



Reaching and teaching the next generation of Tucsonans means getting them involved in activities that make learning about water fun.

Management's Discussion and Analysis

Overview

Tucson Water is an enterprise fund of the City of Tucson. 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 are derived from the City's Charter and ordinances and resolutions of the Mayor and Council. We provide water service to over 710,000 people (about 85% of the greater Tucson metropolitan area's total population) within a 300 square-mile service area of Pima County. We ended fiscal year 2006 with approximately 221,000 customer connections to our water system, and during the year delivered enough potable water to fill nearly 2.3 million residential swimming pools (37.1 billion gallons). Additionally, we delivered 4.5 billion gallons of reclaimed water for turf irrigation.

Potable Customer Connections (FY 2005 average)	220,571
FY 2006 Growth in Connections	4,660 /2.2%
Potable Peak Day Demand	165.3 mg
Potable Average Day Demand	109.5 mg
Miles of Pipelines	over 4,500
Potable Reservoirs	51
Potable Storage Capacity	296 mg

In FY 2006, our Clearwater Renewable Resource Facility, (CRRF), an \$81 million project completed during fiscal year 2004, pumped 46,305 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 77,000 acre-feet during FY 2007. CRRF, constructed northwest of the City of Tucson, is composed of recharge basins, recovery well fields, storage, and transmission facilities. The facility handles the recharge of up to 71.4 million gallons per day (80,000 acre-feet / year) of Colorado River water. Current recovery well capacity is 54 million gallons per day. Within five years we intend to meet nearly one hundred percent of our customers' current demand for potable water with Colorado River water, enabling us to nearly eliminate groundwater pumpage from the central well field, over which the majority of the City of Tucson lies, thereby easing concerns related to land subsidence.

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

Operations

Potable Water:

During FY 2006 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 approximately 190 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.

Reclaimed Water:

Although only 10.8% of our total FY 2006 water sales, reclaimed water (effluent treated to higher water quality) is playing an increasingly important role in our meeting current and future water demands. 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 the reclaimed water system 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

Management's Discussion and Analysis

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 mid-town. This facility generates 3 million gallons per day of Class A reclaimed water which is piped directly into the reclaimed water system.

Our next increment of reclaimed water supply will come from the expansion of the recharge and recovery facility. Tucson Water continues to work to bring additional customers onto the reclaimed water system, thereby transferring their demand from potable to reclaimed water.

Discussion of Basic Financial Statements

We report our financial results 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.

Statement	Description/Purpose
<i>Statement of Net Assets</i>	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 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.

Financial Highlights/Condensed Financial Statements

Net Assets: Our total assets exceeded our total liabilities at the close of the fiscal year by \$635.3 million, an increase from FY 2005 of \$26.1 million. Of this amount, \$3.3 million was restricted for capital projects or debt service. At June 30, 2006 we had capital assets, net of depreciation, of \$974.8 million, and outstanding long-term debt of \$373.3 million.

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

	2006	2005
Current Assets	\$ 45,839	\$ 43,657
Restricted Assets	31,063	52,552
Other Assets	4,415	4,685
Capital Assets	974,773	930,035
Total Assets	1,056,090	1,030,929
Current Liabilities	24,844	22,013
Liabilities from		
Restricted Assets	22,688	19,627
Long-term Debt		
Outstanding	373,265	380,065
Total Liabilities	420,797	421,705
Net assets		
Invested in capital		
assets net of debt	602,172	576,713
Restricted	3,254	186
Unrestricted	29,867	32,325
Total Net Assets	\$ 635,293	\$ 609,224

Management's Discussion and Analysis

Revenues –Potable and reclaimed water sales revenues, including the Central Arizona Project surcharge, make up approximately 88% of the Utility's operating revenues. During FY 2006 water sales revenues were \$105.9 million and water sales volume totaled 55.5 million Ccfs or about \$5.1 million and 3.3 million Ccfs greater than in FY 2005. Total revenues, when combined with System Equity fee collections (reported as Contributed Capital on the *Statement of Changes in Net Assets*) increased by \$9.9 million; in addition to the water sales revenue increase, significant increases included billing services revenues (\$1.0 million) and increases in area development fees and connection fees (\$.8 million each).

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 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, and consultant costs).

Excluding the \$.7 million increase in depreciation, FY 2006 operating costs were \$5.2 million higher than FY 2005 costs.

Fixed Costs (\$1.3 million net increase from FY 2005)
 Increased costs:

- Employee costs increased \$1.3 million resulting from cost of living adjustments, employee merits, and increases in employee insurance costs.
- The administrative charge paid to the City of Tucson for indirect services provided increased \$.5 million.
- Increases of \$.3 million each in fleet related and water system maintenance costs resulting from increased gas prices and increased main break repair expenses.

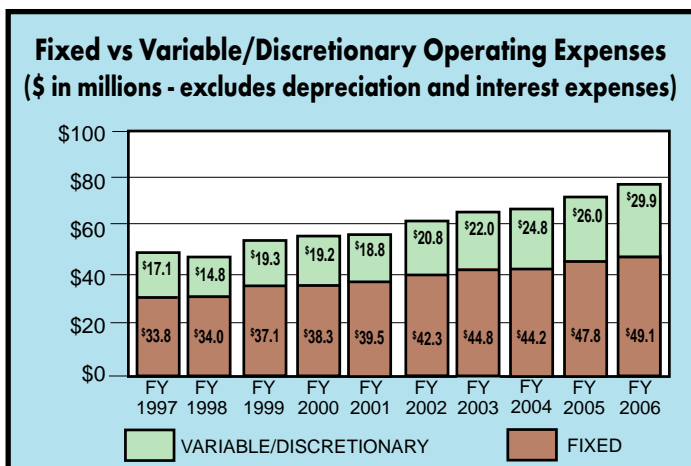
Offsetting these increases were the following reductions to fixed costs:

- A bond authorization election was held in FY 2005 with expenses of \$.6 million – no election was held in FY 2006.
- The CAP capital charge (set by the Central Arizona Water Conservation District) was reduced in FY 2006, lowering costs by \$.5 million.

Variable/Discretionary Costs \$29.9 million (\$3.9 million increase from FY 2005)

Increased costs:

- Increased power costs of \$2.4 million reflecting record water sales and higher power rates.
- Increased chemical and other supply costs of \$.5 million related to record water sales.
- Increased CAP water expense of \$.4 million resulting from purchasing more CAP water.
- Increased consultant costs of \$.6 million resulting from initiation of studies to assess future water quality treatment alternatives.



Management's Discussion and Analysis

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

	2006	2005
Operating Revenues:		
Water Sales	\$ 103,951	\$ 98,989
Other Revenues (including CAP surcharge)	15,887	15,358
Total Operating Revenues	119,838	111,347
Operating Expenses	99,637	93,781
Net Operating Income	20,201	17,566
Non-Operating Income	2,655	1,621
Non-Operating Expenses	19,550	18,578
Net Income before Capital Contributions/ Adjustments	3,306	609
Capital Contributions		
System Equity (buy-in) Fee	7,844	7,438
Developer Contributions/Grant Receipts/Transfers	14,919	6,864
Total Capital Contributions	22,763	14,302
Change in Net Assets	\$ 26,069	\$ 14,911

The remainder of this *Management's Discussion and Analysis* provides a closer look into our fiscal year 2006 revenues, operating expenses, capital outlays, debt service, changes in net assets, and cash flows.

Revenues

KEY DATA: REVENUES	2006 Actual	2006 Planned	2005 Actual
Total Water Sales Revenue ¹	\$ 105.9	\$ 103.3	\$ 100.8
Potable	\$ 100.1	\$ 98.2	\$ 95.2
Reclaimed	\$ 5.8	\$ 5.1	\$ 5.6
Other Revenue ²	\$ 24.4	\$ 22.4	\$ 19.6
Total Water Sales (Ccf ³)	55,533,422	53,520,066	52,253,833
Potable	49,535,732	48,283,718	47,250,548
Reclaimed	5,997,690	5,236,348	5,003,285
Average Monthly Water Service Connections ³	221,521	221,139	216,653
Potable Metered	217,685	217,371	213,025
Fire Protection	2,886	2,805	2,760
Reclaimed Metered	950	963	868
Potable Water 12-Month Average Use Per Svc Per Month (Ccf)	18.97	18.52	18.49
Single Family Customers Only	11.80	11.39	11.44
Total Additions: Potable Metered Service Connections ⁴	4771	4744	3941

¹ Total water sales revenue includes revenue generated by usage rates, fixed monthly charges based on meter size, and special surcharges based on water usage.

² Other revenue consists of other operating revenues and non-operating income from the audited financial statements. Development fees which result in cash collections have been included in other revenue for both FY 2006 and FY 2005, but developer-contributed infrastructure has been excluded in both years.

³ 1 Ccf = 748 gallons. Monthly average connections for the 12 months of the Fiscal Year.

⁴ The change in potable metered connections from June of one fiscal year to June of the following fiscal year.

Management's Discussion and Analysis

FY 2006 set a record as Tucson Water's strongest revenue year ever. Water sales revenue, the combined total of the potable and reclaimed systems, exceeded both the plan for the year and last year's actual revenue by 2.5% and 5.0%, respectively. Other revenue, including the 'buy-in' development fee known as the system equity fee, also exceeded both the plan for the year and last year's actual revenue by 9.0% and 25.0%, respectively. Revenue from the system equity fee (\$7.8 million) exceeded last year's by around \$400,000, fueled by 4,771 new potable metered connections added during the course of the year. Of note, all of these revenue increases occurred absent any change in the Utility's rates and fees. (See Appendix A for the FY 2006 monthly water rate schedule.)

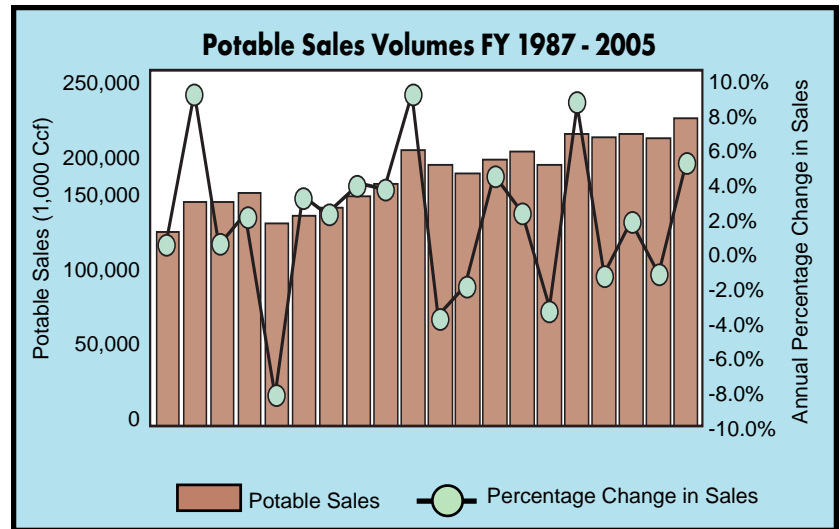
Potable Water Sales Volume, Metered Connections, Revenue Effects:

Our FY 2006 potable water sales volume (37.1 billion gallons or 49,535,732 Ccf) exceeded FY 2005's volume by 4.8%. It was also greater than the plan for FY 2006 by 2.6%. Since Tucson Water's rate structure is weighted in favor of volume rates, the level of sales volume was the main determinate in this particular year of the favorable revenue results.

The most interesting aspect of the year, however, was the fact that both revenue and volume trailed the plan for eight months of the year, and the catch-up to the plan occurred during the winter and early spring months (December through March). For anyone familiar with Tucson's climate, this pattern would be deemed unusual.

FY 2006, while its outcomes were favorable financially, continued to illustrate the unpredictability of potable sales volume. The chart above, showing twenty years of volume sales, illustrates that fact.

Management discussions in prior years have noted that both water sales volume and water sales revenues are influenced by many factors: for



example, metered 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.

Metered 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 2006 growth in average metered service connections (4,660, or 2.2%) was greater than that for FY 2005 (4,201, 2.0%) and slightly above the plan for the year. However, it should be noted that the annual growth rate in average metered connections has been trending downward since FY 2000, FY 2004 being an exception to the trend; the system equity fee was first introduced in FY 2004 and a rush of meter applications occurred prior to the fee's becoming effective.

Weather can pull sales volume and hence revenue in either a positive or contrary direction. Overall, FY 2006 was both hotter and drier than FY 2005 (whose water sales volume and revenues were less than those of the prior year, FY 2004) and so weather is assumed to have had a positive water sales effect in FY 2006. The rainfall pattern for FY 2006 conforms particularly well to the pattern of water sales volume for the year.

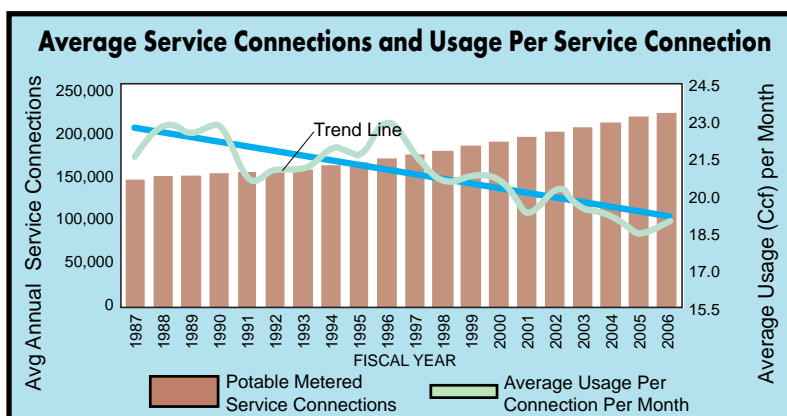
Management's Discussion and Analysis

Rainfall occurred almost entirely in summer months (6.11 inches of the 6.53 inches total for the year), with the winter months being extremely dry (0.42 inches). In addition, while the entire year was hotter than the prior year and hotter than normal, the winter months were over 30% hotter than either the prior year or the norm.

FY 2006 represents the second year of our meter replacement program. Initial tests at the beginning of the program indicated that 20% of the then-existing meters were under-registering water use, so it is also possible that improved meter accuracy contributed to sales volume being higher than in FY 2005. It is likely prudent to remember, however, that many variables can influence how much water customers use, that individually the variables may pull water usage in different directions, and that the majority of variables are beyond the control of Tucson Water.

Positive water sales volume and metered connection growth combined in FY 2006 to produce the first upward tick in monthly usage per metered connection that Tucson Water has seen since FY 2002; average monthly usage per metered connection for FY 2006 (18.97 Ccf) was approximately 0.5 Ccf more than in FY 2005 but was still less than every fiscal year this century except for FY 2005.

Thus, the *trend* in monthly usage per connection remains downward while service growth continues to increase, albeit at a reduced pace. The following chart illustrates this conclusion.



Reclaimed Water Sales Revenue, Sales Volume, Metered Connections:

Reclaimed water sales revenue for FY 2006 offered the same positive results as potable sales revenue. FY 2006 revenue of \$5.8 million was about 3.6% more than FY 2005 revenue and around 13.0% (about \$0.7 million) greater than plan. Reclaimed water sales volume (5,997,690 Ccf or 4.5 billion gallons) was about 20.0%, or 994,405 Ccf, greater than in FY 2005 and 14.5% greater than the plan for the year. Two months into FY 2006, Tucson Water began selling reclaimed water to another nearby municipality which uses the reclaimed water to irrigate golf courses within its jurisdiction. Sales to this one new customer accounted for 41.0% of the increase in sales volume from FY 2005 to FY 2006.

Average metered connections for FY 2006 increased by 82 to 950. New residential connections accounted for 71 of the 82. FY 2006 continued the trend of residential customers driving connection growth but commercial customers (golf courses, parks, schools) driving sales volume.

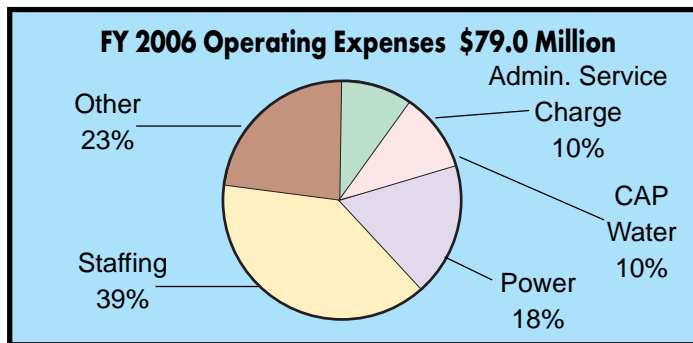
Revenue Outlook: Next Five Years

The major revenue change we are expecting during the next five years continues to be in fees affecting new development, or connection growth, in our service area. While the pace of new connection growth appears to be tapering off in the early years of this century, growth is still occurring and additional water resources and water system infrastructure are required as a result. Our analysis of long-term water resource requirements continues to be reviewed by the community and our governing body, and discussions continue to indicate that impact, or development, fees will play a major role in financing future water resource requirements and related infrastructure. Higher annual water rate increases are also anticipated to provide for costs not eligible to be recovered in development fees, such as increasing energy costs and replacement of an aging infrastructure.

Management's Discussion and Analysis

Operating Expenses

We expend considerable financial resources to operate our two water systems (potable and reclaimed). We incurred \$79.0 million in operating expenses in FY 2006 (excluding depreciation of \$20.6 million and taxes of \$9.5 million) or about \$357 per service account, a 4% increase over FY 2005.

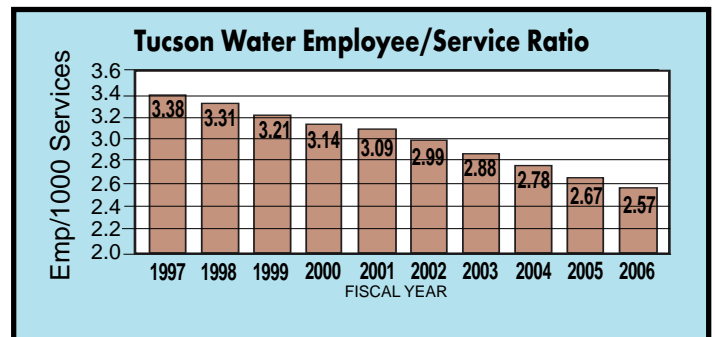


Despite continuing increases in the number of customers, our ratio of employees per 1,000 customer services (meter connections) has steadily decreased in recent years. Restructuring of meter reading routes, flexible work hours, reorganization of fieldwork teams, and increased use of technology and automation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

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.

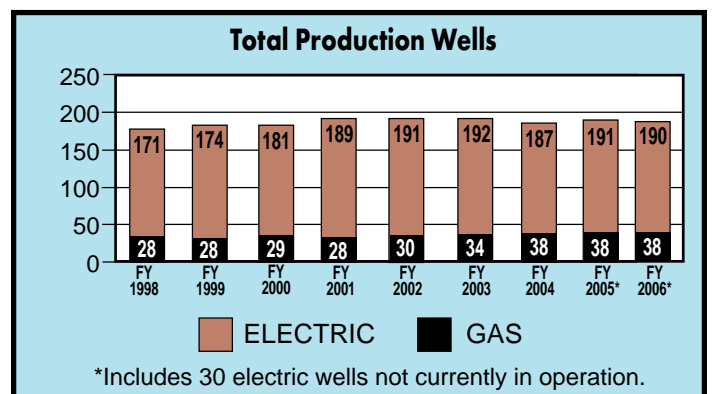
Employee costs (\$30.5 million in FY 2006 and \$29.2 million in FY 2005) relate to our diverse staff of 571 employees (a reduction of five employees from FY 2005). Our employees serve in varying roles: planning for our community's growing water resource needs; insuring the quality of the water we deliver; 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 \$1.3 million increase in employee costs from FY 2005.



Power costs (approximately \$14.3 million in FY 2006 and \$12.1 million in FY 2005 respectively) are incurred as we pump water up from depths ranging to 700 feet and move it through our distribution system. 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.

With both increased power rates and increased water sales during FY 2006, total power costs increased significantly, nearly 17% over fiscal year 2005. We anticipate increasing power costs in the coming years as we increase production from our recharge and recovery facilities. Recharged water, recovered and moved from the facilities approximately 20 miles outside of our central service area, will continue to replace groundwater from numerous wells currently located throughout the central wellfield.



Management's Discussion and Analysis

CAP water costs (\$8.3 million in FY 2006 and \$8.4 million in FY 2005) result from our purchase of Colorado River water from the CAWCD. Our FY 2006 CAP water costs consisted of two components:

- The capital financing charge, \$3.3 million in FY 2006 and \$3.8 million in FY 2005, is based on the Utility's allotment of 135,966 acre-feet. The FY 2006 decrease was the result of a rate reduction by CAWCD.
- The commodity charge \$5.0 million and \$4.6 million in FYs 2006 and 2005, respectively is based on actual CAP water taken. We purchased approximately 48,000 acre-feet of CAP water in FY 2006, down slightly from FY 2005 purchases levels. The increased expenses reflects the increased cost per acre-foot charged by CAWCD.

Administrative service charges, \$7.7 million in both FY 2006 and FY 2005, 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 Utility funds are transferred to support non-Utility related purposes. FY 2005 administrative service charges included direct costs resulting from holding a water revenue bond election; when adjusted for this non-recurring charge, FY 2006 administrative service charges costs increased by \$.5 million over the prior year.

Operating Expenses Outlook: Next Five Years

Managing our operational expenses continues to be a significant challenge. Operating expenses are anticipated to increase significantly over the next five years due to expanded use of CAP water. Operating costs will be incurred for purchasing increasing amounts of water at increasing rates, as well as operation of the expanded recharge and recovery facilities. Additional operational cost pressures are expected from continued customer growth, the potential for continued 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 costs while meeting increasing demands for water and

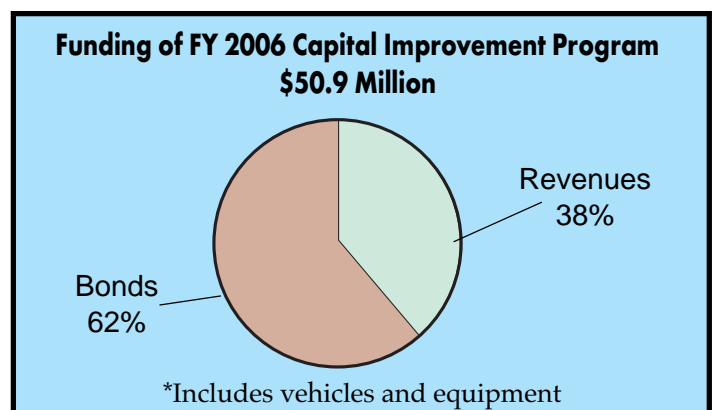
maintaining water rate adjustments to levels acceptable to the community we serve. We have ongoing planning efforts throughout our organization.

Capital Improvements

At the end of FY 2006, our water system was composed of 208 potable wells, 7 reclaimed wells, approximately 4,500 miles of delivery pipelines, 113 boosters to move water around our delivery area, and 52 reservoirs (46 potable and 6 reclaimed) to store water to meet peak demands. Our capital planning focuses on the design, and construction improvements to our system; the infrastructure requirements to meet the demands of our current and future customers.

We fund our capital program with a combination of current revenues (cash from the sale of water to our customers) and bond proceeds (cash from the sale of revenue bonds). This enables both current and future customers to participate in the funding of capital improvements. In May 2005, the citizens of Tucson approved a \$142 million Water Revenue Bond authorization; as of June 30, 2006, we have utilized \$36.2 million of this authorization. This authorization is anticipated to provide the funds to meet our bond requirements through FY 2010.

During FY 2006 we spent approximately \$51 million on improvements to our system compared with FY 2005 spending of \$39 million. Higher spending in FY



Management's Discussion and Analysis

2006 was partially the result of completing several large projects in the reclaimed program - over \$12.7 million was expended on four reclaimed projects. In addition, \$3.7 million was spent on three related potable projects focused on protecting the integrity of our water mains. Another \$4.3 million was spent on System Enhancements (Roadway Improvement Projects), and \$1.5 million on a meter replacement program. Also during FY 2006, \$2.8 million was spent on projects related to construction of our second major recharge and recovery facility.

The following program areas made up the remaining \$ 25.0 million of FY 2006 CIP spending:

Transmission and distribution mains	\$5.8 million
Capitalized expense	\$5.4 million
Reservoirs and pumping facilities	\$3.2 million
New services	\$3.1 million
Well drilling, equipping, and upgrades	\$2.4 million
General plant improvement/vehicle/equipment	\$6.1 million

Capital Expenditure Outlook: Next Five Years

The Five-Year CIP is the infrastructure foundation of our water supply strategy for the community. Over the next five years, we plan to spend nearly \$260 million to fund important capital projects. During this five year period, our emphasis will be on construction of our second facility (and related infrastructure) to enable us to eventually recharge and recover an additional 60,000 acre feet of Colorado River water, thereby reducing groundwater pumping and utilizing our full CAP allocation. This facility will include drilling additional recovery wells and construction of recharge basins, a 10 million gallon reservoir, and raw water and recovery transmission mains. Also included in our five-year CIP 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.

Bond Ratings:

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

Debt and Debt Service

At June 30, 2006, we had \$342.9 million in outstanding water revenue bonds. In addition, we had \$40.4 million outstanding in Water Infrastructure Finance Authority (WIFA) loans. Water revenue bond interest payments on this debt (\$18.9 million in FY 2006) are reported as expenses on our income and flow of funds statements. Repayment of principal (\$11.2 million in FY 2006) is reported only on our flow of funds statement. In addition, we paid \$0.5 million in fiscal agent fees.

During FY 2006, the following bond sales or loans agreements occurred:

<u>Amount</u>	<u>Interest Rate</u>	<u>Month</u>
\$2.5 million WIFA loan*	3.42%	April
\$2.0 million WIFA loan*	3.21%	April

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

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

	<u>FY 2006</u>	<u>FY 2005</u>
System Equity		
Fee Revenue	\$7.8 million	\$7.4 million
Water Revenue		
Bond/WIFA		
Loan Debt Service	\$30.1 million	\$27.9 million
System Equity		
Fee as % of		
Debt Service	26%	27%

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 ten years.

RATIO OF OUTSTANDING WATER REVENUE BONDS TO CAPITAL ASSETS⁽¹⁾ June 30, (\$ in millions)

	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Land	\$ 41.4	\$ 43.1	\$ 44.6	\$ 46.9	\$ 46.4	\$ 45.1	\$ 45.1	\$ 45.1	\$ 45.3	\$ 45.5
Buildings	95.7	96.3	97.3	97.3	100.7	102.1	108.5	108.6	134.5	119.4
Water Mains	408.5	442.5	467	528.2	549.3	582.2	608.6	635.7	739.7	803.7
Reservoirs	114	127.3	132.5	142.1	183.1	199.6	198.2	202.3	102.4	110.7
Construction in Progress	117.6	109.3	127.2	108.3	106.7	95.9	115.2	134.9	147.4	153.5
Machinery	11.9	15.6	17.1	15.2 ⁽²⁾	16.7	19.6	20.8	22.6	23.2	24.3
Less Accumulated Depreciation	(143.8)	(156.9)	(169.6)	(181.6)	(196.5)	(217.1)	-225	-244.3	(262.4)	(282.3)
Total Capital Assets	\$ 645.3	\$ 677.2	\$ 716.1	\$ 756.4	\$ 806.4	\$ 827.4	\$ 870.6	\$ 904.9	\$ 930.1	\$ 974.8
Water Revenue Bonds/WIFA Loans Outstanding	\$223.9	\$216.7	\$250.0	\$244.1	\$273.9	\$335.0	\$334.0	\$365.8	\$388.3	\$383.3
Ratio Water Revenue Bonds/ Capital Assets	0.35	0.32	0.35	0.32	0.34	0.40	0.38	0.40	0.42⁽³⁾	0.39

(1) Goodwill and capitalized water rights not included

(2) \$2 million of machinery assets were written off in FY 2000 due to change in capitalization threshold.

(3) Includes \$31.7 million of bonds sold in June and unspent at June 30, 2005; ratio with this debt removed is .38.

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 2006 was \$26.1 million, a \$11.2 million increase from FY 2005.

Change In Increase to Net Assets FY 2006 from FY 2005 (\$ in millions)	
Increase to net assets FY 2006	\$ 26.1
Increase to net assets FY 2005	14.9
Change in amount of Increase	<u>\$ 11.2</u>
Detail of changes FY 2006 from FY 2005	
Revenues	
Increase in water sale revenues (potable and reclaimed)	\$ 5.1
Increase in other revenues	4.4
Change in revenues	<u>9.5</u>
Expenses	
Increase in depreciation expense	-0.7
Increase in power expense	-2.3
Increase in employee costs	-1.3
Increase in administrative service charge	-0.5
Increase in interest expense	-0.9
Increase in other expenses	-1.0
Changes in expenses	<u>-6.7</u>
Capital contributions	
Increase – system equity (buy-in) fee	0.4
Increase - contributed water systems/grant receipts	8.0
Changes in Capital Contributions	<u>8.4</u>
Change in Increase to Net Assets FY 2006 from FY 2005	<u>\$ 11.2</u>

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

Cash Reserves – During June 2002, the Mayor and Council adopted a Financial Plan that targeted cash reserve levels at approximately \$13 million by the end of FY 2006. At June 30, 2006, unrestricted / undesignated cash on hand was \$15.3 million.

Debt Service Coverage (the % by which revenues, after meeting operating cash needs, cover Water Revenue bond and WIFA loan principal and interest payments) – Mayor and Council policy is to maintain an annual average debt coverage of at least 1.75.

Management's Discussion and Analysis

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

The following "summary flow of funds" identifies the major cash sources and uses during FY 2006. Appendix A provides additional details.:

Summary FY 2006 Flow of Funds (\$ in millions)			
<i>CASH INFLOWS:</i>			
What we received:	from sale of water*	\$	105.9
	from water system equity fees		7.8
	from other revenues/sources**		25.0
	<i>TOTAL INFLOWS</i>	<u>\$</u>	<u>138.7</u>
 <i>CASH OUTFLOWS & USES</i>			
How much of our revenues we used for:			
	operations/maintenance ***	\$	88.4
	bond debt service (principal/interest)		30.6
	capital improvements		19.4
	other purposes		.3
	<i>TOTAL OUTFLOWS</i>	<u>\$</u>	<u>138.7</u>
* includes CAP surcharge revenues		*** includes taxes of \$9.5 million and payment to City of Tucson for direct and indirect administrative support \$7.7	
** includes taxes of \$9.5 million			

Financial Planning and Outlook:

Each year, we develop a rolling six-year *Financial Plan (current year plus five)*. This plan is built on our projected capital improvement and operating budgets, and our projected water sales revenues under existing rates. Our plan is aligned with the City of Tucson's budgetary process. This alignment enables Mayor and Council to be provided with the water revenue increases necessary to support operating and capital needs (over the five years of our financial plan period) 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 2006-FY 2011, which was adopted by Mayor and Council during FY 2006, 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 recharged/recovered Colorado River water resource and the financing of our capital program.

During fiscal year 2007, we will be developing a more defined business plan focusing on our strategic initiatives and core functions. This project will involve a wide cross-section of our staff and will become the cornerstone of future planning efforts and resource allocation. In addition, we will be increasing efforts to significantly improve security for our water delivery and storage infrastructure. 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.