



# Managing Efficiencies

to Maximize  
Arizona's Resources

ARIZONA POWER AUTHORITY  
48TH ANNUAL REPORT 2006



“Common sense is not so common.”  
– Voltaire

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**COMMISSION**

JOHN I. HUDSON  
CHAIRMAN

DALTON H. COLE  
VICE-CHAIRMAN

MICHAEL C. FRANCIS  
DELBERT R. LEWIS  
RICHARD S. WALDEN



**ARIZONA POWER AUTHORITY**

1810 W. Adams Street • Phoenix, AZ 85007-2697  
(602) 542-4263 • FAX (602) 253-7970

**STAFF**

JOSEPH W. MULHOLLAND  
EXECUTIVE DIRECTOR

MICHAEL A. GAZDA  
DEPUTY DIRECTOR

RITA K. GALLANT  
EXECUTIVE SECRETARY

December 1, 2006

The Honorable  
Janet A. Napolitano  
Governor of Arizona  
State Capitol  
Ninth Floor, West Wing  
Phoenix, AZ 85007

Dear Governor:

On behalf of the Arizona Power Authority's Commissioners and staff, I submit the 48th Annual Report. This report details the Authority's operation and financial activities for the fiscal year ending June 30, 2006, and features the Authority's efforts in administering Arizona's hydroelectric power entitlement generated at the Hoover Dam and Power Plant located on the Colorado River. As you are aware, the Colorado River system is experiencing a severe drought cycle of seven years, one of the most severe in recorded history. This has adversely impacted the entire river system, including Lake Mead and other reservoirs.

As a result of the lowered levels of water impounded in Lake Mead, the amount of hydroelectric generation available to Arizona has been reduced by 13 percent from Arizona's contractual entitlement of 377 megawatts. The storage in Lake Mead is at approximately fifty-four percent (54%) of its capability. Nevertheless, the State's water and power entitlements, although at reduced levels of electric generation, are still available for the State's use. The Authority continues its aggressive and active involvement in the federal and state efforts to mitigate the drought impacts.

The Authority is also continuing to investigate opportunities for development of various renewable, electric power generating resources to assist our customers with greater diversity of electric power generation and reduce their dependency on fossil-fuel energy resources. These resources, if developed, would supplement the hydro resource and provide clean energy for Arizona.

Sincerely,

A handwritten signature in black ink, appearing to read 'John I. Hudson', is written over a horizontal line.

John I. Hudson, LT GENERAL, USMC (Ret.)  
Chairman

## REPORT OF THE COMMISSION

Effective management has always been a key to fulfilling the Arizona Power Authority's mandate to provide the citizens of Arizona with low cost power. Now more than ever the efficient administration of Arizona's federal hydroelectric power entitlement from Hoover Dam and Power Plant is essential. This includes monthly oversight and the application of comprehensive cost containment measures as well as exploring innovative approaches for delivering low-priced electric power for Arizona. In this way, the Authority remains focused on maximizing existing resources, as well as examining opportunities for leveraging new energy sources.



### **JOHN I. HUDSON, LT GENERAL, USMC (RET.) CHAIRMAN**

First appointed to the Arizona Power Authority Commission in March 2000, John I. Hudson was elected Chairman in January 2006 with his current term expiring in 2012. A retired Lieutenant General in the U.S. Marine Corps where he served for 37 years, John Hudson is a member of the Board of Directors of the Yuma Regional Medical Center. In addition, he is a member and past chairman of the Greater Yuma Port Authority Board of Directors, a founding Director of the Foothills Bank of Yuma, a member of the Foothills Rotary Club of Yuma and past president of Yuma's 78-CRIME Board of Directors.



### **DALTON H. COLE VICE-CHAIRMAN**

Appointed to the Commission in January 2002 for a term to run until 2008, Dalton Cole was elected to be the Vice-Chairman in January 2006. A retired businessman and farmer, a past member of the Central Arizona Water Conservation District Board, Mr. Cole co-founded and chaired the HoHoKam Irrigation District. For 18 years, he also served on the board of Electrical District No. 2 in Pinal County and is a past chairman. In addition, Mr. Cole is a past chairman of the State Board of Directors for Community Colleges. He has served on the Ground Water Management Committee for Pinal County, as well as advisory committees to the Arizona Legislature regarding water and power issues.



### **MICHAEL C. FRANCIS**

Starting his tenure on the Commission in 1999, Mr. Francis was selected Chairman in April 2003 and re-elected to this position in 2005. His current term expires in January 2008. In addition to his invaluable work on the Commission, Mr. Francis is a partner in Santa Lucia Farms, producer of over 3.7 million garden rose bushes annually. Mr. Francis also owns and operates Francis Insurance Agency, which insures Arizona and California farmers. Mr. Francis is a Board of Directors member of M&I Bank, Arizona Region. He is also a member of the American Rose Society.



### **DELBERT R. LEWIS**

First appointed to the Arizona Power Commission in April 2003, Delbert Lewis has been reappointed for a six-year term ending in January 2010. As one of the founders of KTVK Channel 3 and the CEO of MAC America Communications, Inc., Mr. Lewis' past and present civic affiliations include the Arizona Broadcasters Association, Metropolitan Phoenix Broadcasters, Phoenix Chamber of Commerce, Samaritan Health Services, Greater Phoenix Leadership, the National Conference, Maricopa County Sports Authority and Orpheum Theatre Foundation. Now farming 4,000 acres of farmland near Florence, Arizona. Mr. Lewis and his wife, Sharon, have been nationally recognized for their financial support and commitment to education and community service.



### **RICHARD S. WALDEN**

Appointed to the Commission in 1984 and re-appointed through his present term expiring in 2010, Mr. Walden is the President and CEO of Farmers Investment Company, a family-owned, pecan growing and processing company headquartered in Sahuarita, Arizona. Mr. Walden is a member of the Board of the International Tree Nut Council and in that capacity serves as the chairman of the Committee for Nutrition and Education associated with the Nutrition and Education Foundation. Mr. Walden is also a former member of the Advisory Council on Small Business and Agriculture for the Federal Reserve Bank of San Francisco and a member of the Board of the National Pecan Shellers Association.



## REPORT OF THE EXECUTIVE DIRECTOR

# THE ENERGY TO EXCEL

Energy is in the news and will no doubt remain there for the foreseeable future. Fluctuations in the availability and cost of energy directly influence Arizona's economy. So efficiency is at a premium as never before. At the Arizona Power Authority, this means maximizing resources and preparing now to meet the needs of the future.

Without a doubt, the Authority's most vital resource is its people. Recent years have seen considerable staff turnover, ushering in a younger, more energetic team who are truly qualified and motivated to excel. We're particularly pleased to welcome our new Deputy Director, Mike Gazda, previously with the Municipal Electric Authority of Georgia, who arrives with a great deal of experience and knowledge in power generation and transmission planning and operations.

As a team, we take great pride in understanding the challenges at hand and developing innovative approaches for meeting them. Professionalism is high and the commitment to serve our customers is taken personally. As a result, we have become a more able and responsive organization.

This year, the Arizona State Legislature extended the Authority's operating mandate through July 1, 2016. During the review process, the Legislature expressed strong interest in the Authority's performance, reflecting the heightened awareness regarding energy resources. In doing so, the Legislature acknowledged a more dynamic role for the Authority to play in the energy welfare of the state.

In keeping with this mission, the Authority is actively responding to on-going drought conditions throughout the Colorado River system. Lake Mead, which provides the water for generation at the Hoover Power Plant, is currently at 54% of its capacity. Water levels are at 1125 feet above sea level, whereas the 30-year average is about 1200 feet.

To mitigate these conditions and their impact on generation capacity, modifications are being implemented at Hoover's power plant. Improved turbines and associated equipment generate greater power per unit, thereby helping to offset the power lost from lower water levels. In addition, superior water flow systems have been implemented, to reduce friction and help maintain generation capacity.

In addition, the Authority is exploring the possibility of reducing transmission costs through a purchase in capacity from the Western Transmission System, which Western could use to reduce its debt service. The saving incurred would be passed on directly to our customers. The Authority is also exploring ways of integrating renewable energy resources, such as solar and wind, to complement Hoover power and ensure reliability.

Security remains a high priority as well. As a national icon, Hoover Dam requires comprehensive safety measures. New methodologies are being developed and implemented on a continuous basis, in order to remain ahead of any potential threats.

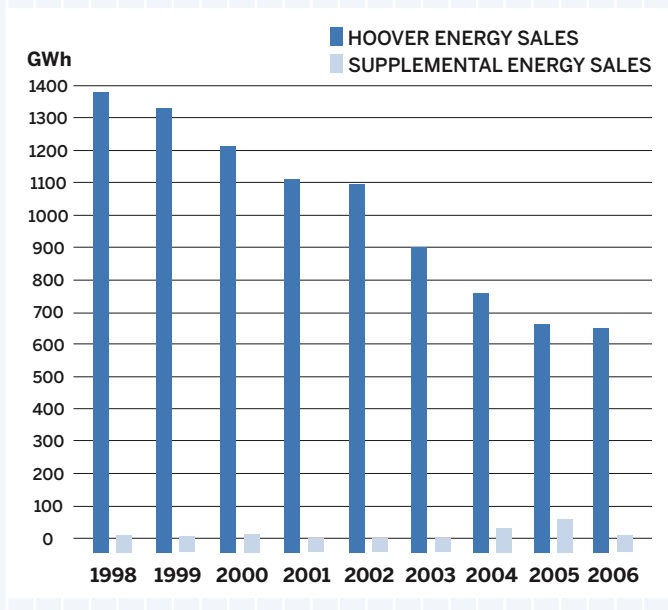
While the challenges are significant, the Authority has never been better positioned to meet them. As we address immediate needs of our customers, we continue to look forward as well, in order to ensure efficiency and stability for the long term.

"Experience is one thing you can't get for nothing."

— Oscar Wilde

## HISTORICAL ENERGY SALES

The following graph illustrates the Authority's historical energy sales (GWh) since 1998 for power obtained from the Hoover Power Plant and for supplemental sales. Supplemental power is obtained by the Authority for sale to customers on an "as requested" basis. This energy augments the customers' allocation from the Authority.



FISCAL YEAR	1998	1999	2000	2001	2002	2003	2004	2005	2006
HOOVER ENERGY	1,389	1,318	1,205	1,103	1,098	899	753	681	653
SUPPLEMENTAL ENERGY	3	2	4	0	0	0	23	38	6
TOTAL ENERGY	1,392	1,320	1,209	1,103	1,098	899	776	719	659

## OPERATIONS AND ENVIRONMENT

### COLORADO RIVER OPERATIONS

The Colorado River System experienced a "wet year" primarily in the lower basin through heavy rainfall in the mountains surrounding the various tributaries that drain into Lake Mead and other smaller reservoirs. As a result, deliveries to the International Boundary with Mexico were satisfied through these inflows, which allowed the entire 8.23 million acre feet of releases from the upper basin to be stored in Lake Mead, increasing its storage slightly. For water year 2007, the Secretary of the Interior has indicated that there may be some "partial domestic surpluses" available, which would provide more water to the Hoover generators and an increase in energy generation for the fifteen Hoover customers, including the Arizona Power Authority.

Although below normal inflow to the Colorado River Basin system continued through 2006, improvements to the efficiencies of the Hoover generators have been accelerated to mitigate the loss of capacity and total energy produced. In the last two years, two of the Hoover generating units have been overhauled with new, stainless-steel wicket gates resulting in about fourteen MW of increased capacity at the lower water levels, plus a substantial reduction of bypass water leakage.

During the 2006-2007 Winter overhaul period, two additional unit overhauls and two unit modifications are planned for a total of four units with improved capacities. These improvements will potentially add another thirty-three megawatts to the total Hoover capacity at lake levels below 1,145 feet, as well as substantial reductions in water leakage. Since Lake Mead levels historically are below 1,145 feet about 90% of the time, these improvements will benefit customers for many years to come.

### ENVIRONMENT

The voluntary Lower Colorado River Multi-Species Conservation Program is nearing the completion of its second year of the 50-year program. Many of the administrative procedural processes are completed and the focus is now centered on actual implementation of the program's objectives.

"It's not what you look at that matters, it's what you see."

— Henry David Thoreau

## SALE OF HYDRO POWER

<b>CUSTOMERS</b>	<b>AVERAGE BILLING DEMAND (KW)</b>	<b>ENERGY DELIVERED (KWH)</b>	<b>SALES (\$)</b>	<b>MILLS PER KWH</b>	<b>PRIOR YEAR ADJ. (\$)</b>
Aguila Irrigation District	4,964	9,128,000	\$ 242,489	26.57	(4,013)
Avra Valley Irrigation & Drainage District	497	2,215,000	\$ 49,846	22.50	(1,147)
Buckeye Water Conseration District	2,352	6,778,000	\$ 158,642	23.41	(2,394)
Central Arizona Water Conservation District	127,515	120,428,000	\$ 4,817,867	40.01	(107,266)
Chandler Heights Citrus Irrigation District	734	3,263,000	\$ 65,164	19.97	(841)
Cortaro-Marana Irrigation District	5,081	13,616,000	\$ 232,559	17.08	(956)
Electrical District No. 2, Pinal	15,348	52,205,000	\$ 1,178,980	22.58	(18,380)
Electrical District No. 3, Pinal	12,546	58,458,000	\$ 1,553,205	26.57	(19,378)
Electrical District No. 4, Pinal	15,348	61,228,000	\$ 1,202,709	19.64	(22,521)
Electrical District No. 5, Pinal	11,655	43,836,000	\$ 861,511	19.65	(16,114)
Electrical District No. 5, Maricopa	276	3,277,000	\$ 59,616	18.19	(1,437)
Electrical District No. 6, Pinal	6,320	17,607,000	\$ 351,830	19.98	(4,889)
Electrical District No. 7, Maricopa	8,285	16,521,000	\$ 391,543	23.70	(4,620)
Electrical District No. 8, Maricopa	19,096	44,029,000	\$ 1,114,549	25.31	(18,518)
Harquahala Valley Power District	1,964	7,481,000	\$ 169,124	22.61	(3,350)
Maricopa County Municipal Water District No. 1	6,976	21,547,000	\$ 488,666	22.68	(5,230)
McMullen Valley Water Conserv. & Drainage Dist.	7,173	13,187,000	\$ 344,520	26.13	(6,184)
Ocotillo Water Conservation District	1,886	11,892,000	\$ 224,253	18.86	(3,076)
Queen Creek Irrigation District	1,397	1,843,000	\$ 37,272	20.22	
Roosevelt Irrigation District	2,541	12,620,000	\$ 258,554	20.49	(3,906)
Roosevelt Water Conservation District	5,334	4,847,000	\$ 98,414	20.30	(225)
Salt River Project	30,609	101,351,000	\$ 2,250,600	22.21	(48,251)
San Tan Irrigation District	410	1,699,000	\$ 32,786	19.30	
Silverbell Irrigation & Drainage District	560	4,336,000	\$ 78,956	18.21	(1,534)
Tonopah Irrigation District	1,223	3,767,000	\$ 88,059	23.38	(1,495)
Wellton-Mohawk Irrigation & Drainage District	2,296	7,610,000	\$ 163,679	21.51	(1,157)
City of Page	821	848,000	\$ 18,473	21.78	
City of Safford	1,641	3,470,000	\$ 86,815	25.02	(310)
Town of Thatcher	828	1,855,000	\$ 45,836	24.71	(214)
Town of Wickenburg	1,807	1,816,000	\$ 50,848	28.00	
<b>TOTAL HYDRO POWER SALES</b>	297,483	652,758,000	\$ 16,717,365	\$22.69	\$ (297,406)
<b>PRIOR YEAR (OY-05) CUSTOMER REFUND ACCRUAL</b>					\$ (302,754)
<b>CURRENT FISCAL YEAR CUSTOMER REFUND ACCRUAL</b>					\$(1,201,939)
<b>TOTAL SUPPLEMENTAL POWER SALES</b>			\$ 5,950,918		
<b>OTHER ELECTRIC SERVICES INCOME*</b>			\$ 5,462,409 *		
<b>TOTAL POWER INCOME</b>			\$ 26,328,596		

\* Includes Administrative fees, facilities charges, late charges, and Scheduling Entity revenue.



## MANAGEMENT'S DISCUSSION AND ANALYSIS

The following is a discussion and analysis of the Arizona Power Authority's ("Authority") financial performance for the fiscal years ended June 30, 2006 and 2005. This discussion is designed to: (a) assist the reader in focusing on significant financial issues, (b) provide an overview of the Authority's financial activity, and (c) identify changes in the Authority's financial position.

The Management's Discussion and Analysis ("MD&A") focuses on the 2006 and 2005 fiscal year's activities, resulting changes and known facts, and should be read in conjunction with the Authority's annual report for the years ended June 30, 2006 and 2005.

This MD&A is an introduction to the basic financial statements of the Authority, which are comprised of two components.

- (1) Fund Financial Statements
- (2) Notes to the Financial Statements

The Fund Financial Statements begin on page 18 and provide detailed information about the individual funds. A fund is a fiscal and accounting entity with a self-balancing set of accounts that the Authority uses to keep track of specific sources of revenues and disbursements for specific purposes. The Authority's funds are treated as proprietary and are independent of each other. Most of the Authority's financial dealings are with contracts outside of state government. A separate fund is not maintained for government activities. The Authority does not act as a fiduciary.

### USING THIS ANNUAL REPORT

This annual report consists of a series of financial statements. The Statements of Net Assets, the Statements of Revenues, Expenses and Changes in Net Assets and the Statements of Cash Flows (on pages 18-21, respectively) provide information about the activities of the Authority as a whole and present a longer-term view of the Authority's finances. The Authority is a body, corporate and politic, of the State of Arizona and is a special-purpose government entity engaged only in business-type activities. Accordingly, the financial statements presented in this Annual Report are the required basic financial statements in accordance with the provisions of Governmental Accounting Standards Board Statement No. 34, *Basic Financial Statements – and Management's Discussion and Analysis – for State and Local Governments*.

### AUTHORITY HIGHLIGHTS

#### Scheduling Entity Agreement

The Authority and Salt River Project Agricultural Improvement and Power District were parties to a Scheduling Entity Agreement which expired on September 30, 2004, and provided for Salt River Project ("SRP") to pay the Authority \$8.4 million each year in return for allowing SRP to be the Scheduling Entity of the Hoover generation in Arizona. The new Agreement became effective as of October 1, 2004, provides for SRP to pay the Authority \$5.4 million each year, and expires on September 30, 2011. The effect of this agreement is that the energy banking program with SRP has been increased, to the advantage of our customers. However, because payment from SRP has been reduced by \$3.0 million each year, the rates for Hoover power increased accordingly.

#### Transmission Agreement

On January 24, 2003, the Authority and the Western Area Power Administration ("Western") entered into an agreement for the Advancement of Funds for Transmission Services. The Authority had an existing agreement with Western that provided for the delivery of power and energy. The agreement provides for the Authority to advance funds to Western on a monthly basis to fund operations, maintenance and replacement costs associated with Western's transmission services. For the years ended June 30, 2006 and 2005, the Authority advanced a net prepaid deposit of \$182,360, which is included in the Statements of Net Assets. This new contract gives Western greater flexibility and allows them to work more effectively with the Authority and other customers.

#### Contributions

During fiscal years 2006 and 2005, the Authority contributed \$60,000 via the Arizona Power Authority Scholarship Program. The following schools each received \$20,000: Arizona State University, The University of Arizona, and Northern Arizona University.

#### Funds

On January 1, 1971, new Hoover contracts between the Authority and its customers went into effect. At that time, previously earned funds from "steam sales" and other sales were placed into a fund identified as the APA Fund. Simultaneously, the Arizona Power Authority Commission established the Hoover Energy Fund to account for revenues and expenditures applicable to the sale and transmission of power and energy received by the Authority under its Hoover Energy Contract.

### **Effects of Drought on Hoover Energy**

The Colorado River Basin has been experiencing severe drought conditions for the past seven years. Although the drought conditions have mitigated in recent years, there has been a reduction in Lake Mead's storage and the power production at Hoover Dam. In response to customer requests, the Authority continues to purchase supplemental power to offset the reduced energy production at Hoover. The supplemental power costs are significantly higher than Hoover rates, and are passed directly to the requesting customers. These supplemental revenues and costs are reflected on the Authority's books, resulting in higher revenue and purchased power costs.

### **Arizona State Treasurer-Held Investment Write-off**

The Authority is statutorily required to invest funds through the Arizona State Treasurer ("Treasurer"), who has sole investment decision-making authority. In November 2002, the Authority was advised that one of the Treasurer's chosen investments managed by National Century Financial Enterprises was under investigation for fraud. In December 2002, the Authority was informed that the Treasurer was vitiating the investment in question, thereby reducing the value to zero. Since that time, litigation was initiated and continues. There is no guarantee that the litigation will result in the recovery of the Authority's funds, which total \$227,224. Therefore, the Authority wrote off the lost investment amount as of June 30, 2003. As of June 30, 2006, a total of \$88,785 has been recovered. In fiscal year 2006, \$62,702 was received and is presented as Other Income.

## **REVENUES**

### **Increase/Decrease in Commission-Approved Power Rates**

State statute requires the rates be set at levels to recover the cost of supplying service. In addition, contracts between the Authority and its customers provide specific details regarding rate determination. The Arizona Power Authority Commission is solely responsible for periodically adjusting rates, as appropriate. In response to the reduced power production from Hoover, and bond rating analysis, the Commission raised rates by 15% in February 2006.

### **Market Impacts on Investment Income**

Favorable market conditions during fiscal year 2006 resulted in an increase in interest rates, yielding greater investment income for the year.

### **Economic Drought Condition**

Although the drought condition in the Colorado River Basin continues, improvements at Hoover Dam have resulted in increased efficiency and increased capacity from the generators.

## **EXPENSES**

### **Introduction of New Programs**

There were no changes during this fiscal year; however, individual programs may be added or deleted to meet changing Authority needs.

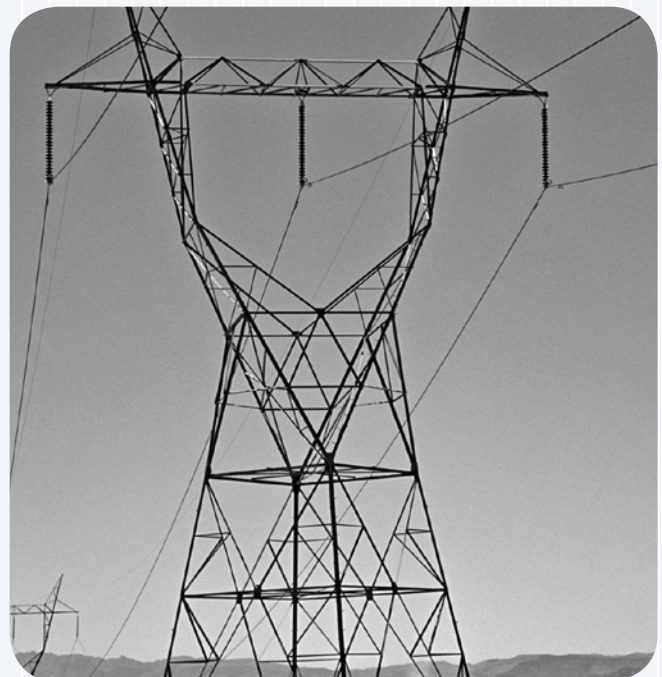
### **Increase/Decrease in Authorized Personnel**

Changes in the Authority's services may result in increasing/decreasing authorized staffing. Fiscal year 2006 staffing costs (salary and related benefits) represent 2.62% of the Authority's operating costs. For fiscal year 2005, staffing costs represent 2.60% of the Authority's operating costs.

### **Salary Structure**

#### **(cost of living, merit and market adjustment)**

The ability to attract and retain competent personnel requires the Authority to provide a competitive salary structure, which is reviewed annually, pursuant to State guidelines. During fiscal years 2006 and 2005, changes in staffing resulted in a net reduction in salaries.





## FINANCIAL HIGHLIGHTS

- The Authority's 2006 net assets increased by \$561,639, or 20.4%, due mainly to increased rates.
- The Authority's 2005 net assets decreased by \$773,807, or 21.9%, primarily due to the timing in prepaid purchased power usage.
- The Authority's 2006 operating revenues decreased by \$143,839, or 0.5%, due to accrual of fiscal year 2006 customer refunds.
- The Authority's 2005 operating revenues increased by \$1,026,668, or 4.0%, primarily due to increased supplemental power sales volume.

## STATEMENTS OF NET ASSETS

There are six normal transactions that will affect the comparability of the Statements of Net Assets summary presentation:

### Net Results of Activities

which will impact (increase/decrease) current assets and undesignated net assets.

### Borrowing for Capital

which will increase assets and long-term debt.

### Spending Borrowed Proceeds on New Capital

which will reduce current assets and increase capital assets. There is a second impact, an increase in invested capital assets and an increase in related net debt, which will not change the investment in capital assets, net of debt.

### Spending of Non-borrowed Current Assets on New Capital

which will (a) reduce current assets and increase capital assets, and (b) will reduce undesignated net assets and increase investment in capital assets, net of debt.

### Principal Payment on Debt

which will reduce current assets and reduce long-term debt.

### Reduction of Capital Assets through Depreciation

which will reduce capital assets and investment in capital assets, net of debt.



**CONDENSED STATEMENTS OF NET ASSETS  
BUSINESS TYPE ACTIVITIES**

	June 30,		Diff \$	Diff %
	2006	2005		
Current assets	\$ 1,377,025	\$ 1,155,522	\$ 2,215,503	19.2%
Long-term assets	49,307,084	52,113,652	(2,806,568)	(5.4%)
Capital assets, net	235,769	211,786	23,983	11.3%
Total assets	63,316,878	63,883,960	(567,082)	(0.9%)
Current liabilities	7,077,825	5,261,291	1,816,534	34.5%
Long-term (bonds payable, net)	52,921,922	55,867,177	(2,945,255)	(5.3%)
Total liabilities	59,999,747	61,128,468	(1,128,721)	(1.8%)
Net assets				
Invested in capital assets	235,769	211,786	23,983	11.3%
Unrestricted	3,081,362	2,543,706	537,656	21.1%
Total net assets	3,317,131	2,755,492	561,639	20.4%
Total liabilities and net assets	\$ 63,316,878	\$ 63,883,960	\$ (567,082)	(0.9%)

**FISCAL YEAR 2006 CONDENSED STATEMENTS  
OF NET ASSETS DISCUSSION**

**Current Assets**

Increased due to an increase in prepaid purchased power, increased accounts receivable, and an increase in the Debt Service cash account.

**Long-Term Assets**

Decreased because of a payment of principal for the current year Uprating Program.

**Capital Assets, Net**

Increased due to the investment in the new parking lot for the office building.

**Current Liabilities**

Increased due to an increase in amounts owed pursuant to power contracts at June 30, 2006 and an accrual for fiscal year 2006 customer refunds.

**Long-Term Liabilities**

Decreased due to a pay down of the bond principal. See further explanation on page 12.

**Net Assets**

Are explained on page 13 and 14.



**CONDENSED STATEMENTS OF NET ASSETS  
BUSINESS TYPE ACTIVITIES**

	June 30,		Diff \$	Diff %
	2005	2004		
Current assets	\$ 11,558,522	\$ 13,045,876	\$ (1,487,354)	(11.4%)
Long-term assets	52,113,652	54,296,784	(2,183,132)	(4.0%)
Capital assets, net	211,786	159,403	52,383	32.9%
Total assets	63,883,960	67,502,063	(3,618,103)	(5.4%)
Current liabilities	5,261,291	5,421,283	(159,992)	(3.0%)
Long-term (bonds payable, net)	55,867,177	58,551,481	(2,684,304)	(4.6%)
Total liabilities	61,128,468	63,972,764	(2,844,296)	(4.4%)
Net assets				
Invested in capital assets	211,786	159,403	52,383	32.9%
Unrestricted	2,543,706	3,369,896	(826,190)	(24.5%)
Total net assets	2,755,492	3,529,299	(773,807)	(21.9%)
Total liabilities and net assets	\$ 63,883,960	\$ 67,502,063	\$ (3,618,103)	(5.4%)

**FISCAL YEAR 2005 CONDENSED STATEMENTS  
OF NET ASSETS DISCUSSION**

**Current Assets**

Decreased due to a reduction in prepaid purchased power and an increase in customer refunds, which resulted in a reduction in cash.

**Long-Term Assets**

Decreased because of a payment of principal for the current year Uprating Program.

**Capital Assets**

Net increased due to additions of new air conditioning units for the office building, a new circuit breaker and a right-of-way easement for the E.D. #5 substation. See further explanation on page 12.

**Current Liabilities**

Decreased due to a reduction in amounts owed pursuant to power contracts at June 30, 2005.

**Long-Term Liabilities**

Decreased due to a pay down of the bond principal. See further explanation on page 12.

**Net Assets**

Are explained on pages 13 and 14.

## CAPITAL ASSETS

As of June 30, 2006 and 2005, the Authority had \$235,769 and \$211,786, respectively, invested in a variety of capital assets, as reflected in the following schedule, which represents a net increase (additions less retirements and depreciation) of \$23,983, or 11.3% during fiscal year 2006 and a net increase of \$52,383 or 32.9% during fiscal year 2005.

	<u>June 30, 2006</u>	<u>June 30, 2005</u>
Transmission plant	\$ 27,464	\$ 30,516
Distribution plant	31,757	40,482
General plant - office	176,548	140,788
Invested in capital assets, end of year	<u>\$ 235,769</u>	<u>\$ 211,786</u>

The following reconciliation summarizes the change in Capital Assets for the years ended June 30, 2006 and 2005, which is presented in detail on page 25 of the Notes to the Financial Statements:

	<u>June 30, 2006</u>	<u>June 30, 2005</u>
Beginning balance	\$ 211,786	\$ 159,403
Additions	64,248	98,420
Disposals	-	(5,013)
Depreciation	(40,265)	(41,024)
Ending balance	<u>\$ 235,769</u>	<u>\$ 211,786</u>

## DEBT OUTSTANDING

As of June 30, 2006, the Authority had \$54,960,000 in debt outstanding, compared to \$57,520,000 in the prior year, as a result of the payment of a principal payment of \$2,560,000, which was paid on October 1, 2005. As of June 30, 2005, the Authority had \$57,520,000 in debt outstanding, compared to \$60,065,000 in the prior year, as a result of the payment of a principal payment of \$2,545,000, which was paid on October 1, 2004. Also see page 26 of the Notes to the Financial Statements for a detailed summary of debt activity during the year.

## LIQUIDITY

Pursuant to Arizona Revised Statutes (A.R.S.) Section 30-124, the Commission of the Authority shall establish electric rates to include such price components as are necessary to maintain the Authority, to provide and maintain reasonable working capital and depreciation and other necessary and proper reserves. Components that are necessary to maintain the Authority include employee payroll, occupancy costs, cost of purchases or construction of generation and transmission services, and any cost factors chargeable to the cost of providing service as the Commission deems necessary or advisable to establish and maintain the financial integrity of the Authority. Contracts for sale of electric power to the Authority's customers include rates which may be modified upon 24-hour notice when such action is necessary in the sole judgment of the Commission in order to achieve the purposes of A.R.S. Section 30-124. The Commission, on a monthly basis, reviews the financial status of the Authority, including expenses and revenues and the adequacy of the rates to maintain the Authority's financial integrity.





## STATEMENTS OF REVENUES, EXPENSES, AND CHANGES IN NET ASSETS

There are normal transactions that will affect the comparability of the Statements of Changes in the Net Assets summary presentation:

### Operating Revenues

Which increase/decrease as a result of economic conditions and power usage.

### Operating Expenses

Which increase/decrease as a result of purchased power costs, transmission costs, and operating costs.

### Other Income (Deductions)

Which increase/decrease as a result of investment market conditions.

## STATEMENTS OF REVENUES, EXPENSES, AND CHANGES IN NET ASSETS BUSINESS TYPE ACTIVITIES

	June 30,		Diff \$	Diff %
	2006	2005		
Operating revenues	\$ 26,328,596	\$ 26,472,435	\$ (143,839)	(0.5%)
Operating expenses				
Purchased power	19,404,200	20,805,429	(1,401,229)	(6.7%)
Western credits	(5,167,368)	(5,119,484)	(47,884)	0.9%
Amortization of Hoover Upgrading Program costs	5,167,368	5,119,484	47,884	0.9%
Transmission and distribution	5,258,886	5,256,841	2,045	0.0%
Administrative and general	1,405,247	1,348,146	57,101	4.2%
Depreciation	40,265	41,024	(759)	(1.9%)
Other	109,518	70,837	38,681	54.6%
Total operating expenses	26,218,116	27,522,277	(1,304,161)	( 4.7%)
Operating income (loss)	110,480	(1,049,842)	1,160,322	110.5%
Other (deductions) income				
Interest expense	(2,862,363)	(2,990,812)	128,449	(4.3%)
Deferred interest expense	2,347,319	2,520,052	(172,733)	(6.9%)
Amortization	120,255	124,304	(4,049)	(3.3%)
Interest income	750,465	596,597	153,868	25.8%
Other, net	95,483	25,894	69,589	268.7%
Total other (deductions) income	451,159	276,035	175,124	63.4%
Change in net assets	561,639	(773,807)	1,335,446	172.6%
Net assets, beginning of year	2,755,492	3,529,299	(773,807)	(21.9%)
Net assets, end of year	\$ 3,317,131	\$ 2,755,492	\$ 561,639	20.4%

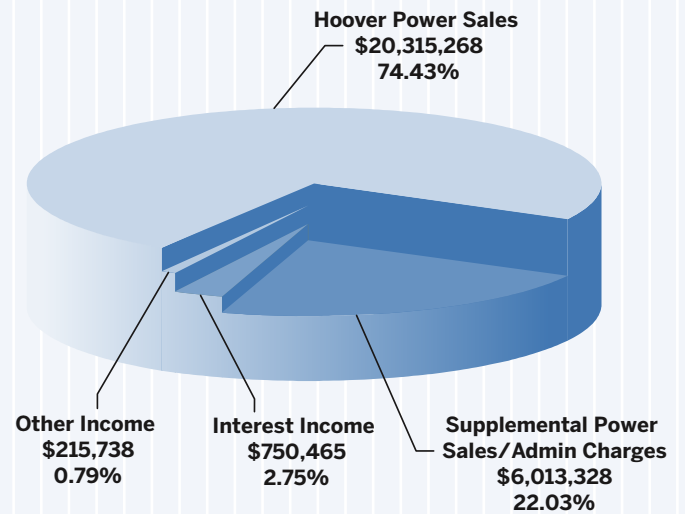
## FISCAL YEAR 2006 CHANGES IN NET ASSETS DISCUSSION

### Net Assets increased overall because of the following:

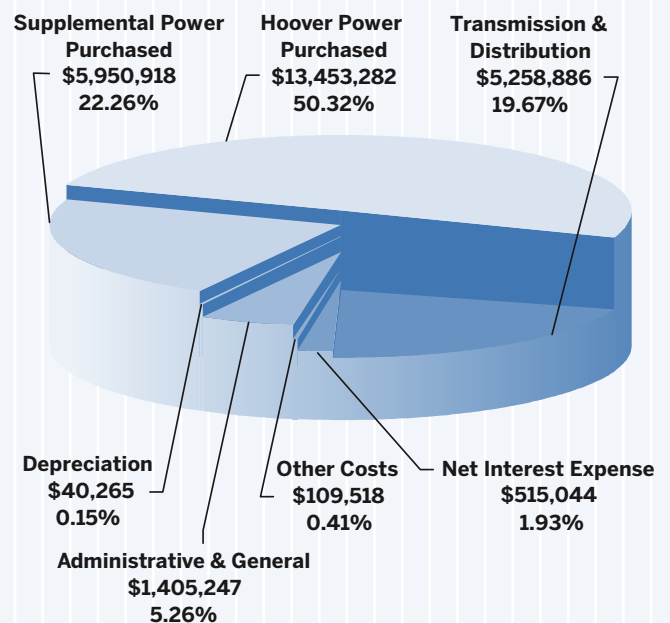
- Operating Revenues decreased due to the accrual of fiscal year 2006 customer refunds.
- Total Operating Expenses decreased due to a decrease in purchased power.
- Western Credits increased because of changes in debt payments and associated costs related to the Uprating Program.
- Amortization of the Uprating Program increased because of the increase in the amortization of long-term bond costs.
- Administrative and General expenses increased due to Lower Colorado River Multi-Species Conservation Program (MSCP) expenses.
- Depreciation decreased due to the normal attrition of capital assets.
- Other expenses increased due to the initiation of special expenses, such as the Colorado River Legal Defense Fund and National Renewable Energy Laboratory (NREL).



### 2006 REVENUES



### 2006 EXPENSES





## STATEMENTS OF REVENUES, EXPENSES, AND CHANGES IN NET ASSETS

There are basic or normal transactions that will affect the comparability of the Statements of Changes in the Net Assets summary presentation:

### Operating Revenues

Which increase/decrease as a result of economic conditions and power usage.

### Operating Expenses

Which increase/decrease as a result of purchased power rates, transmission costs, and operating costs.

### Other Income (Deductions)

Which increase/decrease as a result of investment market conditions.

## STATEMENTS OF REVENUES, EXPENSES, AND CHANGES IN NET ASSETS BUSINESS TYPE ACTIVITIES

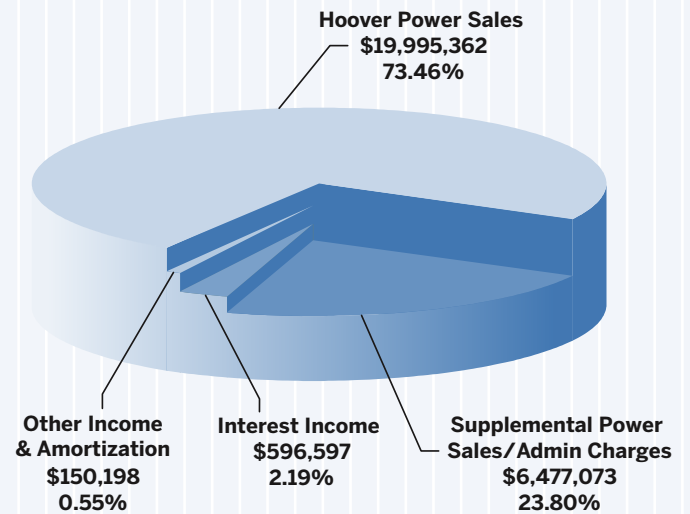
	June 30,		Diff \$	Diff %
	2005	2004		
Operating revenues	\$ 26,472,435	\$ 25,445,767	\$ 1,026,668	4.0%
Operating expenses				
Purchased power	20,805,429	18,014,692	2,790,737	15.5%
Western credits	(5,119,484)	(5,224,715)	105,231	(2.0%)
Amortization of Hoover Upgrading Program costs	5,119,484	5,224,715	(105,231)	(2.0%)
Transmission and distribution	5,256,841	5,247,155	9,686	0.2%
Administrative and general	1,348,146	1,564,083	(215,937)	(13.8%)
Depreciation	41,024	35,870	5,154	14.4%
Other	70,837	102,322	(31,485)	(30.8%)
Total operating expenses	27,522,277	24,964,122	2,558,155	10.2%
Operating income (loss)	(1,049,842)	481,645	(1,531,487)	(318.0%)
Other (deductions) income				
Interest expense	(2,990,812)	(3,209,937)	219,125	(6.8%)
Deferred interest expense	2,520,052	2,735,366	(215,314)	(7.9%)
Amortization	124,304	47,177	77,127	163.5%
Interest income	596,597	541,265	55,332	10.2%
Other	25,894	2,882	23,012	798.5%
Total other (deductions) income	276,035	116,753	159,282	136.4%
Change in net assets	(773,807)	598,398	(1,372,205)	(229.3%)
Net assets, beginning of year	3,529,299	2,930,901	598,398	20.4%
Net assets, end of year	\$ 2,755,492	\$ 3,529,299	\$ (773,807)	(21.9%)

## FISCAL YEAR 2005 CHANGES IN NET ASSETS DISCUSSION

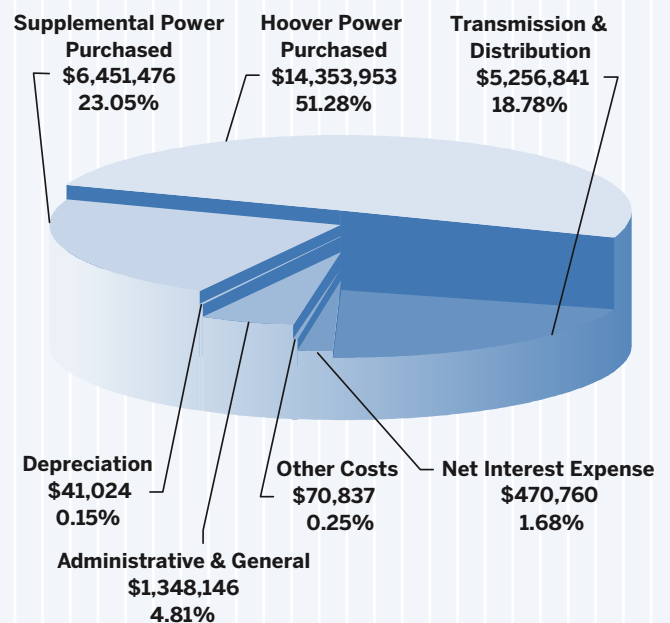
### Net Assets decreased overall because of the following:

- Operating Revenues increased as a result of increased supplemental power sales.
- Total Operating Expenses increased due to an increase in purchased power costs.
- Western credits decreased because of changes in debt payments and associated costs related to the Uprating Program.
- Amortization of the Uprating Program increased because of the increase in the amortization of long-term bond costs.
- Administrative and general expenses decreased due to a reduction in annual report expenses, reduction in Commission and staff travel, payroll costs, and a reduction of legal expenses.
- Depreciation increased because additional capital assets were acquired (such as new air conditioning units for the office building, a new circuit breaker and a right-of-way easement for the ED #5 substation).
- Other operating expenses decreased due to reduced costs in connection with utility organizations, such as WestConnect, which is an independent system operator-type organization that has suspended further development.

### 2005 REVENUES



### 2005 EXPENSES





## REPORT OF THE INDEPENDENT ACCOUNTANTS

To the Arizona Power Authority Commission

In our opinion, the accompanying statements of net assets and the related statements of revenues, expenses, and changes in net assets, and statements of cash flows present fairly, in all material respects, the financial position of the Arizona Power Authority (the "Authority") (A Body, Corporate and Politic, of the State of Arizona) at June 30, 2006 and 2005, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America. These financial statements are the responsibility of the Authority's management. Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits of these statements in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audits 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, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

The accompanying management's discussion and analysis is not a required part of the financial statements but is supplementary information required by the Governmental Accounting Standards Board. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the supplementary information. However, we did not audit the information and express no opinion on it.

*PricewaterhouseCoopers LLP*

November 21, 2006

## FINANCIAL STATEMENTS

### STATEMENTS OF NET ASSETS JUNE 30, 2006 AND 2005

	APA General Fund		Hoover Upgrading Fund		Total	
	2006	2005	2006	2005	2006	2005
<b>Assets</b>						
Current assets						
Cash and cash equivalents	\$ 3,517,969	\$ 3,619,626	\$ 2,457,591	\$ 1,973,165	\$ 5,975,560	\$ 5,592,791
Investments held by Trustee	-	-	2,818,376	2,426,277	2,818,376	2,426,277
Accounts receivable, customer power purchases	598,577	464,188	2,349,602	2,181,432	2,948,179	2,645,620
Interest receivable	20,331	15,477	128,733	122,963	149,064	138,440
Other assets	170,063	50,702	-	-	170,063	50,702
Prepaid purchased power	-	-	1,712,783	704,692	1,712,783	704,692
Total current assets	4,306,940	4,149,993	9,467,085	7,408,529	13,774,025	11,558,522
Capital assets, net	235,769	211,786	-	-	235,769	211,786
Investments held by Trustee	-	-	6,546,569	6,766,682	6,546,569	6,766,682
Advances for Hoover Upgrading Program, net	-	-	42,578,155	45,164,610	42,578,155	45,164,610
Prepaid transmission	182,360	182,360	-	-	182,360	182,360
Total assets	\$ 4,725,069	\$ 4,544,139	\$ 58,591,809	\$ 59,339,821	\$ 63,316,878	\$ 63,883,960
<b>Liabilities</b>						
Current liabilities						
Accounts payable and other	\$ 15,440	\$ 33,640	\$ 96,239	\$ 112,920	\$ 111,679	\$ 146,560
Customer refunds	-	-	1,504,693	-	1,504,693	-
Power contracts payable	593,456	461,973	1,335,405	1,353,166	1,928,861	1,815,139
Accrued interest payable	-	-	707,592	739,592	707,592	739,592
Bonds payable	-	-	2,825,000	2,560,000	2,825,000	2,560,000
Total current liabilities	608,896	495,613	6,468,929	4,765,678	7,077,825	5,261,291
Bonds payable	-	-	52,135,000	54,960,000	52,135,000	54,960,000
Premium (discounts) on bonds payable	-	-	2,474,561	2,852,699	2,474,561	2,852,699
Deferred amounts, net	-	-	(1,687,639)	(1,945,522)	(1,687,639)	(1,945,522)
Bonds payable, net	-	-	52,921,922	55,867,177	52,921,922	55,867,177
Total liabilities	\$ 608,896	\$ 495,613	\$ 59,390,851	\$ 60,632,855	\$ 59,999,747	\$ 61,128,468
<b>Net Assets</b>						
Invested in capital assets	\$ 235,769	\$ 211,786	\$ -	\$ -	\$ 235,769	\$ 211,786
Unrestricted	3,880,404	3,836,740	(799,042)	(1,293,034)	3,081,362	2,543,706
Total net assets	4,116,173	4,048,526	(799,042)	(1,293,034)	3,317,131	2,755,492
Total liabilities and net assets	\$ 4,725,069	\$ 4,544,139	\$ 58,591,809	\$ 59,339,821	\$ 63,316,878	\$ 63,883,960

The accompanying notes are an integral part of these financial statements.



## FINANCIAL STATEMENTS

### STATEMENTS OF REVENUES, EXPENSES AND CHANGES IN NET ASSETS JUNE 30, 2006 AND 2005

	APA General Fund		Hoover Uprating Fund		Total	
	2006	2005	2006	2005	2006	2005
<b>Operating revenues</b>	\$ 6,013,328	\$ 6,477,073	\$ 20,315,268	\$ 19,995,362	\$ 26,328,596	\$ 26,472,435
<b>Operating expenses</b>						
Purchased power	5,950,918	6,451,476	13,453,282	14,353,953	19,404,200	20,805,429
Western credits	-	-	(5,167,368)	(5,119,484)	(5,167,368)	(5,119,484)
Amortization of Hoover Uprating Program costs	-	-	5,167,368	5,119,484	5,167,368	5,119,484
Transmission and distribution	324	18,946	5,258,562	5,237,895	5,258,886	5,256,841
Administrative and general	70,558	67,666	1,334,689	1,280,480	1,405,247	1,348,146
Depreciation	40,265	41,024	-	-	40,265	41,024
Other	82,899	40,110	26,619	30,727	109,518	70,837
Total operating expenses	6,144,964	6,619,222	20,073,152	20,903,055	26,218,116	27,522,277
Operating income (loss)	(131,636)	(142,149)	242,116	(907,693)	110,480	(1,049,842)
Other (deductions) income						
Interest expense	-	-	(2,862,363)	(2,990,812)	(2,862,363)	(2,990,812)
Deferred interest expense	-	-	2,347,319	2,520,052	2,347,319	2,520,052
Amortization	-	-	120,255	124,304	120,255	124,304
Interest income	131,356	69,361	619,109	527,236	750,465	596,597
Other	67,927	15,777	27,556	10,117	95,483	25,894
Total other (deductions) income	199,283	85,138	251,876	190,897	451,159	276,035
Changes in net assets	67,647	(57,011)	493,992	(716,796)	561,639	(773,807)
Net assets, beginning of year	4,048,526	4,105,537	(1,293,034)	(576,238)	2,755,492	3,529,299
Net assets, end of year	\$ 4,116,173	\$ 4,048,526	\$ ( 799,042)	\$ ( 1,293,034)	\$ 3,317,131	\$ 2,755,492

The accompanying notes are an integral part of these financial statements.

## FINANCIAL STATEMENTS

### STATEMENTS OF CASH FLOWS JUNE 30, 2006 AND 2005

	APA General Fund		Hoover Uprating Fund		Total	
	2006	2005	2006	2005	2006	2005
<b>Cash flows from operating activities</b>						
Cash received from customers	\$ 5,759,578	\$ 6,666,029	\$ 21,651,791	\$ 19,950,426	\$ 27,411,369	\$ 26,616,455
Cash payments to suppliers for goods or services	(5,991,416)	(6,783,401)	(20,512,553)	(19,407,140)	(26,503,969)	(26,190,541)
Cash payments to employees for services	-	-	(603,132)	(612,545)	(603,132)	(612,545)
Net cash provided by (used in) operating activities	(231,838)	(117,372)	536,106	(69,259)	304,268	(186,631)
<b>Cash flows from capital and related financing activities</b>						
Interest payments on bonds payable	-	-	(2,894,363)	(3,023,260)	(2,894,363)	(3,023,260)
Payments on bonds payable	-	-	(2,560,000)	(2,545,000)	(2,560,000)	(2,545,000)
Acquisition of capital assets	(64,248)	(98,420)	-	-	(64,248)	(98,420)
Advances for Hoover Uprating Program	-	-	4,933,774	4,923,316	4,933,774	4,923,316
Net cash provided by (used in) capital and related financing activities	(64,248)	(98,420)	(520,589)	(644,944)	(584,837)	(743,364)
<b>Cash flows from investing activities</b>						
Interest on investments	194,429	77,479	640,895	531,952	835,324	609,431
Purchase of investments	-	-	(7,467,429)	(10,429,978)	(7,467,429)	(10,429,978)
Proceeds from sale and maturities of investments	-	-	7,295,443	10,437,032	7,295,443	10,437,032
Net cash provided by (used in) investing activities	194,429	77,479	468,909	539,006	663,338	616,485
Net change in cash and cash equivalents	(101,657)	(138,313)	484,426	(175,197)	382,769	(313,510)
Cash and cash equivalents, beginning of year	3,619,626	3,757,939	1,973,165	2,148,362	5,592,791	5,906,301
Cash and cash equivalents, end of year	\$ 3,517,969	\$ 3,619,626	\$ 2,457,591	\$ 1,973,165	\$ 5,975,560	\$ 5,592,791

The accompanying notes are an integral part of these financial statements.



# FINANCIAL STATEMENTS

## STATEMENTS OF REVENUES, EXPENSES AND CHANGES IN NET ASSETS (CONTINUED) JUNE 30, 2006 AND 2005

	APA General Fund		Hoover Upgrading Fund		Total	
	2006	2005	2006	2005	2006	2005
<b>Reconciliation of operating income (loss) to net cash provided by (used in) operating activities</b>						
Operating income (loss)	\$ (131,636)	\$ (142,149)	\$ 242,116	\$ (907,693)	\$ 110,480	\$ (1,049,842)
Adjustments to reconcile operating income (loss) to net cash provided by (used in) operating activities						
Depreciation	40,265	41,024	-	-	40,265	41,024
Loss on disposal of capital asset	-	5,013	-	-	-	5,013
Changes in assets and liabilities						
(Increase) decrease in accounts receivable	(134,389)	231,770	(168,170)	(44,936)	(302,559)	186,834
(Increase) decrease in other assets	(119,361)	(42,814)	-	-	(119,361)	(42,814)
(Increase) decrease in prepaid purchased power	-	-	(1,008,091)	815,698	(1,008,091)	815,698
Increase (decrease) in accounts payable and other	(18,200)	21,033	(16,681)	13,238	(34,881)	34,271
Increase (decrease) in customer refunds	-	-	1,504,693	-	1,504,693	-
Increase (decrease) in power contracts payable	131,483	(231,249)	(17,761)	54,434	113,722	(176,815)
Total adjustments	(100,202)	24,777	293,990	838,434	193,788	863,211
Net cash provided by (used in) operating activities	\$ (231,838)	\$ (117,372)	\$ 536,106	\$ (69,259)	\$ 304,268	\$ (186,631)
<b>Supplemental schedule of noncash capital and related financing activities</b>						
Deferred interest expense	\$ -	\$ -	\$ 2,347,319	\$ 2,520,052	\$ 2,347,319	\$ 2,520,052
<b>Supplemental schedule of cash paid for interest</b>						
	\$ -	\$ -	\$ 2,894,363	\$ 3,023,260	\$ 2,894,363	\$ 3,023,260

The accompanying notes are an integral part of these financial statements.

# NOTES TO FINANCIAL STATEMENTS

## 1. DESCRIPTION OF BUSINESS AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

### Description of Business

The Arizona Power Authority (the "Authority") is a body, corporate and politic, without taxing power, established by the Arizona Legislature on May 27, 1944 by the Power Authority Act. Under the Power Authority Act, the Authority is directed to obtain electric power developed from the mainstream of the Colorado River and sell such power to certain qualified purchasers. The Power Authority Act provides that the Authority must be a self-supporting agency and prohibits the Authority from incurring any obligation, which would be binding upon the State of Arizona.

The Authority supplies capacity and energy on a wholesale basis to certain power purchasers in the State of Arizona. The Authority's primary source of power and energy is the Hoover Power Plant at Hoover Dam, located approximately 25 miles from Las Vegas, Nevada. Hoover power is produced by the Boulder Canyon Project hydropower plant owned by the Bureau of Reclamation. Hoover Dam is the highest and third largest concrete dam in the United States of America. Hoover Dam was dedicated in 1935 and the first generator of the Hoover Power Plant was in full operation in October 1936 and has been in continuous operation since. Power and energy from the Hoover Power Plant is transmitted to load centers in Arizona, California and Nevada. The Authority first contracted for Arizona's share of Hoover power in 1952 and has continuously provided power and energy to its customers since that time.

The Authority is governed by a commission of five members appointed by the Governor and approved by the Senate (the "Commission"). The term of office for each member is six years and the members select a chairman and vice-chairman from among its membership for two-year terms.

Pursuant to Arizona law, the Commission serves as the Authority's regulatory body with the exclusive authority to establish electric prices. The Authority is required to follow certain procedures, pertaining to public notice requirements and public meetings, before implementing changes in electric price schedules.

### Measurement Focus

The Authority's funds are accounted for on a flow of economic resources measurement focus. All assets and liabilities (whether current or noncurrent) associated with their activity are included in the Statements of Net Assets. The Statements of Revenues, Expenses and Changes in Net Assets

present increases (revenues) and decreases (expenses) in total net assets. The Authority's reported total net assets are segregated into invested in capital assets and unrestricted components.

### Basis of Accounting

Basis of Accounting refers to the time at which revenues and expenses are recognized in the accounts and reported in the financial statements, regardless of the measurement focus applied. The accrual basis of accounting is used by the Authority whereby revenues are recognized in the accounting period in which they are earned and become measurable, and expenses are recognized when incurred.

The accompanying financial statements are presented in conformity with accounting principles generally accepted in the United States of America ("GAAP"). The accompanying financial statements have been prepared in accordance with the reporting model defined by Governmental Accounting Standards Board ("GASB") Statement No. 34, *Basic Financial Statements - and Management's Discussion and Analysis - for State and Local Governments*, as amended by GASB Statement No. 37, *Basic Financial Statements and Management's Discussion and Analysis - for State and Local Governments: Omnibus - an Amendment of GASB Statements No. 21 and No. 34*, and GASB Statement No. 38, *Certain Financial Statement Note Disclosures*.

### Accounting Standards

GASB No. 20, *Accounting and Financial Reporting for Proprietary Funds and Other Governmental Entities That Use Proprietary Fund Accounting*, requires that governments' proprietary activities apply all GASB pronouncements as well as pronouncements issued on or before November 30, 1989, unless those pronouncements conflict with or contradict GASB pronouncements, Financial Accounting Standards Board ("FASB") Statements and Interpretations, Accounting Principles Board Opinions and Accounting Research Bulletins. Governments are given the option 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. The Authority has elected not to implement FASB Statements and Interpretations issued after November 30, 1989.



## NOTES TO FINANCIAL STATEMENTS

### New Accounting Pronouncements

In July 2004, the GASB published Statement No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions*. This Statement establishes standards for the measurement, recognition, and display of OPEB expense/expenditures and related liabilities (assets), note disclosures, and, if applicable, required supplementary information (RSI) in the financial reports of state and local governmental employers. GASB Statement No. 45 is effective for fiscal periods beginning after December 15, 2007. The Authority believes the implementation of GASB Statement No. 45 will not have an impact on the financial statements.

In September 2006, the GASB published Statement No. 48, *Sales and Pledges of Receivables and Future Revenues and Intra-Entity Transfers of Assets and Future Revenues*. This Statement establishes accounting and financial reporting standards for transactions in which a government receives, or is entitled to, resources in exchange for future cash flows generated by collecting specific receivables or specific future revenues. It also contains provisions that apply to certain situations in which a government does not receive resources but, nevertheless, pledges or commits future cash flows generated by collecting specific future revenues. This Statement is effective for financial statements for periods beginning after December 15, 2006. GASB No. 48 is currently being evaluated by the Authority.

### Revenue Recognition

The Authority recognizes revenue when power is delivered to the customers.

### Cash and Cash Equivalents

The Authority treats short-term temporary cash investments with original maturities, when purchased, of three months or less as cash equivalents.

All cash and cash equivalent balances are maintained by the State of Arizona Treasurer within the Local Government Investment Pool ("LGIP"). The LGIP is not registered with the Securities and Exchange Commission and investments are not subject to custodial credit risk. The State Board of Investment conducts monthly reviews of investment activity and performance. LGIP amounts are carried at fair value. Participant shares are purchased and sold based on the Net Asset Value ("NAV") of the shares. The NAV is determined by dividing the fair value of the portfolio by the total shares outstanding.

### Capital Assets and Depreciation

Capital assets are stated at original cost less accumulated depreciation. Depreciation is provided on the straight-line method based on the estimated useful lives of the property items, which range from 3 to 20 years. The costs of additions and replacements are capitalized. Repairs and maintenance are charged to expense as incurred. Retirements, sales and disposals are recorded by removing the cost and accumulated depreciation from the asset and accumulated depreciation accounts with any resulting gain or loss reflected in Other within the Statements of Revenues, Expenses and Changes in Net Assets. Assets are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount may not be recoverable. If the fair value is less than the carrying amount of the asset, a loss is recognized for the difference.

### Advances for Hoover Upgrading Program

Proceeds from bonds payable were advanced by the Authority for upgrading the Hoover Power Plant and are recorded as advances. Such advances, including debt issue costs, plus net interest expense incurred by the Authority are reimbursed in the form of credits on the monthly power bills rendered by the Western Area Power Administration of the Department of Energy ("Western"). These credits are issued over the 30-year life of the bonds. Substantially all advances, net interest expense and other related costs on the bonds are charged to the Upgrading Program as amounts to be recovered from future credits.

### Schedule C Energy

Under its Electric Service Contract with Western, the Authority has preferential rights to excess energy ("Schedule C energy") generated at the Hoover Power Plant. The Authority buys Schedule C energy when available from Western during an operating year (October 1 to September 30). The Authority's financial statements are prepared on a fiscal year (July 1 to June 30) basis. When excess energy is available, the Authority bills its customers as Schedule C energy is delivered and receives payment during a given operating year, but Western does not bill for the cost of such Schedule C energy until the following operating year. An estimate of such amounts is accrued at the end of the fiscal year. The Statements of Net Assets as of June 30, 2006 and 2005 has a \$0 accrual for Schedule C energy, as no Schedule C energy was available during the operating years.

### Operating Revenues

Operating revenues are derived from the sale of power to customers or from other contractual agreements. Operating revenues include \$5,400,000 and \$6,150,000 received

## NOTES TO FINANCIAL STATEMENTS

from Salt River Project for scheduling entity services during the years ended June 30, 2006 and 2005, respectively. The revenues are the result of an agreement between the Authority and the Salt River Project which will yield \$5,400,000 annual revenues to the Authority thereby reducing the overall revenue requirements to be paid by the Authority's customers through power rates. The agreement will expire on September 30, 2011.

### Application of Net Assets to Expenses Incurred

The Authority applies unrestricted, undesignated net assets to expenses incurred. To the extent undesignated net assets are unavailable, unrestricted, designated net assets will be applied to expenses incurred.

### Customer Credits

The Authority operates on a nonprofit basis and reduces charges to its customers through credits on power bills or checks to customers, for any revenues in excess of expenses after the close of the operating year. Likewise, the Authority bills its customers for any deficit in revenues versus expenses incurred during the operating year.

Refunds of \$297,405 and \$1,024,562 were paid to the customers during the years ended June 30, 2006 and 2005, respectively.

During the year ended June 30, 2006, the accrued amount to be refunded to the customers was \$1,504,693.

### Income Taxes

The Authority is exempt from federal and Arizona state income taxes. Accordingly, no provision for income taxes has been recorded for the Authority in the accompanying financial statements.

### 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 that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from these estimates.

Current liabilities include customer refunds of \$1,504,693 for fiscal year 2006.

### Geographic and Product Concentration

The Authority's revenues are derived from the sale of electrical power and services to water districts, electrical and irrigation

districts, and cities, which represent contracted customers in the state of Arizona. The Hoover Upgrading Fund is used to purchase electric power solely from Western. The Authority's APA General Fund is used to purchase electric power from various providers.

## 2. FUND ACCOUNTING

### Hoover Upgrading Fund

The Hoover Power Plant Act of 1984 ("Hoover Act") authorized the U.S. government to increase the capacity of existing generating equipment at the Hoover Dam Power Plant ("Upgrading Program"). Instead of appropriating further federal funds for the Upgrading Program, Congress implemented an advancement of funds procedure whereby prospective nonfederal purchasers of the upgraded Hoover capacity and associated energy contribute to the financing of the Upgrading Program. The Upgrading Program was determined to be complete in September 1995. The Authority financed a portion of the total Upgrading Program by issuing bonds.

The Hoover Upgrading Fund accounts for advances by the Authority in connection with the Upgrading Program. Effective June 1, 1987, the Authority executed new power contracts with Western and its customers which expire in 2017. The revenues and expenditures applicable to the sale and transmission of power and energy received by the Authority from Western under these contracts are accounted for in the Hoover Upgrading Fund.

### APA General Fund

The Authority's operations other than those applicable to the Hoover Upgrading Fund are accounted for in the APA General Fund. The purchase of supplemental power and the sale and transmission of such power to the Authority's customers comprise the majority of this fund's activity.

## 3. CAPITAL ASSETS, NET

Capital assets, net, of the APA General Fund at June 30, 2006 and 2005 were as follows:

	2006	2005
Transmission plant	\$ 319,565	\$ 319,565
Distribution plant	227,518	227,518
General plant	777,076	726,808
	1,324,159	1,273,891
Less: Accumulated depreciation	(1,088,390)	(1,062,105)
Capital assets, net	<u>\$ 235,769</u>	<u>\$ 211,786</u>



## NOTES TO FINANCIAL STATEMENTS

	June 30, 2005	Additions	Disposals	June 30, 2006
<b>Capital assets</b>				
Transmission plant	\$ 319,565	\$ -	\$ -	\$ 319,565
Distribution plant	227,518	-	-	227,518
General plant - office	726,808	64,248	(13,980)	777,076
Total capital assets	1,273,891	64,248	(13,980)	1,324,159
<b>Accumulated depreciation</b>				
Transmission plant	(289,049)	(3,052)	-	(292,101)
Distribution plant	(187,036)	(8,725)	-	(195,761)
General plant - office	(586,020)	(28,488)	13,980	(600,528)
Total accumulated depreciation	(1,062,105)	(40,265)	13,980	(1,088,390)
Capital assets, net	\$ 211,786	\$ 23,983	\$ -	\$ 235,769

The transmission and distribution plant is comprised of a substation and related equipment. Purchased power is delivered over transmission facilities owned by Western.

#### 4. ADVANCES FOR HOOVER UPRATING PROGRAM

Advances for the Hoover Uprating Program were reimbursed by Western through credits on the Authority's power bills in the amount of \$5,167,368 and \$5,119,484 for the years ended June 30, 2006 and 2005, respectively. Credits were received for the upraters' portion of principal and interest expense on the bonds and other costs associated with the Hoover Uprating Program.

#### 5. BONDS PAYABLE

Bonds payable consists of the following:

	June 30, 2005	Increases	Reductions	Transfers	June 30, 2006
Bond payable current	\$ 2,560,000	\$ -	\$ (2,560,000)	\$ 2,825,000	\$ 2,825,000
Bond payable long-term	54,960,000	-	-	(2,825,000)	52,135,000
Total bonds payable	\$ 57,520,000	\$ -	\$ (2,560,000)	\$ -	\$ 54,960,000

## NOTES TO FINANCIAL STATEMENTS

In prior years, the Authority defeased various issues of bonds by purchasing U.S. government securities which were deposited in an irrevocable trust with an escrow agent to provide for future debt service until the call dates. As a result, those bonds are considered to be defeased and the corresponding liability has been removed from the Hoover Upgrading Fund. Accordingly, the trust account assets and related liabilities are not included in the Authority's financial statements.

The Authority's outstanding bonds, totaling \$54,960,000, bear interest ranging from 5.00% to 5.25%, are due from fiscal year 2006 through 2018, and are secured by the pledged property, as defined by the Resolution, which includes the proceeds from the sale of the bonds, rights and interest in various contracts and revenues. The Authority amortizes the bond premium (discount) using the effective interest method. Principal amounts due over the next five fiscal years ending June 30 and thereafter are as follows: \$2,825,000 in 2007, \$3,120,000 in 2008, \$3,450,000 in 2009, \$3,815,000 in 2010, \$4,220,000 in 2011 and \$37,530,000 in 2012 through 2018. Interest amounts due over the next five fiscal years ending June 30 and thereafter are as follows: \$2,759,738 in 2007, \$2,611,113 in 2008, \$2,446,863 in 2009, \$2,265,238 in 2010, \$2,064,363 in 2011 and \$7,291,771 in 2012 through 2018.

### Crossover Refunding

On September 12, 2001, the Authority issued \$57,520,000 of Special Obligation Crossover Refunding Bonds. Proceeds from the sale of the bonds along with a fund contribution by the Authority were held in an escrow trust account invested in government securities until October 1, 2003 (the "Crossover Date") when a crossover refunding took place. The crossover refunding resulted in \$57,520,000 of Special Obligation Crossover Refunding Bonds being exchanged for 2001 Series Power Resource Revenue Refunding Bonds of the same principal amount, maturity date and interest rates as the crossover bonds. The Authority called the \$62,630,000 of the 1993 Series Power Resource Revenue Refunding Bonds maturing on and after October 1, 2005.

The proceeds in the government securities escrow trust account, together with the income realized from investment of trust assets, served as collateral for the Special Obligation Crossover Bonds and paid the debt service on those bonds until the Crossover Date. The Special Obligation Crossover Bonds were payable solely from the amounts in the escrow trust account and were not payable from any other source.

As a result of the crossover refunding transaction on October 1, 2003, the 2001 Series Bonds are reflected as obligations of the Authority at June 30, 2006 and the

called portion of the 1993 Series Bonds are no longer outstanding and cease to be entitled to any lien on the revenues pledged to payment of those bonds. Instead, the revenue stream originally pledged to secure the called portion of the 1993 Series Bonds "crossed over" to pay debt service on the 2001 Series Bonds on October 1, 2003. The 2001 Series Bonds bear interest at a rate of 5.00% and 5.25% payable on April 1 and October 1, respectively, of each year, commencing April 1, 2004 and maturing in 2017. In addition, the Authority recognized an economic gain (difference between the present value of the old and new debt service payments) of \$2,095,648. The crossover refunding also resulted in the recognition of a deferred amount of \$2,411,956 that has been reflected as a decrease in bonds payable and which will be amortized using the effective interest method as a component of interest expense over the life of the refunded bonds. The Authority amortized \$257,883 and \$266,532 for the years ended June 30, 2006 and 2005, respectively, resulting in a net deferred amount of \$1,687,639 and \$1,945,522 in the Statement of Net Assets, respectively. The Authority also recognized a premium of \$3,536,652 on the crossover refunding which has been reflected as an increase in bonds payable and which will be amortized using the effective interest method. The Authority amortized \$378,138 and \$390,836 for the years ended June 30, 2006 and 2005, respectively, resulting in a net premium of bonds payable of \$2,474,561 and \$2,852,699 in the Statement of Net Assets, respectively.

## 6. COMMITMENTS AND CONTINGENCIES

The Lower Colorado Multi-Species Conservation Program ("MSCP") is a cooperative effort between Federal and non-federal entities that will create more than 8,100 acres of riparian, marsh and backwater habitat for 31 species of fish, birds, mammals and plants. The program became effective on April 4, 2005 and expires April 30, 2055. As a party to this Agreement, the Arizona Power Authority's financial obligation is approximately \$119,000 per year (in 2003 dollars, adjusted annually for inflation). For the year ended June 30, 2006, the Authority paid \$128,877.

The Authority is involved in various claims arising in the ordinary course of business, none of which, in the opinion of management, if determined adversely against the Authority, will have a material adverse effect on the business financial condition or results of operations of the Authority.



## NOTES TO FINANCIAL STATEMENTS

### 7. INVESTMENTS HELD BY TRUSTEE

As of June 30, 2006 and 2005, investments are collateralized with securities held by the Authority's trustee. The fair value of the investment securities at June 30 is as follows:

	2006	2005
Repurchase agreement	\$ 6,546,569	\$ 6,766,682
U.S. government securities	2,818,376	2,426,277
Total investments held by Trustee	\$ 9,364,945	\$ 9,192,959

On September 19, 1996, the Authority entered into a repurchase and custody agreement with MBIA Investment Management Corporation ("IMC") wherein the Authority agreed to effect a series of repurchase transactions with IMC, in investments allowable under the bond resolution agreements and state law, with a fixed earnings rate of 6.95%. The securities are held in trust by JP Morgan Institutional Trust Services. If at any time the aggregate market value of all purchased securities is less than the amount required under the repurchase and custody agreement (calculated using a percentage of 104%), the Authority may require IMC to transfer additional securities so the aggregate market value of all securities will equal or exceed such requirement. At June 30, 2006, the aggregate market value of all purchased securities exceeded the amount required under the repurchase and custody agreement.

### 8. RETIREMENT PLAN

The Authority contributes to the retirement plan described below. Benefits are established by state statute and generally provide retirement, death, long-term disability, survivor, and health insurance premium benefits.

The Arizona State Retirement System (the "Plan" or "ASRS") administers a cost-sharing multiple-employer defined benefit pension plan that covers permanent, full-time employees of the Authority. The ASRS is governed by the Arizona State Retirement System Board according to the provisions of ARS Title 38, Chapter 5, Article 2. The ASRS issues a publicly available financial report that includes its financial statements and required supplementary information. By actuarial computation, employee member and Authority contributions to the Plan were fixed at 8.25% (7.75% retirement and 0.50% long-term disability) and 5.70% (5.20% retirement and 0.50% long-term disability) of their compensation for the years ended June 30, 2006 and 2005, respectively, with the contributions made through payroll deductions. Employee contributions vest

immediately. Total contributions to the Plan for the years ended June 30, 2006 and 2005 by the Authority's covered employees were \$45,864 and \$35,527, respectively.

Matching employer member contributions were actuarially determined and fixed at the same rate as employee member contributions for the years ended June 30, 2006 and 2005. In the event the Plan's actuary determines that additional contributions are needed in order to amortize an unfunded accrued liability, every employer member will be required to contribute the revised contribution percentage which is established by the Arizona State Legislature.

All full-time employees of the Authority are required to become members of the Plan. The Authority's total payroll for employees covered by this Plan for the years ended June 30, 2006 and 2005 was \$603,132 and \$612,545, respectively. Contributions to the Plan by the Authority for its covered employees vest over five years. All required employer contributions are made to the Plan by the end of each month.

### 9. ADDITIONAL BENEFITS

In addition to the pension benefits described above, ASRS offers health care benefits to retired and disabled members who are no longer eligible for health care benefits through their former member employer's group health plan. Retired is defined as actively receiving an annuity benefit and disabled is defined as receiving a long-term disability ("LTD") benefit through the LTD program administered by ASRS. A premium benefit is applied to the member's health insurance cost. The following chart illustrates the maximum amount of the monthly available benefit supplement for eligible members and their dependents:

Years of Credited Service	% of Premium Benefit	Member		Member and Dependent(s)	
		Not Medicare Eligible	Medicare Eligible	Not Medicare Eligible	Medicare Eligible
5.0 - 5.9	50%	\$ 75.00	\$ 50.00	\$ 130.00	\$ 85.00
6.0 - 6.9	60%	90.00	60.00	156.00	102.00
7.0 - 7.9	70%	105.00	70.00	182.00	119.00
8.0 - 8.9	80%	120.00	80.00	208.00	136.00
9.0 - 9.9	90%	135.00	90.00	234.00	153.00
10.0+	100%	150.00	100.00	260.00	170.00

## NOTES TO FINANCIAL STATEMENTS

### 10. PURCHASED POWER, SALES AND TRANSMISSION COMMITMENTS

The Authority is party to Firm Electric Service and Transmission Service Contracts with terms expiring September 30, 2017. This requires the Authority to pay approximately nineteen percent of Western's revenue requirements each operating year until the contract expires. During the years ended June 30, 2006 and 2005, the Authority paid \$13,453,282 and \$14,353,953, respectively, for purchased power under this contract. The Authority is obligated to pay these costs under the contract even in the unlikely event that no power is supplied.

The Authority also has a contract with Western for transmission services. During the years ended June 30, 2006 and 2005, the Authority paid \$5,258,562 and \$5,237,895, respectively, for transmission costs to Western. On January 24, 2003, the Authority entered into the Advancement of Funds for Transmission Services contract with Western. The contract provides for the Authority to advance funds to Western on a monthly basis to fund operations, maintenance and replacement costs associated with Western's transmission services. The advanced funds are then applied to the subsequent month's transmission invoice. As of June 30, 2006 and 2005, the Authority recognized a prepaid deposit of \$182,360 that is refundable upon termination of the contract.

The Authority has sales contracts with all customers. Under these contracts, customers are obligated to pay for their percentage allocation if any Hoover power is delivered or made available for delivery. These sales contracts expire September 30, 2017, but some can be terminated by the Authority on June 1, 2007 or thereafter.

The Authority also has contracts with Salt River Project for the purchase and transmission of power to the Authority's customers. Under the transmission contract, the Authority must pay an annual transmission fee of \$63,898 until September 30, 2017. The Authority has a power contract with SRP in which supplemental power purchases can be made by the Authority on behalf of its customers. There are no minimum quantities that the Authority is required to purchase. This agreement is applicable when supplemental power is necessary, during such times of low production of Hoover energy, and during summer months when customers require higher levels of energy. During the years ended June 30, 2006 and 2005, the Authority paid \$5,950,918 and \$6,451,476, respectively, for purchased power under this contract for its customers.





**DEBT SERVICE COVERAGE RATIO**  
For Year Ended June 30, 2006

<b>NET INCOME</b>	\$493,992
<hr/>	
<b>Add:</b>	
Interest Expense	\$2,862,363
Amortization	\$257,883
Depreciation	\$26,619
Western Credits	\$5,167,368
Credits to Customers for Prior Years	\$1,802,098
<hr/>	
<b>Total Additions</b>	\$10,610,323
<hr/>	
<b>Deduct:</b>	
Deferred Interest Expenses	(2,347,319)
Premium Amortization	\$(378,138)
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<b>Total Deductions</b>	\$(2,725,457)
<hr/>	
<b>Income available for debt service</b>	\$7,884,866
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<b>Debt Service</b>	\$5,621,113
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<b>Debt service Coverage ratio</b>	1.40
<hr/>	



## **ARIZONA POWER AUTHORITY**

1810 WEST ADAMS STREET  
PHOENIX, ARIZONA 85007

(602) 542-4263  
FAX (602) 253-7970

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