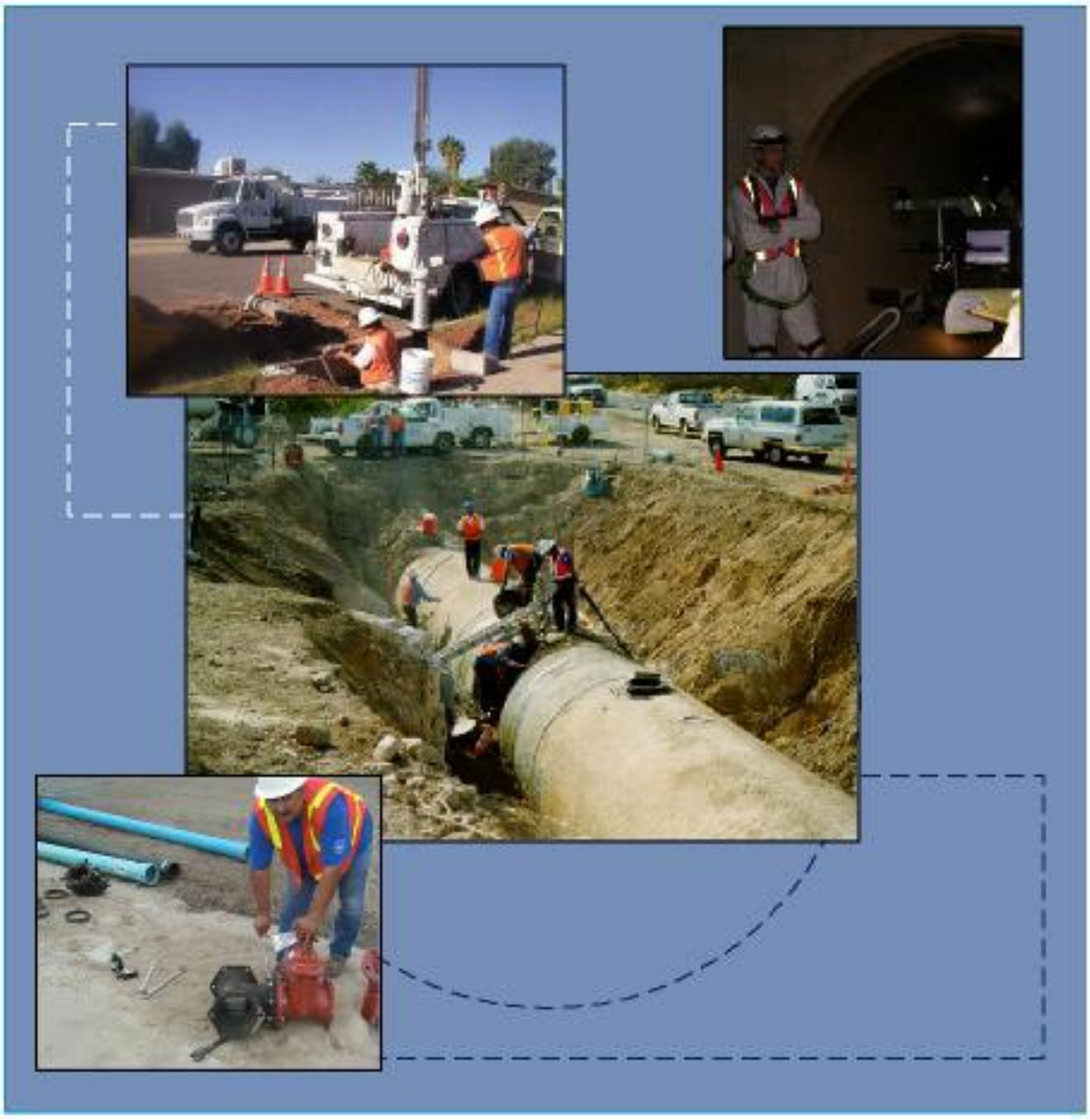
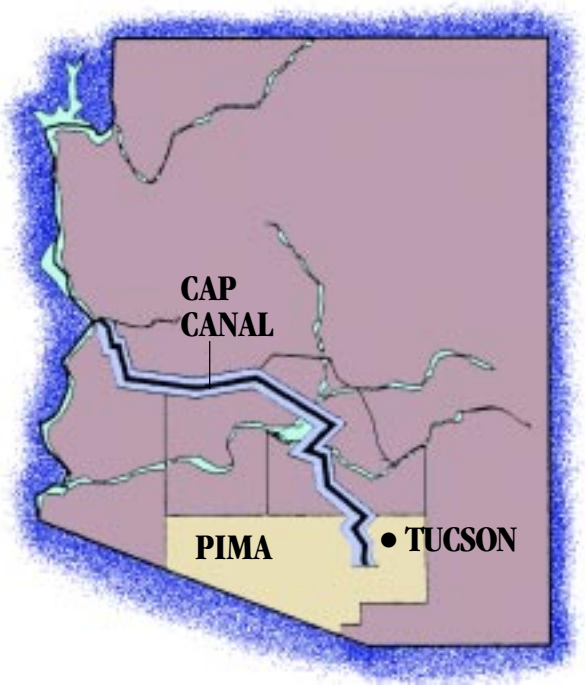
TUCSON WATER

PROTECTING OUR PIPELINES



Annual Report • Fiscal Year 2005

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

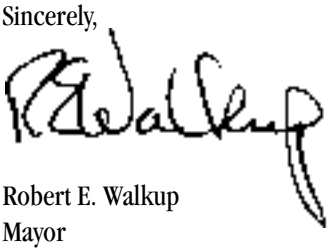
Whenever you build something… a house, a business, even a swing for your back porch, you can be sure that unless you maintain it properly, it won't last very long.

That's even more true when you're talking about a water system made up of thousands of miles of pipes, all buried under ground and out of sight. It's a system that each of us depends on every day to provide us with safe, clean, life-giving water. Wouldn't it be useful if we could "keep an eye" on those pipes all the time, and find any problems and fix them before they affect our water supply?

That's exactly what Tucson Water is doing – and what you'll read about in this Annual Report - using innovative technology to continuously monitor the condition of our most important pipelines. These are the pipes that bring us the Clearwater Blend – the mixture of Colorado River water and groundwater that's now meeting nearly one-half of our annual water needs. Using that blend, in turn, has allowed us to turn off most of our wells in Central Tucson. As a result, the groundwater beneath our City is beginning to recover from decades of over pumping.

Over the past 10 years, Tucson has stepped to the forefront in the nation in many water-related areas. In addition to being a national leader in water conservation, we're also taking a leadership role in making our water system more secure, providing up-to-date water quality information directly to customers via the web, communicating with citizens, and planning for the water future of our community. Using this new pipeline monitoring technology once again marks Tucson as willing to strive to be the best in all the services we provide.

Sincerely,



Robert E. Walkup
Mayor

City of Tucson Council

José J. Ibarra
Ward 1

Carol W. West
Ward 2

Kathleen Dunbar
Ward 3

Shirley C. Scott
Ward 4

Steve Leal
Ward 5

Fred Ronstadt
Ward 6

Mike Hein
City Manager

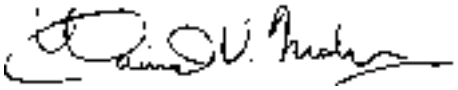
Letter from David V. Modeer Director

Tucson Water is responsible for maintaining a drinking water system that includes more than 4300 miles of water mains, dozens of reservoirs that can hold more than 280 million gallons of water, hundreds of drinking water production wells and thousands of valves. In all, our system represents a community investment of more than $1 billion! Looking after that system to ensure that it works to provide you with water every time you turn on your tap is one of our most critical priorities.

In this Annual Report, you'll be reading about how Tucson Water is using new and very innovative technology, along with old fashioned hard work, to monitor some of our most important water mains to identify any potential problems and resolve them before they lead to failure of those mains. In this way, we not only provide more assurance and reliability for your water supply, but we also can operate more efficiently and effectively.

Incorporating new technology is just one of the many ways that Tucson Water strives for excellence in all that we do on behalf of our customers, our community, and our fragile desert environment. The staff at Tucson Water are some of the most dedicated I've ever had the pleasure of working with. As you read this report, you'll also see how well we manage our finances. As we do our daily jobs, and as we plan for the future, one of our goals is to ensure that we're making the best use of the resources that our customers provide, and continue to offer them the highest quality water and service while keeping water affordable.

Sincerely,



David V. Modeer
Director

Tucson Water

Marie S. Peathree, PE
Deputy Director

Bruce Johnson
Assistant Director

Dennis Rule
Administrator

Eric Unangst
Customer Services

Ray Wilson
Operations & Maintanence

Pat Eisenberg
Planning & Engineering

Jeff Biggs
Water Quality Management

Larry Mulhern
Planning Administrator

David Cormier
Business Services

Citizens' Water Advisory Committee

Jim Aslin	Corina A. Baca	Rita Bartels
Frank J. Boyle, Vice Chair	John R. Carhuff, Chair	Karen M. Cesare
Robert Emanuel	Sarah T. Evans	Martin M. Fogel
Chuck Freitas	Keith Gentzler	James Horvath
James J. Riley	Dr. Joselph L. Scott	David A. Smutzer

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PROTECTING OUR PIPELINES

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PROTECTING OUR PIPELINES

Most of us turn the faucet handle and give little thought to how it is that we instantly have clean, quality water flowing from the tap. At Tucson Water, it is our job to give much thought to the processes and facilities involved in delivering water to all of our 216,000 service connections, so our customers don't have to. Integral to our success is the maintenance of the pipe infrastructure that we, and the community, depend on to distribute the water throughout our service area.

A Pipeline Failure

On the morning of February 5, 1999, a catastrophic failure occurred in a foot segment of 96-inch pipeline, the largest in the Tucson Water system. The pipeline is made of prestressed concrete cylinder pipe (PCCP), which gains much of its strength from spirally-wrapped high tension wiring embedded in the concrete pipeline casing. This transmission main connects Tucson Water's largest (60-million gallon) Clearwell storage reservoir to the central portion of Tucson. The sudden rupture of the pipeline drained much of the reservoir and allowed approximately 38 million gallons of water to flood the area downhill of the break site. It took about 3 months to make the segment fully operational again and the cost of replacement, cleanup, and payment of collateral damages eventually reached more than $4 million. Equally important to us was the great inconvenience to our customers in the area.

Why did the pipe break? There were several conditions identified at the break site that led to the failure of the water main, including the type of soil and drainage in the pipe trench which encouraged corrosion of the metallic wires in the pipe walls. The magnitude of the pipeline failure and its affects made us keenly aware of the benefits that a structured preventative pipeline maintenance program, along with regular monitoring and maintainance of our largest pipeline would provide.

Pipeline Protection Program

Immediately following the water main failure Tucson Water began develping a *Pipeline Protection Program* (PPP). This program incorporates ongoing activities that can significantly reduce the likelihood of future failures on large diameter pipes in our system. The major program elements include:

- Regular periodic inspections and evaluations
- Planned maintenance based on inspections
- Corrosion evaluation and monitoring
- Repairs / Replacements as warranted

After the main break, we conducted an inspection of the 96-inch pipe from the point of the rupture to the 60-million gallon Clearwell reservoir. A sounding rod was used to acoustically detect areas within the pipeline walls that "sounded" differently, indicating possible deterioration of the pipe integrity. These inspection techniques were than applied to all of Tucson Water's large diameter pipes. These initial inspections established a baseline so that future inspections would alert us to changes and problems before they reached the failure point, thus allowing us to plan and perform maintenance and repairs in a far more efficient manner.

Once routine pipeline inspections were underway for our largest, most critical pipelines, the focus of the PPP turned to the engineering and installation of corrosion monitoring facilities and cathodic protection for these pipelines. Cathodic protection involves applying an electrical current to the water main. This protects the metallic components from corrosion, and is effective as a preventative to stress corrosion cracking, a likely contributor to the 96-inch main break. After a process of evaluating the mains, utilizing methods such as soil and pipe sampling, interference testing and close internal surveying, installation of cathodic protection began with the construction of sacrificial anode and impressed electrical current systems, corrosion test stations, and other components. Installation of cathodic protection for all of the PCCP pipe in our system was completed within a few years, and the project is ongoing to include protection of approximately 32 miles of other metallic pipe in the drinking water system. Cathodic protection is now routinely designed and installed in all new large diameter transmission mains as part of our "best practices" policies.

The managers of our *Pipeline Protection Program* are also committed to keeping abreast of and researching the newest technologies in pipeline protection as developments occur. As a result, in fiscal year 2005, we began installing an Acoustic Fiber Optic system that reliably

PROTECTING OUR PIPELINES

detects areas of active deterioration within PCCP. This state-of-the-art technology is designed to record any prestressed wire events, such as slips or breaks, or any third party damage that often occurs during roadway repair or reconstruction. The special fiber optic cables installed inside the pipelines will provide continuous acoustic monitoring of the mains, with the data recorded, documented, and plotted in our pipeline management computer system via wireless technology. Additionally, this fiber optic system is being researched to provide leak detection, internal lighting, and communication for employees working the pipeline. Our utilization of this advanced pipeline monitoring system will make us the first utility in the world to employ acoustic fiber optics throughout a PCCP system.

Maintaining the Mains

A planned routine maintenance program is essential to delivering quality water. Our *Maintaining the Mains* program was first implemented in 2001. Over time, naturally occurring sand, silt, and other sediments build up in water mains. As a preventative maintenance measure, crews flush water at high speed (a water flow of at least 5 feet per second) through mains for several minutes, and check water valves and fire hydrants for proper operation. The water "scours" the neighborhood water system, removing naturally occurring sediments that can impart a taste, odor, or color to tap water and shorten the life of water mains, valves, and other system facilities. The flushing is done only at night to minimize the impact of temporarily lowering water pressure in neighborhoods, and the program is only conducted during the off peak winter months. Each year, a specific region of our service area is targeted for this water main maintenance, and we cleanse dozens of miles of mains to help ensure quality drinking water and to help extend the life of the mains.

Main Replacement and Rehabilitation

Over the years, as Tucson grew, many iron and galvanized steel water mains were installed, and as our community expanded, we acquired those water lines along with the responsibility of maintaining them. To make our water system more reliable and avoid inevitable water quality problems that occur with old, deteriorating mains, we undertook the task of rehabilitating and, where necessary, replacing these pipes. We identified 175 miles of galvanized steel pipes that were prone to corrosion due to soil conditions and replaced them with plastic or ductile iron piping. Additionally, we analyzed 45 miles of unlined cast iron piping, and lined it with cement mortar, in effect making them like new for a fraction of the cost of replacing them. In recognition of this unique project as an effort to build a high quality system and deliver good customer service, the *Water Main Replacement and Cast Iron Rehabilitation Program* was awarded a "Project of the Year" citation for excellence in service by the Arizona Chapter of the American Public Works Association (APWA).

Continuing to Improve

In fiscal year 2005, we initiated a reorganization of our Operations and Maintenance division as part of our *Maintenance Management Program* (MMP). The O&M division was restructured into four distinct water service areas by location, and work teams consisting of trained, multi-skilled staff have been created to support each area. Because crews are based in separate locations of our service area, we are realizing efficiencies. Travel times, for both routine maintenance and emergency response have been reduced, and vehicle and equipment longevity has been enhanced. The multi-skilled workers are able to respond to and perform various tasks, greatly reducing or eliminating the need for specialty crews. Another important aspect of the MMP is the transition from a paper-based system of maintenance to a digital-based system. Laptop computers containing electronic valve maps and equipped with wireless technology to access in-house computer systems were deployed. During fiscal year 2006, field workers will be able to access information such as maintenance history, work orders, layered maps contained in our *Geographical Information System* (GIS), and other real-time data from any location.

In conjunction with the creation of separate service areas, we are also developing a pilot fire hydrant maintenance program specifically targeted to each service area, for implementation in fiscal year 2006. The program will expand the operational inspections of the hydrants, currently part of our *Maintaining the Mains* program, to include lubricating, checking for leaks, painting the hydrants and installing reflective street markers to further assist firefighters in locating hydrants in an emergency. Because the focus will be on hydrant maintenance, as opposed to flushing the water mains, the hydrant inspections will take less time to complete, and allow us to annually check more hydrants over a wider area. Additionally, we will consider the benefits of adding an element to the program for exercising and inspecting valves in the vicinity of each fire hydrant as it is worked on. Fire hydrants and valves are vital parts of our system and this program will help provide the system dependability that our community expects.

PROTECTING OUR PIPELINES

Reinvesting in our Water Future

Even as we implement comprehensive programs to maintain or improve the integrity of our water infrastructure, we understand that much of our underground piping is aging. Many, if not most, water utilities throughout the country are also facing significant economic challenges as their infrastructure, consisting of various materials laid down at different times in history, is now approaching the end of its expected life span. In 2000, Tucson Water participated in a national study conducted by the American Water Works Association (AWWA), the first comprehensive assessment of drinking water infrastructure needs ever performed. Dubbed *Nessie,* a reference to the Loch Ness Monster because of the rising wave shape of the graph, the study brought to light the need for huge reinvestment in infrastructure in the coming decades. Our participation in the study provided an estimate of future replacement requirements, but the work to provide replacement details and develop a strategic plan to handle the upcoming costs continues. In the years since the study, we have implemented and are integrating programs such as *Pipeline Protection, Maintenance Management*, and *GIS* to aggressively manage our infrastructure replacement.

In addition to enabling us to maintain the integrity and quality of our infrastructure into the indefinite future, a replacement planning approach helps establish long term financial policies. One important goal is finding a fair balance between the monetary requirements of dependably delivering high quality water while keeping that water affordable to ratepayers. To that end, since 1998, we have funded $36 million primarily for water main replacements with low-interest 20-year loans through the Water Infrastructure Finance Authority of Arizona. Also, in 2002, we utilized proceeds received under a legal settlement to establish a fund designated for future infrastructure replacement. That fund, with accumulated interest, totaled $9.8 million at the end of fiscal year 2005. Funding methods such as these allow us to adhere to a prioritized replacement plan while minimizing the financial impact to our ratepayers.

We believe that our customers should never have to worry about whether they will have quality water available in their homes whenever they need it. We strive to develop programs, perform maintenance, and make improvements that help ensure that our drinking water system remains among the most dependable in the world. As we move into the future, we will face many challenges to keep our pipe infrastructure in good working order. By utilizing predictive and preventative maintenance programs and tools, incorporating the newest technology, and committing to careful financial planning, we are confident that we can meet our goal of providing safe and dependable water to our growing desert community for decades to come.

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FINANCIAL SECTION

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MANAGEMENT'S DISCUSSION AND ANALYSIS

OVERVIEW

Tucson Water is an enterprise fund of the City of Tucson, Arizona. This means we operate similar to a private business, covering all costs of doing business with revenues from operations. Our fiscal year runs from July 1 through June 30. Our authority and responsibility is derived from the City's Charter and ordinances and resolutions of the Mayor and Council. We provide water service to approximately 700,000 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 2005 with approximately 217,000 customer connections to our water system, and during the year delivered enough potable water to fill nearly 2.2 million residential swimming pools (35.3 billion gallons). Additionally, we delivered 3.7 billion gallons of reclaimed water for turf irrigation.

Customer Connections	216,653 (FY 2005 average)
FY 2005 Growth in Connections	2.1%
Miles of Pipelines	4,480
Wells	229
Reservoirs/Storage Capacity	48/303 million gallons

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

OPERATIONS

Potable Water:

During FY 2005 we obtained our municipal potable water (water meeting or exceeding all federal, state, and local drinking water standards) from our four groundwater well fields (Central, Avra Valley, Santa Cruz, and Southside) and a facility where we recharge and recover Colorado River water. These four well fields and the recharge and recovery facility provide us with an aggregate production capacity of 170 million gallons per day.

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 2005, our Clearwater Renewable Resource Facility, (CRRF), pumped 47,712 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 62,000 acre-feet during FY 2006. 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 up to 71 million gallons per day (80,000 acre-feet/year) of Colorado River water, a renewable source. Current recovery well capacity is 50 million gallons per day. Meeting approximately fifty percent of our customers' current demand for potable water with Colorado River water enables us to reduce groundwater pumpage from the central well field, over which the majority of the City of Tucson lies, thereby easing concerns related to land subsidence.

Production from Clearwater Facility

FY	Acre-Feet
2001	3,300
2002	26,000
2003	29,510
2004	45,000
2005	47,712
2006*	62,000

* Projected

Reclaimed Water:

Although only 9.6% of our total FY 2005 water sales, reclaimed water and effluent treated to 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 and recovery 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. Additionally, we receive reclaimed water from a Pima County operated wastewater treatment plant located in Randolph Park, a central city

multi purpose recreational facility. This facility has the capacity to generate 3 million gallons per day of Class A quality effluent directly into the reclaimed water system.

Our next increment of reclaimed water supply will come from the second phase of a managed in-channel recharge and recovery project. 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 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: Flow of Funds	A summary of our FY 2005 results commensurate with the methodology we use in establishing water rates.

FINANCIAL HIGHLIGHTS/CONDENSED FINANCIAL STATEMENTS

Net Assets: Our total assets exceeded our total liabilities at the close of the fiscal year by $609.2 million, an increase from FY 2004 of $14.9 million. Of this amount, $.2 million was restricted for capital projects or debt service. At June 30, 2005 we had capital assets, net of depreciation, of $930.0 million, and outstanding long-term debt of $380.1 million.

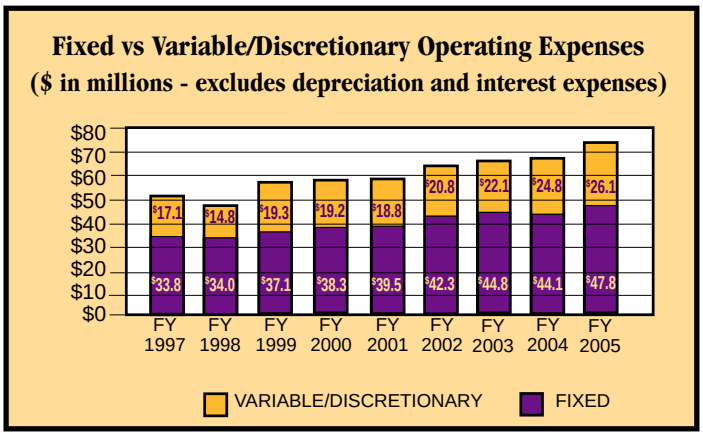
Tucson Water Summarized Statement of Net Assets as of June 30 ($ in thousands)

	2005	2004
Current Assets	$ 43,657	$ 42,787
Restricted Assets	52,552	35,692
Other Assets	4,685	3,353
Capital Assets	930,035	904,865
Total Assets	1,030,929	986,697
Current Liabilities	22,013	17,838
Liabilities from Restricted Assets	19,627	19,025
Long-term Debt Outstanding	380,065	355,521
Total Liabilities	421,705	392,384
Net assets		
Invested in capital assets net of debt	576,713	555,372
Restricted	186	2,486
Unrestricted	32,325	36,455
Total Net Assets	$ 609,224	$ 594,313

Revenues –Potable and reclaimed water sales revenues, including the Central Arizona Project surcharge, make up approximately 85% of the Utility's operating revenues. During FY 2005 water sales *revenues* were ($100.8 million) and water sales *volume* (52.3 million Ccfs) or about $.4 million less than in FY 2004. However total revenues, when combined with System Equity fee collections (reported as Contributed Capital in the *Statement of Changes in Net Assets*) increased by $5.1 million, largely due to $7.4 million in System Equity fees, an increase of $4.1 million from FY 2004 (the fee began to be assessed in August 2003). The fee, collected when new customers connect to the water system, is intended to recover the costs of our capital investment made to provide capacity to serve new users.

Operating Expenses - The majority of our operating costs are fixed, at least in the twelve months of our fiscal year. On average, approximately 65%-70% of our annual operating expenses will not vary as a result of the quantity of water we sell. Staff related expenses, payments to the City of Tucson for administrative support, and CAP capital payments are our most significant fixed items. The remaining 30%-35% of our

MANAGEMENT'S DISCUSSION AND ANALYSIS



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.

Fixed Costs $47.8 million (contributors to the $3.1 million increase from FY 2004):

- increased employee costs ($1.9 million) resulting from cost of living adjustments, employee merits, and increases in employee insurance costs
- costs of the May 2005 water revenue bond election ($.6 million)
- costs associated with implementing a predictive maintenance program for water mains added $.7 million to fixed costs; acoustic fiber optics are now utilized to monitor wire slips and breaks within our large pre-stressed concrete cylinder transmission mains
- increased focus on system preventative maintenance via the rollout of four geographic maintenance areas contributed to the $.8 million increase in system maintenance costs
- Somewhat offsetting these increases were the $.5 million decrease in the CAP capital charge

Variable/Discretionary Costs $26.1 million (contributors to the $1.3 million increase from FY 2004):

- increased CAP water expense resulting from purchasing more CAP water ($1.2 million)
- increased department-wide expenses for computers (hardware and software), community relations and chemicals contributed to a $.7 million increase in variable costs.
- Partially offsetting these increases were decreases in power costs ($.2 million) and consulting services ($.5 million).

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

	2005	2004*
Operating Revenues:		
Water Sales	$ 98,989	$ 99,785
Other Revenues (including CAP surcharge)	12,358	11,433
Total Operating Revenues	111,347	111,218
Operating Expenses	93,781	88,541
Net Operating Income	17,566	22,677
Non-Operating Income	1,621	705
Non-Operating Expenses	18,578	18,271
Net Income before Capital Contributions/Adjustments	609	5,111
Capital Contributions		
System Equity (buy-in) Fee	7,438	3,340
Developer Contributions/grant receipts	6,864	11,889
Total Capital Contributions	14,302	15,229
Change in Net Assets	$ 14,911	$ 20,340

* FY 2004 was restated to record *System Equity Fee* collections as capital contributions; fees were previously reported in Other Revenues.

The remainder of this *Management's Discussion and Analysis* provides a more detailed look into our fiscal year 2005 revenues, operating expenses, capital outlays, debt service, changes in net assets, and cash flows.

CAP water is pumped into basins at our facility in Avra Valley and stored for future use.

MANAGEMENT'S DISCUSSION AND ANALYSIS

REVENUES

Key Data: Revenues

	2005 Actual	2005 Planned	2004 Actual
Total Water Sales Revenue [1]	$100.8	$102.4	$101.2
Potable	$95.2	$96.3	$95.3
Reclaimed	$5.6	$6.1	$5.9
Other Revenue [2]	$19.6	$18.0	$14.3
Total Water Sales (Ccf [3])	52,253,833	53,314,573	53,169,578
Potable	47,250,548	47,900,000	47,973,513
Reclaimed	5,003,285	5,414,573	5,196,578
Total Water Service Connections[4]	216,653	216,820	212,227
Potable Metered	213,025	213,123	208,821
Fire Protection	2,760	2,850	2,643
Reclaimed Metered	868	847	763
Potable Water 12-Month Average			
Use Per Svc Per Month (Ccf)	18.49	19.19	19.16
Single Family Customers Only	11.44	11.92	11.93

[1] Total water sales revenue includes revenue generated by usage rates, fixed monthly charges based on meter size, and CAP surcharges based on water usage.
[2] Other revenue consists of other operating revenues and non-operating income from the audited financial statements. Development fees which result in cash collections have been included in other revenue for both FY 2005 and FY 2004, but developer-contributed infrastructure has been excluded in both years.
[3] 1 Ccf = 748 gallons.
[4] Monthly average connections for the 12 months of the Fiscal Year.

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 2005, other revenue, bolstered by a system capacity 'buy-in' fee(System Equity Fee) assessed on new potable metered connections to the water system first implemented in FY 2004, constituted about 16.0% of the total revenue stream and exceeded plan by about $1.6 million.

The Hayden-Udall Treatment Plant houses the water quality lab and Maintenance Management.

MANAGEMENT'S DISCUSSION AND ANALYSIS

The first year (FY 2004) of the 'buy-in' fee produced disappointing revenue results, possibly because of the customer rush to have new metered connections installed prior to the fee becoming effective. In FY 2005, however, the fee produced revenues ($7.4 million) at the level anticipated when it was being developed and was the bright spot in a year in which water sales revenues did not materialize to the extent expected.

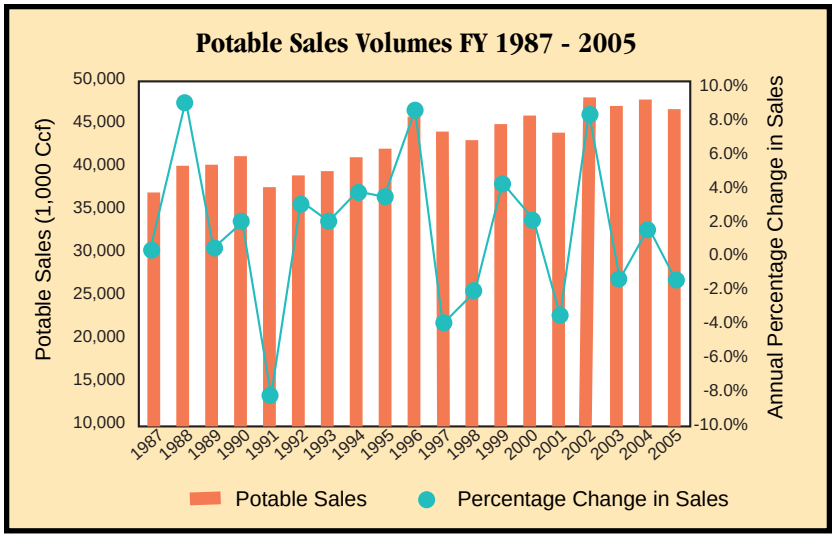
FY 2005 water sales revenue was less than originally forecast by approximately 6.0% ($6.1 million). However, the forecast was adjusted prior to the adoption of the FY 2005 Financial Plan, so that the final shortfall from plan ($1.5 million, or about 1.5%) was mitigated. Apart from the plan shortfall is the fact that FY 2005 water sales revenue was approximately $400,000 less than in FY 2004. A modest water rate increase of 1.5% during FY 2005 helped make the final results for the year less gloomy than they otherwise would have been. (See Appendix A for the FY 2005 rate schedule.)

Potable Water Sales, Services, Revenue Effects

FY 2005 potable water sales *revenue* decreased by less than 1% ($155,000) from FY 2004, but was less than the original forecast for the year by approximately $5.5 million, or 5.5%. However, the revised forecast for the year resulted in a much reduced shortfall from plan ($1.1 million, or 1.1%).

Our FY 2005 potable water sales *volume* (47,250,548Ccf or 35.3 billion gallons) was also less than that of FY 2004 by 1.5% and, like revenue, below the final forecast for the year by 1.4%.

The following nineteen-year chart illustrates the continuing volatility in potable sales and, hence the difficulty of projecting future sales volume with a high degree of accuracy.



Potable Sales Volumes FY 1987-2005

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; new single family homes having less acreage than in the past; landscaping codes encouraging low water use plants; on-going conservation programs emphasizing education and behavioral changes; and conservation-oriented rate structures.*

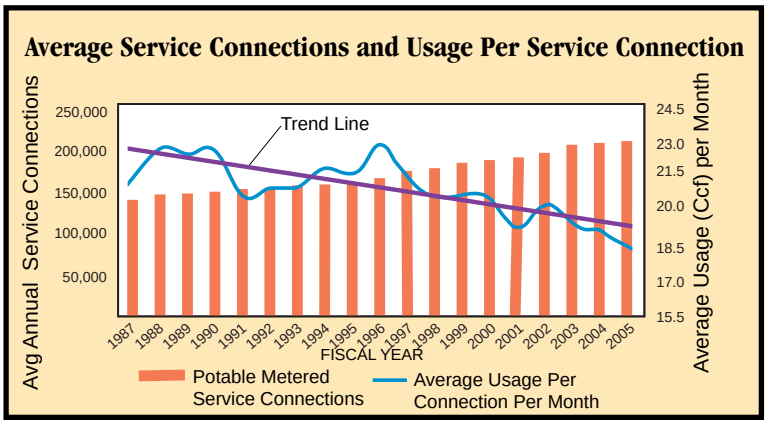
Service connection growth always pulls potable revenues in a positive direction, due to the additional volume of water provided to the new connection as well as the monthly service charge assessed to each account regardless of the amount of water used. FY 2005 growth in average metered service connections (4,204) was considerably less than in FY 2004 (6,647), probably related to the 'buy-in' fee and the rush to have meters installed in FY 2004 prior to that fee's becoming effective. Although the FY 2005 growth rate (2.0%) was less robust than in recent years, it was just shy of projection (0.1% under) and thus did not contribute to the revenue shortfall experienced.

Weather can pull sales volume and hence revenue in either a positive or contrary direction. FY 2005 recorded over 3" less rainfall than FY 2004, most of that difference occurring in the summer months when water use for outdoor irrigation is likely to be higher than in the winter. However, the year was cooler than FY 2004, and cooler in five out of the six summer months. As was the case when FY 2004 and FY 2003 weather results were compared in last year's discussion, FY 2005 weather might be viewed as almost neutralizing the direction of potable water usage.

Since customer usage is measured at the meter, we have a meter test and replacement program underway. Preliminary results indicate that around 20% of our existing meters are under-registering water use, and we will be replacing those meters over the next four years. As meter accuracy improves, so may water sales volume, though other variables, many beyond our control, will continue to influence how much water customers use.

Whatever caused customers to use less potable water in FY 2005, the fact is that they did, both in total and per metered service connection. Average monthly potable use per metered connection fell again in FY 2005, to 18.49 Ccf, down over 3% (.7 Ccf) from FY 2004 which itself was down about 2% (.3 Ccf) from FY 2003.

MANAGEMENT'S DISCUSSION AND ANALYSIS



The chart above illustrates our continued metered service connection growth while average monthly usage per connection continues to trend downward.

Reclaimed Water Sales, Services, Revenue Effects:

Reclaimed water sales revenue offered no respite from potable sales revenue results. FY 2005 revenue of $5.6 million was about 5.0% lower than FY 2004 revenue and around 8.0% (about $0.5 million) below plan. Reclaimed water sales volume (5,003,285 Ccf or 3.7 billion gallons) was about 4.0% lower than in FY 2004 and around 8.0% below the final plan for the year. An existing resort added a new nine-hole golf course to its reclaimed connection during the last month of FY 2004, so that the connection served a total of 27 holes of golf during FY 2005. That connection accounted for around 6% of the FY 2005 sales volume.

Average service connections for FY 2005 increased by 105 to 868. No new major user connected to the system during the year, and the majority of our additional service connections, as in prior years, were related to residential customers.

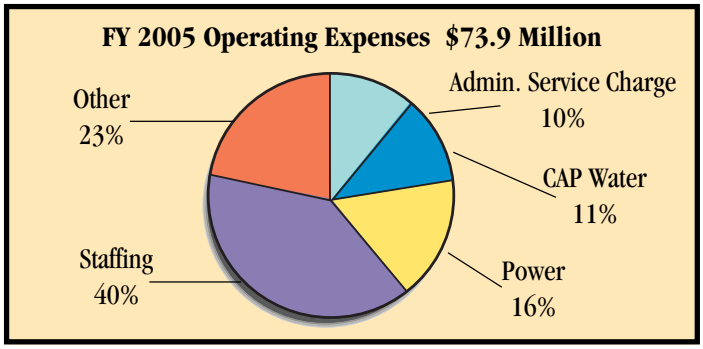
Revenue Outlook: Next Five Years

The major revenue change we are expecting during the next five years continues to be in fees associated with new development, or customer growth in our service area. However, higher annual water rate increases are also anticipated. Our analysis of long-term water resource requirements continues to be reviewed by the community and our governing body, but discussions thus far indicate that both higher water rates and an impact fee in addition to the 'buy-in' fee will be necessary to finance future water source requirements and related infrastructure.

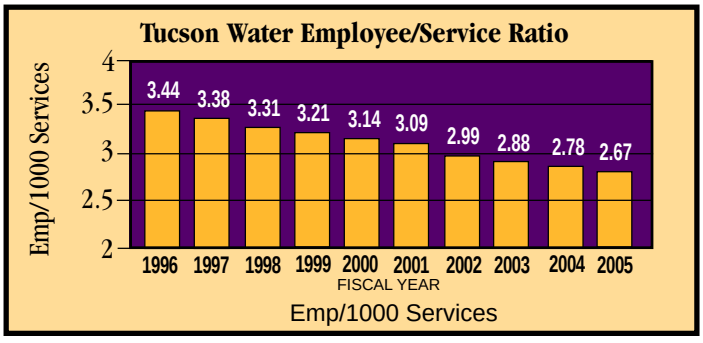
Operating Expenses

We expend considerable financial resources to operate our potable and reclaimed water systems. We incurred $73.9 million in operating expenses in FY 2005 (excluding depreciation of $19.9 million and taxes of $9 million) or about $341 per service connection, a 6% increase over FY 2004. While we are a large utility with many varied expenses, four cost categories made up 77% of our total operating costs: employee costs, power costs, CAP water costs, and administrative service charges.

Employee costs ($29.2 million in FY 2005 and $27.3 million in FY 2004) relate to our diverse staff of 576 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 $1.9 million increase in employee costs from FY 2004. Partially offsetting these increases was the reduction of employees from 580 in FY 2004 to 576 in FY 2005.

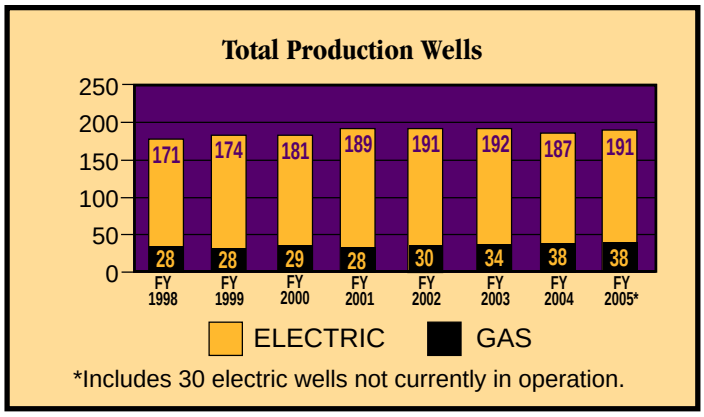


Despite continuing increases in the number of customers, our ratio of employees per 1,000 customer service connections has steadily decreased in recent years. Restructuring of meter reading routes, flexible work hours, reorganization of fieldwork teams, and increased use of technology and automation continue to contribute to a reduction in the employee per-service ratio. While our focus on obtaining efficiencies will continue, we expect that increasing maintenance and replacement needs, along with steady increases in our customer base, will require our staffing levels to rise in the coming years.



Power costs (approximately $12.1 million in FY 2005 and $12.3 FY 2004 respectively) are incurred as we pump water up from depths ranging to 700 feet and move it through our distribution system. Power rates remained relatively stable during FY 2005; total power expenses decreased slightly, reflective of the slight decrease in water sales volumes. In the future, as we utilize increased production from our CRRF, we anticipate increasing power expenses. Recharged water, recovered and moved from the CRRF site 21 miles outside of our central service area, will continue to replace wells scattered throughout the central wellfield.

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



CAP water costs ($8.4 million in FY 2005 and $7.7 million in FY 2004) result from our purchase of Central Arizona Project water from the CAWCD. CAWCD establishes both the capital and commodity rates annually. Our FY 2005 costs consisted of two components:

- The capital financing charge, $3.8 million in FY 2005 and $4.3 million in FY 2004, is based on the Utility's allotment of 135,966 acre-feet. The FY 2005 decrease was the result of a rate reduction by CAWCD.
- The commodity charge ($4.6 million and $3.4 million in FYs 2005 and 2004, respectively) is based on actual CAP water taken and reflects the Utility's continuing transition from groundwater to Colorado River Water. We purchased approximately 64,000 acre-feet of CAP water in FY 2005, up from 54,000 in FY 2004.

Administrative service charges ($7.7 million in FY 2005 and $7.2 million FY 2004, respectively) are our payments to the City of Tucson for support services (procurement/payroll/budget/etc). All payments are for direct services or indirect administrative support; no funds are transferred to support non-Utility related purposes.

OPERATING EXPENSES OUTLOOK: NEXT FIVE YEARS

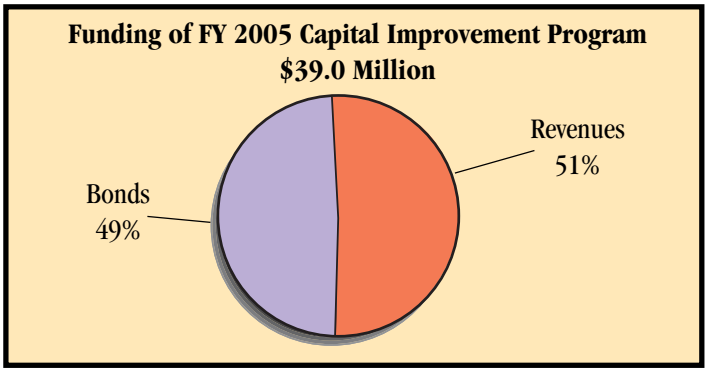
Managing our operational expenses will be a significant challenge in the future. Operating expenses are anticipated to increase over the next five years due to continued customer growth, the utilization of an increasing amount of both CAP water (at increasing rates), the potential for increased volatility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

The Utility will be challenged with managing these costs while meeting increasing demands for water *and* maintaining water rate adjustments at levels acceptable to the community we serve. We have ongoing strategic planning and employee-driven re-engineering efforts, which impact all areas of our organization, to assist in these efforts. Through increased maintenance management operations, 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 the most affordable rates possible.

Capital Improvements

At the end of FY 2005, our water system was composed of 222 potable wells, 7 reclaimed wells, 4,480 miles of delivery pipelines, 111 boosters to move water around our delivery area, and 48 reservoirs (42 potable and 6 reclaimed) to store water to meet peak demands. Our capital planning enables us to 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 water revenue bonds). This enables both current and future customers to participate in the funding of capital improvements. In May 2005, the citizens of Tucson approved a $142 million Water Revenue Bond authorization; the first sale from this authorization $31.7 million occurred in June 2005. This authorization is anticipated to provide the funds to meet our bond requirements through FY 2010.



MANAGEMENT'S DISCUSSION AND ANALYSIS

During FY 2005 we spent approximately $39 million (or 73% of our fiscal year capital budget) on improvements to our system compared with FY 2004 spending of $40.8 (76% of budget). Lower spending in FY 2005 resulted from a combination of factors, including permitting delays on a major reclaimed transmission main resulting in project expenditures running $4 million below plans.

During FY 2005, work was initiated on three South Avra Valley Storage and Recovery Projects (SAVSARP recharge basins, reservoir, and raw water recovery pipeline). The new facility has been designed to recharge and recover 45,000 acre-feet of Colorado River water annually, substantially increasing our use of a renewable water resource. Although FY05 expenditures on the preliminary phases of these projects were small ($324,520), the projects will be an important part of the Utility's Capital Improvement Program in the upcoming years.

FY 2005 also included expenditures for numerous transmission and distribution main projects. In Potable Transmission, $4,112,000 was expended on three projects, (Southeast E-Zone, Old Nogales Highway, and Southside Gravity Transmission Mains). In Potable Distribution, $2,282,000 was expended on road improvement main projects and $1,139,000 for distribution main replacements. In reclaimed transmission, $4,382,000 was expended on two large projects, Campbell/Drexel and the 18th Street/10th Avenue transmission mains.

The FY 2005 CIP included investment in the Utility's on-going Pipeline Protection Program (the installation of fiber optics to acoustically monitor pipelines for potential failures, thereby enabling us to service/rehabilitate the mains before failures occur -$1,104,000), our Meter Replacement Program, (approximately 5,500 meters replaced - $401,000) and well drilling and equipping (eight wells - $2,074,000).

The remaining $23.2 million was spent in the following program areas:

Transmission and Distribution Mains	$5.5 million
Reservoirs and Pumping Facilities	$2.4 million
New Services (water meters, minor extensions)	$2.6 million
Reclaimed System Expansion and Improvements	$3.5 million
Equipment and Vehicles	$1.2 million
General Plant Improvements	$1.1 million
Other	$6.9 million
Total	$23.2 million

Capital Expenditure Outlook: Next Five Years

The Five-Year CIP is the foundation of our water supply strategy for the community. Over the next five years, we plan to spend nearly $260 million to fund capital projects. The CIP will significantly assist in achieving the long-term goal of attaining a sustainable water source through balancing groundwater pumping with replenishment of the aquifer.

During this five year period, our emphasis will be on construction of SAVSARP. Also included are storage and transmission projects to address the Utility's growing customer base and various improvements to protect the security and integrity of the water system

Debt and Debt Service

At June 30, 2005, we had $352.2 million in outstanding water revenue bonds. In addition, we had $36.1 million outstanding in Water Infrastructure Finance Authority (WIFA) loans. Water revenue bond interest payments on this debt ($17.9 million in FY 2005) are reported as expenses on our income and flow of funds statements. Repayment of principal ($10.0 million in FY 2005) is reported only on our flow of funds statement. In addition, we paid $0.7 million in fiscal agent fees.

Bond Ratings:

• **Moody's Investors Service**	**Aa3**
• **Standard and Poors**	**A+**
• **Fitch**	**AA**

During FY 2005, the following bond sales or loans agreements occurred:

Amount	Interest Rate	Month
$55.1 million Water Revenue Bond Refunding	4.98%	January 2005
$3.0 million WIFA loan*	3.10%	February 2005
$31.7 million Water Revenue Bonds	4.31%	June 2005

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

Revenues generated from the System Equity (buy-in) fee are dedicated to payment of the annual requirements for debt service.

	FY 2005	FY 2004
System Equity Fee Collections	$7.4 million	$3.3 million
Water Revenue Bond/WIFA Loan Debt Service	$27.9 million	$26.4 million
System Equity Fee as % of Debt Service	27%	13%

MANAGEMENT'S DISCUSSION AND ANALYSIS

The financing of our capital program with a combination of bond proceeds/loans *and* water sales revenues insures a healthy ratio of outstanding water revenue bond debt to system fixed assets. This ratio has averaged .37 over the last nine years.

Ratio of Outstanding Water Revenue Bonds to Capital Assets at June 30 ($ in millions)

	1997	1998	1999	2000	2001	2002	2003	2004	2005
Land	$ 41.4	$ 43.1	$ 44.60	$ 46.9	$ 46.4	$ 45.1	$ 45.1	$ 45.1	$ 45.3
Buildings	95.7	96.3	97.3	97.3	100.7	102.1	108.5	108.6	134.5
Water Mains	408.5	442.5	467	528.2	549.3	582.2	608.6	635.7	739.7
Reservoirs	114	127.3	132.5	142.1	183.1	199.6	198.2	202.3	102.4
Construction in Progress	117.6	109.3	127.2	108.3	106.7	95.9	115.2	134.9	147.4
Machinery	11.9	15.6	17.1	15.2[1]	16.7	19.6	20.8	22.6	23.2
Less Accumulated Depreciation	(143.8)	(156.9)	(169.6)	(181.6)	(196.5)	(217.1)	(225.8)	(244.3)	(262.4)
Total Fixed Assets	$645.3	$677.2	$716.1	$756.4	$806.4	827.4	870.6	904.90	930.1
Water Revenue Bonds/ WIFA Loans Outstanding	$223.9	$216.7	$250.0	$244.1	$273.9	$335.0	334.0	365.8	$388.3
Ratio Water Revenue Bonds/Fixed Assets	0.35	0.32	0.35	0.32	0.34	0.40	0.38	0.40	0.42[2]

(1) $2 million of machinery assets were written off in FY 2000 due to change in capitalization threshold.
(2) Includes $31.7 million of bonds sold in June and unspent at June 30 2005; ratio with this debt removed is .38.

Testing turbity levels is just one of the many aspects of our Operations and Maintenance Division.

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 2005 was $14.9 million, a $5.4 million decrease from FY 2004's increase of $203 million.

Change In Increase to Net Assets FY 2005 from FY 2004 ($ in millions)

Increase to Net assets FY 2005	**$ 14.9**
Increase to Net assets FY 2004	**20.3**
Change in Amount of Increase	**$ -5.4**
Detail of Changes FY 2005 from FY 2004 Revenues	
Decrease in water sale (potable and reclaimed)	$ -0.4
Increase in other revenues	1.4
Change in Revenues	1.0
Expenses	
Increase in depreciation expense	-0.3
Decrease in power expense	0.2
Increase in employee costs	-1.9
Increase in administrative service charge	-0.4
Increase in interest expense	-0.4
Increase in CAP water expense (capital & commodity)	-0.7
Increase in other expenses	-1.8
Changes in Expenses	-5.3
Capital Contributions	
Increase – System Equity (buy-in) fee	4.3
Decrease - contributed water systems/grant receipts	-5.2
Changes in Capital Contributions	-1.1
Change in Increase to Net Assets FY 2005 from FY 2004	$ -5.4

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 *changes in net assets*.

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

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, 2005, unrestricted/undesignated cash on hand was $15.0 million.

Debt Service Coverage (the percent 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 2005 was 188%.

Central Arizona Project water arrives in the valley and is one of the renewable resources for Tucson Water customers.

MANAGEMENT'S DISCUSSION AND ANALYSIS

The following "summary flow of funds" identifies our major cash sources and uses during FY 2005:

Summary FY 2005 Flow of Funds ($ in millions)

CASH INFLOWS:		
What we received: from sale of water*		$100.8
from water system equity fees		7.4
from other revenues/sources**		25.1
	TOTAL INFLOWS	$133.3
CASH OUTFLOWS & USES		
How much of our revenues we used for:		
operations/maintenance ***		$82.9
bond debt service (principal/interest)		29.3
capital improvements		20.0
other purposes		1.1
	TOTAL OUTFLOWS	$133.3

* includes CAP surcharge revenues
** includes taxes ($9 million and use of working capital - $3.7 million)
*** includes taxes ($9million and payment to City of Tucson for administrative support)

Financial Planning and Outlook:

Each year, we develop a rolling six-year *Financial Plan* (*current year plus five*). This plan is built on our projected capital improvement and operating budgets, and our projected water sales revenues under existing rates. This presentation of our plan to the governing body is coordinated with budgeting review and 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) as part of their review of those capital and operating budgets. As a result, our governing body has the opportunity to know the revenue/rate effects of the capital and operating plans being considered and can adjust the plans if the revenue/rate effects are not deemed acceptable.

Our Financial Plan for the period FY 2005-FY 2010, which was adopted by Mayor and Council during July 2005, calls for annual water revenue adjustments beginning in FY 2007. Primary drivers behind the need for increased revenues include the continued transition from groundwater to our renewable water resource and the financing of our capital program. 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 to a growing desert community.

Requests for Financial Information

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

JULY 12, 2004 MONTHLY WATER RATE SCHEDULE

Monthly Service Charge

Service Size: Inches	Potable Charge (1)	Reclaimed Charge (1)	Fire Sprinkler Service (2)
5/ 8	$ 5.35	$ 5.35	$ N/A
1	6.99	6.99	N/A
1-1/2	10.73	10.73	N/A
2	15.41	15.41	5.41
2-1/2	21.73	21.73	N/A
3	28.05	28.05	8.39
4	45.84	45.84	12.96
6	90.78	90.78	24.87
8	135.71	135.71	38.87
10	205.92	205.92	60.63
12	338.39	338.39	97.58

Monthly Water Usage Charge (3):

Customer Class:		Potable: Winter $ / Ccf	Potable: Summer $ / Ccf	Reclaimed: All Seasons $ / Ccf
All				1.40
Single Family	1 - 15 Ccf	1.03	1.03	
	16 - 30 Ccf	3.60	3.60	
	31 - 45 Ccf	5.05	5.05	
	Over 45 Ccf	7.13	7.13	
Duplex-Triplex	1 - 20 Ccf	1.03	1.03	
	21 - 35 Ccf	3.60	3.60	
	36 - 50 Ccf	5.05	5.05	
	Over 50 Ccf	7.13	7.13	
Multifamily	Basic Volume Charge	1.59	1.59	
Submetered				
Mobile Hm Prks	Basic Volume Charge	1.25	1.25	
Commercial	Basic Volume Charge	1.49	1.49	
	Summer Surcharge - Tier 1 (4)	———	0.95	
	Summer Surcharge - Tier 2 (5)	———	0.25	
Industrial	(More than 5 mg per month & Tucson Unified School District by contract)			
	Basic Volume Charge	1.47	1.47	
	Summer Surcharge - Tier 1 (4)	———	0.95	
	Summer Surcharge - Tier 2 (5)	———	0.25	
Construction Water				
	Basic Volume Charge	1.94	1.94	
Central Arizona Project Charge (6)		0.04	0.04	

NOTES:

(1) Applied per meter to all customer classes, regardless of the amount of water used.
(2) Fixed monthly fee based on connection size. Any water used for fire suppression is not metered.
(3) Usage charges begin with the first unit/Ccf of water used.
(4) Tier 1 summer surcharge applied to the customer's usage in a summer month which is greater than that customer's average winter monthly usage. Summer months: May through October; Winter months: November through April. This surcharge amount is added to the basic volume charges.
(5) Tier 2 summer surcharge applied to the customer's usage in a summer month which is greater than 145% of that customer's average winter monthly usage. Summer months: May through October; Winter months: November through April. This surcharge amount is added to the tier 1 surcharge amount and the basic volume charges.
(6) The Central Arizona Project Charge is applicable to all potable customer classes and to all potable water used.

HEINFELD, MEECH & CO., P.C.
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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, 2005, 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, 2005, 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, 2005, 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 7, 2005

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Annual Report Fiscal Year 2005

FINANCIAL STATEMENTS

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(Dollar Amounts In Thousands)

STATEMENTS OF NET ASSETS

	2005	2004
Assets		
Current assets:		
Cash and cash equivalents		
Undesignated	$ 15,056	$ 17,824
Designated for customer deposits	2,795	629
Designated for infrastructure replacement	9,877	9,672
Total Cash and cash equivalents	27,728	28,125
Billed accounts receivable, net of allowance for doubtful accounts of $280 and $336 respectively	8,956	7,322
Unbilled accounts receivable	6,671	6,944
Prepaids and other assets	302	396
Total current assets	43,657	42,787
Restricted assets	52,552	35,692
Investments for contract payments	—	463
Long-term accounts receivable	1,377	1,053
Capital Assets:		
Utility property, plant and equipment	1,045,089	1,014,262
Construction-in-progress	147,385	134,874
Less accumulated depreciation	(262,439)	(244,271)
Net capital assets	930,035	904,865
Other	3,308	1,837
Total assets	$ 1,030,929	$ 986,697

(Continued on next page)

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

STATEMENTS OF NET ASSETS (CONTINUED)

	2005	2004
Liabilities and Net Assets		
Current liabilities:		
Accounts payable	$ 5,574	$ 4,604
Salaries, wages and payroll taxes payable	2,440	2,377
Current installments of revenue bonds payable	11,084	9,785
Current installments of contract payable	115	400
Refundable/customer deposits	2,795	629
Accrued interest payable	—	38
Unearned receipts	5	5
Total current liabilities	22,013	17,838
Liabilities payable from restricted assets	19,627	19,025
Long-term liabilities:		
Revenue bonds payable	378,284	354,072
Contract payable	484	-
Other long-term liabilities	1,297	1,449
Total long-term debt	380,065	355,521
Total liabilities	421,705	392,384
Commitments, contingencies and subsequent events (notes 16 and 17)		
Net Assets		
Invested in capital assets net of debt	576,713	555,372
Primarily Restricted for:		
Capital Projects	45	2,454
Debt Service	141	32
Unrestricted	32,325	36,455
Total net assets	$ 609,224	$ 594,313

See accompanying notes to financial statements.

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

STATEMENTS OF REVENUES, EXPENSES AND CHANGES IN NET ASSETS

STATEMENTS OF REVENUES, EXPENSES AND CHANGES IN NET ASSETS

	2005	2004 Restated
Operating revenues:		
Potable water sales	$ 93,336	$ 93,910
Reclaimed water sales	5,653	5,875
Total water sales	98,989	99,785
Central Arizona Project surcharge	1,852	1,433
Connection fees	2,997	3,737
Billing services -		
Pima County Sewer, City of Tucson Solid Waste	1,915	1,877
Miscellaneous:		
TCE cleanup reimbursement	714	794
Area development fees	439	830
Service charges	1,903	1,363
Plan Review and Inspection Fees	1,877	926
Reimbursed prior year expenses	576	332
Other	85	141
Total miscellaneous	5,594	4,386
Total operating revenues	111,347	111,218
Operating expenses:		
Director's office:		
Personal services	2,294	1,549
Contractual services	1,591	1,928
Commodities	527	240
Total director's office	4,412	3,717
Business services:		
Personal services	1,574	1,552
Contractual services	815	833
Commodities	1,074	1,133
Total business services	3,463	3,518
Customer services:		
Personal services	5,311	4,868
Contractual services	346	650
Commodities	471	368
Total Customer Services	6,128	5,886
Water operations:		
Personal services	11,318	11,780
Contractual services	14,556	13,476
Commodities	4,308	4,042
Total water operations	30,182	29,298

(Continued on next page)

(Dollar Amounts In Thousands)

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

	2005	2004 Restated
Planning and engineering:		
Personal services	$ 3,704	$ 4,011
Contractual services	565	98
Commodities	420	403
Total planning and engineering	4,689	4,512
Water quality management:		
Personal services	4,356	2,831
Contractual services	2,161	2,671
Commodities	705	500
Total water quality *	7,222	6,002
CAP water charges:		
Capital charges	3,807	4,351
Commodity charges	4,587	3,391
Total CAP water charges	8,394	7,742
General expenses:		
Personal services	594	694
Contractual services	8,639	7,534
Commodities	147	14
Total general expenses	9,380	8,242
Depreciation and goodwill amortization (note 2g)	19,911	19,624
Total operating expenses	93,781	88,541
Net operating income	17,566	22,677
Nonoperating income:		
Investment earnings	1,175	643
Gain on sale of property/equipment	436	62
Other nonoperating	10	-
Total nonoperating income	1,621	705
Nonoperating expenses:		
Interest expense	17,992	17,607
Other nonoperating expenses	586	664
Total nonoperating expenses	18,578	18,271
Net income before capital contributions	609	5,111
Capital contributions	14,302	15,229
Change in net assets	14,911	20,340
Net assets - July 1	594,313	573,973
Net assets - June 30	$ 609,224	$ 594,313

See accompanying notes to financial statements.

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

STATEMENTS OF CASH FLOW

	2005	2004
Cash flows from operating activities:		
Cash received from customers	$ 112,533	$ 120,552
Cash payments to suppliers for goods and services	(42,704)	(43,144)
Cash payments to employees for services	(30,602)	(26,904)
Net cash provided by operating activities	39,227	50,504
Cash Flows from Noncapital Financing Activities:		
Subsidy from Federal Grant	10	—
Net Cash Provided (Used) by Capital & Noncapital Financing Activities	10	—
Cash flows from capital and related financing activities:		
Bond proceeds	35,364	36,404
Acquisition and construction of capital assets	(27,563)	(45,001)
Principal paid on capital debt	(10,400)	(9,435)
Interest paid on capital debt	(17,980)	(16,802)
Fiscal agent fees paid on capital debt	(478)	(569)
Proceeds from sale of property and equipment	428	298
Net cash used in capital and related financing activities	(20,629)	(35,105)
Cash flows from investing activities – interest received on investments	1,638	1,575
Net increase (decrease) in cash and cash equivalents	20,246	16,974
Cash and cash equivalents at beginning of year	42,720	25,746
Cash and cash equivalents at end of year	$ 62,966	$ 42,720
Reconciliation of operating income to net cash provided by operating activities:		
Operating income	$ 17,567	$ 26,017
Adjustments to reconcile operating income to net cash provided by operating activities:		
Depreciation and amortization	19,911	19,624
Decrease (increase) in cash resulting from changes in:		
Accounts receivable/due from other agencies	(1,095)	2,531
Internal Receivable	—	10
Prepaids and other assets	(13)	(47)
Long-term accounts receivable	259	3,734
Accounts payable	366	(1,759)
Accrued expenses	(90)	420
Deferred revenues		(41)
Customers/refundable deposits/due to other agencies	2,322	15
Net cash provided by operating activities	$ 39,227	$ 50,504
A reconciliation of cash and cash equivalents at June 30 follows:		
Unrestricted cash	$ 27,729	$ 28,125
Restricted cash (included in restricted assets)	35,237	14,595
Cash and cash equivalents at June 30	$ 62,966	$ 42,720

Noncash investing, capital and financing activities:

Developers contributed water systems to the Utility valued at $6,869 and $10,166 during the years ended June 30, 2005 and 2004, respectively. At June 30, 2005 contractors had placed $97 of securities in the custody of the Utility in lieu of contract retainage.

Other noncash transactions during the year ended June 30, 2005 included a $146 writeoff of the Rita Ranch payable.

The Water Utility Fund holds a long term promissory note of $1,500 from Starr Pass Resort Developers LLC for the construction of certain water systems on Starr Pass's Behalf.

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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 700,000 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 FY 2005 we obtained our municipal potable water (water meeting or exceeding all federal, state, and local drinking water standards) from our four groundwater well fields (Central, Avra Valley, Santa Cruz, and Southside) and a facility where we recharge and recover Colorado River water. These four well fields and the recharge and recovery facility provide us with an aggregate production capacity of 170 million gallons per day.

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 2005, the Clearwater Renewable Resource Facility, (CRRF), pumped 47,712 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 62,000 acre-feet during FY 2006. 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 million gallons per day (80,000 acre-feet/year) of Colorado River water, a renewable source. Current recovery well capacity is 50 million gallons per day. Meeting approximately fifty percent of our customers' current demand for potable water with Colorado River water enables us to reduce groundwater pumpage from the central well field, over which the majority of the City of Tucson lies, thereby easing concerns related to land subsidence.

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, 2005.

- 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 $13 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 ($2,795 at June 30, 2005.)
  - ~ *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, 2005 was $9,877.

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

- Water rates and charges shall be reviewed annually.

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

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

A. General

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

B. Basis of Accounting

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

C. Use of Estimates

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

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

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 in Trust. Pooled investments are reported at fair market 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.

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, 2005 or 2004, as the amounts were not material. Maintenance and repairs are expensed as incurred.

H. Goodwill and Water Rights

Goodwill is recorded upon the acquisition of Water companies and represents the excess of cost over fair market value at the time of acquisition. Goodwill is being amortized over 40 years using the straight-line method. Total goodwill at June 30, 2005 was $1,122, of which $963 had been amortized.

Purchased water rights related to CAWCD allocations are recorded at historical cost and amortized over the years remaining on the CAWCD contract for those rights. The total historical cost of water rights at June 30, 2005 was $749, of which $23 had been amortized.

I. 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 $2,423 at June 30, 2005.

J. 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. RESTATEMENTS

System Equity Fee Revenues were reclassified from Operating Revenues to a component of contributed capital for Fiscal Year 2004. The Statement of Revenues, Expenses and Change in Net Assets was restated to reflect this change. The net effect of the change is reflected below.

Increase/(Decrease)	FY 2004 Original	FY 2004 Restated	Net Change
Operating Revenues	$114,558	$111,218	($3,340)
Capital Contributions	11,889	15,229	3,340
Totals	$126,447	$126,447	0

The Operating Expense Sections of the Statement of Revenues, Expenses and Changes in Net Assets, expenses by Division was restated for Fiscal Year 2004 to move organizational units between Divisions to maintain comparability between Fiscal Year 2004 and 2005. This was needed to accurately reflect organizational changes which occurred in Fiscal Year 2005. Total operating expenses remained the same.

4. DEPOSITS/INVESTMENTS

The Utility had approximately $16,773 in cash and investments held with fiscal agents at June 30, 2005, 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.

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

At year-end, the Utility had $27,728 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, credit risk, and interest rate risk is provided in the City's Comprehensive Annual Report (CAFR). Copies of the CAFR can be obtained from the City's Finance Department, 255 W. Alameda Street, Tucson, AZ 85701.

5. ACCOUNTS RECEIVABLE

A. Current

The Utility's current accounts receivable at June 30, 2005 were:

Billed Accounts	$	9,236
Unbilled (*estimated unbilled water sales delivered at June 30)*		6,671
Less: Allowance for doubtful accounts		(280)
Total current accounts receivable	$	15,627

B.Long-term

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, 2005, the project was complete, with a short term balance on the note of $123, and a long term balance on the note of $1,377.

6. RESTRICTED ASSETS AND LIABILITIES PAYABLE FROM RESTRICTED ASSETS

A. Restricted Assets

Restricted assets as of June 30, 2005 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	$	16,676
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 projects		35,779
Construction project vendor deposited investments	Construction vendor investments (deposited in lieu of Utility retainage on construction payments) restricted for reimbursement to vendor		97
	Total restricted assets	$	52,552

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

B. Liabilities Payable from Restricted Assets

Liabilities payable from restricted assets as of June 30, 2005 consist of the following:

Source	*Restricted Purpose*	*$ Amount*
Debt service restricted assets	Matured bonds and interest payable	$ 16,676
Unspent revenue bond/loan proceed assets	Accounts payable on authorized bond funded capital projects/ due to other funds pending loan reimbursement	2,500
Construction project vendor deposited	Accounts payable, investments returnable to vendors (deposited in lieu of Utility retainage on construction payments)	451
	Total liabilities payable from restricted assets	$ 19,627

7. CAPITAL ASSETS

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

	Beginning Balance	***Additions/ Transfers***	***Reductions/ Transfers***	***Ending Balance***
Land	$ 45,077	$ 230	$ <11>	$ 45,249
Building, Equipment & Improvements	133,222	3,146	<1,801>	134,567
Transmission & Distribution Systems	835,963	30,359	<1,096>	865,226
Construction in Progress	134,874	38,141	<25,630>	147,385
Total at Historical Cost	$ 1,149,136	$ 71,876	$ <28,538>	$ 1,192,474
Less Accumulated Depreciation for:				
Buildings & Equipment	$ 34,442	$ 5,011	$ <1,692>	$ 37,741
Transmission & Distribution Systems	209,849	14,907	<58>	224,698
Total Accumulated Depreciation	$ 244,271	$ 19,918	$ <1,750>	$ 262,439
Net Capital Assets	$ 904,865	$ 51,958	$ <26,788>	$ 930,035

Note: Improvements, such as reservoir improvements, booster enhancements, and building additions, are included with Buildings and Equipment for FY 2005. In FY 2004, improvements were included with Transmission and Distribution Systems.

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

8. CHANGES IN LONG-TERM DEBT

A summary of changes in long-term debt as of June 30, 2005 is as follows:

	Beginning Balance	*Additions/ Refunded Issues*	*Reductions/ Refunded Issues*	*Ending Balance*	*Due Within One Year*
Water Revenue Bonds Payable	$ 364,701	$ 89,849	$ <66,225>	$ 388,325	$ 11,084
Deferred Amounts:					
Bond sale refundings	<7,021>	<3,715>	488	<10,248>	
Bond sale premiums	6,178	5,551	<438>	11,291	
Total Water Revenue Bonds Payable	363,858	91,685	<66,175>	389,368	11,084
Compensated Absences	3,155	210	<172>	3,193	1,896
Contracts Payable	400	619	<420>	599	115
Total Long Term Debt	$ 367,413	$ 92,514	$ <66,767>	$ 393,160	$ 13,095

9. REVENUE BONDS PAYABLE

Water revenue bonds, secured by water sales revenues, to be sold by the Utility require approval of a majority of City of Tucson voters at a bond election. At the most recent bond election, held May 2005, voters approved an additional $142 million water revenue bond authorization.

At June 30, 2005, the long-term portion of bonds payable was:

Bonds Maturing 2009 - 2025	$ 388,325
Less current installments	<11,084>
Deferred amounts *	1,043
Total long-term revenue bonds payable	$ 378,284

*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, 2005 and 2004 was $50 and $126, respectively.

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

Water Utility Revenue Bonds Issued and Outstanding

Series	*Interest Rates*	*Maturity Date*	*Original Amount*	*Balance Outstanding June 30, 2005*
1984 Series D (1991)	9.75%	2010	$ 48,000	$ 3,000
1993 March (Refunding)	5.25-5.50	2014	35,360	17,585
1994 Series A (1996)	6.0-8.0	2018	33,000	3,000
1994 Series B (1997)	4.50-6.25	2012	11,700	2,000
1997 July (Refunding)	4.20-5.125	2021	32,980	32,205
1998A Water Infrastructure Finance Authority (WIFA) Subsidized	3.425	2017	6,000	4,388
1994 Series C (1999)	4.75-6.75	2009	33,400	4,100
1999A Refunding	5.00	2010	14,045	10,085
1994 Series D (2000)	5.25-7.25	2024	23,740	11,315
2000 Water Infrastructure Finance Authority (WIFA) Subsidized	4.125	2020	5,120	4,342
2000 Water Infrastructure Finance Authority (WIFA) Unsubsidized	5.00	2020	7,780	6,682
2000 Series A (2001)	5.0-7.5	2023	37,800	36,000
2001 A April (Refunding)	5.0	2016	40,850	32,785
2001 Water Infrastructure Finance Authority (WIFA) Subsidized	3.43	2021	8,800	7,757
2002 Refunding	5.50	2018	57,820	55,890
2000 Series B (2002)	3.5-5.125	2021	18,900	17,400
2003 Water Infrastructure Finance Authority (WIFA) Subsidized	3.48	2022	8,300	7,656
2003 Refunding	5.00	2018	12,000	12,000
2000 Series C (2003)	4.25-5.25	2021	16,300	9,400
2000 Series D (2004)	4.0-5.0	2023	18,765	18,765
2000 Water Infrastructure Finance Authority (WIF5) Subsidized	3.75	2023	3,000	2,882
2004 Water Infrastructure Finance Authority (WIF6) Subsidized	3.255	2023	2,500	2,403
2005 Refunding	4.98	2022	55,110	55,020
2005 Series A (2005)	4.31	2025	31,665	31,665
Total			$ 562,935	$ 388,325

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

Maturities of the bonds and related interest payable after June 30, 2005 are as follows:

Year Ending June 30,	*Principal*	*Interest*	*Total*
2006	$ 11,084	$ 19,380	$ 30,464
2007	13,070	18,807	31,877
2008	14,184	18,123	32,307
2009	15,516	17,379	32,895
2010	17,149	16,575	33,724
2011-2015	102,724	68,385	171,109
2016-2020	128,890	40,133	169,023
2021-2025	85,708	9,442	95,150
Total	$ 388,325	$ 208,224	$ 596,549

10. ADVANCED REFUNDING/DEFEASANCE OF DEBT

On December 16, 2004, the City issued $55,110 in Water System Revenue Bonds to refund all or partial debt scheduled after July 1, 2005 for the 1994 and 2000 Water System Revenue Bonds and to pay costs relating to the issuance of the bonds. The interest rate on the bonds ranges from 3.0% to 5.0%, with a final maturity due July 1, 2022. Debt service payments are scheduled semi-annually at amounts that range from $90,000 to $6,830,000. The economic gain resulting from this refunding is $3,104, based upon Net Present Value from delivery date. The difference in cash flow requirements to service the old debt ($56, 225) and the cash flows required to service the new debt ($55,111) is $2,235.

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, 2005, the amount of defeased debt outstanding, but removed, is $184,935.

11. LEASE OBLIGATIONS/LONG TERM CONTRACTS PAYABLE

The Utility has entered into long-term capital leases involving the acquisition of equipment for use by the Utility. Long term Contracts Payable for the Utility as of June 30, 2005 were:

Equipment Contracts	$599
Less: Current Portion	$115
Long Term Contracts Payable	$484

Below is a schedule by years of future minimum lease payments unter the capital leases as of June 30, 2005.

Years ending June 30,	
2006	$134
2007	$142
2008	$143
2009	$143
2010	$ 91
Total Minimum Lease Payments	$653
Less: Amount Representing Interest (interest rates range from 3.57% to 3.60%)	$ 54
Present Value of Net Minimum Lease Payments	$599

Equipment purchased for the Utility through long term capital leases totaled $1,013.

12. OTHER LONG-TERM LIABILITIES

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

A. Accrued Compensated Absences

The costs of employee vacation leave, sick leave, accumulated compensatory time, and any salary-related amounts are expensed as earned. Accrued compensated absences not expected to be utilized by employees within the next year are recorded as long-term liabilities. The long-term liability related to accrued compensated absences was $1,297 at June 30, 2005.

B. Arbitrage Tax Liability

The arbitrage tax liability results when interest earnings on water revenue bond proceeds exceed the related water revenue bond's yield. The Utility's liability balance at June 30, 2005 was $0. The Utility's next required rebate date is July 1, 2006.

13. DEVELOPER CONTRIBUTIONS

Developers of land within the Utility's service area are required to install water distribution systems meeting the Utility's standards. Once completed and inspected by Utility staff, the developer donates the systems to the Utility. During the year ended June 30, 2005, developers donated water systems valued at $6,869.

14. INSURANCE

The Utility is exposed to various risks of losses related to tort: theft of, damage to, and destruction of assets; errors and omissions; injuries to employees; and natural disasters. Coverage is obtained through participation in the City's self-insurance program. The Utility pays a premium, calculated annually based on its claims history, to the City's Self-Insurance Fund. During Fiscal Year 2005, the Utility premium was $905. 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).

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

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

A. Pension Plan

Utility employees participate in the Tucson Supplemental Retirement System (TSRS), a single-employer defined benefit plan. Currently, employee contributions are 5% of their annual covered payroll and are made through payroll deductions. A reserve is established for contributions and earnings allocations, less amounts transferred to reserves for retirement and disability and amounts reserved for terminated employees. If an employee leaves covered employment before attaining five years' service credit (eight years' service credit if the member dies), the accumulated contributions plus interest are refunded to the employee or his designated beneficiary. The City contributes the remaining amounts necessary to finance employee participation in the System and to fund the costs of administering the System. Tucson Water's contribution rate for years ended June 30, 2005, 2004, and 2003 was 14.06%, 11.17%, and 8.41%, or $3,453, $2,611, and $2,063, respectively.

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

B. Deferred Compensation

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

C. Post Retirement Benefits

The City subsidizes a health insurance benefit to Utility employees who have qualified to receive a monthly retirement allowance from the Tucson Supplemental Retirement System and are less than 65 years of age, and are not Medicare-eligible. These benefits apply only to those employees who retired after March 1, 1981 and were above the minimum eligible age in effect on the date of their retirement. 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, 2005, the Utility's portion of retiree medical insurance premiums was $448.

16. CONTINGENCIES AND COMMITMENTS

A. Operating Leases

The Utility has entered into operating leases with terms in excess of one year which are not material when taken either individually or collectively and, therefore, are not disclosed in these notes. All the operating leases are cancelable. The Utility's total rent expense, resulting predominately from as needed rental of heavy equipment to support maintenance functions, was $331 for the year ended June 30, 2005.

(Dollar Amounts In Thousands)

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, 2005, 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, 2005 are appropriately identified as accounts payable. Contract commitments for future capital improvement work totaled $19,608 as of June 30, 2005.

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 2005, the Utility made capital and commodity payments of $3,807 and $4,587, respectively. Estimated CAP water expenses for the next five years are as follows:

CAP Payment Schedule (unaudited)

Fiscal Year	*CAP Capital**	*CAP Commodity***
2006	$ 3,807	$5,057
2007	2,855	6,705
2008	4,214	8,977
2009	4,366	12,091
2010	2,059	13,745

**Includes capital cost impacts associated with obtaining an additional 8,206 acre-feet of CAP allocation in fiscal year 2008 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.

17. SUBSEQUENT EVENTS

A. Water Infrastructure Finance Authority Loan

During March 2006, the City of Tucson Mayor and Council approved entering into two new loan agreements with the Water Infrastructure Authority of Arizona. The loans, totaling $4,500 have semi-annual payments due January 1 and July 1 beginning July 1, 2007. The $2,500 loan has a subsidized interest and fee rate of 4.00% and the $2,000 loan has a subsidized interest and fee rate of 3.75%. Both loans are issued against the 2005 voter authorization of Water revenue bond capacity.

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

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

Revenues:			
Sale of water (potable and reclaimed)		$	93,336
Potable water sales			
Reclaimed water sales			5,653
Central Arizona Project Surcharge			1,852
Connection fees			2,997
System Equity Fees			7,438
Billing services -			
Pima County Sewer, City of Tucson Solid Waste			1,915
Miscellaneous revenue			
TCE clean-up reimbursement	714		
Area Development Fees	439		
Service Charges	1,903		
Plan Review and Inspection Fees	1,877		
Prior Year and Reimbursed Expenses	576		
Other	86		
Total miscellaneous			5,595
Investment earnings – Operating Fund			489
Investment earnings – Debt Service Fund			142
Proceeds on sale of property/equipment			436
Total revenues			119,853
Adjusted Operating Interest			
Operation and maintenance expenses:			
Director's office			6,069
Business services			3,682
Customer Services			6,128
Water operations			19,379
Planning and engineering			7,533
Water quality management			6,042
Power – potable system	11,143		
Power – reclaimed system	839		
Total Power			11,982
CAP water purchases			
Capital charges	3,807		
Commodity	4,587		
Total CAP water purchases			8,394
General expenses			1,708
Capitalized operation and maintenance expenses			(4,719)
Total operating and maintenance expenses			66,198
Net revenue available after operations (2)			53,655
Debt Service for revenue bonds:			
Interest on long-term debt			17,922
Principal payments on long-term debt			9,988
Fiscal fees			478
Total Debt Service for revenue bonds			28,388
Net revenue available after operations and water revenue bond debt service		$	25,267

(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 Junes 30, 2005, the debt coverage calculation for this covenant (before permitted adjustments) was 171%.

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, 2005, the debt coverage calculation for this covenant was 189%.

See accompanying independent auditors' report.

(Dollar Amounts In Thousands)

SCHEDULE II: SUPPLEMENTAL SCHEDULE OF FLOW OF FUNDS(1)

Revenues for operations and debt service:		
Sale of potable water	$ 93,336	
Sale of reclaimed water	5,653	
Total Sale of Water		98,989
Central Arizona Project Surcharge (3)		1,852
Connection fees		2,997
System Equity Fees		7,438
Taxes:		
Business privilege tax (State/City)	7,683	
Utility tax (City)	1,323	
Total taxes		9,006
Interest earnings:		
Operating fund interest earnings	710	
Debt service fund interest earnings	142	
Less restricted earnings	(209)	
Total interest earnings available for operations and debt service		643
Sewer billing services -		
Pima County Sewer, City of Tucson Solid Waste		1,915
Miscellaneous revenue:		
TCE Clean-up Reimbursement	714	
Area Development Fees	439	
ServiceCharges	1,903	
Plan Review and Inspection Fees	1,877	
Prior Year and Reimbursed Expenses	576	
Other	86	
Total miscellaneous revenue		5,595
Other receipts:		
Proceeds from sale of property and equipment	436	
Principal received on loans to school district	262	
Total other receipts		698
Total revenues for operations and debt service		129,133
Other sources:		
Use of Metropolitan Water Company Reserve Account (2)	419	
CAP Reserve Fund interest earnings (3)	15	
Use of working capital	3,694	
Total other sources		4,128
Total revenues and other sources		$ 133,261

(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) The final principal and interest payments on the Metropolitan Water Company purchase were made in January, 2005.

(3) CAP Reserve Fund revenues and interest were generated by a $.04/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.

Continued

(Dollar Amounts In Thousands)

SCHEDULE II (CONTINUED): SUPPLEMENTAL SCHEDULE OF FLOW OF FUNDS(1)

Operations and maintenance expense: (4)			
Director's office		$	6,069
Business services			3,682
Customer Sevices			6,128
Water operations (excluding power)			19,379
Planning and engineering (including waterline relocation)			7,533
Water quality management (excluding CAP water purchases/power)			6,042
CAP water: Capital charges	3,807		
Commodity	4,587		
Total CAP water			8,394
Power: Potable system	11,143		
Reclaimed system	839		
Total power			11,982
General expense (including sales taxes of $9,006)			10,714
Capitalized operations and maintenance expense			(4,719)
Total operations and maintenance expense			75,204
Adjustment for accrued compensated absences (5)			152
Adjusted total operations and maintenance expense			75,356
Debt service on water revenue bonds:			
Interest	17,922		
Principal	9,988		
Adjustment for Cost of Issuance Payments	877		
Fiscal fees	478		
Total debt service on water revenue bonds			29,265
Capital outlay:			
Improvements/Equipment from revenues and other sources	14,245		
Capital equipment from revenue and other sources	993		
Capitalized operations and maintenance expense	4,719		
Improvements funded by Central Arizona Project Reserve Fund	15		
Total capital outlay			19,972
Other uses:			
Private water company contract payments	414		
Administrative service charges	7,672		
Reclaimed loans and other uses	582		
Total other uses			8,668
Total expenses, debt service, capital outlay and other uses		$	133,261

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

(5) Change in year-end long-term compensated absences payable is subtracted from this statement.
See accompanying independent auditors' report.

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Annual Report Fiscal Year 2005

ANNUAL SAFETY SUMMARY

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(Dollar Amounts In Thousands)

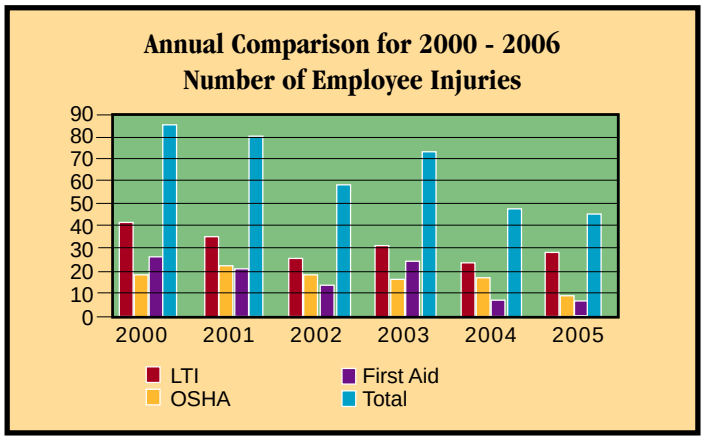
ANNUAL SAFETY REPORT SUMMARY

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. We received a 73% effort grade in a November 2005 internal audit (up from the prior year's 70% grade) thus maintaining a 3 star rating.

One of the components that affect our star rating is employee injury experience. A reduction in injury rates can 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, we must comply with annual accident and injury reporting requirements as promulgated by the Occupational Safety and Health Act (OSHA).

We began tracking Lost Time Incidents (LTI), OSHA reportable incidents and first aid cases in 2000 when the 5 Star Program was implemented. The graph below provides a summary of reported injury incidents over the last five years.



Important statistics related to employee injuries include:

- In 2005 the total number of internally logged injuries not including first aid, decreased by 2 cases when compared to 2004
- In 2005 the Utility had 562 full-time employees (filled positions); for this workforce Tucson Water reported 26 lost workdays and 52 restricted duty days.
- During 2005 Tucson Water employees incurred a total of 47 injuries as reported in the Federal OSHA 300 log.

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

- In 2005 Tucson Water incurred 4 reportable OHSA disabling injuries (i.e. injuries defined as OSHA lost time and restricted work related injuries or illness that equates to days away from work or modified work assignments). This was a decrease of 13 injuries from the 17 reportable OSHA disabling injuries that occurred in 2004.
- In 2005 we incurred $80,865 in injury related costs (the sum of indemnity costs and medical costs paid for treatment or rehabilitation). This is a decrease of $36,137 when compared to the 2004 experience of $117,002

Since the inception of the 5 Star safety program in 2000, work related disabling injuries have been on the decline.

Tucson Water continues to show improvement in safety performance. The utility continues to develop a strong, proactive approach to health and safety with the backing of senior management. Internal communications, safety meetings and ongoing training coupled with safety awareness throughout the organization has resulted in a trend of decreased serious injuries.

To achieve further safety improvements, each Division is responsible for setting safety priorities and developing safe workplace strategies. New safety initiatives such as safety recognition programs, Division Administrator injury review and employee input on improved work methods have been implemented this year. All of the initiatives are focused on injury prevention and are intended to ensure that all employees return safety home at the end of every day.

Tucson Water continues integrating the 5 Star Safety System within its management practices with a goal of obtaining a 5 Star rating.

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