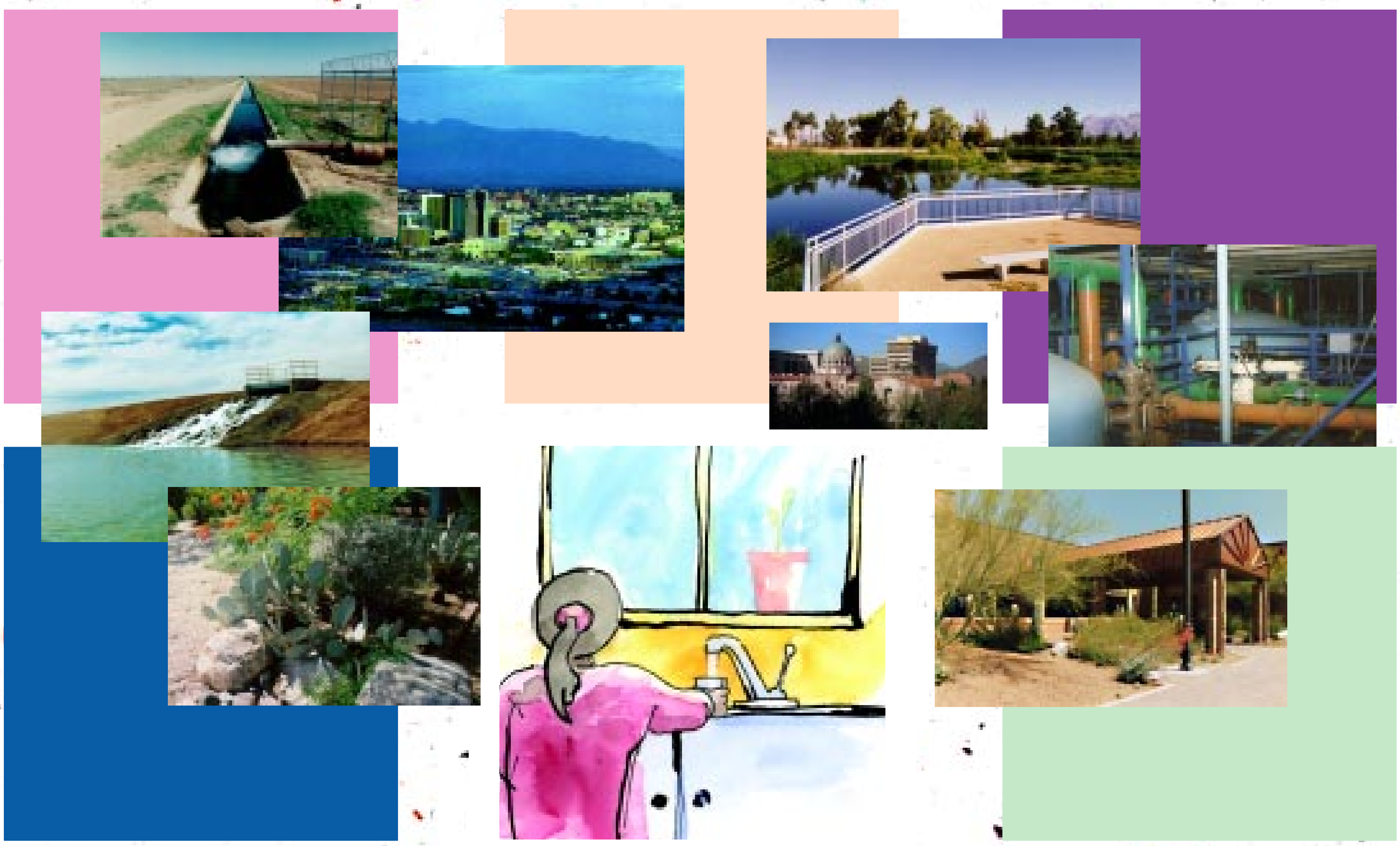
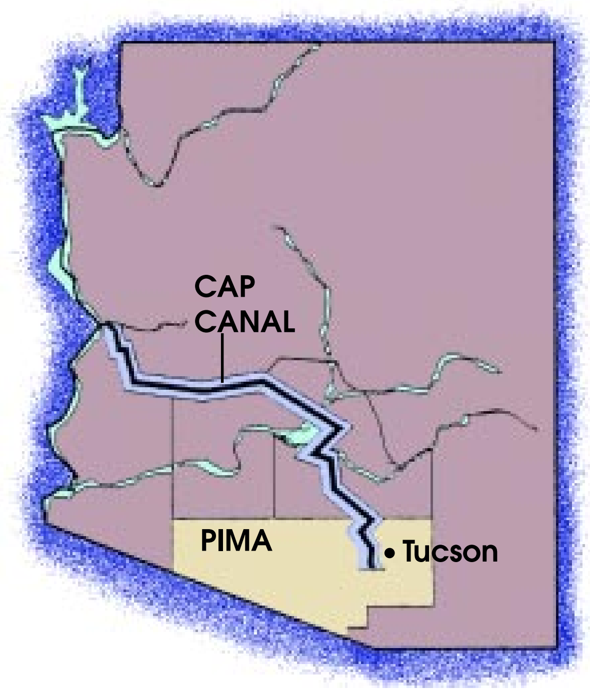
Annual Report ♦ Fiscal Year 2004



Planning for the Future

The City of Tucson Water Department



Tucson, *the county seat for Pima County, is the second largest city in Arizona, and has a population of over 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 more than 400 square miles, with a population nearing one million people.

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Letter from
Robert E. Walkup
Mayor

Tucson Water has now provided our community with an updated Long-Range Water Resources Plan.

Tucson Water's Water Plan 2000-2050 lays out a number of potential pathways to successfully meeting the water requirements for ourselves, for our children and for future generations of Tucsonans.

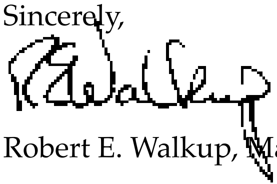
The Plan answers critical questions and identifies what water supplies we currently have. It discusses what we must do to obtain enough water supplies to meet the demands of our growing metropolis. And it addresses our community's desire to balance environmental protection and economic development.

A great deal of work has been put into the development of the Water Plan 2000-2050. It is the culmination of a process that includes study, analysis, and evaluating the pros and cons of the various pathways to the future.

Of course, no water plan will lead to success unless it results in real action and has the support of the customers of Tucson Water and our neighbors. As you read about Water Plan 2000-2050 in this Annual Report, be sure to note down your questions, comments and areas that you'd like to explore further. Contact Tucson Water, read the full plan on their web site, and get involved in the decision-making process.

If we want to make sure that Tucson continues to be a vibrant and thriving community, nothing is more important than having sufficient, high-quality and affordable water resources. Wise use of water has been a hallmark of Tucson for decades, and as we move into the future, the decisions we make must also be wise. Using the Water Plan 2000-2050 as a starting point, we can make the right decisions for today, and for a sustainable future.

Sincerely,



Robert E. Walkup, Mayor

Letter from
David V. Modeer
Director

The Annual Report you are about to read focuses on our activities of the past fiscal year. Our successes at delivering excellent water and service to our customers in a cost-effective manner came not just from having a dedicated and motivated staff, but was also the result of Tucson Water's long tradition of planning ahead to ensure that we are ready to provide that high quality product and exceed our customer's expectations.

A primary example of our commitment to plan for the future is the development and release late last year of Water Plan 2000-2050. The Plan provides a detailed look at what our water needs will be in the future and how best to use our available resources and other supplies that we will obtain to meet those needs. The culmination of several years of effort, the Plan provides a "guidebook" for community discussions on a number of critical water resource issues and lays out the decisions that must be made by the community at key points in time.

The outcome of these decisions, some of which must be made in 2006, will allow Tucson Water to ensure the timely implementation of projects and programs to guarantee long-term sustainability of water resources for the Tucson Water service area. How we make the best use of our renewable Colorado River water will occupy center stage during much of 2005 and 2006. We are moving forward to expand the recharge and recovery of Colorado River water at our Clearwater facility, and will be working with our customers and Tucson's Mayor and Council to decide how we will make use of our entire allocation of this critical water supply.

Other decisions about how we might make better use of our available wastewater, through expansion of our reclaimed system or in some other manner, and pursuing other alternative water resources, will need to be made in the next several years. I invite you to read more about our Water Plan 2000-2050 in this Annual Report, and be sure to read it on our website at www.tucsonaz.gov/water. I hope that you will be motivated to take part in the community discussions that will take place in the months and years ahead as we work together to ensure a sustainable water future for our desert home.

David Modeer, Director

Tucson Water

Marie S. Pearthree, PE
Deputy Director

Bruce Johnson
Assistant Director

Eric Unangst
Customer Services

Ray Wilson
Operations & Maintenance

Joe Babcock
Planning & Engineering

Jeff Biggs
Water Quality Management

Larry Mulhern
Planning Administrator

David Cormier
Business Services

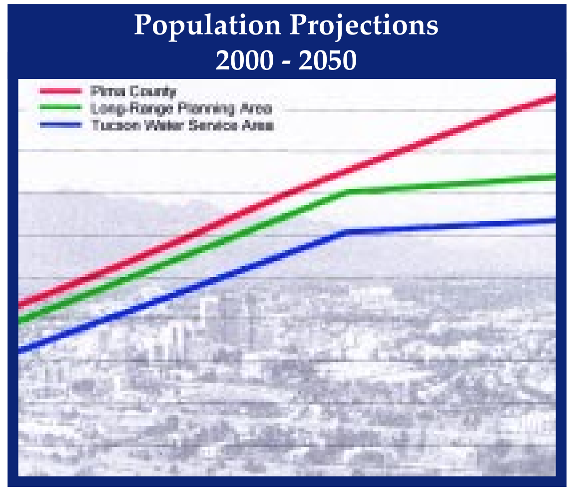
Citizens' Water Advisory Committee

James J. Riley, Chair
John Carhuff, Vice-Chair
C. Jason Bill
Francis J. Boyle
Sarah T. Evans
Martin Fogel
Chuck Freitas
Keith Gentzler
Irene Ogata
Stephen R. Popelka
David A. Smutzer
Joan "Tarke" Sweet
Jennifer Sprung
Vernon Watwood

Annual Report
Fiscal Year 2004

PLANNING FOR THE FUTURE

PLANNING FOR THE FUTURE



WATER PLAN: 2000 - 2050

In 2050, will we have enough water for everyone in Tucson? Where will it come from? What will it taste like, and how much will it cost? To answer these questions, Tucson Water developed a comprehensive long range water resources plan entitled "Water Plan 2000-2050." Our growing desert community has some tough choices ahead about our water. Water Plan 2000 - 2050 lays out the challenges to be faced and opportunities to be realized, as well as decisions we will have to make as a community to ensure a secure water future.

DEFINING THE GOALS

The overall goal of our Water Plan 2000-2050 is the development of a strategy to ensure that our community has enough quality water to meet our needs through the year 2050. No matter which strategy we choose, the end result must provide:

- Sustainable and flexible water supplies for the future
- Water quality that meets customers' expectations and preferences, as well as all local, state and federal requirements
- Financial planning that manages costs and water rate impacts
- Maximized use of renewable water supplies
- Environmentally sound levels of groundwater pumping

Our Plan considers social, economic, environmental and technical issues. It takes into account local, state, and federal water regulations, financial planning, and costs. Most importantly, it takes a close look at our water resources – the ones we use today and the ones we might be able to use or acquire for use in the future.

A GROWING DEMAND FOR WATER

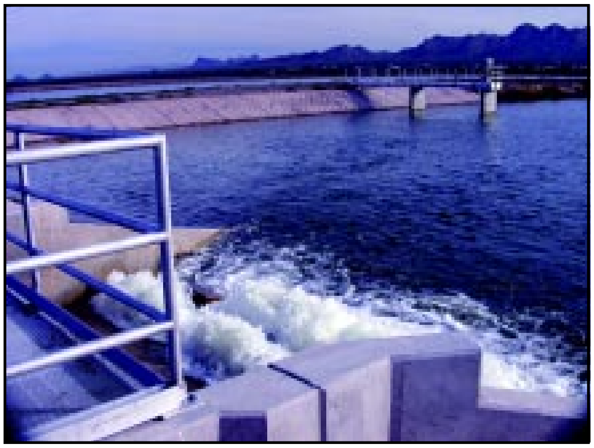
Do we have enough water to meet the needs of our growing community? Yes, but only if we use all of our available water resources wisely and aggressively seek and obtain new ones. Based on population projections provided by federal, state, and local governmental agencies, we estimated our project service area population to grow from about 640,000 customers cited in 2000 to about 1.3 million by 2050. When we apply our estimated total water usage rate of 177 gallons per capita per day to the population projections, we calculate that annual total demand will nearly double from 125,000 acre feet (40.7 million gallons) in 2000 to just over 250,000 acre feet (81.5 million gallons) by the year 2050.

In order to ensure that we can meet such water demand, we based the Plan on the water resources that we have available to our community today. That way, we know exactly what resources we can count on while we look to obtain additional water resources.

OUR WATER RESOURCES

Until recently, the Tucson community relied on groundwater for most of its water supply. In order to continue our use of groundwater without causing environmental damage, we need to limit our pumping to no more than the rate of natural replenishment. Since May 2001 when we began using blended water, a mix of recharged Colorado River water and groundwater from our Clearwater Facility in Avra Valley, we have been able to suspend pumping from wells in areas where the water table has dropped the most, allowing the underground water table to slowly begin to rise. One of our challenges will be to maintain this trend as the population increases.

PLANNING FOR THE FUTURE



Another water resource is Colorado River water, which comes to us through the Central Arizona Project (CAP) canal, and is recharged through specially constructed basins at our Clearwater Facility. The river water seeps into the earth and blends with native groundwater beneath. This blend is then recovered by a number of wells and piped to our water distribution system. While we currently only use about 20 billion gallons of our 44 billion gallon annual allocation of Colorado River water, nearly half of all the drinking water delivered to Tucson Water customers annually now comes from the Clearwater Facility.

Effluent, treated wastewater, is our only resource that increases as water use increases. The City of Tucson owns much of the effluent that is produced at Pima County's wastewater treatment plants, and we have access to about 11 billion gallons of effluent a year. While we reuse about 1/3 of that as reclaimed water to irrigate golf courses, parks, and other grass areas, the remainder of the effluent is discharged in the Santa Cruz River where it eventually filters through the riverbed into the water table.

Critically important to how we manage these water resources is water conservation. Making more efficient use of our water sources through conservation has proven to be an economical and environmentally responsible way to help manage Tucson's growing demand for water. Tucson Water customers have become good stewards of our precious desert water, but even more aggressive conservation programs will likely be a key factor in balancing our current water resources with future water demand.

CREATING THE PLAN

Tucson Water utilized planning assumptions and the best available information to address the many possible views of the future. Of course, no matter how well we plan, the future can never be fully predicted. In order to provide a pathway to a successful water future, yet keep as much flexibility as possible to meet unknown challenges and opportunities, we used a system called Scenario Planning. The process involved analyzing the critical uncertainties that affect water resources to create different potential futures. Then planners constructed pathways to the possible futures, and identified common elements along the paths. The futures we considered included options for use of Colorado River water (including projected mineral content and the appropriate treatment technologies) and options for the long term utilization of effluent (continue with our current effluent disposal method or implement enhanced treatment with recharge and recovery). By identifying common elements of all the future options, we can confidently proceed to invest in those programs and projects that will lead us toward whatever future may occur. Our Water Plan 2000 - 2050 includes a series of critical decision points where the different future options diverge and where the community will need to determine which pathway they want to follow, based on the benefits, costs, and other factors of each alternative.

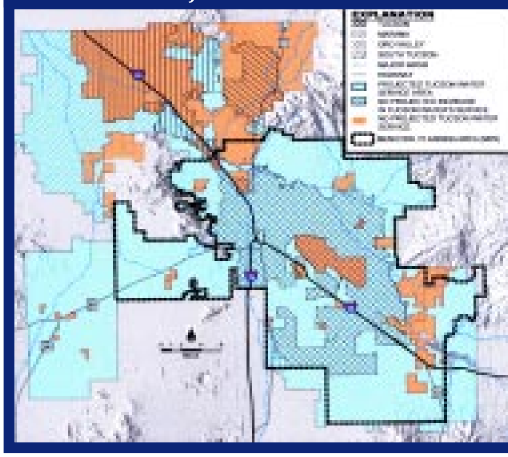
PLANNING FOR THE FUTURE

THE COMMON ELEMENTS

There are a number of elements common to all of the pathways that lead to each of the futures.

- Acquisition of additional water supplies is a priority under all scenarios. This can include obtaining additional Colorado River water, effluent, ground water, and any other water resources that may become available over time.
- Developing a salinity management program to mitigate increases in mineral content of our water supplies.
- Encouraging sewer connections to provide more municipal wastewater effluent for potential reuse.
- Evaluating the effectiveness of more aggressive conservation programming designed to achieve a targeted usage rate.
- Evaluating emerging contaminants in current and future water supplies, increasingly important as the availability of water resources becomes more constrained over time.
- Expanding public outreach to provide information and obtain input from the public on a range of water resource issues.
- Providing water resource information to planning entities as they also plan for the future of the community.
- Pursuing regional cooperation with other water providers in the area, in an effort to acquire additional water sources, create an integrated regional salinity control program, and arrange for the use of renewable resources within the region.
- Achieving full Colorado River water utilization of our current Central Arizona Project allocation.
- Achieving an environmentally sustainable rate of groundwater pumping.
- Evaluating effluent exchanges and opportunities to market unused effluent supplies for lease or exchange with other water users within the area.

Long Range Planning Boundary and Projected Service Area



CHOOSING THE PATHWAY

Having identified the projects and programs common to all of the future pathways included in our Plan, we need to consider the issues that appear where the pathways diverge. Each pathway has a series of critical decision points, where we as a community must determine which alternative pathway we want to follow. The first set of critical decisions must be made during 2006 in regard to our use of Colorado River water.

- *Decision #1: What is an acceptable long-term mineral level for the Clearwater blend?* The answer to this question will direct us to either allow the natural increase in mineral content as we use more Colorado River water in our blended water supply, or mandate us to construct an additional treatment facility to reduce mineral levels and maintain that lower level over time.
- *Decision #2: Should Tucson Water recharge and recover all of our Colorado River water allotment, or restore the existing water treatment plant to treat and blend a portion of this supply on the surface?* By 2012, we anticipate full utilization of our Central Arizona Project allocation. This is a critical first step toward attaining water resource sustainability for the community.

PLANNING FOR THE FUTURE

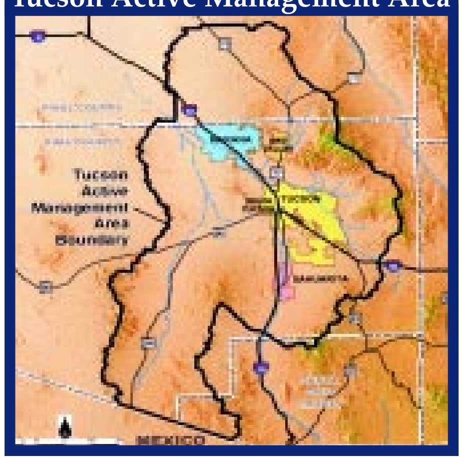
Two additional critical decisions must be made by 2014 concerning the long-term utilization of effluent:

- *Decision #3: Should current effluent disposal practices continue or should Tucson Water maximize the use of effluent as a water supply?*
- *Decision #4: If the use of effluent is to be maximized, should it be stored in long-term banking facilities or should it be used to augment the potable water supply?*
  Effluent - treated wastewater - is the one resource that increases proportionately to the amount of water we use. Although we'll continue to use effluent as reclaimed water for turf irrigation, some additional form of effluent reuse is an important consideration for the future.

HOW TO DECIDE?

Many people will be involved in the important decisions to be made about our water future: from hydrologists and engineers to administrators and financial and management analysts. But even with all of this technical and administrative help, we cannot implement the Plan without our customers. We want our customers to tell us their preferences and expectations for future water availability and quality, and we'll need their input on issues that will determine how much water will cost in the future. Before we can ask our customers to help make these decisions, though, we'll need to make sure they are well informed about the Plan and the related issues.

Tucson Active Management Area



To get the initial Water Plan 2000 - 2050 information out to the community, we plan to hold news briefings with the local newspapers and television stations. Regular articles related to the plan and the decisions to be made will be included in our newsletter that accompanies customers' water bills each month. Additionally, the Plan will be available on our Tucson Water website, with the opportunity for site visitors to ask questions and provide feedback via email.

In the upcoming months, we will be creating opportunities to meet and talk with the community about the Plan. Our Speakers Bureau, consisting of trained Tucson Water employee volunteers, will provide additional outreach to various groups, including business and service organizations and neighborhood, professional, and special interest groups. Town halls, with presentations on the Long Term Plan and time allotted for discussion, will be scheduled in each voting ward inside the city and in selected locations outside the city limits. We'll also be appearing at special community events, conducting community surveys, recruiting customer volunteers to lead discussion groups, and establishing on-going E-groups to further our efforts to get the information about the Long Range Plan to the Tucson community. Sometime in 2006, we will need to make those first decisions; we know that the thorough and effective communication of this plan will generate the necessary input to assure that the City is on the proper course to meet customer expectations.

In the decades ahead, we know that many things about Tucson will change, including our water supplies and quality. To be prepared for those changes, we need to discuss now how to prepare for them, and determine in advance ways to manage the changes so they have minimal impact on our water and our quality of life. The planning of our water future is an on-going process, and this Plan is designed to be flexible. No matter what route we may map out, our Long Range Water Plan: 2000 - 2050 provides a pathway that will eventually lead to a secure water future for our community.

Annual Report
Fiscal Year 2004

FINANCIAL SECTION

MANAGEMENT'S DISCUSSION AND ANALYSIS

OVERVIEW

Customer Connections	212,227 (FY 2004 Average)
FY 2004 Customer Growth	3.34%
Miles of Pipelines	4,340
Wells	225
Reservoirs/Storage Capacity	46 / 287 Million Gallons

Units of Measure:
1 Acre Foot = 325,851 Gallons
1 Ccf = 748 Gallons

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 2004 with over 212,000 customer connections to our water system, and during the year delivered enough potable water to fill over 2.2 million residential swimming pools (35.9 billion gallons). Additionally, we delivered 3.9 billion gallons of reclaimed water for turf irrigation.

OPERATIONS

Potable Water:

During FY 2004 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 a maximum aggregate capacity of 142 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 135,966 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 2004, our Clearwater Renewable Resource Facility, (CRRF), an $81 million project completed during the year, pumped 45,000 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 60,000 acre-feet during FY 2005. 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.

Production from Clearwater Facility

FY	Acre-Feet
2001	3,300
2002	26,000
2003	29,510
2004	45,000
2005*	60,000
2006*	60,000

* projected

MANAGEMENT'S DISCUSSION AND ANALYSIS

Reclaimed Water:

Although only 9.8% of our total FY 2004 water sales, reclaimed water and, eventually, effluent treated to even higher water quality levels, 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 with wells to recover this recharged water, and a managed in-channel recharge project recovering, via wells, some of the effluent that has been discharged by the Pima County Wastewater treatment plants into the nearby Santa Cruz River. This recovered water is blended with water produced at our filtration plant or distributed directly to customers throughout the reclaimed system.

Our next increment of reclaimed water supply will come from the second phase of the managed in-channel recharge and recovery project and from Pima County's new wastewater treatment plant, located in Randolph Park, which will discharge Class A quality effluent directly into the reclaimed water system.

Tucson Water continues 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.
Statements 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 2004 results commensurate with the methodology we use in establishing water rates.

MANAGEMENT'S DISCUSSION AND ANALYSIS

FINANCIAL HIGHLIGHTS/CONDENSED FINANCIAL STATEMENTS

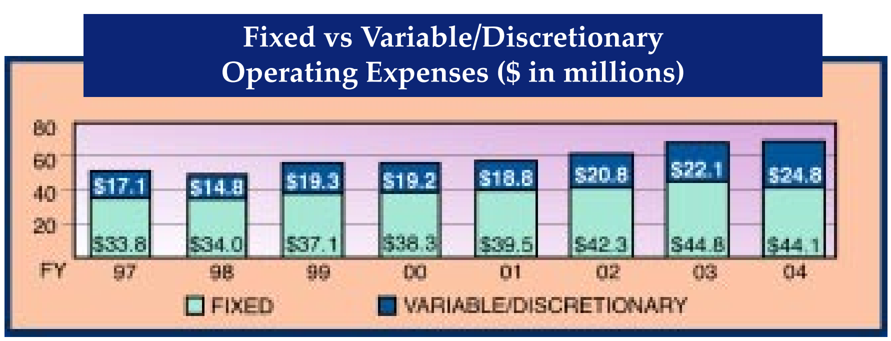
Net Assets: Our total assets exceeded our total liabilities at the close of the fiscal year by $594.3 million, an increase from FY 2003 of $20.3 million. Of this amount, $2.5 million was restricted for capital projects or debt service. At June 30, 2004 we had capital assets, net of depreciation, of $904.9 million, and outstanding long-term debt of $355.5 million.

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

	2004	2003
Current Assets	$ 42,787	$ 40,906
Restricted Assets	35,692	20,579
Other Assets	3,353	6,652
Capital Assets	904,865	870,684
Total Assets	986,697	938,821
Current Liabilities	17,838	18,860
Liabilities from Restricted Assets	19,025	21,037
Long-term Debt Outstanding	355,521	324,951
Total Liabilities	392,384	364,848
Net assets		
Invested in Capital Assets Net of Debt	555,372	538,391
Restricted	2,486	100
Unrestricted	36,455	35,482
Total Net Assets	$ 594,313	$ 573,973

Revenues –Potable and reclaimed water sales revenues, including the Central Arizona Project surcharge on potable water sales, make up approximately 88% of our annual revenues. During FY 2004 we set a record for both water sales revenues ($101.2 million) and water sales volume (53.1 million Ccfs). Total revenues increased by $4.0 million from FY 2003. A contributor to the increase was the Water System Equity fee initialed in August 2003. The fee, collected when new customers connect to the water system, is intended to recover the capital investment made to provide capacity to serve new users. The fee generated $3.3 million in revenues during FY 2004.

Expenses - The majority of our operating costs are fixed, at least in the twelve months of our fiscal year. Approximately 65% 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 35% of our operating expenses are made up of expenses that vary with the quantity of water produced (power costs, purchase of CAP water, chemicals) or are of a discretionary nature, for example, community relations, training, consultants.



MANAGEMENT'S DISCUSSION AND ANALYSIS

FY 2004 operating costs were $2.0 million higher than FY 2003 costs. Major changes included:

Fixed Costs ($.7 million decrease from FY 2003)

- Increased employee costs ($.6 million) resulting from cost of living adjustments, employee merits, and increases in employee insurance costs
- Substantially offsetting these increases were decreases in the CAP capital charge, maintenance expenses of $1.0 million and $.3 million, respectively.

Variable/Discretionary costs ($2.7 million increase from FY 2003)

- Increased costs for CAP water ($.9 million) the result of both our growing utilization of this renewable resource and increased rates charged by CAWCD
- Increased power costs ($1.2 million) reflecting the power needed (purchased at increased rates) to deliver a record quantity of water to our customers during the year
- Increased consultant expenses ($.6 million) relating primarily to our continuing efforts in support of increasing operational efficiency and effectiveness.

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

	2004	2003
Operating Revenues		
Water Sales (including CAP surcharge)	$ 101,218	$ 99,533
Other Revenues	13,340	9,872
Total Operating Revenues	114,558	109,405
Operating Expenses	(88,541)	(86,675)
Net Operating Income	26,017	22,730
Non-Operating Income	705	1,828
Non-Operating Expenses	(18,271)	(17,678)
Net Income before Capital Contributions/Adjustments	8,451	6,880
Capital Contributions	11,889	10,172
Prior Period Adjustment	——	(3,211)
Change in Net Assets	$ 20,340	$ 20,263

The remainder of this Management's Discussion and Analysis provides a more detailed look into our fiscal year 2004 revenues, operating expenses, capital outlays, debt service, changes in net assets, and cash flows.

MANAGEMENT'S DISCUSSION AND ANALYSIS

REVENUES

Historically, 90% of our annual revenue has been generated by the sale of water and 10% from other fees (charges for service installations, various customer service charges, billing services provided to other entities, and interest earnings).

This historical revenue pattern began to change in FY 2003 and FY 2004 with the introduction of new fees designed to recover costs related to growth and development. These costs had been, and would otherwise be, embedded in water rates and recovered by water sales revenue. In FY 2004, other revenue, bolstered by a new system capacity 'buy-in' fee, was expected to constitute about 15.0% of the total revenue stream; in essence, replacing 5% of the revenue from water sales.

Key Data: Revenues	2004 Actual	2004 Planned	2003 Actual
Total Water Sales Revenue[1]	$101.2	$105.2	$99.5
Potable	$95.3	$99.7	$94.0
Reclaimed	$5.9	$5.5	$5.5
Other Revenue[2]	$14.3	$18.0	$11.7
Total Water Sales (Ccf[3])	53,169,578	54,598,830	51,912,510
Potable	47,973,513	49,536,722	47,274,303
Reclaimed	5,196,578	5,062,108	4,638,207
Total Water Service Connections[3]	212,227	211,405	205,369
Potable Metered	208,821	208,022	202,174
Fire Protection	2,643	2,646	2,525
Reclaimed Metered	763	737	670
Potable Water 12-Month Average Use Per Svc Per Month (Ccf)	19.16	19.84	19.49
Single Family Customers Only	11.93	12.30	12.04

[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 revenue consists of other operating revenues and nonoperating income from the audited financial statements. Development fees which result in cash collections have been included in other revenue for both FY 2004 and FY 2003, but developer-contributed infrastructure has been excluded in both years.
[3] 1 Ccf = 748 gallons. Monthly average connections for the 12 months of the Fiscal Year.

Other revenue, however, missed the mark in FY 2004, falling $3.7 million below forecast, although it was about 22.0% greater than in FY 2003. Revenue from the new System Equity or 'buy-in' fee was the major source of the shortfall. The 'buy-in' fee generated $3.3 million of revenue in FY 2004 versus the $5.5 million projected. The fee, assessed upon meter application, resulted in a 'rush' of meter applications prior to the fee's effective date (August 11, 2003), thereby reducing revenue from the fee. The overall outcome for other revenue was that, instead of constituting around 15% of total revenues, other revenues accounted for about 12.4%.

MANAGEMENT'S DISCUSSION AND ANALYSIS

While the intent for the past two fiscal years has been to reduce the reliance on water sales revenues (and mitigate water bill rate increases), the staple for financing our operations remains water sales revenue. Like the 'buy-in' fee revenue, FY 2004 water sales revenue, dominated by potable revenue, was less than forecast by approximately 3.8% ($4.0 million).

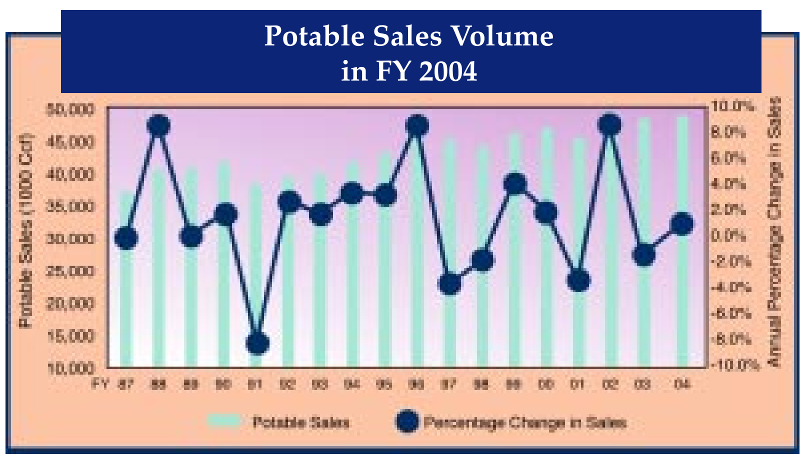
However, FY 2004 water sales revenue of $101.2 million did increase by about 1.7%, or around $1.7 million, from FY 2003. This increase occurred without the benefit of an upward adjustment in water bill rates. (Based on the strategy of removing costs not directly attributable to the general water rate payer from water rates, we devoted the rate cycle for FY 2004 to creation and implementation of the 'buy-in' fee.)

Potable Water Sales, Services, Revenue Effects

FY 2004 potable water sales revenue increased by about 1.5% ($1.3 million) from FY 2003, but was less than the forecast for the year by approximately $4.4 million, or 4.0%. Although revenue was below expectation, the fact that it was sufficient enough to surpass that of the prior fiscal year makes FY 2004 potable sales revenue the highest in our history.

Our FY 2004 potable water sales volume (47,973,513 Ccf or 35.9 billion gallons) was also modestly higher than that of FY 2003 by 1.5% but like revenue, below the forecast for the year by 3.2%.

The following eighteen-year chart, while revealing that the potable sales volume in FY 2004 was just about equal to the record volume set in 2002, also illustrates the continuing volatility in potable sales and, hence the difficulty of projecting future sales volume with a high degree of accuracy.



Management 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.*

Potable 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. FY 2004 growth in average metered service connections (6,647), surpassed that of FY 2003 (5,012) in both absolute number and rate (3.3% vs. 2.5%) and exceeded plan by a 0.5%. Of note, however, is the fact that the new 'buy-in' fee, referred to earlier, caused a 'rush' of meter applications during the first month of FY 2004 before the fee became effective. Most likely, a number of the 'rush' applications would not have been made at all in FY 2004, or would have occurred later in the fiscal year, reducing average connections for the year. Thus, while additional revenue was realized from the monthly service charge, sales volume may have been increased only modestly by the new connections. This interpretation is supported by the fact that average customer usage per service connection was less in FY 2004 (19.16 Ccf per month) than in FY 2003 (19.49 Ccf per month).

MANAGEMENT'S DISCUSSION AND ANALYSIS

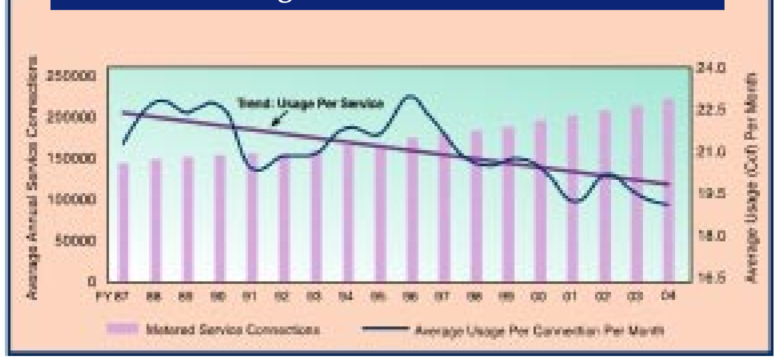
Weather can pull sales volume and hence revenue in either a positive or contrary direction. However, FY 2004 weather data shows an unsettled pattern in relationship to water use. Rainfall for the year was nearly 3 inches greater than in the prior year, in fact close to the 'normal' 12 inches for Tucson. But the year was much hotter than both 2003 and the 'normal' temperatures for the year. The year's weather might be viewed as almost neutralizing the direction of potable water usage. That interpretation would leave robust customer growth accompanied by less than robust demand for water from new customers to account for the modest 1.5% increase in potable sales volume.

What exactly drove potable water sales volume may be less clear in FY 2004 than in most prior years, but the pattern for the year conforms to Tucson Water's history:

- Service connections growing at expected or higher 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.

The chart to the right illustrates this message.

Average Service Connections and Usage Per Service Connection



Reclaimed Water Sales, Services, Revenue Effects

Reclaimed water sales revenue represented a bright spot in an otherwise unappealing year for revenues. FY 2004 revenue of $5.9 million was about 5% ($400,000) higher than both the forecast for the year and FY 2003 revenue. Reclaimed water sales volume (5,196,065 Ccf or 3.9 billion gallons) was about 12.0% more than in FY 2003 and nearly 3.0% greater than forecast for the year. The increase in sales volume outstripped the increase in sales revenue because a major portion of sales volume was billed at special rates which are lower than the standard reclaimed water rate. Special rate agreements are approved by the Mayor and Council, and their objective is to conserve potable water resources by providing an incentive to convert turf irrigation and other suitable uses from potable to reclaimed water, and once on reclaimed water, to remain on that source. In addition, in recent years, agreements with governmental agencies which use reclaimed water have provided for rates which are below the standard usage rate.

Average service connections for FY 2004 increased by 93 to 763. Although one new golf course connection occurred toward the end of the fiscal year, the majority of our additional service connections, as in prior years, were related to residential customers.

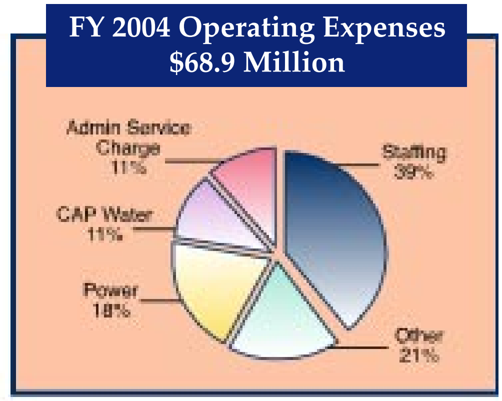
Revenue Outlook: Next Five Years

The major revenue change we are expecting during the next five years continues to be in fees affecting new development, or customer growth in our service area. 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). In FY 2004, the 'buy-in' fee designed to recover a proportionate share of the cost of existing system capacity from new potable connections became effective. Our analysis of the long-term water resource requirements (through 2050) for our future service area has been completed. Community and governing body direction is currently being received. Discussions thus far indicate that financing resource requirements related to growth will include a prospective impact fee.

MANAGEMENT'S DISCUSSION AND ANALYSIS

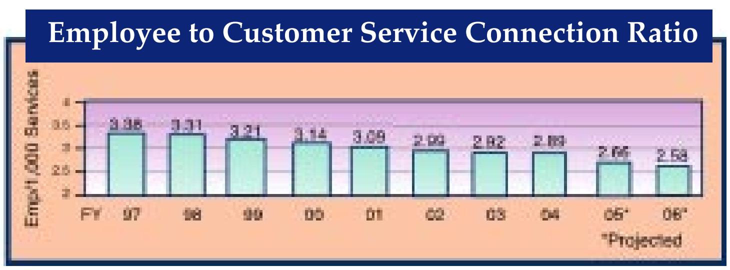
OPERATING EXPENSES

We expend considerable financial resources to operate our two water systems (potable and reclaimed). We incurred $68.9 million in operating expenses in FY 2004 (excluding depreciation of $19.6 million and taxes of $9.3 million) or about $325 per service account, basically unchanged from FY 2003. While we are a large utility with many varied expenses, four cost categories made up 79% of our total operating costs: employee costs, power costs, CAP water costs, and administrative service charges.



FY 2004 Operating Expenses $68.9 Million

Employee costs ($27.3 million in FY 2004 and $26.3 million in FY 2003) relate to our diverse staff of 580 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. A cost of living adjustment, employee merit increases, and increases in employee insurance premiums contributed to the $1 million increase in employee costs from FY 2003. Partially offsetting these increases was the reduction of employees from 586 in FY 2003 to 580 in FY 2004.

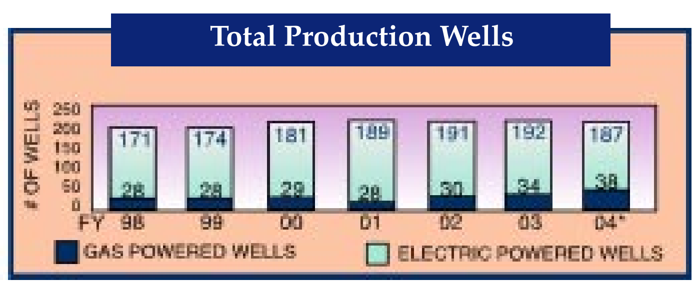


Employee to Customer Service Connection Ratio

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 $12.3 million in FY 2004 and $11.2 million in FY 2003) are incurred as we pump water up from depths ranging to 700 feet and move it through our distribution system. In FY 2004, we increased production from our CRRF, where recharged water is recovered and moved from the CRRF site 21 miles outside of our central service area. This increased production, combined with higher power rates, primarily natural gas increases, and the increase in water sales volume resulted in power costs increasing by $1.1 million during FY 2004 over FY 2003 costs.

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.



Total Production Wells

** The reduction in electric powered wells results from more efficient Clearwater Renewable Resource Facility wells coming into production, thereby allowing shutdown of older, less efficient wells in the central well field.*

MANAGEMENT'S DISCUSSION AND ANALYSIS

CAP water costs ($7.7 million in FY 2004 and $7.8 million in FY 2003) result from a contractual obligation for the purchase of Central Arizona Project water from the CAWCD. Our FY 2004 costs consisted of two components:

- The capital financing charge, $4.3 million in FY 2004 and $5.4 million in FY 2003, is based on the Utility's allotment of 135,966 acre-feet. The FY 2004 decrease was the result of a rate reduction by CAWCD.
- The commodity charge ($3.4 million and $2.5 million in FYs 2004 and 2003, respectively) is based on actual CAP water taken.

CAWCD establishes both the capital and commodity rates annually.

We purchased approximately 54,000, acre-feet of CAP water in FY 2004, and will increase to 60,000 acre-feet in FY 2005.

Administrative service charges ($7.2 million in FY 2004 and $6.8 million FY 2003) 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.

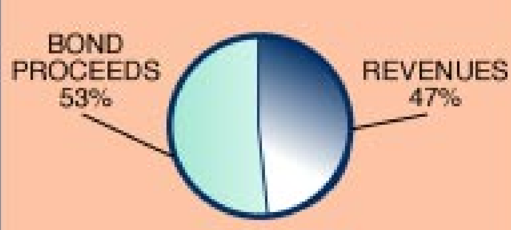
OPERATING EXPENSES OUTLOOK: NEXT FIVE YEARS

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 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 have continued implementation of our Maintenance Management Program (MMP), which has identified new approaches to the operation and maintenance of our water systems, and includes expansion of our geographic information system. System-wide rollout of the MMP will occur over several years, beginning in July 2004. The improved ways of doing business are expected to continue to generate both reductions in operating expenses and improved customer service. Although the program has required significant investment in staff training, equipment, and related technologies, we estimate the MMP will generate $9.2 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.

Funding of FY 2004 Capital Improvements: $40.8 Million



CAPITAL IMPROVEMENTS

At the end of FY 2004, our water system was composed of 218 potable wells, 7 reclaimed wells, 4,227 miles of delivery pipelines, 111 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.

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). This enables both current and future customers to participate in the funding of capital improvements. 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 2004 we spent over $40.8 million (or 76% of our fiscal year capital budget) on improvements to our system. In FY 2003, $50.2 (87% of budget) was expended in our capital program. Lower spending in FY 2004 resulted primarily from scope changes in the reclaimed area which required redesign of several major projects.

During FY 2004, $2.5 million was spent on the final elements of the CRRF project including construction of the raw water pipeline and additional recharge basins, and expansion of the related recovery wellfield (well drilling and equipping.) In addition, $1.7 million of expenditures were incurred on 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 $38.9 million was spent in the following program areas:

• Transmission and Distribution Mains	15.3
• Reservoirs and Pumping Facilities	6.3
• New Services (water meters, minor extensions)	3.6
• Reclaimed System Expansion and Improvements	3.5
• Well Drilling, Equipping, and Upgrades	1.7
• Equipment / Vehicles	1.8
• General Plant Improvements	1.1
• Other	5.6

Capital Expenditure Outlook: Next Five Years

Over the next five years, we plan to spend $254 million to fund capital projects. The capital program will significantly assist in achieving the long-term goal of balancing groundwater pumping with replenishment of the aquifer. Emphasis will remain on expanding the use of our renewable water resources (increasing the recharge of Colorado River water and expansion of the 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 drilling and equipping of 24 wells, construction of 10 potable and 4 reclaimed reservoirs, and construction or improvements to 81 miles of potable and 32 miles of reclaimed mains. Also included is the construction of a production facility that will add up 8 million gallons per day (8,962 acre-feet per year) of processed effluent into the reclaimed water system.

MANAGEMENT'S DISCUSSION AND ANALYSIS

DEBT AND DEBT SERVICE

At June 30, 2004, we had $365 million in outstanding bonds or Water Infrastructure Finance Authority(WIFA) loans. Water revenue bond interest payments ($17.4 million in FY 2004) are reported as expenses on our income and flow of funds statements. Repayment of principal ($9.0 million in FY 2004) is reported only on our flow of funds statement. In addition, we paid $0.4 million in fiscal agent fees.

Bond Ratings:
- Moody's Investors Service Aa3
- Standard and Poors A+

During FY 2004, the following bond sales or loans agreements occurred:

Amount	Interest Rate	Month
$16.3 million Water Revenue Bonds	4.56%	September 2003
$ 5.5 million WIFA Loan*	3.75%	February 2004
$18.8 million Water Revenue Bonds	4.81%	May 2004

** Long Term Bonds payable increase for WIFA loans as expenditures occur on loan financed projects.*

Cash receipts generated from the newly implemented System Equity (buy-in) fee are dedicated to provide a portion of the annual requirements for debt service. During FY 2004, the $3.3 million System Equity fee covered approximately 13% of the total debt service payments for the year ($26.4 million).

The financing of our capital program with a combination of bond proceeds/loans and water sales revenues ensures a healthy ratio of outstanding water revenue bond debt to system fixed assets. This ratio has averaged .36 over the last eight years.

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

	1997	1998	1999	2000	2001	2002	2003	2004
Land	$41.4	$43.1	$44.6	$46.9	$46.4	$45.1	$45.1	$45.1
Buildings	95.7	96.3	97.3	97.3	100.7	102.1	108.5	108.6
Water Mains	408.5	442.5	467	528.2	549.3	582.2	608.6	635.7
Reservoirs	114	127.3	132.5	142.1	183.1	199.6	198.2	202.3
Construction in Progress	117.6	109.3	127.2	108.3	106.7	95.9	115.2	134.9
Machinery	11.9	15.6	17.1	15.2[1]	16.7	19.6	20.8	22.6
Less Accumulated Depreciation	(143.8)	(156.9)	(169.6)	(181.6)	(196.5)	(217.1)	(225.8)	(244.3)
Total Fixed Assets	$645.3	$677.2	$716.1	$756.4	$806.4	$827.4	$870.6	$904.9
Water Revenue Bonds Outstanding	$223.9	$216.7	$250.0	$244.1	$273.9	$335.0	$334.0	$365.8
Ratio Water Revenue Bonds/Fixed Assets	0.35	0.32	0.35	0.32	0.34	0.40	0.38	0.40

[1] $2 million of machinery assets were written off in FY 2000 due to change in capitalization threshold.

MANAGEMENT'S DISCUSSION AND ANALYSIS

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 FY's 2004 and 2003 was $20.3 million in both fiscal years. One unusual item affecting the change in net assets occurred during FY 2003: a prior period adjustment of $3.2. million resulting from changes in depreciation methods instituted during FY 2002. The effect of this item is removed for comparison purposes:

	FY 2004	FY 2003
Change in Net Assets (in millions)	$20.3	$20.3
Remove Prior Period Adjustments	-	(3.2)
Change in Net Assets (Adjusted)	$20.3	$17.1

When adjusted, the FY 2004 change in net assets increased over FY 2003 by $3.2 million.

	($ in millions)
Revenues	
Increase in water sales (potable and reclaimed)	$1.7
Increase -- System Equity (buy-in) fee	3.3
Decrease in other revenues	(1.0)
Net increase in revenues	4.0
Expenses	
Decrease in depreciation expense	.1
Increase in power expense	(1.2)
Increase in employee costs	(.9)
Increase in administrative service charge	(.4)
Increase in interest expense	(.5)
Decrease in CAP water expense (capital and commodity)	.1
Decrease in other expenses	.3
Net (increase) in expenses	(2.5)
Capital Contributions	
Increase in contributed water systems/grant receipts	1.7
Change in Net Assets FY 2004 from FY 2003	$3.2

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 net income.

Cash Reserves - During June 2002, the Mayor and Council adopted a Financial Plan that targeted cash reserve levels at approximately $13 million by the end of FY 2006. At June 30, 2004, unrestricted/undesignated cash on hand was $17.8 million.

Debt Service Coverage (the % by which revenues, after meeting operating cash needs, cover Water Revenue bond and WIFA loan 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 2004 was 1.99%.

MANAGEMENT'S DISCUSSION AND ANALYSIS

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 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 2004:

SUMMARY FY 2004 FLOW OF FUNDS ($ IN MILLIONS)

INFLOWS:		
What we received:	From sale of water*	$101.2
	From water system equity fees	3.3
	From other revenues/sources**	24.6
	TOTAL INFLOWS	*$129.1*
OUTFLOWS & USES		
How much of our revenues we used for:	Operations/maintenance ***	$78.0
	Bond debt service (principal/interest)	26.8
	Capital improvements	20.1
	Other purposes****	4.2
	TOTAL OUTFLOWS	*$129.1*

* Includes CAP surcharge revenues
** Includes taxes
*** Includes taxes and payment to City of Tucson for administrative support
**** Includes increase in working capital reserves

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. Our plan 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.

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, bond holders, 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, please contact Tucson Water Financial Services, P.O. Box 27210, Tucson, AZ 85726-7210 (520) 791-2666.

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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, 2004, 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. 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, 2004, 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, 2004, 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, 2004

(Dollar Amounts In Thousands)

STATEMENT OF NET ASSETS

	2004	2003
Assets		
Current assets:		
Cash and cash equivalents		
Undesignated	$ 17,824	$ 12,744
Designated for customer deposits	629	1,038
Designated for infrastructure replacement	9,672	9,587
Total cash and cash equivalents	28,125	23,369
Billed accounts receivable, net of allowance for doubtful accounts of $336 and $390 respectively	7,322	9,637
Unbilled accounts receivable	6,944	7,287
Prepaids and other assets	396	613
Total current assets	42,787	40,906
Restricted assets	35,692	20,579
Investments for contract payments	463	965
Long-term accounts receivable	1,053	3,992
Capital assets		
Utility property, plant and equipment	1,014,262	981,315
Construction-in-progress	134,874	115,199
Less accumulated depreciation	(244,271)	(225,830)
Net capital assets	904,865	870,684
Other	1,837	1,695
Total assets	$ 986,697	$ 938,821

(Continued)

(Dollar Amounts In Thousands)

STATEMENT OF NET ASSETS (CONTINUED)

	2004	2003
Liabilities and Net Assets		
Current liabilities:		
Accounts payable	$ 4,604	$ 6,439
Salaries, wages and payroll taxes payable	2,377	1,957
Current installments of revenue bonds payable	9,785	8,888
Current installments of contract payable	400	450
Refundable/customer deposits	629	1,038
Accrued interest payable	38	83
Unearned receipts - area development fees	5	5
Total current liabilities	17,838	18,860
Liabilities payable from restricted assets	19,025	21,037
Long-term liabilities:		
Revenue bonds payable	354,072	323,062
Contract payable	-	400
Other long-term liabilities	1,449	1,489
Total long-term debt	355,521	324,951
Total liabilities	392,384	364,848
Commitments, contingencies and subsequent events (notes 15 and 16)		
Net assets		
Invested in capital assets net of debt	555,372	538,391
Restricted for:		
Capital projects	2,454	59
Debt service	32	41
Unrestricted	36,455	35,482
Total net assets	$ 594,313	$ 573,973

See accompanying notes to financial statements.

(An Enterprise Fund of the City of Tucson, Arizona) (Dollar Amounts In Thousands)

STATEMENT OF REVENUES, EXPENSES AND CHANGES IN NET ASSETS

	2004	2003
Operating revenues:		
Potable water sales	$ 93,910	$ 92,683
Reclaimed water sales	5,875	5,578
Total water sales	99,785	98,261
Central Arizona Project surcharge	1,433	1,272
Connection fees	3,737	3,382
System equity Fees	3,340	
Billing services -		
Pima County Sewer, City of Tucson Solid Waste	1,877	1,446
Miscellaneous:		
TCE Cleanup reimbursement	794	850
Area development fees	830	1,091
Service charges	1,363	1,231
Plan review and inspection fees	926	1,245
Reimbursed prior year expenses	332	448
Other	141	179
Total miscellaneous	4,386	5,044
Total operating revenues	114,558	109,405
Operating expenses:		
Director's office:		
Personal services	1,492	1,184
Contractual services	1,368	1,030
Commodities	70	110
Total director's office	2,930	2,324
Business services:		
Personal services	1,552	1,741
Contractual services	833	857
Commodities	1,133	1,014
Total business services	3,518	3,612
Customer services:		
Personal services	4,868	4,372
Contractual services	650	656
Commodities	368	297
Total customer services	5,886	5,325
Water operations:		
Personal services	11,780	11,840
Contractual services	13,476	12,419
Commodities	4,042	3,976
Total water operations	29,298	28,235
Planning and engineering:		
Personal services	4,011	3,092
Contractual services	98	376
Commodities	403	381
Total planning and engineering	4,512	3,849

(Continued)

(Dollar Amounts In Thousands)

STATEMENT OF REVENUES, EXPENSES AND CHANGES IN NET ASSETS (CONTINUED)

	2004	2003
Water quality management:		
Personal services	2,831	3,520
Contractual services	2,671	2,855
Commodities	500	652
Total water quality	6,002	7,027
CAP water charges:		
Capital charges	4,351	5,379
Commodity charges	3,391	2,461
Total CAP water charges	7,742	7,840
General expenses:		
Personal services	751	590
Contractual services	8,099	8,013
Commodities	185	113
Total general expenses	9,035	8,716
Depreciation and goodwill amortization (note 2g)	19,624	19,747
Total operating expenses	88,541	86,675
Net operating income	26,017	22,730
Nonoperating income:		
Investment earnings	643	1,620
Gain on sale of property/equipment	62	143
Other nonoperating	-	65
Total nonoperating income	705	1,828
Nonoperating expenses:		
Interest expense	17,607	17,151
Other nonoperating expenses	664	527
Total nonoperating expenses	18,271	17,678
Net income before capital contributions	8,451	6,880
Capital contributions	11,889	10,172
Change in net assets	20,340	17,052
Net assets - July 1	573,973	553,710
Prior period adjustment	-	3,211
Net assets restated - July 1	573,973	556,921
Net assets - June 30	$ 594,313	$ 573,973

See accompanying notes to financial statements.

(Dollar Amounts In Thousands)

STATEMENT OF CASH FLOWS

	2004	2003
Cash flows from operating activities:		
Cash received from customers	$ 120,552	$ 110,558
Cash payments to suppliers for goods and services	(43,144)	(40,964)
Cash payments to employees for services	(26,904)	(27,403)
Net cash provided by operating activities	50,504	42,191
Cash flows from capital and related financing activities:		
Bond proceeds	36,404	10,971
Acquisition and construction of capital assets	(45,001)	(50,077)
Principal paid on capital debt	(9,435)	(8,441)
Interest paid on capital debt	(16,802)	(17,136)
Fiscal agent fees paid on capital debt	(569)	(331)
Proceeds from sale of property and equipment	298	143
Net cash used in capital and related financing activities	(35,105)	(64,871)
Cash flows from investing activities – interest received on investments	1,575	1,926
Net increase (decrease) in cash and cash equivalents	16,974	(20,754)
Cash and cash equivalents at beginning of year	25,746	46,500
Cash and cash equivalents at end of year	$ 42,720	$ 25,746

	2004	2003
Reconciliation of operating income to net cash provided by operating activities:		
Operating income	$ 26,017	$ 22,730
Adjustments to reconcile operating income to net cash provided by operating activities:		
Depreciation and amortization	19,624	19,747
Decrease (increase) in cash resulting from changes in:		
Accounts receivable/due from other agencies	2,531	516
Internal Receivable	10	(27)
Prepaids and other assets	(47)	39
Long-term accounts receivable	3,734	335
Accounts payable	(1,759)	17
Accrued expenses	420	(1,065)
Deferred revenues	(41)	5
Customers/refundable deposits/due to other agencies	15	(106)
Net cash provided by operating activities	$ 50,504	$ 42,191

	2004	2003
A reconciliation of cash and cash equivalents at June 30 follows:		
Unrestricted cash	$ 28,125	$ 23,369
Restricted cash (included in restricted assets)	14,595	2,377
Cash and cash equivalents at June 30	$ 42,720	$ 25,746

Noncash investing, capital and financing activities:
Developers contributed water systems to the Utility valued at $10,166 and $9,809 during the years ended June 30, 2004 and 2003, respectively. At June 30, 2004 contractors had placed $136 of securities in the custody of the Utility in lieu of contract retainage.
Other noncash transactions during the year ended June 30, 2004 included a $500 writeoff of the Rita Ranch payable.

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, multifamily, 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

During Calendar Year 2004, the Utility obtained about half of its municipal potable water from groundwater produced from four well fields that have an aggregate capacity of 142 million gallons per day (Mgd).

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 135,966 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 recharges 60,000 acre-feet of CAP water annually (54 million gallons per day) and, as of June 30, 2004, recovered approximately 45 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, 2004.

- 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 non-restricted 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, 2004 was $9,672.

- 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.

NOTES TO FINANCIAL STATEMENTS

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 financial statements present only the financial position, changes in financial position, and cash flows of Tucson Water which 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 funding are retained by the Utility. Tucson Water's management has the day-to-day operational accountability for the Utility and is managed by a Director appointed by the City Manager. However, ultimate accountability for the Utility remains with the City of Tucson.

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 City maintains an investment pool that is available for use by all City funds, including Tucson Water. All assets of the investment pool are held by a single master custodian. Pooled investments are reported at fair value.

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.

(Dollar Amounts In Thousands)

NOTES TO FINANCIAL STATEMENTS

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	2 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, 2004 or 2003, 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 $1,654 at June 30, 2004.

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. DEPOSITS/INVESTMENTS

The Utility had approximately $16,085 in cash and investments held with fiscal agents at June 30, 2004, 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 $28,125 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.

(Dollar Amounts In Thousands)

4. ACCOUNTS RECEIVABLE

A. Current

The Utility's current accounts receivable at June 30, 2004 were:

Billed Accounts	$	7,658
Unbilled (*estimated unbilled water sales delivered at June 30*)		6,944
Less: Allowance for doubtful accounts		(336)
Total current accounts receivable	$	14,266

B. Long-term

The Utility's long-term accounts receivable at June 30, 2004 were:

Receivable from promissory note	$	795
Receivable from local school district		258
Total long-term accounts receivable	$	1,053

C. Promissory Note

In October, 2003, the City of Tucson entered a Pre-annexation Development Agreement with Starr Pass Resort Developments, LLC. As part of the agreement, the City agreed to finance, through a promissory note, water infrastructure improvements for the development in the amount of $1,500. Interest will be paid on the note at a yearly rate of 4.25%. After substantial completion of the water improvements, as evidenced by a "Notice of Substantial Completion", Starr Pass Resort Developments LLC agreed to make monthly payments of $15 until all principal, interest and other associated charges on the Promissory Note have been paid to Tucson Water. As of June 30, 2004, $795 of the anticipated $1,500 in water infrastructure improvements had been made. Since the work was not substantially complete at this point, Starr Pass Resort Developments, LLC had not yet made any payments.

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 $64 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 $51 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 $143 will be repaid in May 2008.

(Dollar Amounts In Thousands)

NOTES TO FINANCIAL STATEMENTS

5. RESTRICTED ASSETS AND LIABILITIES PAYABLE FROM RESTRICTED ASSETS

A. Restricted Assets

Restricted assets as of June 30, 2004 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	$ 15,981
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	19,575
Construction project vendor deposited investments	Construction vendor investments (deposited in lieu of Utility retainage on construction payments) restricted for reimbursement to vendor	136
	Total restricted assets	$ 35,692

B. Liabilities Payable from Restricted Assets

Liabilities payable from restricted assets as of June 30, 2004 consist of the following:

Source	*Restricted Purpose*	*$ Amount*
Debt service restricted assets	Matured bonds and interest payable	$ 15,949
Unspent revenue bond/loan proceed assets	Accounts payable on authorized bond funded capital improvement projects	2,940
Construction project vendor deposited	Accounts payable, investments returnable to vendors (deposited in lieu of Utility retainage on construction payments)	136
	Total liabilities payable from restricted assets	$ 19,025

(Dollar Amounts In Thousands)

NOTES TO FINANCIAL STATEMENTS

6. CAPITAL ASSETS

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

	Beginning Balance	*Additions/ Transfers*	*Reductions/ Transfers*	*Ending Balance*
Land	$ 45,119	$ 9	$ (51)	$ 45,077
Buildings & Equipment	129,335	3,081	(1,293)	131,123
Transmission & Distribution Systems	806,861	31,242	(41)	838,062
Construction in Progress	115,199	41,486	(21,811)	134,874
Total at Historical Cost	$ 1,096,514	$ 75,818	$ (23,196)	$ 1,149,136
Less Accumulated Depreciation for:				
Buildings & Equipment	$ 30,330	$ 5,156	$ (1,150)	$ 34,336
Transmission & Distribution Systems	195,500	14,464	(29)	209,935
Total Accumulated Depreciation	$ 225,830	$ 19,620	$ (1,179)	$ 244,271
Net Capital Assets	$ 870,684	$ 56,198	$ (22,017)	$ 904,865

Expanding our Clearwater facilities will increase our use of Colorado River Water, a renewable water resource. This would mean reduced groundwater pumping, protecting the environment and creating long-term reliablity.

(Dollar Amounts In Thousands)

NOTES TO FINANCIAL STATEMENTS

7. CHANGES IN LONG-TERM DEBT

A summary of changes in long-term debt as of June 30, 2004 is as follows:

	Beginning Balance	*Additions/ Refunded Issues*	*Reductions/ Refunded Issues*	*Ending Balance*	*Due Within One Year*
Water Revenue					
Bonds Payable	$ 333,665	$ 40,021	$ (8,985)	$ 364,701	$ 9,785
Deferred Amounts:					
Bond sale refundings	(7,509)		488	(7,021)	
Bond sale premiums	5,794	747	(363)	6,178	
Total Water Revenue					
Bonds Payable	331,950	40,768	(8,860)	363,858	9,785
Compensated					
Absences	3,025	1,653	(1,523)	3,155	1,707
Contracts Payable	850	0	(450)	400	400
Total Long Term Debt	$ 335,825	$ 42,421	$ (10,833)	$ 367,413	$ 11,892

8. 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, 2004, the long-term portion of bonds payable was:

Bonds Maturing 2004 - 2024	$ 364,701
Less current installments	(9,785)
Deferred amounts *	(844)
Total long-term revenue bonds payable	$ 354,072

*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, 2004 and 2003 was $126 and $172, respectively.

(Dollar Amounts In Thousands)

NOTES TO FINANCIAL STATEMENTS

Water Utility Revenue Bonds Issued and Outstanding at June 30, 2004 are as follows:

Series	*Interest Rates*	*Maturity Date*	*Original Amount*	*Balance Outstanding June 30, 2004*
1984 Series D (1991)	9.75%	2010	$ 48,000	$ 3,500
1993 March (Refunding)	5.25-5.50	2018	35,360	19,935
1994 Series A (1996)	6.0-8.0	2018	33,000	3,000
1994 Series B (1997)	4.50-6.25	2012	11,700	8,000
1997 July (Refunding)	4.20-5.125	2021	32,980	32,305
1998A Water Infrastructure Finance Authority (WIFA) Subsidized	3.425	2017	6,000	4,680
1994 Series C (1999)	4.75-6.75	2016	33,400	33,100
1999A Refunding	5.00	2010	14,045	11,520
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	4,549
2000 Water Infrastructure Finance Authority (WIFA) Unsubsidized	5.00	2020	7,780	6,977
2000 Series A (2001)	5.0-7.5	2023	37,800	37,800
2001 A April (Refunding)	5.0	2016	40,850	34,175
2001 Water Infrastructure Finance Authority (WIFA) Subsidized	3.43	2021	8,800	8,116
2002 Refunding	5.50	2018	57,820	56,930
2000 Series B (2002)	3.5-5.125	2021	18,900	18,900
2003 Water Infrastructure Finance Authority (WIFA) Subsidized	3.48	2022	7,379	7,114 [1]
2003 Refunding	5.00	2018	12,000	12,000
2000 Series C (2003)	4.25-5.25	2021	16,300	16,300
2000 Series D (2004)	4.0-5.0	2023	18,765	18,765
2000 Water Infrastructure Finance Authority (WIF5) Subsidized	3.75	2023	795	795 [2]
2000 Water Infrastructure Finance Authority (WIF6) Subsidized	3.75	2023	2,500	2,500
Total			$ 473,034	$ 364,701

[1] Total issue $8,300; balance of issue ($921) will be recognized when proceeds are received.

[2] Total issue $3,000; balance of issue ($2,205) will be recognized when proceeds are received.

(Dollar Amounts In Thousands)

NOTES TO FINANCIAL STATEMENTS

Maturities of the bonds and related interest payable after June 30, 2004 are as follows:

Year ending June 30,	*Principal*	*Interest*	*Total*
2005	$ 9,785	$ 18,377	$ 28,162
2006	10,425	17,830	28,255
2007	12,387	17,291	29,678
2008	13,517	16,642	30,159
2009	14,835	15,924	30,759
2010-2014	94,278	66,566	160,844
2015-2019	118,673	40,504	159,177
2020-2024	90,801	10,647	101,448
Total	$ 364,701	$ 203,781	$ 568,482

9. ADVANCED REFUNDING/DEFEASANCE OF DEBT

In prior years, the Utility 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 Utility's basic financial statements. As of June 30, 2004, the amount of defeased debt outstanding, but removed, is $132,495.

10. LONG TERM CONTRACT PAYABLE

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 restricted assets of the Utility.

As of June 30, 2004, the principal payments of $8,600 have been made on the Metropolitan Water Company purchase. The remaining principal of $400 is payable on January 1, 2005.

11. 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 $1,449 and $1,489 at June 30, 2004, and June 30, 2003 respectively.

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 was $0 at June 30, 2004 and June 30, 2003. The Utility's next required rebate date is July 1, 2005.

NOTES TO FINANCIAL STATEMENTS

12. DEVELOPER CAPITAL CONTRIBUTIONS AND FEDERAL AND STATE GRANTS

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, 2004, developers donated water systems valued at $11,693. In addition, the Utility received $196 in federal and state grants.

13. 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 2004, the Utility premium was $834. All risk management activities are accounted for in this City Fund.

During the last three years, claims and settlements have been paid out of the 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.

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).

14. 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, 2004, 2003, and 2002 was 11.17%, 8.41%, and 7.35%, or $2,611, $2,063, and $1,661, 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.

(Dollar Amounts In Thousands)

NOTES TO FINANCIAL STATEMENTS

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. Depending on the date of retirement, 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, 2004, the Utility's portion of retiree medical insurance premiums was $455.

15. 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 $312 for the year ended June 30, 2004.

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, 2004, 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, 2004 are appropriately identified as accounts payable. Contract commitments for future capital improvement work totaled $7,987 as of June 30, 2004.

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 135,966 acre-feet, and (2) a commodity charge based upon actual CAP water taken.

During fiscal year 2004, the Utility made capital and commodity payments of $4,345 and $3,391, respectively. Estimated CAP water expenses for the next five years are as follows:

CAP Payment Schedule (unaudited)

Fiscal Year	*CAP Capital* *	*CAP Commodity* **
2005	$ 4,060	$ 4,628
2006	3,807	5,057
2007	4,527	5,302
2008	4,663	7,458
2009	4,663	9,992

** Includes capital cost impacts associated with obtaining an additional 8,206 acre-feet of CAP allocation in fiscal year 2007 as part of a statewide distribution of unallocated CAP water.*

*** Includes commodity costs associated with an additional 20,000 acre-feet for the Southern Avra Valley Storage and Recovery Project facility beginning in fiscal year 2008 and increasing to 45,000 acre-feet in fiscal year 2009.*

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.

16. 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. Water Rate Increase

On June 7, 2004 the City of Tucson's Mayor and Council approved a rate increase applicable to potable and reclaimed customers. The new rates became effective July 12, 2004 and are projected to increase fiscal year 2005 water sales revenues by 1.5%, or approximately $1.6 million.

This well at the Utility's Clearwater facility pumps a mix of groundwater and recharged Colorado River water.

(Dollar Amounts In Thousands)

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

Revenues:		
Sale of water (potable and reclaimed)		
Potable water sales		$ 93,910
Reclaimed water sales		5,875
Central Arizona Project surcharge		1,433
Connection fees		3,737
System equity fees		3,340
Billing services -		
Pima County Sewer, City of Tucson Solid Waste		1,877
Miscellaneous revenue		
TCE clean-up reimbursement	794	
Area development fees	830	
Service charges	1,363	
Plan review and inspection fees	926	
Prior year and reimbursed expenses	332	
Other	141	
Total miscellaneous		4,386
Investment earnings – operating fund		464
Investment earnings – debt service fund		46
Proceeds on sale of property/equipment		62
Total revenues		115,130
Operation and maintenance expenses:		
Director's office		4,952
Business services		3,692
Customer services		5,886
Water operations		18,622
Planning and engineering		6,708
Water quality management		4,472
Power – potable system	11,249	
Power – reclaimed system	1,098	
Total power		12,347
CAP water purchases		
Capital charges	4,351	
Commodity	3,391	
Total CAP water purchases		7,742
General expenses		1,640
Capitalized operation and maintenance expenses		(4,391)
Total operating and maintenance expenses		61,670
Net revenue available after operations [2]		53,460
Debt service for revenue bonds:		
Interest on long-term debt		17,437
Principal payments on long-term debt		8,985
Fiscal fees		410
Total debt service for revenue bonds		26,832
Net revenue available after operations and water revenue bond debt service		$ 26,628

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 City will issue additional parity bonds only if the Net Revenue Available After Operations for the most recenty completed Fiscal Year, subject to permitted adjustments, is at least 120% of the maximum future annual debt service on existing parity bonds. For the period ending June 30, 2004, the debt coverage calculation for this covenant (before permitted adjustments) was 180%.
Section 7.01 of the Ordinance requires that if Net Revenue Available After Operations in any Fiscal Year does not equal or exceed 175% of the Annual Debt Service Requirement for both Senior Lien (Parity Bonds) and Junior Lien Debt, the City will deposit additional monies into a reserve account. For the period ended June 30, 2004, the debt coverage calculation for this covenant was 199%.
See accompanying independent auditors' report.

SCHEDULE II (SUPPLEMENTAL SCHEDULE OF FLOW OF FUNDS)

The following *Flow of Funds* schedule reports fiscal year 2004 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 improvement 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 waters, fringe benefits, purchased power, payment 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 infrastructure 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 provided 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 2004 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 2004.

(Dollar Amounts In Thousands)

SCHEDULE II (SUPPLEMENTAL SCHEDULE OF FLOW OF FUNDS[1])

Revenues for operations and debt service:		
Sale of potable water	$ 93,910	
Sale of reclaimed water	5,875	
Total sale of water		99,785
Central Arizona Project surcharge[2]		1,433
Connection fees		3,737
System equity fees		3,340
Taxes:		
Business privilege tax (State/City)	7,709	
Utility tax (City)	1,335	
Total taxes		9,044
Interest earnings:		
Operating fund interest earnings	549	
Debt service fund interest earnings	46	
Less restricted earnings	(92)	
Total interest earnings available for operations and debt service		503
Billing services - Pima County Sewer, City of Tucson Solid Waste		1,877
Miscellaneous revenue:		
TCE Clean-up Reimbursement	794	
Area Development Fees	830	
Service Charges	1,363	
Plan Review and Inspection Fees	926	
Prior Year and Reimbursed Expenses	332	
Other	141	
Total miscellaneous revenue		4,386
Other receipts:		
Proceeds from sale of property and equipment	62	
Principal received from Oro Valley settlement	4,382	
Principal received on loans to school district	82	
Total other receipts		4,526
Total revenues for operations and debt service		128,631
Other sources:		
Use of Metropolitan Water Company Reserve Account [3]	494	
CAP Reserve Fund interest earnings[2]	5	
Total other sources		499
Total revenues and other sources		$ 129,130

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 CAP Reserve Fund revenues and interest were generated by a $.03/Ccf charge applied to potable water sales. 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.

3 See Notes to the Financial Statements, #10.

Continued

(Dollar Amounts In Thousands)

SCHEDULE II CONTINUED(SUPPLEMENTAL SCHEDULE OF FLOW OF FUNDS[1])

Operations and maintenance expense:[5]		
Director's office		$ 4,952
Business services		3,692
Customer services		5,886
Water operations (excluding power)		18,622
Planning and engineering (including waterline relocation)		6,708
Water quality management (excluding CAP water purchases/power)		4,472
CAP water: Capital charges	4,351	
Commodity	3,391	
Total CAP water		7,742
Power: Potable system	11,249	
Reclaimed system	1,098	
Total power		12,347
General expense (including sales taxes of $9,044)		10,684
Capitalized operations and maintenance expense		(4,391)
Total operations and maintenance expense		70,714
Adjustment for accrued compensated absences[6]		40
Adjusted total operations and maintenance expense		70,754
Debt service on water revenue bonds:		
Interest	17,437	
Principal	8,985	
Fiscal fees	410	
Total debt service on water revenue bonds		26,832
Capital outlay:		
Improvements/Equipment from revenues and other sources	14,026	
Capital equipment from revenue and other sources	1,685	
Capitalized operations and maintenance expense	4,391	
Improvements funded by Central Arizona Project Reserve Fund	6	
Total capital outlay		20,102
Other uses:		
Private water company contract payments	494	
Administrative service charges	7,248	
Other uses/increases in reserves	3,700	
Total other uses		11,442
Total expenses, debt service, capital outlay and other uses		$ 129,130

5 Capitalized operations and maintenance expense reported separately on this statement.
It is allocated to Utility Divisions on the Statement of Operations.

6 Change in year-end long-term compensated absences payable is subtracted from this statement.

See accompanying independent auditors' report.

Annual Report
Fiscal Year 2004

SAFETY REPORT SUMMARY

(Dollar Amounts In Thousands)

ANNUAL SAFETY REPORT SUMMARY

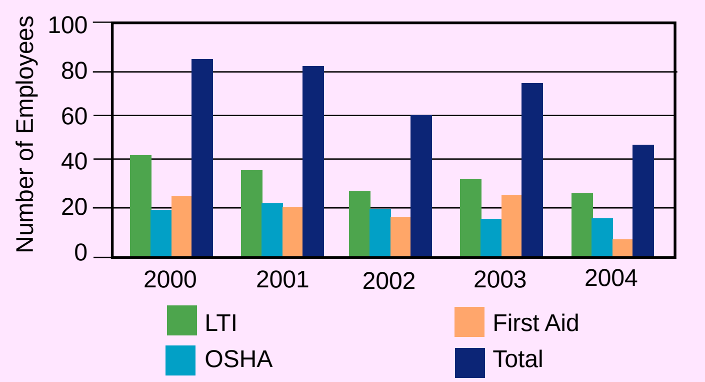
TUCSON WATER: ANNUAL SAFETY REPORT SUMMARY

We participate in the 5 Star Safety System, a program based on internationally recognized safety standards. The program compares Tucson Water's safety systems with the world's best practices and quantifies our safety performance by awarding star ratings. At June 30, 2004 we had attained a 3 star rating with a 70% effort grade.

☆	40-50	Fair
☆☆	51-60	Average
☆☆☆	61-74	Good
☆☆☆☆	75-90	Very Good
☆☆☆☆☆	91-100	Excellent

One of the components that affect our star rating is injury experience, which is also measured as the Disabling Injury Incident Rate. A reduction in injury rates can only occur if accident and injury experience is tracked, reviewed for cause, and followed up with prevention steps to decrease worker injury experience. In addition to these procedures, the Utility must comply with annual accident and injury reporting requirements as promulgated by the Occupational Safety and Health Act. The department began tracking Lost Time Incidents (LTI), OSHA reportable, and first aid cases in 2000 when the 5 Star program was implemented. The graph below provides the data.

Annual Comparison for 2000-2004: Number of Employee Injuries



Important statistics related to employee injuries include:

- In 2004 the Utility had 556 full-time employees; for this workforce Tucson Water reported 294 lost workdays and 278 restricted duty days.
- During 2004, Tucson Water employees incurred a total of 49 injuries (LTI, OSHA, and first aid.)
- In 2004 the total number of injuries, including first aid cases, decreased by 16 cases when compared to 2003. This reduced our industrial injury worker's compensation claim payements.
- In 2003 the department incurred $236 in injury related costs (the sum of indemnity costs and medical costs paid for treatment or rehabilitation). In 2004, these costs, along with the injury experience, were $117.
- Tucson Water's disabling injury rate[1] declined from 6.5 to 5.5 injuries per 100 workers per year, comparing favorably to the 2003 private sector rate of 6.2 for mid-size establishments.
- Our total incident rate[2] declined from 11.2 to 7.4 total injuries per 100 workers per year.

Within the 5 Star system we have a Disabling Injury Incidence Rate of 1.4%, this is considered to be an excellent rating. Since the inception of the 5 Star safety program in 2000, work related disabling injuries have been on the decline. Tucson Water will continue integrating the 5 Star safety system within its management practices and drive towards a 5 Star rating.

[1] Disabling Injury Rate = Lost Time Accidents + Restricted Duty Cases X 200,000 hours divided by actual hours worked per year.
[2] Total Incident Rate = Total Injuries (not including first aid cases) X 200,000 hours.

Tucson Water's Mission

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

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.

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Tucson Water

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