY 2002 costs. Major changes included:

Fixed Costs ($2.5 million increase from FY 2002)

- Increased employee costs ($1.5 million) resulting from cost of living adjustments, employee merits, and increases in employee insurance costs
- Increased maintenance expenses ($1.5 million); FY 2002 expenses in this category were low as maintenance staff efforts were diverted to increased safety efforts after the September 11, 2001 terrorist attacks. In addition, improved capitalization policies resulted in several programs being moved from our capital program to maintenance expense
- Partially offsetting these increases were decreases in the CAP capital charge and liability insurance of $.6 million and $.4 million, respectively

Variable/Discretionary Costs ($1.3 million increase from FY 2002)

- Increased costs for CAP water ($.8 million) reflecting our growing utilization of this renewable resource
- Increased consultant costs ($.7) related to operational and maintenance studies (system operations, pipeline protection, corrosion monitoring)
- Decreased power costs ($.4 million), resulting from a slight decline in water sales, partially offset the increases in variable costs

Tucson Water Summarized Statement of Revenues, Expenses and Changes in Net Assets
Fiscal Years Ending June 30 ($ in thousands)

	2003	2002
Operating Revenues:		
Water Sales	$ 98,261	$ 97,483
CAP Surcharge	1,272	963
Other Revenues	9,872	14,348
Total Operating Revenues	109,405	112,794
Operating Expenses	(86,675)	(85,209)
Net Operating Income	22,730	27,585
Non-Operating Income	1,828	2,062
Non-Operating Expenses	(17,678)	(16,369)
Net Income before Capital Contributions/Adjustments	6,880	13,278
Capital Contributions	10,172	9,972
Prior Period adjustment (see Notes to Financial Statement)	3,211	(7,509)
Change in Net Assets	$ 20,263	$ 15,741

The remainder of this *Management's Discussion and Analysis* provides a more detailed look into our fiscal year 2003 revenues, operating expenses, capital outlays, debt service, changes in net assets, and cash flows.

REVENUES

KEY DATA: REVENUES

	2003 Actual	2003 Planned	2002 Actual
Water Sales Revenues[1] ($ in millions)			
Potable	$94.0	$95.8	$92.9
Reclaimed	$5.5	$5.3	$5.6
Total	$99.5	$101.1	$98.5
Other Revenues[2] ($ in millions)	$11.7	$11.5	$11.0
Water Sales (Ccf[3])			
Potable	47,274,303	48,429,061	48,015,870
Reclaimed	4,638,207	4,429,355	4,990,224
Total	51,912,510	52,858,416	53,006,094
Water Service Connections			
Potable Metered	202,174	202,084	197,162
Fire Protection	2,525	2,474	2,449
Reclaimed Metered	670	639	576
Total	205,369	205,197	197,162
Potable Water 12-Month Average			
Use Per Svc Per Month (Ccf)	19.49	19.97	20.30
Single Family Customers Only	12.04	12.30	12.59

1 Total water sales revenue includes revenue generated by usage rates, fixed monthly charges based on meter size, and special surcharges based on water usage.
2 Other revenues consist of other operating revenues and non-operating income from the audited financial statements. In FY 2002, a settlement ($5.4 M) whose proceeds will be received over time was excluded from other revenues presented here.
3 1Ccf = 748 gallons.

Approximately 90% of our annual revenues are generated by the sale of water (we have customers inside and outside the corporate limits of the City of Tucson). The remaining 10% comes from fees charged for meter and fire service installations; service charges for account set-up, delinquency processing, and other services benefiting an individual customer; billing services provided to other entities; and interest earnings.

FY 2003 water sales revenues of $99.5 million increased by about 1.1%, or around $1.0 million, from FY 2002. They were less than the forecast for the year by around 1.5%, or $1.6 million.

Other revenues of $11.7 million were $4.7 million less than in FY 2002 and about $0.2 million (2%) greater than the forecast for the year. During FY 2002, $5.4 million in legal settlement revenues were recorded. In FY 2003, other revenues included a new set of fees assessed to developers for reviewing and approving their water system plans and for inspecting their infrastructure installations.

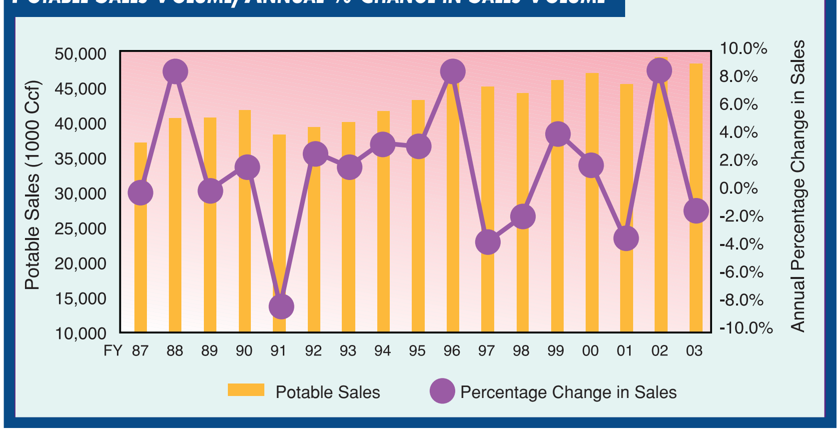
POTABLE WATER SALES, SERVICES, REVENUE EFFECTS:

FY 2003 potable water sales *revenues* increased slightly, by about 1.0% ($1.1 million) from FY 2002, but were less than the forecast for the year by about $1.8 million, or 2.0%. Although revenues were somewhat below expectation, the fact that they were sufficient enough to surpass those of the prior fiscal year makes FY 2003 water sales revenues the highest in our history.

Our FY 2003 potable water sales *volume* (47,274,303 Ccf or 35.4 billion gallons) was lower than that of FY 2002 by 1.5%, as well as under the forecast for the year by nearly 2.5%. This points to the importance of the increase in potable water usage rates that occurred in October 2003. Without that increase, the FY 2003 potable sales revenues would likely not have surpassed those of the prior year.

The following chart, while revealing that sales volume in FY 2003 was the second highest during the past seventeen years, also illustrates the continuing volatility in potable sales.

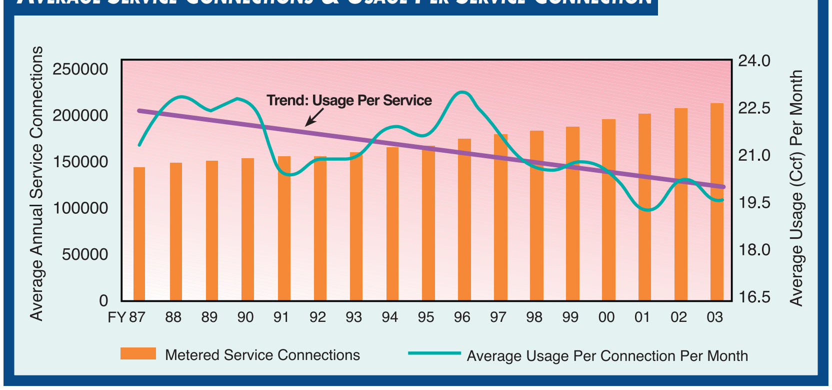
POTABLE SALES VOLUME/ANNUAL % CHANGE IN SALES VOLUME



Our management's discussions in prior years have noted that both water sales volume and water sales revenues are influenced by many factors: for example, *service connection growth, weather, plumbing codes encouraging or enforcing low water use fixtures and appliances in new construction, landscaping codes encouraging low water use plants, on-going conservation programs emphasizing education and behavioral changes, and conservation-oriented rate structures.*

Service connection growth always pulls potable revenues in a positive direction due to the additional volume of water provided to the new connection, as well as the monthly service charge assessed to each account regardless of the amount of water used. Growth in average metered service connections (5,012), while slightly less than in FY 2002 (5,347), increased at a respectable 2.5% annual clip and conformed to our forecast. Thus, the revenue increase (around $400,000) which we anticipated from monthly service charges was achieved.

AVERAGE SERVICE CONNECTIONS & USAGE PER SERVICE CONNECTION



Weather can pull sales volume and the resulting revenues in either a positive or contrary direction. In FY 2003, it is believed to have reduced sales volume and, thus, to have pulled revenues in the direction contrary to that of service growth and opposite of its influence in the prior fiscal year. FY 2003 was much wetter (nearly 9 inches of rainfall) than FY 2002 (just over 4 inches of rainfall) and much cooler in both summer, when sales volume is expected to increase, and winter. Relatedly, average customer usage per service connection dropped in FY 2003 to around 19.5 Ccf of usage per month, nearly 1 Ccf per month less on average than in FY 2002.

So, FY 2003 mirrored the long-term pattern of some major characteristics which determine potable sales revenues:

- *Service connections* growing at expected rates and contributing positively to revenue via fixed monthly charges; but
- *Monthly usage per connection*, while volatile, trending downward, pulling revenues in the contrary direction. (See chart on preceeding page.)

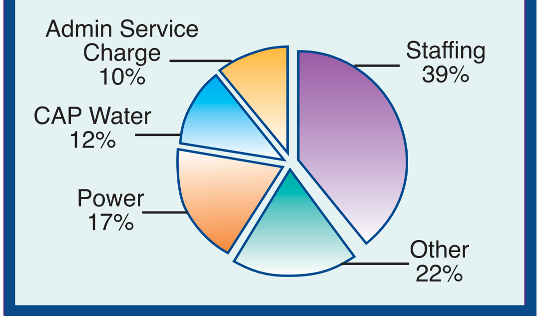
Reclaimed Water Sales, Services, Revenue Effects:

FY 2003 reclaimed water sales revenues of $5.6 million were just about equal to those of FY 2002. Reclaimed water sales volume (4,638,207 Ccf or 3.5 billion gallons) was about 7% less, however, than in FY 2002. Since the majority of reclaimed water is used for turf irrigation, higher rainfall and less heat, which led to lower potable sales in FY 2003, probably led to lower reclaimed water sales as well. Reclaimed rates were increased in October 2003, the standard usage rate by about 10%, and, as with the potable system, it is likely that the increase is responsible for revenues in the two years being about equal, despite the reduced usage in FY 2003. Average service connections for FY 2003 increased by 94 to 670. As in the two prior fiscal years, the majority of our additional service connections were related to residential customers whose irrigation requirements are insignificant compared to large turf facilities, such as golf courses, which receive reclaimed water. Service connection growth for the year, therefore, contributed only marginally to the increase in revenues.

Revenue Outlook: *Next Five Years*

The major revenue change we are expecting during the next five years will not be in water sales revenues, but rather in fees affecting new development. In FY 2003, the first set of such fees became effective: charges for reviewing and approving developers' water system plans for subdivisions and inspecting such projects during construction. These fees produced about $1.3 million of revenue in FY 2003, slightly greater than the amount of the increase in potable water sales revenues for the year. Also in FY 2003, our governing body adopted a water system capacity 'buy-in' fee. This fee, which became effective in August 2003, recovers a proportionate share of the cost of existing system capacity from new potable connections and is expected to generate around $8.0 million in revenue annually. In addition, we expect to complete an analysis of long-term water resource requirements in FY 2004 and begin discussions with the community regarding how to fund the water system infrastructure needed. It may be that elements of that infrastructure necessitated by growth in our service area will lead to a prospective (future looking) development fee as well.

FY 2003 OPERATING EXPENSES: $66.9 MILLION

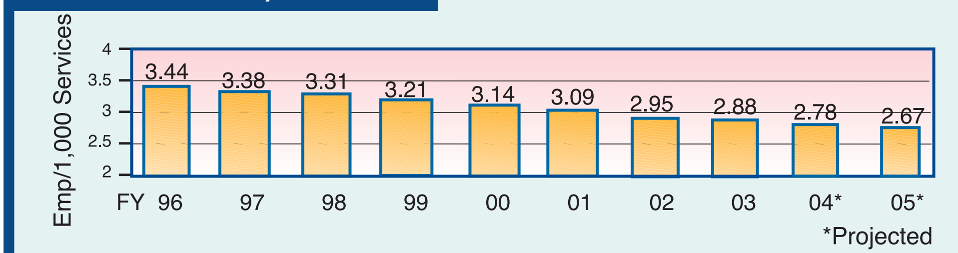


OPERATING EXPENSES

We expend considerable financial resources to operate our two water systems (potable and reclaimed). We incurred $66.9 million in operating expenses in FY 2003 (excluding depreciation of $19.7 million, taxes of $8.7 million, and debt service of $25.1 million or 95% of the planned amount). Operating expenses were about $326 per service account, a 1.9% increase from FY 2002. While we are a large utility with many varied expenses, four cost categories made up 78% of our total operating costs: employee costs, power costs, CAP water costs, and administrative service charges.

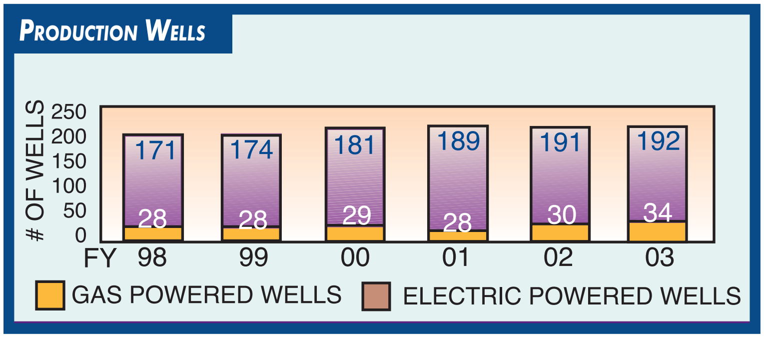
Employee costs ($26.3 million in FY 2003 and $24.8 million in FY 2002 or a 6% increase) relate to our diverse staff of 586 employees. These employees serve in varying roles: planning for our community's growing water resource needs; insuring the quality of the water we deliver; designing storage and delivery systems to meet our customer demands; providing proper maintenance to all elements of our system; and providing customer service through accurate meter reading and billing. The $1.5 million increase from FY 2002 was the result of cost of living adjustments, employee merit increases, and increases in employee insurance premiums.

TUCSON WATER EMPLOYEE / SERVICE RATIO



Despite continuing increases in the number of customers, our ratio of employees per 1,000 customer services (meter connections) has steadily decreased in recent years. Restructuring of meter reading routes, flexible work hours, reorganization of fieldwork teams, and increased use of technology and automation continue to contribute to a reduction in the employee per-service ratio. We expect this trend to continue in the future.

Power costs (approximately $11.2 million in FY 2003 and $11.6 million FY 2002, respectively) are incurred as we pump water up from depths ranging to 700 feet and move it through our distribution system. Power rates remained relatively stable during FY 2003; total power costs decreased slightly, reflective of the slight decrease in water sales volumes. In FY 2004, as we utilize increased production from our CRRF, we anticipate increasing power costs. Recharged water, recovered and moved from the CRRF site 21 miles outside of our central service area, will replace numerous wells scattered throughout the central wellfield.



To control power costs, we have converted, where feasible, to less expensive, interruptible rates and designed our system to operate with a mix of electric and gas powered pumps. In addition, we have negotiated, when possible, special rates with providers of both electricity and gas.

CAP water costs ($7.8 million in FY 2003 and $7.7 million in FY 2002) result from a contractual obligation for the purchase of Central Arizona Project water from the CAWCD. Our obligation consists of two components:

- The capital financing charge, $5.4 million in FY 2003 and $6 million in FY 2002, is based on the Utility's allotment of 134,466 acre-feet. The FY 2003 decrease was the result of a rate reduction by CAWCD.
- The commodity charge ($2.5 and $1.7 million in FYs 2003 and 2002, respectively) is based on actual CAP water taken.

CAWCD establishes both the capital and commodity rates annually. Our full CAP allotment will prove valuable to the community in the future, as it is a renewable source of water, unlike our declining groundwater supply.

Although we purchased approximately 30,000 acre-feet of CAP water in FY 2003, purchases will increase significantly with the CRRF at full build-out. CRRF usage of CAP water will increase to 60,000 acre-feet annually by FY 2005. This increased usage is anticipated to add over $2 million annually to our CAP expense.

Administrative service charges ($6.9 and $6.8 million in FY 2003 and FY 2002, respectively) are our payments to the City of Tucson for support services (procurement/payroll/budget/etc). All payments are for direct services or indirect administrative support; no funds are transferred to support non-Utility related purposes.

Operating Expenses Outlook: Next Five Years

Managing our operational expenses will be a significant challenge in the future. Operating expenses are anticipated to increase over the next five years due to continued customer growth, the utilization of an increasing amount of both CAP water (at increasing rates), increasing employee related costs, particularly those related to health care, and general inflationary pressures. The potential for the volatility in power rates experienced in recent years to continue remains a concern.

We also plan on purchasing additional allocations of CAP water: 1,500 acre-feet in FY 2004 and 8,206 acre-feet in FY 2007. While we are not currently using all of our allocation, acquisition of this renewable water source will prove valuable to our community in the future. However, these purchases will increase our CAP capital costs by approximately $.8 million in FY 2004, and approximately $1.4 million annually from FY 2007 through FY 2011.

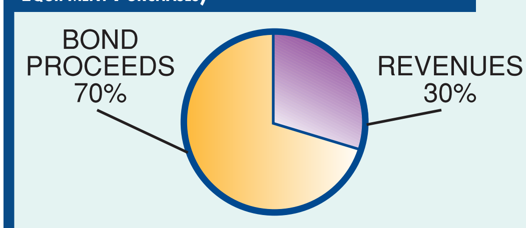
We have continued progress on the implementation of our *Maintenance Management Program (MMP)*, which has identified new approaches to the operation and maintenance of our water systems, and includes a geographic information system (GIS). A pilot phase of the MMP, covering about 20% of our service area, began in February 2003. The improved way of doing business is expected to generate both significant reductions in operating expenses and improved customer service. Attaining these results has required significant investment in staff training, equipment, and related technologies. As of June 30, 2003, we have invested $4.5 million in establishing this important program, and over the next six years, we have programmed an additional $5.5 million. We estimate the MMP will generate $9.7 million in savings during the five years beginning July 1 2004, and nearly $3 million annually thereafter, generating a breakeven point in FY 2010.

Additionally, we have ongoing strategic planning and employee-driven re-engineering efforts, which impact all areas of our organization. Through MMP, GIS, strategic planning, re-engineering and similar programs, we will continue to identify operational efficiencies enabling us to continue to provide potable and reclaimed water to our customers at affordable rates.

CAPITAL IMPROVEMENTS

At the end of FY 2003, our water system was composed of 210 potable wells, 11 reclaimed wells, 4,200 miles of delivery pipelines, 124 boosters to move water around our delivery area, and 51 reservoirs to store water to meet peak demands. We continue to plan, design, and construct improvements to our system infrastructure to meet the demands of our current and future customers.

FUNDING OF FY 2003 CAPITAL IMPROVEMENTS ($50.2 MILLION INCLUDES VEHICLES AND CAPITAL EQUIPMENT PURCHASES)

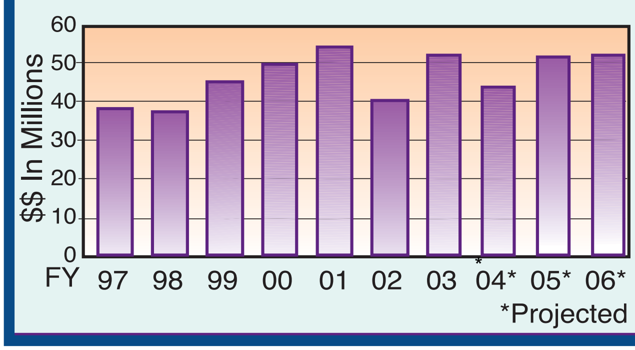


We fund our capital program with a combination of current revenues (cash from the sale of water to our customers) and bond proceeds (cash from the sale of revenue bonds). In May 2000, the citizens of Tucson approved a $123.6 million Water Revenue Bond authorization. This authorization is anticipated to provide the funds to meet our bond requirements through FY 2005. We plan on asking voters to approve a new authorization in the spring of 2005.

During FY 2003, we spent over $50.2 million (or 87% of our fiscal year capital budget) on improvements to our system. In FY 2002, $40.5 (74% of budget) was expended in our capital program. During FY 2002, we dealt with staffing vacancies and vendor difficulties in delivery of the CRRF raw water pipeline (used to transport CAP water from the canal to the recharge basins). These were major contributors to the decrease in spending and percentage of budget spent.

During FY 2003, $15.7 million was spent on the CRRF project for construction of the raw water pipeline and additional recharge basins, and for expansion of the recovery wellfield (well drilling and equipping). In addition, $2.1 million of expenditures were incurred on capitalizable software and related costs for two innovative projects, the Maintenance Management Program and the related Geographic Information System Project. Both programs involve work simplification, broad-banding of job skills, and technical upgrades that will substantially improve the manner in which operations and maintenance are performed by Tucson Water. The remaining $32.4 million was spent in the following program areas:

CAPITAL SPENDING BY FY



• Transmission and Distribution Mains	$ 7.5 million
• Reclaimed System Expansion and Improvements	$ 2.1 million
• Equipment / Vehicles	$ 1.2 million
• New Services (water meters, minor extensions)	$ 3.3 million
• General Plant Improvements	$ 1.4 million
• Reservoirs and Pumping Facilities	$ 7.8 million
• Well Drilling, Equipping, and Upgrades	$ 2.0 million
• Other	$ 7.1 million

CAPITAL EXPENDITURE OUTLOOK: NEXT FIVE YEARS

Over the next five years, we plan to spend $249 million to fund capital projects. This capital program will significantly assist in achieving the long-term goal of balancing groundwater pumping with replenishment of the aquifer. Emphasis will remain on expansion of renewable water resources such as recharged Colorado River water and the Utility's reclaimed water system.

Individual capital projects are structured to increase water production, provide additional storage capacity, and improve operational efficiencies. The five-year program includes projects to drill and equip 10 wells, construct 6 potable storage facilities and 3 reclaimed reservoirs. Funding is also included to construct or enhance 51 miles of potable transmission and distribution mains, as well as 32 miles of reclaimed transmission and distribution mains. Construction of a managed effluent in-channel storage and recovery facility will provide additional reclaimed capacity of approximately 2,500 acre feet per year.

DEBT AND DEBT SERVICE

At June 30, 2003, we had $334 million in outstanding water revenue bonds. During FY 2003, we entered into a $8.3 million long-term debt agreement (utilizing existing revenue bond authorization) with the Water Infrastructure Finance Authority. Repayment, with interest at 3.48%, will occur over a twenty-year period. No water bonds were issued during FY 2003. Water revenue bond interest payments ($16.8 million in FY 2003) are reported as expenses on our Income and Flow of Funds Statements. Repayment of principal ($7.9 million in FY 2003) is reported only on our Flow of Funds Statement. In addition, we paid $0.3 million in fiscal agent fees.

<u>Bond Ratings:</u>

• Moody's Investors Special	Aa3
• Standard and Poors	A+

The financing of our capital program with a combination of bond proceeds/loans *and* water sales revenues insures a healthy ratio of outstanding water revenue bond debt to system capital assets. This ratio has averaged .35 over the last seven years.

RATIO OF OUTSTANDING WATER REVENUE BONDS TO CAPITAL ASSETS
June 30, ($ in millions)

	1997	1998	1999	2000	2001	2002	2003
Land	$ 41.4	$ 43.1	$ 44.6	$ 46.9	$ 46.4	$ 45.1	$ 45.1
Buildings	95.7	96.3	97.3	97.3	100.7	102.1	108.5
Water Mains	408.5	442.5	467.0	528.2	549.3	582.2	608.6
Reservoirs	114.0	127.3	132.5	142.1	183.1	199.6	198.2
Construction in Progress	117.6	109.3	127.2	108.3	106.7	95.9	115.2
Machinery	11.9	15.6	17.1	15.2(1)	16.7	19.6	20.8
Less Accumulated Depreciation	(143.8)	(156.9)	(169.6)	(181.6)	(196.5)	(217.1)	(225.8)
Total Capital Assets	$ 645.3	$ 677.2	$ 716.1	$ 756.4	$ 806.4	$ 827.4	$ 870.6
Water Revenue Bonds Outstanding	$ 223.9	$ 216.7	$ 250.0	$ 244.1	$ 273.9	$ 332.4(2)	$ 331.9
Ratio Water Revenue Bonds/Capital Assets	0.35	0.32	0.35	0.32	0.34	0.40(2)	0.38

(1) $2 million of machinery assets were written off in FY 2000 due to change in capitalization threshold.
(2) Bonds outstanding includes $18.9 million issued June 27, 2002 for which no capital outlay has occurred; ratio is .38 if the debt associated with this bond issuance is removed.

CHANGE IN NET ASSETS AND FLOW OF FUNDS

The change in net assets is the amount by which our revenues and capital contributions exceed our expenses, including depreciation. The change in net assets for FYs 2003 and 2002 was $20.3 and $15.7 million, respectively. Two unusual items affecting the change in net assets occurred during FY 2003 and FY 2002:

1. FY 2002: A settlement of legal issues with the Town of Oro Valley (related to CAP water allocations and other water issues) resulted in revenues of $5.4 million.

2. FY 2003 and FY 2002: Prior period adjustments resulting from write-off of capital assets and changes in depreciation methods in FY 2002; further corrections resulting from the depreciation method change were made in FY 2003.

The effect of these items is removed for comparison purposes:

	FY 2003	FY 2002
Change in Net Assets (in millions)	$ 20.3	$ 15.7
Remove:		
Settlement Revenues	–	(5.4)
Prior Period Adjustments	(3.2)	7.5
	$ 17.1	$ 17.8

When adjusted, the FY 2003 change in net assets lagged behind FY 2002 by $.7 million.

FY 2003 CHANGE IN NET ASSETS - CHANGE FROM FY 2002

	($ in millions)
Revenues	
Increase in water sales (potable and reclaimed)	$ 2.0
Decrease in other revenues	(.2)
Expenses	
Decrease in depreciation expense	1.4
Decrease in power expense	.4
Increase in employee costs	(1.5)
Increase in administrative service charge	(.1)
Increase in interest expense	(1.0)
Increase in CAP water expense	(.2)
Increase in other expense	(1.7)
Capital Contributions	
Increase in contributed water systems	.2
Change in Net Assets FY 2003 from FY 2002	$ (.7)

Since we operate as a self-supporting utility of the City of Tucson, we must receive adequate cash (from revenues) during the year to support our operating *and* capital improvement cash requirements. In addition, we must meet financial policies governing *cash reserve balances* and *debt service coverage*. For this reason, we focus more on our projected and actual *flow of funds* than on *change in net assets*.

Cash Reserves - During June 2002, the mayor and Council adopted a Financial Plan that increases the Utility's cash reserve level to approximately $12.6 million by the end of FY 2007. At June 30, 2003, unrestricted/undesignated cash on hand was $12.7 million.

Debt Service coverage (the % by which revenues, after meeting operating cash needs, cover bond principal and interest payments) Bond covenants and Mayor and Council policy require us to maintain an annual average debt coverage of at least 1.75. Debt service coverage for FY 2003 was 2.01.

Our flow of funds does not include depreciation (a non-cash expense *included* in our income statement), but does include cash outlays for capital improvements and debt principal repayments (cash use items *not included* in our income statement). In addition, revenues resulting in long-term receivables, such as the Oro Valley settlement, are included in our flow of funds the year in which we receive payments.

The following "summary flow of funds" identifies the major cash sources and uses during FY 2003:

Summary FY 2003 Flow of Funds ($ in millions)

CASH INFLOWS:		
What we received:		
From sale of water*	$99.5	
From other revenues/sources**	20.4	
TOTAL INFLOWS		$119.9
CASH OUTFLOWS AND USES		
How much of our revenues we used for:		
Operations/maintenance***	$75.6	
Debt service (principal/interest)	25.1	
Capital improvements	15.2	
Other purposes	4.0	
TOTAL OUTFLOWS		$119.9

* includes CAP surcharge revenues
**includes taxes
*** includes taxes and payment to City of Tucson for administrative support

FINANCIAL PLANNING AND OUTLOOK:

Each year, we develop a rolling six-year *Financial Plan* (*current year plus five*). This plan is built on our projected capital improvement and operating budgets, and our projected water sales revenues under existing rates. Financial plan development is aligned with the City of Tucson's budgetary process. This alignment enables Mayor and Council to be provided with the water revenue increases necessary to support operating and capital needs (over the five years of our financial plan period) *prior* to their review of those capital and operating budgets. As a result, our governing body has the opportunity to know the revenue/rate effects of the capital and operating plans being considered and can adjust the plans if the revenue/rate effects are not deemed acceptable.

Our Financial Plan for the period FY 2004-FY 2008, which was adopted by Mayor and Council during June 2003, calls for biennial water revenue adjustments of 2%. These adjustments are scheduled to begin in FY 2005. Primary drivers behind the need for increased revenues include the continued transition from groundwater to our renewable water resource and the financing of our capital program. In the past, increased revenues have been provided primarily through adjustments to our water rates. The plan, adopted in June 2003, includes revenues from the new "buy-in" fee (discussed in the *Revenue Outlook* section). This fee, designed to recover the capital investment made to provide the capacity to serve new users, has enabled our Utility to move to every-other-year rate adjustments.

We believe our financial planning process, combined with our ongoing focus on cost reductions and improved efficiencies, positions us to meet our goals of reduced dependence on groundwater and continued delivery of affordable, high quality water.

REQUESTS FOR FINANCIAL INFORMATION

Our annual report is intended to provide our customers, investors, and creditors with an overview of our operations and related financial activities. If you have any questions about our annual report or need additional financial information, contact Tucson Water Financial Services, P.O. Box 27210, Tucson, AZ 85726-7210 (520) 791-2666.

2003 ANNUAL REPORT

WATER RESOURCES

FOR A DESERT COMMUNITY

FINANCIAL STATEMENTS

TUCSON WATER (AN ENTERPRISE FUND OF THE CITY OF TUCSON, ARIZONA), JUNE 30, 2002 AND 2003 (DOLLAR AMOUNTS IN THOUSANDS)

STATEMENT OF NET ASSETS

	2003	2002 (Unaudited)
ASSETS		
Current assets:		
Cash and cash equivalents		
Undesignated	$ 12,744	$ 11,040
Designated for customer deposits	1,038	731
Designated for infrastructure replacement	9,587	9,326
Total Cash and cash equivalents	23,369	21,097
Billed accounts receivable, net of allowance for doubtful accounts of $390 and $801 respectively	9,637	11,352
Unbilled accounts receivable	7,287	6,088
Prepaids and other assets	613	461
Total current assets	40,906	38,998
Restricted assets	20,579	45,179
Investments for contract payments	965	1,307
Long-term accounts receivable	3,992	4,327
Capital Assets		
Utility property, plant and equipment	981,315	948,617
Construction-in-progress	115,199	95,850
Less accumulated depreciation	(225,830)	(217,114)
Net capital assets	870,684	827,353
Other	1,695	1,335
Total assets	$ 938,821	$ 918,499

(Continued)

TUCSON WATER (AN ENTERPRISE FUND OF THE CITY OF TUCSON, ARIZONA), JUNE 30, 2002 AND 2003 (DOLLAR AMOUNTS IN THOUSANDS)

STATEMENT OF NET ASSETS (CONTINUED)

	2003	*2002 (Unaudited)*
LIABILITIES AND NET ASSETS		
Current liabilities:		
Accounts payable	$ 6,439	$ 6,835
Salaries, wages and payroll taxes payable	1,957	3,084
Current installments of revenue bonds payable	8,888	8,102
Current installments of contract payable	450	339
Refundable/customer deposits	1,038	731
Accrued interest payable	83	107
Other	5	-
Total current liabilities	18,860	19,198
Liabilities payable from restricted assets	21,037	18,903
Long-term liabilities:		
Revenue bonds payable	323,062	324,301
Contract payable	400	850
Other long-term liabilities	1,489	1,537
Total long-term debt	324,951	326,688
Total liabilities	364,848	364,789
Commitments, contingencies and subsequent events (notes 16 and 17)		
Net Assets		
Invested in capital assets net of debt	538,391	515,706
Restricted for:		
Capital Projects	59	5,665
Debt Service	41	98
Unrestricted	35,482	32,241
Total net assets	$ 573,973	$ 553,710

See accompanying notes to financial statements.

TUCSON WATER (AN ENTERPRISE FUND OF THE CITY OF TUCSON, ARIZONA), JUNE 30, 2002 AND 2003 (DOLLAR AMOUNTS IN THOUSANDS)

STATEMENT OF REVENUES, EXPENSES AND CHANGES IN NET ASSETS

	2003	*2002 (unaudited)*
Operating revenues:		
Potable water sales	$ 92,683	$ 91,916
Reclaimed water sales	5,578	5,567
Total water sales	98,261	97,483
Central Arizona Project surcharge	1,272	963
Connection fees	3,382	3,151
Billing services -		
Pima County Sewer, City of Tucson Solid Waste	1,446	1,419
Proceeds - Settlement with Oro Valley (note 5c)	-	5,410
Miscellaneous:		
TCE Cleanup reimbursement	850	667
Area development fees	1,091	1,488
Service charges	1,231	1,356
Plan Review and Inspection Fees	1,245	-
Reimbursed prior year expenses	448	695
Other	179	162
Total miscellaneous	5,044	4,368
Total operating revenues	109,405	112,794
Operating expenses:		
Director's office:		
Personal services	1,983	1,159
Contractual services	1,068	1,008
Commodities	354	183
Total director's office	3,405	2,350
Business services:		
Personal services	6,113	6,034
Contractual services	1,513	1,347
Commodities	1,311	1,379
Total business services	8,937	8,760
Water operations:		
Personal services	11,040	11,095
Contractual services	12,382	12,608
Commodities	3,732	2,912
Total water operations	27,154	26,615
Planning and engineering:		
Personal services	3,092	2,282
Contractual services	376	322
Commodities	381	228
Total planning and engineering	3,849	2,832

(Continued)

TUCSON WATER (AN ENTERPRISE FUND OF THE CITY OF TUCSON, ARIZONA), JUNE 30, 2002 AND 2003 (DOLLAR AMOUNTS IN THOUSANDS)

STATEMENT OF REVENUES, EXPENSES AND CHANGES IN NET ASSETS

	2003	*2002 (unaudited)*
Water quality management		
Personal services	3,520	3,698
Contractual services	2,855	2,736
Commodities	652	765
Total water quality	7,027	7,199
CAP water charges:		
Capital charges	5,379	5,985
Commodity charges	2,461	1,688
Total CAP water charges	7,840	7,673
General expenses:		
Personal services	590	581
Contractual services	8,013	7,069
Commodities	113	50
Total general expenses	8,716	7,700
Depreciation and goodwill amortization (note 2g)	19,747	21,160
Discount given for early payment (long-term receivable)	-	920
Total operating expenses	86,675	85,209
Net operating income	22,730	27,585
Nonoperating income:		
Investment earnings	1,620	1,948
Gain on sale of property/equipment	143	114
Other nonoperating	65	-
Total nonoperating income	1,828	2,062
Nonoperating expenses:		
Interest expense	17,151	16,147
Other nonoperating expenses	527	222
Total nonoperating expenses	17,678	16,369
Net income before capital contributions	6,880	13,278
Capital contributions	10,172	9,972
Change in net assets	17,052	23,250
Net assets - July 1	553,710	537,969
Prior period adjustment (note 3)	3,211	(7,509)
Net assets restated - July 1	556,921	530,460
Net assets - June 30	$ 573,973	$ 553,710

See accompanying notes to financial statements.

TUCSON WATER (AN ENTERPRISE FUND OF THE CITY OF TUCSON, ARIZONA), JUNE 30, 2002 AND 2003 (DOLLAR AMOUNTS IN THOUSANDS)

STATEMENT OF CASH FLOWS

	2003	2002 (Unaudited)
Cash flows from operating activities:		
Cash received from customers	$ 110,558	$ 111,583
Cash payments to suppliers for goods and services	(40,964)	(51,061)
Cash payments to employees for services	(27,403)	(24,192)
Net cash provided by operating activities	42,191	36,330
Cash flows from capital and related financing activities:		
Bond proceeds	10,971	64,887
Acquisition and construction of capital assets	(50,077)	(40,657)
Principal paid on capital debt	(8,441)	(7,501)
Interest paid on capital debt	(17,136)	(16,045)
Fiscal agent fees paid on capital debt	(331)	(222)
Proceeds from sale of property and equipment	143	114
Net cash used in capital and related financing activities	(64,871)	576
Cash flows from investing activities – interest received on investments	1,926	2,106
Net increase (decrease) in cash and cash equivalents	(20,754)	39,012
Cash and cash equivalents at beginning of year	46,500	7,488
Cash and cash equivalents at end of year	$ 25,746	$ 46,500

	2003	2002 (Unaudited)
Reconciliation of operating income to net cash provided by operating activities:		
Operating income	$ 22,730	$ 27,585
Adjustments to reconcile operating income to net cash provided by operating activities:		
Depreciation and amortization	19,747	21,160
Decrease (increase) in cash resulting from changes in:		
Accounts receivable	516	(4,129)
Internal Receivable	(27)	---
Prepaids and other assets	39	2
Long-term accounts receivable	335	5,930
Accounts payable	17	2,426
Accrued expenses	(1,065)	657
Customers/refundable deposits/due to other agencies	(101)	(1,217)
Due to City of Tucson funds	---	(16,084)
Net cash provided by operating activities	$ 42,191	$ 36,330

	2003	2002 (Unaudited)
A reconciliation of cash and cash equivalents at June 30 follows:		
Unrestricted cash	$ 23,369	$ 21,097
Restricted cash (included in restricted assets)	2,377	25,403
Cash and cash equivalents at June 30	$ 25,746	$ 46,500

Noncash investing, capital and financing activities:

Developers contributed water systems to the Utility valued at $10,172 and $9,972 during the years ended June 30, 2003 and 2002, respectively. During the year ended June 30, 2003, developers contributed securities in place of contract retainage in the amount of $1,256.

Other noncash transaction during the year ended June 30, 2002: an accounts receivable of $5,410 relating to a legal settlement and $208 in interest thereon; a discount of $920 given on early payoff of a long-term accounts receivable.

Other noncash transaction during the year ended June 30, 2003: $3,211 for prior year adjustment to Capital Assets and $153 accrued interest on a legal settlement.

2003 ANNUAL REPORT

WATER RESOURCES

FOR A DESERT COMMUNITY

NOTES TO FINANCIAL STATEMENTS

1. Description of the Business

Tucson Water (the Utility), an enterprise fund of the City of Tucson, Arizona (the City), is operated and maintained as a self-supporting, municipally-owned utility of the City providing customers with potable and reclaimed water. The Utility provides water service to approximately 690,000 people within a 300 square-mile service area that encompasses approximately 85% of the greater Tucson metropolitan area's total population. Customers are classified by the type of service they receive, including residential, multi-family, mobile home park with sub-meters, commercial, and industrial services, and are located both inside and outside of the corporate limits of the City.

Water Sources

The Utility currently obtains the majority of its municipal potable water from groundwater supplied from four well fields with an aggregate capacity of 201 million gallons per day (Mgd) during calendar year 2003.

The Utility also has a surface water source under contract with the United States Department of the Interior and the Central Arizona Water Conservation District (CAWCD) for 134,466 acre-feet annually of Colorado River water delivered via the Central Arizona Project (CAP). The CAP consists of waterworks and associated facilities designed to deliver water from Lake Havasu on the Colorado River to Maricopa, Pinal, and Pima Counties in central Arizona. Although owned by the federal government, the CAP is operated and maintained by the CAWCD.

In May 2001, the Utility began delivering water from its Clearwater Renewable Resource Facility (CRRF) which produces a blend of recharged and recovered CAP water and groundwater. CRRF, constructed northwest of the City of Tucson, is composed of recharge basins, recovery wellfields, and storage and transmission facilities. The facility, which reached full build out June 30, 2003, recharges and recovers 60,000 acre-feet of CAP water annually (54 million gallons per day), thereby reducing pumpage from the central well field and helping to prevent land subsidence in the Tucson metropolitan area.

As part of a 1979 intergovernmental agreement (IGA) transferring the sewer from the City to Pima County, the Utility was granted the right to use 90% of the effluent discharged from the metropolitan wastewater treatment facilities. Planning for use of this water resource was initiated in 1982. In 1984, the Utility began delivering reclaimed water, or effluent treated to tertiary levels, to customers for turf irrigation purposes. The Utility's reclaimed system currently includes a reclaimed water treatment plant which processes effluent to a quality suitable for open-access turf irrigation, a wetlands which biologically treats secondary effluent, basins for the effluent recharge and wells for recovery of the recharged water for delivery in the reclaimed distribution system.

In February 2000, the IGA was amended to resolve issues related to effluent and recharge permits. The amendment contained numerous agreements, including: (1) the City, Pima County and other effluent management entities (Marana/Oro Valley) agreed to establish a Conservation Effluent Pool for use on riparian projects, (2) the City and Pima County agreed to cooperatively plan and establish recharge basins for storage of effluent, (3) effluent from the new treatment facility at Ina Road would be divided among the City, Pima County and U.S. Department of the Interior, (4) the City would no longer control effluent from non-metropolitan treatment plants, and (5) the County could use its 10% of effluent for any public use.

Assured Water Supply

Arizona Department of Water Resources' (ADWR) Assured Water Supply (AWS) Program is designed to encourage water providers to shift their reliance from groundwater to renewable water sources. It is important that water systems have an AWS designation because without it, no new growth can take place within the service area unless developers provide their own water supply. Receipt of the Assured Water Supply designation indicates a sufficient water supply is available to meet 100-years of projected demand for the existing population, committed demand (undeveloped, subdivided land within the service area) and provision for an increment of growth. The Utility's service area received a designation of Assured Water Supply on January 1, 1998 based upon its membership in the Central Arizona Groundwater Replenishment District (CAGRD) and the planned recharge and recovery of CAP water at the CRRF.

Utility Operations

The Utility is operated and maintained as a self-supporting, municipally-owned utility of the City. Although the Utility is a department of the City, it is operated in a manner similar to a private business enterprise where the costs of providing goods and services to its customers are financed primarily by user charges. A fund structure separate from other City accounts is maintained. The Utility's authority and responsibility is derived from the City's Charter and ordinances and resolutions of the Mayor and Council of the City. The Utility has within its organization virtually all of the elements of a self-contained entity. The Mayor and Council adopt the Utility's annual budget, establish water rates and fee structures in accordance with State laws governing municipal water systems, and provide overall policy direction.

To assist with the task of operating the Utility, the Mayor and Council have adopted water service policies. A number of these policies establish guidelines for the water financing and ratemaking process. These water service policies include, but are not necessarily limited to, the following concepts:

- All costs associated with the operation of the Utility (operating, maintenance, renewal and replacement, capital and debt service) shall be funded from revenues derived from the Water System's water rates and other water-related income sources.

- Various combinations of revenue bonds, tax-secured bonds and water revenues are used to finance Utility capital improvements; regardless of what type of bond is used, repayment of the bonds shall be made only from Water System revenues.

- Some portion of the capital improvements are required to be funded from annual revenues to comply with existing bond covenants and Mayor and Council policy and to facilitate new debt issues by maintaining adequate debt coverage. An annual average debt coverage of at least 1.75 shall be maintained. The Utility was in compliance with debt coverage requirements for the fiscal year ending June 30, 2003.

- The policies require the Utility to maintain cash reserves adequate for known future obligations. In June 2002, Mayor and Council adopted a Financial Plan including increasing cash reserve levels to approximately $12.5 million by the end of fiscal year 2007. Cash reserves are nonrestricted cash/equivalents less cash designated for specific purposes. As reported on the Statement of Net Assets, the utility maintains two designations of cash:
  - Designated for customer deposits - Cash/equivalents designated for reimbursement of customer deposits.
  - Designated for infrastructure replacement - Cash/equivalents designated for replacement of water system infrastructure. On June 3, 2002, the Mayor and Council utilized the payoff proceeds received under a legal settlement (and future interest earnings thereon) to establish a fund for future infrastructure replacement. The fund's balance at June 30, 2003 was $9,587.

- Charges for services shall be made on a cost of service basis. Water rate design elements shall reflect the cost of service areas across customer classes and seasons, and shall be designed so as to encourage water conservation and to control peak demand.

- Water rates and charges shall be reviewed annually.

Mayor and Council created the Citizens' Water Advisory Committee (CWAC) in 1977 as the official advisory body to the Council on water issues. The CWAC, composed of fifteen members, annually reviews the Utility's Financial Plan and its underlying capital improvement program, operating plans, and revenue forecasts, and makes recommendations to the Mayor and Council on rate adjustments.

2. Summary of Significant Accounting Policies

a. General

Tucson Water is an enterprise fund of the City. The enterprise fund accounts for the financing and operations of the Utility. All activities necessary to provide water services to Utility customers are accounted for within this enterprise fund. Any Utility annual revenues remaining after providing for operating and maintenance expense and capital project funding are retained by the Utility.

B. Basis of Accounting

The Utility accounts for its activity on the accrual basis of accounting. The Utility applies all applicable Governmental Accounting Standards Board (GASB) Statements, as well as the following pronouncements issued on or before November 30, 1989, unless those pronouncements conflict or contradict GASB pronouncements: Financial Accounting Standards Board Statements and Interpretations, Accounting Principles Board Opinions and Accounting Research Bulletins of the Committee on Accounting Procedure. Governments are given the option of whether or not to apply all FASB Statements and Interpretations issued after November 30, 1989, except for those that conflict with or contradict GASB Pronouncements. Tucson Water has elected not to implement FASB Statements and Interpretations issued after November 30, 1989.

C. Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions. These estimates and assumptions affect (1) the reported amounts of assets and liabilities, (2) the disclosure of contingent assets and liabilities at the date of the financial statements, and (3) the reported amounts of revenue and expenses during the reporting period. Actual results could differ from these estimates.

D. Cash Equivalents

All short-term investments purchased with an original maturity of three months or less are considered to be cash equivalents. For purposes of the statement of cash flow, all highly liquid investments (including participation in the City of Tucson's investment pool account) are considered to be cash equivalents.

E. Investments/Deposits

The Utility participates in the City's external investment pool for all cash balances. Pooled investments are reported at fair value. A single master custodian holds all assets of the investment pool.

F. Income and Other Taxes

The Utility is an enterprise fund of the City of Tucson, Arizona, a municipality exempt from federal and state income taxes. Accordingly, no provision for income taxes is included in the financial statements.

Tucson Water is subject to state and municipal (Tucson, South Tucson, Marana) business privilege taxes. In addition, the City of Tucson levies a separate utility tax on the Utility's sales to customers residing within the City of Tucson limits and the State levies an environmental tax (to support Super-fund cleanup efforts) on all potable water sales.

TUCSON WATER (AN ENTERPRISE FUND OF THE CITY OF TUCSON, ARIZONA), JUNE 30, 2002 AND 2003 (DOLLAR AMOUNTS IN THOUSANDS)

G. Capital Assets

Property, plant, and equipment acquired prior to June 30, 1965 are stated at estimated historical cost. Additions subsequent to that date are stated at actual historical cost. Depreciation has been provided using the straight-line method over the following estimated useful lives.

Asset	Estimated useful life (years)
Buildings	40
Improvements other than buildings	10-40
Wells, reservoirs and improvements	40-100
Machinery and equipment	3 to 20

The Utility does not capitalize interest on capital projects unless it is material, using the effective interest method. No interest costs were capitalized during the fiscal years ended June 30, 2003 or 2002, as the amounts were not material. Maintenance and repairs are expensed as incurred.

H. Deferred Charges

Deferred charges represent the unamortized costs resulting from the issuance of water revenue bonds. These deferred charges, reported under *Other Assets* on the *Statement of Net Assets*, are amortized over the life of the related bonds. Unamortized costs were $1,480 at June 30, 2003.

I. Restricted Assets/Liabilities

In accordance with applicable covenants of Utility bond issues, Mayor and Council Resolutions, or other agreements, appropriate assets and liabilities have been restricted.

3. Accounting Restatement

During a reconciliation of capital assets, adjustments were required to correct errors associated with the conversion from a straight-line depreciation by class method to a straight-line depreciation by individual asset method. This resulted in a restatement of Fiscal Year 2002 beginning Net Capital Assets, as follows:

	Capital Assets as of June 30, 2002	*Restatement*	*Restated Capital Assets as of July 1, 2002*
Total at Historical Cost	$1,044,467	($2,564)	$1,041,903
Total Accumulated Depreciation	(217,114)	5,775	($211,339)
Net Capital Assets	$ 827,353	$ 3,211	$ 830,564

TUCSON WATER (AN ENTERPRISE FUND OF THE CITY OF TUCSON, ARIZONA), JUNE 30, 2002 AND 2003 (DOLLAR AMOUNTS IN THOUSANDS)

4. Deposits/Investments

The Utility had approximately $16,511 in cash held with fiscal agents at June 30, 2003, included in restricted assets in the accompanying statements of net assets. Cash with fiscal agents was covered by collateral held in the fiscal agents' trust departments but not in the Utility's name. Each trust department pledges a pool of collateral against all trust deposits it holds.

At year-end, the Utility had $23,369 in unrestricted cash and cash equivalents. The City Charter and State Statutes authorize the City to invest City investment pool funds in obligations of the U.S. Government, its agencies and instrumentalities, money market funds consisting of the above, repurchase agreements, bank certificates of deposit, commercial paper rated A-1/P-1, corporate bonds and notes rated AAA or AA, and the State of Arizona Local Government Investment Pool. Operating and capital projects funds may be invested for a maximum of 3 years based on projected construction schedules. Since these funds are held by the City of Tucson in its investment pool, they are not categorized by the Utility.

Additional information on the City's investments/deposits, including categorization of the level of custodial credit risk assumed, is provided in the City's Comprehensive Annual Report (CAFR). Copies of the CAFR can be obtained from the City's Finance Department, 255 W. Alameda Street, Tucson, AZ 85701.

5. Accounts Receivable

a. Current

The Utility's current accounts receivable at June 30, 2003 were:

Billed Accounts	$	10,027
Unbilled (*estimated unbilled water sales delivered at June 30)*		7,287
Less: Allowance for doubtful accounts		(390)
Total current accounts receivable	$	16,924

b. Long-term

The Utility's long-term accounts receivable at June 30, 2003 were:

Receivable from settlement agreements	$	3,652
Receivable from local school district		340
Total long-term accounts receivable	$	3,992

c. SETTLEMENT AGREEMENTS

In 1979, the City of Tucson entered into agreements (the "NW Area Agreements") with water companies in the Northwest Area, including the Foothills Water Company and the Rancho Vistoso Water Company. These agreements called for the City to provide imported water supplies, including CAP water, for a price consisting of the City's treatment and operations costs, plus a capital component for infrastructure necessary to deliver water to the Northwest Area water companies. The Town of Oro Valley purchased both the Foothills Water Company (which had been renamed as the Cañada Hills Water Company) and the Rancho Vistoso Water Company in 1996.

On November 5, 2001, Mayor and Council approved an Intergovernmental Agreement (IGA) under which Tucson and Oro Valley resolved outstanding water issues. The IGA represented the conclusion of negotiations over the last several years and deals primarily with four areas: (1) resolution of the Northwest Area Agreement litigation, including a transfer of CAP water entitlement from the City to Oro Valley (4,454 acre-feet); (2) control of effluent derived from Oro Valley water service; (3) cooperation in delivery of reclaimed water to non-potable water users in Oro Valley; and (4) cooperation in provision of additional potable water supplies to Oro Valley.

Under the settlement agreement, the Town of Oro Valley will remit to Tucson Water, over a ten-year period, approximately $5,410 ($3,750 as settlement of the 1979 Northwest Area Agreement and $1,660 in reimbursement of capital charges associated with the CAP entitlement to be transferred to Oro Valley) plus interest at 6.5%.

d. LOANS TO TUCSON UNIFIED SCHOOL DISTRICT

The Utility has entered into three loan agreements with the Tucson Unified School District (TUSD) to provide funds for the conversion of a high school's irrigation system from potable to reclaimed use. Under terms of the first agreement, TUSD continues to pay the higher potable water rate for its reclaimed usage. The billing difference (actual potable billing minus theoretical reclaimed billing), less interest at 8%, will be applied monthly to the loan balance. The loan balance of $94 is anticipated to be repaid by June 2006. Under terms of the second agreement TUSD pays the standard reclaimed usage rate, repaying the loan, with interest at 5%, over a five-year period. The loan balance of $70 will be repaid by November 2006. Under the terms of the third loan, TUSD pays the standard reclaimed usage rate, repaying the loan, with interest at 5%, over a five-year period. The loan balance of $176 will be repaid in May 2008.

TUCSON WATER (AN ENTERPRISE FUND OF THE CITY OF TUCSON, ARIZONA), JUNE 30, 2002 AND 2003 (DOLLAR AMOUNTS IN THOUSANDS)

6. Restricted Assets and Liabilities Payable From Restricted Assets

A. Restricted Assets

Restricted assets as of June 30, 2003 consist of the following:

Source	*Restricted Purpose*	*$ Amount*
Debt service	Cash/investments held by the City of Tucson restricted for payment of matured revenue bond principal and interest	$ 15,296
Unspent revenue bond proceeds/loan proceeds receivable	Cash/investments held by the City of Tucson/ accrued interest receivable/other receivables restricted for authorized bond funded capital improvement projects	4,027
Construction project vendor deposited investments	Construction vendor investments (deposited in lieu of Utility retainage on construction payments) restricted for reimbursement to vendor	1,256
	Total restricted assets	$ 20,579

B. Liabilities Payable from Restricted Assets

Liabilities payable from restricted assets as of June 30, 2003 consist of the following:

Source	*Restricted Purpose*	*$ Amount*
Debt service restricted assets	Matured bonds and interest payable	$ 15,255
Unspent revenue bond/loan proceed assets	Accounts payable on authorized bond funded capital improvement projects/ due to other funds pending loan reimbursement	4,526
Construction project vendor deposited	Accounts payable, investments returnable to vendors (deposited in lieu of Utility retainage on construction payments)	1,256
	Total liabilities payable from restricted assets	$ 21,037

TUCSON WATER (AN ENTERPRISE FUND OF THE CITY OF TUCSON, ARIZONA), JUNE 30, 2002 AND 2003 (DOLLAR AMOUNTS IN THOUSANDS)

7. CAPITAL ASSETS

The following is a summary of the changes in Capital Assets:

	Beginning Balance As Restated	*Additions/ Transfers*	*Reductions/ Transfers*	*Ending Balance*
Land	$ 45,145	$ -0-	$ (26)	$ 45,119
Buildings & Equipment	121,266	9,609	(1,540)	129,335
Transmission & Distribution Systems	779,642	35,623	(8,404)	806,861
Construction in Progress	95,850	48,181	(28,832)	115,199
Total at Historical Cost	$ 1,041,903	$ 93,413	$ (38,802)	$ 1,096,514
Less Accumulated Depreciation for:				
Buildings & Equipment	$ 25,439	$ 8,538	$ (3,647)	$ 30,330
Transmission & Distribution Systems	185,900	11,181	(1,581)	195,500
Total Accumulated Depreciation	$ 211,339	$ 19,719	$ (5,228)	$ 225,830
Net Capital Assets	$ 830,564	$ 73,694	$ (33,574)	$ 870,684

TUCSON WATER (AN ENTERPRISE FUND OF THE CITY OF TUCSON, ARIZONA), JUNE 30, 2002 AND 2003 (DOLLAR AMOUNTS IN THOUSANDS)

8. CHANGES IN LONG-TERM DEBT

A summary of changes in long-term debt as of June 30, 2003 is as follows:

	Beginning Balance	*Additions/ Refunded Issues*	*Reductions/ Refunded Issues*	*Ending Balance*	*Due Within One Year*
Water Revenue					
Bonds Payable	$334,999	$7,228	$ (8,562)	$333,665	$ 8,888
Deferred Amounts:					
Bond sale premiums	(7,187)	(775)	453	(7,509)	
Bond sale refundings	4,591	1,482	(279)	5,794	
Total Water Revenue					
Bonds Payable	$332,403	$7,935	$ (8,388)	$331,950	$ 8,888
Compensated					
Absences	3,143	1,408	(1,526)	3,025	1,536
Contracts Payable	1,189	Ø	(339)	850	450
Arbitrage Rebate	110	Ø	(110)	Ø	Ø
Payable					
Total Long Term Debt	$336,845	$9,343	$ (10,363)	$335,825	$10,874

9. REVENUE BONDS PAYABLE

Water revenue bonds, secured by water sales revenues, to be sold by the Utility require approval of a majority of City of Tucson voters at a bond election. At the most recent bond election, held May 16, 2000, voters approved an additional $123.6 million water revenue bond authorization.

At June 30, 2003, the long-term portion of bonds payable was:

Bonds Maturing 2003 - 2025	$ 333,665
Less current installments	(8,888)
Deferred amounts *	(1,715)
Total long-term revenue bonds payable	$ 323,062

*Losses on refundings are amortized over the shorter of (1) the period remaining on refunded bonds, or (2) the repayment period of refunding bonds. Amortization during the years ended June 30, 2003 and 2002 was $174 and $236, respectively.

TUCSON WATER (AN ENTERPRISE FUND OF THE CITY OF TUCSON, ARIZONA), JUNE 30, 2002 AND 2003 (DOLLAR AMOUNTS IN THOUSANDS)

Water Utility Revenue Bonds Issued and Outstanding at June 30, 2003 are as follows:

Series	*Interest Rates*	*Maturity Date*	*Original Amount*	*Balance Outstanding June 30, 2003*
1984 Series D (1991)	9.5%	2010	$ 48,000	$ 4,000
1992 April (Refunding)	6.2-6.35	2004	13,030	55
1993 March (Refunding)	5.25-5.50	2018	35,360	22,150
1994 Series A (1996)	6.0-8.0	2018	33,000	3,000
1994 Series B (1997)	4.50-6.25	2012	11,700	9,000
1997 July (Refunding)	4.20-5.125	2021	32,980	32,405
1998A Water Infrastructure Finance Authority (WIFA) Subsidized	3.425	2017	6,000	4,962
1994 Series C (1999)	4.75-6.75	2016	33,400	33,200
1999A Refunding	5.00	2010	14,045	12,895
1994 Series D (2000)	5.25-7.25	2024	23,740	23,740
2000 Water Infrastructure Finance Authority (WIFA) Subsidized	4.125	2020	5,120	4,747
2000 Water Infrastructure Finance Authority (WIFA) Unsubsidized	5.00	2020	7,780	7,257
2000 Series A (2001)	5.0-7.5	2023	37,800	37,800
2001 A April (Refunding)	5.0	2016	40,850	35,500
2001 Water Infrastructure Finance Authority (WIFA) Subsidized	3.43	2021	8,800	8,464
2002 Refunding	5.50	2018	57,820	57,820
2000 Series B (2002)	3.5-5.125	2021	18,900	18,900
2003 Water Infrastructure Finance Authority (WIFA) Subsidized	3.48	2022	5,770	5,770 (1)
2003 Refunding	5.00	2018	12,000	12,000
Total			$ 446,095	$ 333,665

(1) Total issue $8,300; balance of issue ($2,530) will be recognized when proceeds are received.

TUCSON WATER (AN ENTERPRISE FUND OF THE CITY OF TUCSON, ARIZONA), JUNE 30, 2002 AND 2003 (DOLLAR AMOUNTS IN THOUSANDS)

Maturities of the bonds and related interest payable after June 30, 2003 are as follows:

Year ending June 30,	*Principal*	*Interest*	*Total*
2004	$ 8,888	$ 17,394	$ 26,282
2005	9,595	16,829	26,424
2006	10,228	16,321	26,549
2007	12,184	15,774	27,958
2008	13,307	15,115	28,422
2009-2013	85,549	63,383	148,932
2014-2018	100,822	38,838	139,660
2019-2023	90,392	13,321	103,713
2024	2,700	142	2,842
Total	$ 333,665	$ 197,117	$ 530,782

10. ADVANCED REFUNDING/DEFEASANCE OF DEBT

On May 1, 2003, the City issued $12,000 Water Utility Revenue Refunding Bonds to refund $12,460 of Revenue Bond Series 1993A and to pay costs relating to the issuance of the bonds. The interest rate on the bonds is 5.0% with the final maturity due July 1, 2018. Debt service payments are scheduled semi-annually at amounts that range from $1,700-$6,450. The economic gain resulting from this refunding is $1,503 (based upon Net Present Value from delivery date). The difference in the cash flow requirements to service the old debt ($21,998) and the cash flows to service the new debt ($20,559) was $1,439.

In prior years, the City has defeased various bond issues by creating irrevocable trusts. The proceeds from the advance refundings have been deposited in these trusts and invested in U.S. Governmental Securities that are designed to meet the requirements of the refunded debt. The debt associated with the refunding issues, as well as the trust assets, has been removed from the City's basic financial statements. As of June 30, 2003, the amount of defeased debt outstanding, but removed, is $137,975.

11. LONG-TERM CONTRACT PAYABLE

Long-term contract payable as of June 30, 2003 consisted of a contract relating to the acquisition of the Metropolitan Water Company:

Purchase of Metro water company	$ 850
Less current installments	(450)
Total long-term contract payable	$ 400

The Metropolitan water company contract bears interest at 7.0% and will mature in January 2005.

Tucson Water (An Enterprise Fund of the City of Tucson, Arizona), June 30, 2002 and 2003 (Dollar amounts in thousands)

The Utility purchased the Metropolitan Water Company, an Arizona limited partnership, on October 1, 1992 for $14,176. A down payment of $5,176 was made and a 13-year note at 7% annual interest was executed for the $9,000 balance. Also on October 1, 1992, the Utility sold these assets and miscellaneous improvements to the Metropolitan Water Improvement District and the Oro Valley Domestic Water Improvement District for $14,497 in cash. Adequate sales proceeds were invested in U.S. Treasury Strips with maturities scheduled to meet all future payment obligations by the Utility to the previous owners of the Metropolitan Water Company. These investments are reported as long-term assets of the Utility - *Investments for Contract Payments* ($965 as of June 30, 2003). As of June 30, 2003, principal payments of $7,934 have been made on the note.

The final principal payment on the Metropolitan Water Co. contract is due January 2005. The remaining principal on the contract is payable as follows:

January 1, 2004	$ 450
January 1, 2005	400
Total balance at June 30, 2003	$ 850

12. Other Long-Term Liabilities

Other long-term liabilities are made up of accrued compensated absences and arbitrage rebates on Water Revenue bonds as follows:

a. Accrued Compensated Absences

The costs of employee vacation leave, sick leave, accumulated compensatory time, and any salary-related amounts are expensed as earned. Accrued compensated absences not expected to be utilized by employees within the next year are recorded as long-term liabilities. The long-term liability related to accrued compensated absences was $1,489 at June 30, 2003.

b. Arbitrage Tax Liability

The arbitrage tax liability results when interest earnings on water revenue bond proceeds exceed the related water revenue bond's yield. The Utility's liability balance at June 30, 2003 was $0. The Utility's next required rebate date is July 1, 2005.

13. Capital Contributions

Developers of land within the Utility's service area are required to install water distribution systems meeting the Utility's standards. Once completed and inspected by Utility staff, the developer donates the systems to the Utility. During the year ended June 30, 2003, developers donated water systems valued at $9,809. In addition, the Utility received $363 in capital grants.

14. INSURANCE

The Utility is exposed to various risks of losses related to tort: theft of, damage to, and destruction of assets; errors and omissions; injuries to employees; and natural disasters. Coverage is obtained through participation in the City's self-insurance program. The Utility pays a premium, calculated annually based on its claims history, to the City's Self-Insurance Fund. During Fiscal Year 2003, the Utility premium was $874. All risk management activities are accounted for in this City Fund.

The City has obtained commercial coverage for Property Insurance, Public Employee Fidelity Bonds, Crime Insurance, Aircraft Insurance, and Miscellaneous Insurance (surety bonds, special event insurance as needed and fine arts coverage).

During the last three years, all City settlements have been less than the insurance coverage provided by this fund. The City retains all of the risk not covered by commercial carriers and manages risk through various employee education and prevention programs.

15. PENSION PLAN/DEFERRED COMPENSATION PLANS/POST RETIREMENT BENEFITS

Utility employees are employees of the City of Tucson and eligible to participate in its pension, deferred compensation, and post-retirement benefit plans.

A. *PENSION PLAN*

Utility employees participate in the Tucson Supplemental Retirement System (TSRS), a single-employer defined benefit plan. Currently, employee contributions are 5% of their annual covered payroll and are made through payroll deductions. A reserve is established for contributions and earnings allocations, less amounts transferred to reserves for retirement and disability and amounts reserved for terminated employees. If an employee leaves covered employment before attaining five years' service credit (eight years' service credit if the member dies), the accumulated contributions plus interest are refunded to the employee or his designated beneficiary. The City contributes the remaining amounts necessary to finance employee participation in the System and to fund the costs of administering the System. Tucson Water's contribution rate for years ended June 30, 2003, 2002, and 2001 was 8.41%, 7.35%, and 7.35%, or $2,063, $1,661, and $1,620, respectively.

The TSRS issues an annual report that includes financial statements and required supplementary information. The financial statements may be obtained from their administrative office located at 255 W. Alameda Street, Tucson, AZ 85701.

B. DEFERRED COMPENSATION

Utility employees may participate in several deferred compensation plans offered by the City, including both externally managed plans and a plan administered by the City. These plans permit employees to defer a portion of their salaries until future years.

C. POST RETIREMENT BENEFITS

The City subsidizes a health insurance benefit to Utility employees who have qualified to receive a monthly retirement allowance from the Tucson Supplemental Retirement System and are less than 65 years of age. The City pays between 75% and 100% of the medical insurance premiums for eligible retirees and their dependents. The costs associated with this retirement benefit are expended as the appropriate medical insurance premiums are paid. During the year ended June 30, 2003, the Utility's portion of retiree medical insurance premiums was $170.

16. CONTINGENCIES AND COMMITMENTS

A. OPERATING LEASES

The Utility has entered into operating leases with terms in excess of one year which are not material when taken either individually or collectively and, therefore, are not disclosed in these notes. All the operating leases are cancelable. The Utility's total rent expense, resulting predominately from as needed rental of heavy equipment to support maintenance functions, was $549 for the year ended June 30, 2003.

B. LITIGATION

The Utility is contingently liable with respect to lawsuits and other claims incidental to the ordinary course of its operations. At June 30, 2003, it is the opinion of management, based on the advice of the City Attorney, that any pending litigation would not have a material adverse effect on the Utility's financial condition or results of operations.

C. CONSTRUCTION RETAINAGE AND OTHER COMMITMENTS

The Utility enters into numerous capital improvement project contracts. Retainage on construction contracts for contract work completed as of June 30, 2003 are appropriately identified as accounts payable. Future commitments under project contracts totaled $9.8 million as of June 30, 2003.

D. CENTRAL ARIZONA PROJECT CONTRACTUAL OBLIGATION

The Utility has a contractual obligation for the purchase of CAP water from the Central Arizona Water Conservation District, the entity responsible for contracting with the Secretary of Interior for CAP water and the resulting subcontracting with users within the State of Arizona. The Utility's obligation consists of two components: (1) a capital financing charge based upon the Utility's current allotment of 134,466 acre-feet, and (2) a commodity charge based upon actual CAP water taken.

TUCSON WATER (AN ENTERPRISE FUND OF THE CITY OF TUCSON, ARIZONA), JUNE 30, 2002 AND 2003 (DOLLAR AMOUNTS IN THOUSANDS)

During fiscal year 2003, the Utility made capital and commodity payments of $5,329 and $2,461, respectively. Estimated CAP water expenses for the next five years are as follows:

CAP Payment Schedule

Fiscal Year	*CAP Capital**	*CAP Commodity*
2004	$ 5,096	$ 4,192
2005	4,351	4,628
2006	4,351	4,782
2007	5,702	4,998
2008	5,841	5,214

**Includes capital cost impacts associated with obtaining an additional 1,500 acre-foot allocation in fiscal year 2004 via acquisition of a water company, and obtaining an additional 8,206 acre-feet of CAP allocation in fiscal year 2007 as part of a statewide distribution of unallocated CAP water.*

E. MEMBERSHIP IN CENTRAL ARIZONA GROUNDWATER REPLENISHMENT DISTRICT (CAGRD)

The Utility entered into a membership agreement with the CAGRD during December 1996 to ensure meeting the December 31, 1996 deadline for early application for the State of Arizona's Assured Water Supply (AWS) designation. By meeting the early filing deadline, the Utility was permitted to pump groundwater during 1998, 1999, and 2000 (about 300,000 acre-feet) without being subject to the groundwater pumping limitations in the AWS rules.

Under terms of the agreement, the Utility is committed to pay an annual replenishment tax for water recharged on the Utility's behalf. Annual payments began in October 2002 and continue through October 2007. The per-acre-foot tax will consist of the current capital and commodity charges for CAP water, as established annually by CAWCD, plus an administrative fee, a CAGRD capital facility fee, and a CAGRD recharge facility operational fee. The tax will be multiplied by the acre-feet of water recharged by the CAGRD on behalf of the Utility during the prior calendar year, but in no case will it be less than 5,000 acre-feet annually during the six-year membership period.

F. WATER QUALITY REGULATIONS

The EPA continues to evaluate studies that may result in a new standard for radon in drinking water. Until the new standard is set, the Utility cannot estimate associated treatment costs.

17. Subsequent Events

a. *Water Infrastructure Finance Authority Loan*

During February 2004, the City of Tucson Mayor and Council approved entering into two new loan agreements with the Water Infrastructure Finance Authority of Arizona. The loans, totaling $5,500, have semi-annual payments due January 1 and July 1, beginning July 1, 2004. The loans, at a subsidized interest and fee rate of 3.75%, are issued against the 2000 voter authorization of Water revenue bond capacity.

b. *System Equity Fee*

Capital improvements needed to provide new capacity in a water system are generally constructed in large increments; therefore, system expansions are often constructed years in advance of when the added capacity will be fully utilized. As a result, current system users are often charged rates that are used to pay for a portion of the system capacity that will serve future users. On May 12, 2003, City of Tucson's Mayor and Council approved the implementation of a water system equity fee applicable to all new connections to the potable system. The fee provides a mechanism to compensate existing customers for the costs they have previously incurred to provide this capacity. The fee, collected at the time of a new connection to the system, is designed to recover the capital investment made to provide the capacity to serve new users, thereby reducing the amount of revenue required from monthly water use rates, resulting in lower future water rate increases than would otherwise be necessary. The fee became effective August 11, 2003, and is projected to provide $5,500 in revenue in Fiscal Year 2004 and $6,933 in Fiscal Year 2005. The implementation of the System Equity Fee helps to allocate costs for system expansion between new construction and existing ratepayers.

c. *Purchase of Midvale Water Company*

On February 3, 2003, the City of Tucson Mayor and Council approved the purchase of Midvale Water Company's assets along with its 1,500 acre foot CAP allocation. The Arizona Corporation Commission subsequently approved the sale of the Midvale Water Company along with the transfer of the CAP allocation. The purchase transaction closed in October 2003. Tucson Water paid $25 for the system assets and $745 for acquisition of the CAP allocation.

TUCSON WATER (AN ENTERPRISE FUND OF THE CITY OF TUCSON, ARIZONA), YEAR ENDED JUNE 30, 2003 (DOLLAR AMOUNTS IN THOUSANDS)

SUPPLEMENTAL SCHEDULE OF NET REVENUE AVAILABLE FOR DEBT SERVICE (1)

Revenues:		
Sale of water (potable and reclaimed)		
Potable water sales		$ 92,683
Reclaimed water sales		5,578
Central Arizona Project Surcharge		1,272
Connection fees		3,382
Sewer billing services -		
Pima County Sewer, City of Tucson Solid Waste		1,446
Miscellaneous revenue		
Area development fees	1,091	
Plan Review and Inspection Fees	1,245	
TCE clean-up reimbursement	850	
Prior Year and Reimbursed Expenses	448	
Service Charges	1,231	
Other	179	
Total miscellaneous		5,044
Investment earnings – Operating Fund		825
Investment earnings – Debt Service Fund		71
Proceeds on sale of property/equipment		143
Total revenues		110,444
Operation and maintenance expenses:		
Director's office		5,515
Business services		8,937
Water operations		17,511
Planning and engineering		6,233
Water quality management		5,631
Power – potable system	10,168	
Power – reclaimed system	997	
Total Power		11,165
CAP water purchases		
Capital charges	5,379	
Commodity	2,461	
Total CAP water purchases		7,840
General expenses		1,692
Capitalized operation and maintenance expenses		(4,493)
Total operating and maintenance expenses		60,031
Net revenue available after operations (2)		50,413
Debt Service for revenue bonds:		
Interest on long-term debt		16,822
Principal payments on long-term debt		7,934
Fiscal fees		331
Total Debt Service for revenue bonds		25,087
Net revenue available after operations and water revenue bond debt service		$ 25,326

(1) This is a special purpose financial statement intended to show compliance with Ordinance 6347. It is not prepared in accordance with Generally Accepted Accounting Principles (GAAP).

(2) Section 5.02(b) of Ordinance 6347 covenants that the Utility will issue additional bonds only if the previous year's net revenue available after operations equaled or exceeded 120% of the maximum future annual debt service requirement. For the year ended June 30, 2003, the debt coverage on Maximim Future Debt Service was 183 %.

An amendment to Section 7.01 or Ordinance 6347 covenants that should Net Revenues of any fiscal year fail to equal or exceed 175% of the year's Annual Debt Service Requirement, the Utility will deposit monies into a reserve account. For the period ended June 30, 2003, the debt coverage for the Annual Debt Service requirement was 201%.

Supplemental Schedule of Flow of Funds

The following *Flow of Funds* schedule reports fiscal year 2003 results commensurate with the methodology Tucson Water uses in establishing water rates; a methodology approved by the American Water Works Association.

Tucson Water, operating as a self-supporting utility of the City of Tucson, must receive sufficient revenues to support operating and capital improvements needs and meet financial policies governing cash reserve balances and debt service coverage (see *Notes to Financial Statements*). The revenues or other available cash sources of the Utility must cover the following each fiscal year:

- *Operations and maintenance expenses*: salaries and wages, fringe benefits, purchased power, payments for Colorado River water, commodities, and taxes.

- *Debt service on water revenue bonds*: principal and interest on water revenue bonds issued by the Utility.

- *Support of system infrastructure development (capital outlay):* Standard financing practices of the water utility industry call for both current ratepayers and future ratepayers to contribute to system infrastruc ture needs. Thus, the annual capital improvement program is financed by a combination of revenues and bond proceeds. In addition, Tucson Water revenue bond covenants and Mayor and council Water Policies require that a portion of the Utility's system improvements and equipment needs to be pro vided from revenues rather than bond proceeds. The capital outlay shown in the following *Flow of Funds* schedule reflects only the revenue-funded portion of the fiscal year 2003 outlay.

- *Other uses*: other uses of revenues including (1) payment to the City of Tucson's General Fund for support services provided to the Utility, (2) payment of principal and interest on long-term debt resulting from purchased water companies, (3) funding of loan programs, and (4) increasing Utility working capital.

Schedule II shows the balancing of cash sources and uses for fiscal year 2003.

TUCSON WATER (AN ENTERPRISE FUND OF THE CITY OF TUCSON, ARIZONA), YEAR ENDED JUNE 30, 2003 (DOLLAR AMOUNTS IN THOUSANDS)

SUPPLEMENTAL SCHEDULE OF FLOW OF FUNDS[1]

Revenues for operations and debt service:		
Sale of potable water	$ 92,683	
Sale of reclaimed water	5,578	
Total sale of water		98,261
Central Arizona Project Surcharge (4)		1,272
Connection fees		3,382
Taxes:		
Business privilege tax (State/City)	7,411	
Utility tax (City)	1,299	
Total taxes		8,710
Interest earnings:		
Operating fund interest earnings	825	
Debt service fund interest earnings	71	
Less restricted earnings	(192)	
Total interest earnings available for operations and debt service		704
Sewer billing services -		
Pima County Sewer, City of Tucson Solid Waste		1,446
Miscellaneous revenue:		
Area development fees	1,091	
Plan review and inspection fees	1,245	
TCE clean-up reimbursement	850	
Prior year and reimbursed expenses	448	
Other	1,410	
Total miscellaneous revenue		5,044
Other receipts:		
Proceeds from sale of property and equipment	143	
Principal received from Oro Valley settlement (2)	487	
Principal received on loans to school district	24	
Total other receipts		654
Total revenues for operations and debt service		119,473
Other sources:		
Use of Metropolitan Water Company Reserve Account (3)	370	
CAP Reserve Fund interest earnings (4)	12	
Total other sources		382
Total revenues and other sources		$ 119,855

(1) This schedule presents a flow of funds under the methodology utilized by the Utility in determining needs for revenue adjustments. That methodology, approved by the American Water Works Association and reviewed by the Utility's independent rate consultant, looks at projected cash requirements for the year. This statement, based on actual results, enables the Utility to compare results with those projections.
(2) Principal payments from settlement agreement included on this statement the year in which received. See *Notes to Financial Statements*, #5(c).
(3) See *Notes to the Financial Statements*, #11.
(4) CAP Reserve Fund revenues and interest were generated by a surcharge applied to potable water sales ($.03/Ccf as of October 2003.) Surcharge revenues are designated for payments of CAP water commodity or capital charges. Related interest earnings are designated for capital projects utilizing Colorado River water.

Continued

TUCSON WATER (AN ENTERPRISE FUND OF THE CITY OF TUCSON, ARIZONA), YEAR ENDED JUNE 30, 2003 (DOLLAR AMOUNTS IN THOUSANDS)

SUPPLEMENTAL SCHEDULE OF FLOW OF FUNDS[1]

Operations and maintenance expense: (5)			
Director's office			$ 5,515
Business services			8,937
Water operations (excluding power)			17,511
Planning and engineering (including waterline relocation)			6,233
Water quality management (excluding CAP water purchases/power)			5,631
CAP water:	Capital charges	5,379	
	Commodity	2,461	
	Total CAP water		7,840
Power:	Potable system	10,168	
	Reclaimed system	997	
	Total power		11,165
General expense (including sales taxes of $8,710)			10,402
Capitalized operations and maintenance expense			(4,493)
Total operations and maintenance expense			68,741
Adjustment for accrued compensated absences (6)			(62)
Adjusted total operations and maintenance expense			68,679
Debt service on water revenue bonds:			
Interest		16,822	
Principal		7,934	
Fiscal fees		331	
Total debt service on water revenue bonds			25,087
Capital outlay:			
Improvements from revenues and other sources		8,478	
Capital equipment from revenues and other sources		2,195	
Capitalized operations and maintenance expense		4,493	
Improvements funded by Central Arizona Project Reserve Fund		10	
Total capital outlay			15,176
Other uses:			
Private water company contract payments		417	
Administrative service charges		6,897	
Other uses		3,599	
Total other uses			10,913
Total expenses, debt service, capital outlay and other uses			$ 119,855

(5) Capitalized operations and maintenance expense reported separately on this statement.
It is allocated to Utility Divisions on the Statement of Revenues, Expenses and Changes in Net Assets.
(6) Change in year-end long-term compensated absences payable is subtracted in this statement.

Tucson Water's Mission

Our commitment is to ensure that our customers
receive high quality water and excellent service
in a cost-efficient, safe, and environmentally responsible manner.

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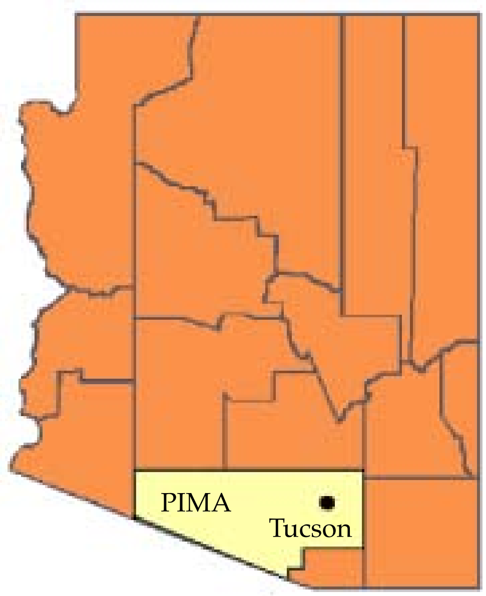
Tucson Water's Vision

In partnership with our community,
we provide excellence in water services
to secure the future and enhance
our quality of life.



Tucson, the county seat for Pima County, is the second largest city in Arizona, and has a population of approximately 500,000. Incorporated in 1877, the City of Tucson began as a 2 square mile village located in what is now Tucson's central downtown. It has now grown to approximately 225 square miles and lies within a greater metropolitan region of approximately 412 square miles, with a population of approximately 900,000.

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