

INVESTING IN

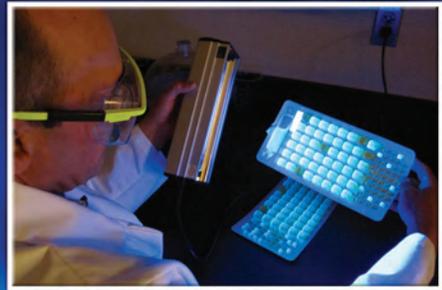
WATER CUSTOMERS

WATER RESOURCES

WATER QUALITY

WATER SYSTEMS

WATER EFFICIENCY



ANNUAL REPORT • FISCAL YEAR
July 1, 2011 – June 30, 2012

CITY OF TUCSON WATER DEPARTMENT

Page intentionally left blank.

TUCSON, the county seat for Pima County, is the second largest city in Arizona. Incorporated in 1877, Tucson started as a small presidio located in what is now the City’s downtown. The City has grown to approximately 300 square miles and lies within a greater metropolitan region of more than 400 square miles with a population of one million people. Tucson Water is southern Arizona’s primary water service provider with customers residing both inside and outside the city limits. The Central Arizona Project delivers Colorado River water via 335 miles of canals and pipelines to Tucson Water.



TABLE OF CONTENTS

Letter from the Director

Tucson Mayor and Council

Strategic Investments Ensure Sustainability 1

Financial Sections 7

- Report of Independent Auditor 9
- Management’s Discussion and Analysis 11
- MD&A Appendix A. Supplemental Schedule of Flow of Funds, 29
 Excludes Conservation Program Fund - FY 2012, unaudited
- MD&A Appendix B. Supplemental Schedule of Flow of Funds, 33
 Conservation Program Fund - FY 2012, unaudited
- Financial Statements – FY 2012 35
 - Statement of Net Assets 37
 - Statement of Revenues, Expenses and Changes in Net Assets 39
 - Statement of Cash Flows 41
 - Notes to the Financial Statements 43
- Supplementary Information 69
 - Supplemental Schedule of Net Revenues Available for Debt Service – 71
 FY 2012, unaudited
 - Rate Schedule - FY 2012, unaudited 73
 - Statement of Net Assets - FY 2011, unaudited 75
 - Statement of Revenues, Expenses and Changes in Net Assets – 77
 FY 2011, unaudited
 - Statement of Cash Flows – FY 2011, unaudited 81

Page intentionally left blank.



**A Letter from
Alan Forrest
Director**

Tucson Water is considered one of the nation's finest water utilities for many reasons:

- We consistently deliver high quality water to more than 700,000 customers in a desert community that leads the nation in conserving water.
- We have more than a \$1 billion invested in infrastructure and delivery assets.
- We pump less groundwater and are moving toward increased sustainability in water supplies. More than 70% of the water delivered to our customers is recharged and recovered Colorado River water, a renewable resource.
- We are a financially stable utility, able to manage the present and conduct long-range planning.

This FY 2012 Annual Report offers important information about Tucson Water's financial position and also reflects on how we are investing in our customers, water quality, water resources, utility operations, and water efficiency.

As an enterprise fund, Tucson Water is dependent on customers – for generating water sales revenue, providing feedback, shaping water rates and fees, and helping to develop conservation programs. Public and stakeholder involvement contributes to the bottom line, and helps make Tucson Water strong, accountable and more efficient now and for future generations.

Sincerely,

Alan Forrest
Director

**FY 2012
CITIZENS' WATER
ADVISORY
COMMITTEE
(CWAC)**

Mark Taylor, P.E., Chairman
Christopher Brooks, J.D., Vice Chair
Bruce Billings, Ph.D
Evan Canfield, Ph.D., P.E.
W. Mark Day, M.S., M.B.A.

Chuck Freitas
Bob Gilby
Kelly Lee
Amy McCoy, Ph.D.
Thomas Meixner, Ph.D.

Catlow Shipek, M.S.
Alan Tonelson
Vincent Vasquez, M.S.
Brian Wong

Page intentionally left blank.



**City of Tucson
Mayor and Council**



**Mayor
Jonathan Rothschild**



**Regina Romero,
Ward One**



**Paul Cunningham,
Ward Two**



**Karin Uhlich,
Ward Three**



**Shirley Scott,
Ward Four**



**Richard Fimbres,
Ward Five**



**Steve Kozachik,
Ward Six**

Page intentionally left blank.

STRATEGIC INVESTMENTS ENSURE SUSTAINABILITY

Tucson Water strategically invests in programs and projects to help ensure that our community will have clean, safe water today and for future generations. Some of the specific ways that the Utility invested in our customers, water resources, water quality, water systems, and conservation and efficiency during Fiscal Year (FY) 2012 include:

FY 2012 INVESTING IN WATER CUSTOMERS



Tucson Water believes that an informed and engaged community is essential to long-term sustainability – in water and finances. Customers help the Utility to shape policy, financial plans, rates, service improvements, conservation programs and more. For example:

CONTINUING IMPROVEMENTS AT TUCSON WATER'S CALL CENTER

The Tucson Water Call Center team processes approximately 80,000 calls per month. During FY 2012, Tucson Water recruited and hired 7 additional customer service representatives and filled 6 existing vacant positions, intensified training, and upgraded the interactive voice response phone system. Tucson Water also created a team of 9 people to focus solely on billing issues, a major source of customer calls. The utility also established a new protocol to monitor residential water meters to better target aging and malfunctioning units. Calls to the Center are consistently answered in less than two minutes, resulting in shorter wait times and faster service.



CONNECTING WITH CUSTOMERS IN FY 2012

- 2012 telephone surveys: Customer Service and Water Conservation
- Four rate focus group meetings
- Monthly newsletter online and in billing statements
- Working with the Citizens' Water Advisory Committee, the Unified Community Advisory Board, and the Customer Rate Design Group
- Holding town halls
- Website www.tucsonaz.gov
- Social media including email updates
- TV Public Service Announcements (PSAs) on water efficiency
- Briefing Mayor and Council and presentations at meetings
- Free water conservation workshops
- Employee newsletter
- Collaborating with the University of Arizona and other regional partners
- Multi-cultural outreach materials



STRATEGIC INVESTMENTS ENSURE SUSTAINABILITY

- Special events and facility tours
- Public Information Office responds to 5,000 phone calls and emails a month
- Working with local media
- YouTube videos
- In-home water audits
- Developing displays, brochures, and flyers
- Liaison to businesses about water efficiency
- K-12 water conservation programs
- Field work to educate and enforce our water waste ordinance
- Annual Water Quality Report to customers



INVESTING IN WATER RESOURCES



Tucson Water and its customers are better prepared for drier conditions, and even drought, than are most western communities. We have multiple water resource options: Central Arizona Project (CAP) water, groundwater, and recycled water. Key ways that the Utility invested in water resources in FY 2012 include:

PURCHASING OUR FULL ALLOCATION OF COLORADO RIVER WATER OF 45 BILLION GALLONS

Water is delivered through CAP canals to the Utility's Clearwater Renewable Resource Facility, where it is recharged, recovered and delivered to customers. Because the Colorado River flows year-round, it is a critical renewable water resource. And, by purchasing and recharging approximately 54,000 acre feet more CAP water than we delivered, we are banking this water for future use by our customers.

INCREASING CAPACITY AT TUCSON WATER'S CLEARWATER RENEWABLE RESOURCE FACILITY

Crews have been adding essential infrastructure to the Clearwater Facility: building an 8 million gallon reservoir and a booster station capable of moving 40 million gallons of water a day, hooking up 25 recovery wells and adding a 48 inch pipeline that delivers recovered CAP water. The Clearwater facility supplies more than 70% of our customers' water needs.

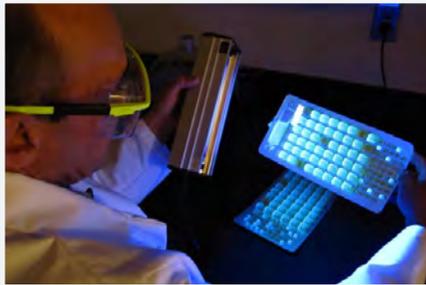


STRATEGIC INVESTMENTS ENSURE SUSTAINABILITY

EXPANDING SITES USING RECLAIMED WATER, A LOCAL RECYCLED AND RENEWABLE WATER SOURCE

Tucson Water has been producing and delivering reclaimed water since 1984, one of the first utilities in the nation to begin to recycle water for irrigation and other non-drinking uses. In FY 2012, Rose, Henry, and Hollinger Elementary Schools and Sahuaro High School started using reclaimed water to irrigate turf. We deliver reclaimed water for irrigation to nearly 1,000 sites.

INVESTING IN WATER QUALITY



Tucson Water delivers safe, quality drinking water that meets the strict regulations set by the U.S. Environmental Protection Agency (EPA). Tucson Water regularly performs thousands of tests each year on water samples collected from across its service area, tests them at its Water Quality Laboratory and reports on the results to the Arizona Department of Environmental Quality. We also

report to customers about water quality: via online, in the monthly newsletter, brochures, the Annual Water Quality Report and community presentations. Some ways in FY 2012 the Utility continued to focus on water quality:

PROACTIVELY RESPONDING TO CONTAMINANT 1,4-DIOXANE

In January 2011 the EPA issued a new health advisory level for contaminant 1,4-dioxane, a level much lower than the previous advisory level. Anticipating such changes to 1,4-dioxane guidelines, Tucson Water staff had been researching and planning to build a new advanced oxidation treatment plant for the water near the existing Tucson Airport Remediation Project (TARP). The Advanced Oxidation Process (AOP) Water Treatment Facility will use ultraviolet light and hydrogen peroxide to efficiently remove 1,4-dioxane and other contaminants from the TARP water supply. The AOP and the TARP will work in conjunction, treating and purifying up to 8 million gallons of water a day.



PARTNERING LOCALLY TO LEVERAGE RESEARCH FUNDING AND TO GAIN KNOWLEDGE



As technology advances and instruments are able to detect contaminants at levels smaller than parts per billion, Tucson Water professionals must respond with new approaches and systems. Partnerships with local and national entities allow us to leverage funding as a way to gain new knowledge from research. In FY 2012, Tucson Water

STRATEGIC INVESTMENTS ENSURE SUSTAINABILITY

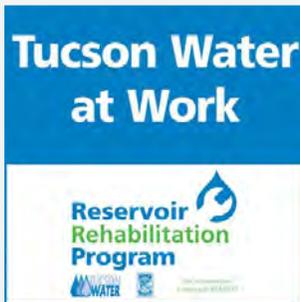
completed two major collaborative studies with The University of Arizona and Pima County Regional Wastewater Reclamation Department. We've also completed a study for the WaterReuse Foundation, in collaboration with the cities of Phoenix and Scottsdale, the U.S. Bureau of Reclamation, and the Sanitation Districts of Los Angeles County, among others. Tucson Water professionals are also active in Arizona's Water/Wastewater Response Agency (AzWARN), the Advisory Panel on Emerging Contaminants (APEC), and the EPA's Environmental Research Laboratory Network/Water Laboratory Alliance.

INVESTING IN WATER SYSTEMS



Tucson Water has invested more than \$1 billion in assets – reservoirs, wells, mains, buildings, meters, fire hydrants, recharge facilities, pumping stations, and more. The water system needs regular maintenance, repair and improvement so customers can turn on the tap with confidence. Here are some specific ways that Tucson Water focuses on water systems and operations in FY 2012:

LAUNCHING A MULTI-YEAR RESERVOIR REHABILITATION PROGRAM



Tucson Water launched its first comprehensive inspection, repair, and improvement effort for its potable and reclaimed reservoirs, most of which are decades old. Tucson Water's 69 potable and reclaimed facilities contain more than 315 million gallons of available storage and represent approximately \$200 million in assets. During FY 2012, work crews completed rehabilitation on the 20-million gallon Martin Reservoir and the 0.65-million gallon Craycroft Reservoir.

REPLACING 9,010 RESIDENTIAL AND COMMERCIAL METERS

Old and under-recording meters are being replaced. New meters will offer accurate data to help forecast our community's water demands and ensures revenue is collected for the water actually being used. In addition, Tucson Water is also equipping new meters with automatic meter reading technology that transmits data via radio signal to a hand-held device or mobile collector making our meter reading more efficient. Tucson Water has a certified testing facility with a staff of three that can troubleshoot, calibrate, rebuild and retire meters and backflow assemblies.



STRATEGIC INVESTMENTS ENSURE SUSTAINABILITY



ONGOING WORK TO REPLACE AGING PIPELINE AND WATER MAINS REPLACEMENTS

Tucson Water is replacing aging pipeline throughout the city as part of ongoing road improvements. In FY 2012, water main replacements associated with road improvements in our community accounted for \$4.5 million of Tucson Water's capital spending.

INVESTING IN WATER EFFICIENCY



Water and resource efficiency is something that both the Utility and our customers can work to achieve. Tucson Water is working to use resources efficiently, eliminating leaks, and ensuring storage facilities are secure. To encourage water conservation among customers, we offer a wide range of education and assistance programs.

OPENING A NEW EAST SIDE SERVICE CENTER (ESSC) THAT USES RESOURCES FOR MAXIMUM EFFICIENCY

Open in February 2012, the ESSC is a self-contained satellite facility for Tucson Water's metering group, a maintenance shop, a warehouse and outdoor storage yard. Some 75 Tucson Water employees work at the ESSC, allowing maintenance professionals to save time and fuel with quick access to tools and infrastructure. The Center's design and architecture is both eye-catching and energy efficient. The ESSC facility has been awarded an ENERGY STAR label from the U.S. Environmental Protection Agency, and it meets the requirements for Leadership in Energy and Environmental Design (LEED) silver certification - and is pending a LEED gold certification.



TUCSON WATER INTRODUCES WATER-SAVING REBATES FOR HOME AND BUSINESS

In FY 2012, Tucson Water offered more rebates to encourage customers to save water and potentially reduce utility bills:

- The gray water rebate offers up to \$200 to homeowners who install a permanent gray water system that uses water from clothes washers, bathtubs, showers, or hand washing sinks on home landscaping.



STRATEGIC INVESTMENTS ENSURE SUSTAINABILITY

- The new residential rainwater harvesting rebate program encourages and educates customers on how to collect and use rainwater on landscaping – instead of using drinking water. Customers can receive rebates of up to \$2,000.
- Businesses and commercial properties may receive up to \$200 when they replace older, water-wasting urinals with a WaterSense certified High Efficiency Urinal, which uses only 1 pint per flush.



Financial Sections

Page intentionally left blank.



CliftonLarsonAllen

CliftonLarsonAllen LLP
www.cliftonlarsonallen.com

Independent Auditors' Report

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

We have audited the accompanying financial statements of Tucson Water, an enterprise fund of the City of Tucson, Arizona (the "City") as of and for the year ended June 30, 2012, as listed in the table of contents. These financial statements are the responsibility of the City's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Tucson Water, an enterprise fund of the City of Tucson, Arizona, as of June 30, 2012, and the changes in financial position and cash flows, where applicable, for the year then ended in conformity with accounting principles generally accepted in the United States of America.

Our audit was conducted for the purpose of forming opinions on the bank financial statements as a whole. The Management's Discussion and Analysis on pages 11 through 34 is presented for purposes of additional analysis and is not a required part of the basic financial statements, but is supplementary information required by the Governmental Accounting Standards Board. We have applied certain limited procedures to the required supplementary information in accordance with auditing standards generally accepted in the United States of America, which consisted of inquiries of management about the methods of preparing the information and comparing the information for consistency with management's responses to our inquiries, the financial statements, and other knowledge we obtained during our audit of the financial statements. However, we did not audit the information and express no opinion on it.

The letter from the director, the information contained in *Strategic Investments Ensure Sustainability*, the appendices, and supplementary information as listed in the table of contents have not been subjected to auditing procedures applied in the audit of the financial statements and, accordingly, we express no opinion on them.

CliftonLarsonAllen LLP

Tucson, Arizona
November 21, 2013

Page intentionally left blank.

MANAGEMENT'S DISCUSSION AND ANALYSIS

INTRODUCTION

The Management's Discussion and Analysis (MD&A) section of Tucson Water's Annual Financial report presents discussion and analysis about the Utility's financial performance during the fiscal year ended on June 30, 2012. The MD&A focuses on significant financial issues, provides an overview of the Utility's financial activity, and provides descriptions of significant asset and debt activity.

Potable Customer Connections	Potable Peak Day Demand	Potable Average Day Demand	Miles of Potable Pipeline	Potable Storage Capacity	FY 2012 Potable sales	FY 2012 Potable sales
228,245	128.9 MGD	95.4 MGD	4,500	301 MGD	\$128.2 M	90,200 AF (39.3 million Ccf)

OVERVIEW

Tucson Water is an enterprise fund of the City of Tucson, Arizona. This means we operate similar to a private business, covering all the costs of doing business with revenues from operations. Our fiscal year runs from July 1 through June 30. Our authority and responsibility is derived from the City's Charter and ordinances and resolutions of the Mayor and Council. We provide water service to approximately 705,000 people (about 85% of the greater Tucson metropolitan area's total population) within a 300 square-mile service area that lies within Pima County. We ended fiscal year 2012 with approximately 230,000 customer connections to our water system, and during the year delivered approximately 90,200 acre-feet (29.4 billion gallons of potable water) or approximately enough potable water to fill nearly 1.9 million residential swimming pools. Additionally, we delivered 5.0 billion gallons of reclaimed water for turf irrigation.

OPERATIONS POTABLE WATER

During FY 2012 Tucson Water obtained its municipal potable water – water meeting or exceeding all federal, state, and local drinking water standards - from two sources:

- four groundwater well fields (Central, Avra Valley, Santa Cruz, and Southside)
- facilities where the Utility recharges and recovers Colorado River water.

These four well fields and the recharge and recovery facility provide us with an aggregate production capacity of 730 acre-feet (238 million gallons) per day.

Units of measure	
1 acre foot	1 Ccf
325,851 gallons	748 gallons

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 144,172 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.

MANAGEMENT'S DISCUSSION AND ANALYSIS

In FY 2012, our Clearwater Renewable Resource Facility (CRRF), a facility/system used to recharge, recover, and distribute CAP water, pumped 77,300 acre-feet of blended recharged/recovered CAP water and groundwater into our distribution system. CRRF, constructed northwest of the City of Tucson, is composed of recharge basins, recovery well fields, storage, and transmission facilities. The facility, with a current capital investment of \$244 million, permits the recharge annually of our entire 144,172 acre-foot allocation of Colorado River water, an important renewable source. Current recovery well capacity is 85,162 acre-feet annually. We have been recharging annually more Colorado River water than our customers' water demand. This enables 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 and enabling us to store water for future use.

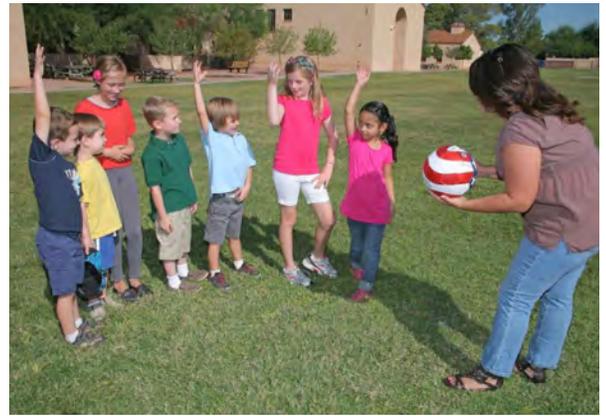
OPERATIONS RECLAIMED WATER

Recycled water is an important water resource. Tucson Water uses some of its recycled water to produce reclaimed water, which is specially treated for applications such as irrigation, dust control, fire fighting, and industrial uses. Reclaimed water is excellent for the irrigation of turf, ornamental landscaping, food crops, orchards, and vineyards as the nitrogen and phosphorus in the water provide fertilizer for plants and grass.

Although only 7% of our total FY 2012 water sales revenue and 15% of water sales volume, reclaimed water is playing an increasingly important role in meeting our current and future water demands. Tucson Water has the right to use more than 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 Tucson Water provides to our customers is, like all of the water we deliver, regulated by the Arizona Department of Environmental Quality (ADEQ). The reclaimed water delivered by Tucson Water is rated as Class A by ADEQ.

Our reclaimed system currently includes:

- a treatment plant which filters secondary effluent,
- a wetlands which biologically treats the backwash water from the filtration plant,
- constructed basins for the recharge of secondary effluent with wells to recover this recharged water, and



We deliver reclaimed water for irrigation to more than 1,000 sites, including 18 golf courses, 50 parks, 65 schools (including the University of Arizona and Pima Community College) and 700+ single family homes.

MANAGEMENT’S DISCUSSION AND ANALYSIS

- 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 up to 3 million gallons per day reclaimed water which is piped directly into our reclaimed water system.

We continue 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
AND MD&A
APPENDIX
SCHEDULES**

We report our financial results in this report on the accrual basis of accounting, in conformance with all applicable accounting principles generally accepted in the United States.

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

Statement/Schedule	Description/Purpose
Statement of Net Assets	A summary at year end of our current and long-term obligations and our assets available to meet those obligations. The difference between total assets and total obligations represents our net assets.
Statement of Revenues, Expenses and Changes in Net Assets	A summary of our revenues and our operating and non-operating expenses, and the resulting change in net assets.
Statement of Cash Flows	A summary of our cash sources, including proceeds from the sale of water revenue bonds, and our use of cash.

MANAGEMENT'S DISCUSSION AND ANALYSIS

FINANCIAL HIGHLIGHTS/ CONDENSED FINANCIAL STATEMENTS

Net Assets: At June 30, 2012 our total assets exceeded our total liabilities by \$766.4 million, an increase from FY 2011 of \$21.7 million. Of this amount, \$28.1 million was restricted for capital projects or debt service. At June 30, 2012 we had capital assets, net of depreciation, of \$1,197.0 million, and outstanding long-term debt of \$498.6 million.

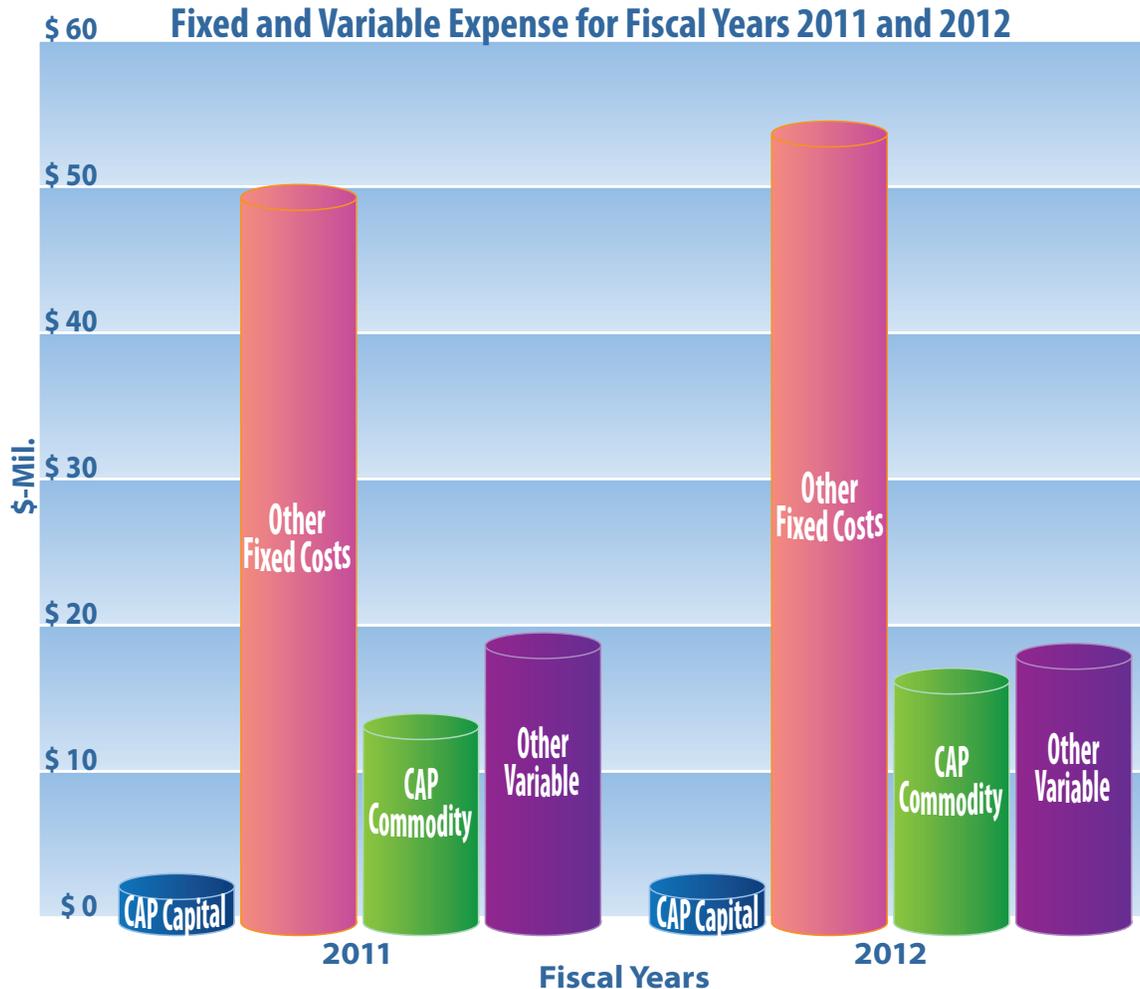
Tucson Water
Summarized Statement of Net Assets as of June 30
 (\$ in thousands)

	2012	2011
Current assets	\$ 57,034	\$47,489
Restricted assets	71,360	67,075
Other assets	4,770	4,546
Capital assets, net of depreciation	1,197,039	1,164,886
Total assets	1,330,203	1,283,996
Current liabilities	31,415	29,208
Liabilities from restricted assets	33,678	30,974
Long-term debt outstanding	498,634	478,989
Total liabilities	563,727	539,171
Net assets		
Invested in capital assets, net of related debt	700,566	692,101
Restricted	28,097	27,691
Unrestricted	37,813	25,033
Total net assets	\$766,476	\$744,825

Operating Revenues: Potable and reclaimed water sales revenues, including the Central Arizona Project (CAP) surcharge and the Conservation Program fee, make up approximately 92% of the Utility's operating revenues. During FY 2012, these water sales revenues were \$140.4 million and water sales volume totaled 46 million Ccfs or about \$7.3 million more and 2 million Ccfs less than in FY 2011. Billing services revenues increased \$.5 million. Total operating revenues increased by \$7.8 million.

Operating Expenses: The majority of our operating costs are fixed, at least in the twelve months of our fiscal year. In FY 2012, approximately 62% of our annual operating expenses did not vary as a result of the quantity of water we sold. Staff-related expenses, payments to the City of Tucson for administrative support, and CAP capital payments are our most significant fixed items. The remaining 38% of our operating expenses are made up of expenses that vary with the quantity of water produced or stored (purchase of CAP water - nearly 48% of variable costs, power costs, chemicals), or are of a *discretionary* nature; for example, community relations, and certain training, consultant, or membership costs.

MANAGEMENT'S DISCUSSION AND ANALYSIS



Excluding the \$1.0 million increase in depreciation, FY 2012 operating costs were \$6.8 million higher than FY 2011 costs. Major changes included:

- Employee costs within our Customer Services Division increased by \$1.1 million, the result, primarily, of increased overtime and sick leave paid out for employee retirements.
- A \$1.0 million increase in commodity expenses utilized by our Water Operations Division representing increased investment in maintenance supplies for system machinery and buildings.
- We purchased 130,787 acre feet of CAP water at an additional commodity cost of \$3.1 million over FY 2011.
- Increased costs were partially offset by a decrease of \$.9 million in natural gas costs for potable system wells.

MANAGEMENT'S DISCUSSION AND ANALYSIS

Additionally, non-operating expenses increased \$2.2 million, primarily due to increased interest expenses of \$1.9 million on our long-term debt.

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

	2012	2011
Operating revenues:		
Water sales	\$ 135,278	\$ 128,836
Other revenues (including CAP surcharge)	16,532	15,156
Total operating revenues	151,810	143,992
Operating expenses	118,793	110,996
Net operating income	33,017	32,996
Non-operating income	1,716	1,493
Non-operating expenses	21,671	19,490
Net Income before capital contributions/ adjustments	13,062	14,999
Capital contributions	10,189	9,976
Net transfers out	(1,600)	(1,600)
Change in net assets	\$ 21,651	\$ 23,375

MANAGEMENT'S DISCUSSION AND ANALYSIS

**FINANCIAL
HIGHLIGHTS/
CONDENSED
FINANCIAL
STATEMENTS**

The remainder of this MD&A provides a look into our fiscal year 2012 revenues, operating expenses, capital outlays, debt service, changes in net assets, and cash flows.

FY 2012 and FY 2011 Comparison Revenues (\$ in thousands)

	2012 Actual	2011 Actual
Total Water Sales Revenue⁽¹⁾	\$ 140,430	\$ 133,047
Potable	131,100	123,400
Reclaimed	9,330	9,647
Other Revenue⁽²⁾	13,100	12,400
Total Water Sales (Ccf⁽³⁾)	45,985,227	47,890,565
Potable	39,284,398	41,018,347
Reclaimed	6,700,829	6,872,218
Average monthly water service connections⁽³⁾	229,335	227,904
Potable metered	224,426	223,040
Fire protection	3,819	3,777
Reclaimed metered	1,090	1,087
Potable water 12-month average use per svc per month (Ccf)		
Single family customers only	14.58	15.33
	9.6	10.06
Total Additions: potable metered service connections⁽⁴⁾	1,386	304

(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 financial statements. Other Revenue does not include system equity or water resource fees received (\$2.7 million and \$2.9 million in FY 2012 and 2011, respectively). These fees are recorded on the financial statements as capital contributions.

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

(4) Change in year's average potable metered connections.

MANAGEMENT'S DISCUSSION AND ANALYSIS

POTABLE WATER – SALES AND VOLUME

Our FY 2012 potable water sales volume (39.3 million Ccf or 29.4 billion gallons) was short of FY 2011's volume by 4%. This continues a multi-year term trend of declining water consumption by the community. Potable water revenues did, however, increase as a result of the water rate increase effective in July 2011.

**Potable Water – Average Monthly Use/Service
for Fiscal Years 2006 to 2012**



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; our conservation-oriented rate structure; and perhaps most importantly, overall community economic conditions.

Growth in metered connections always pulls revenues in a positive direction, due to any 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 2012 growth in average metered service connections (1,431 or .6%) was a slight improvement over FY 2011, but continued to reflect the slowly recovering housing industry within our service area.

MANAGEMENT’S DISCUSSION AND ANALYSIS

RECLAIMED WATER – SALES AND VOLUME

When compared to FY 2011, both reclaimed water sales revenue and sales volumes decreased for FY 2012, despite a July 2011 rate increase. Revenues decreased from \$9.6 million to \$9.3 million (3% decrease), while sales volumes decreased from 6.9 million Ccfs to 6.7 million (2% decrease). The decreases were largely the result of decreased reclaimed consumption by local golf courses.

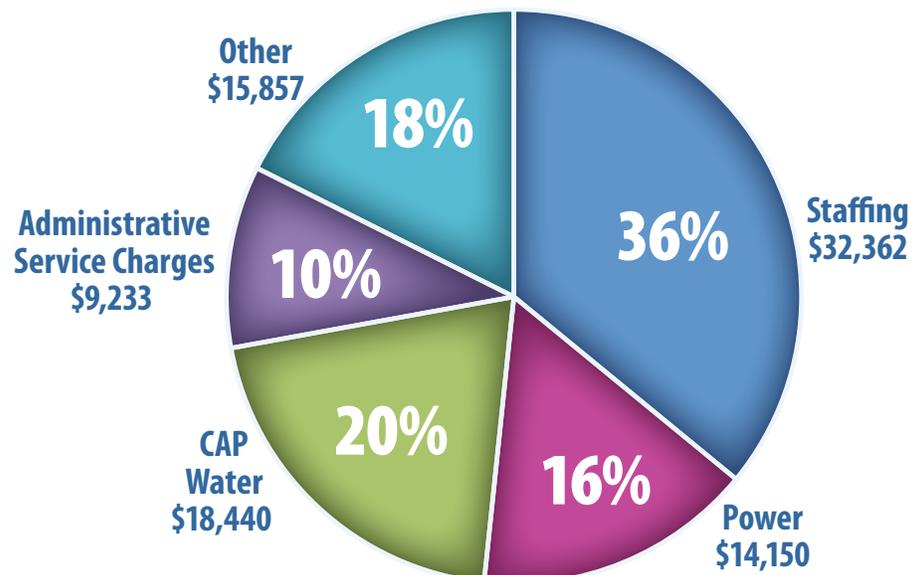
REVENUE OUTLOOK: NEXT FIVE YEARS

The decline in consumption per service and the slow increase in new connections are financial realities. Revenues from water sales have been below planned levels for the last five fiscal years. Current financial planning is, therefore, more conservative and has incorporated a continuing decline in consumption for the next five years. The number of projected new connections included in planning is also at a conservative level of approximately 1,000 per year, well below the 4,000-6,000 levels experienced before the economic downturn.

OPERATING EXPENSES

We expend considerable financial resources to operate our two water systems (potable and reclaimed). We incurred \$90.0 million in operating expenses in FY 2012 (excluding depreciation of \$28.8 million and taxes of \$16.6 million) or about \$392 per service account, an 8.2% increase over FY 2011. While we are a large utility with many varied expenses, four cost categories made up 77% of our total operating costs: employee costs, power costs, CAP water costs, and administrative service charges.

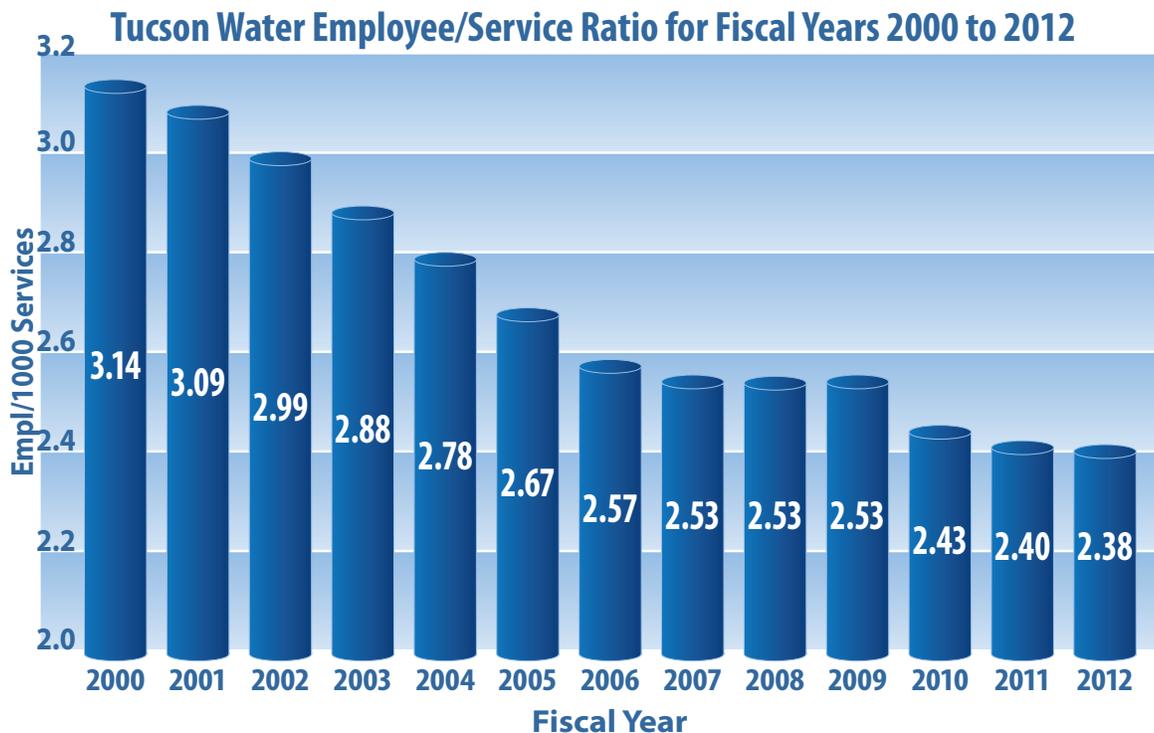
Fiscal Year 2012 Operating Expenses – \$90 Million



MANAGEMENT'S DISCUSSION AND ANALYSIS

Employee costs (\$32.4 million in FY 2012 and \$30.9 million in FY 2011) relate to our diverse staff of 556 budgeted employees, reflecting no increase in the number of positions from FY 2011. Our employees serve in varying roles: planning for our community's growing water resource needs; ensuring 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. Increased sick leave paid at retirement and overtime costs within our Customer Services Division and Maintenance Division were significant contributors to the \$1.5 million increase in FY 2012 costs over FY 2011.

Despite continuing, although modest, increases in the number of customers, our ratio of employees per 1,000 customer services (meter connections) has steadily decreased over the last twelve years, decreasing an additional 1% in FY 2012. Monitoring of meter reading routes, flexible work hours, and increased use of technology and automation continue to contribute to a reduction in the employee per-service ratio. While our efficiency attainment efforts will continue, we expect that our increasing focus on system reliability will result in elevated maintenance and replacement costs and will require our staffing levels to rise modestly in the coming years.



Power costs are incurred as we pump groundwater up from depths up to 700 feet and move it through our distribution system. Recharged CAP water is recovered and moved from the facilities approximately 20 miles outside of our central service area. This facility has significantly offset the numerous central wellfield wells that previously pumped and delivered groundwater. To control power costs, we have converted, where feasible, to less expensive, interruptible rates and have designed

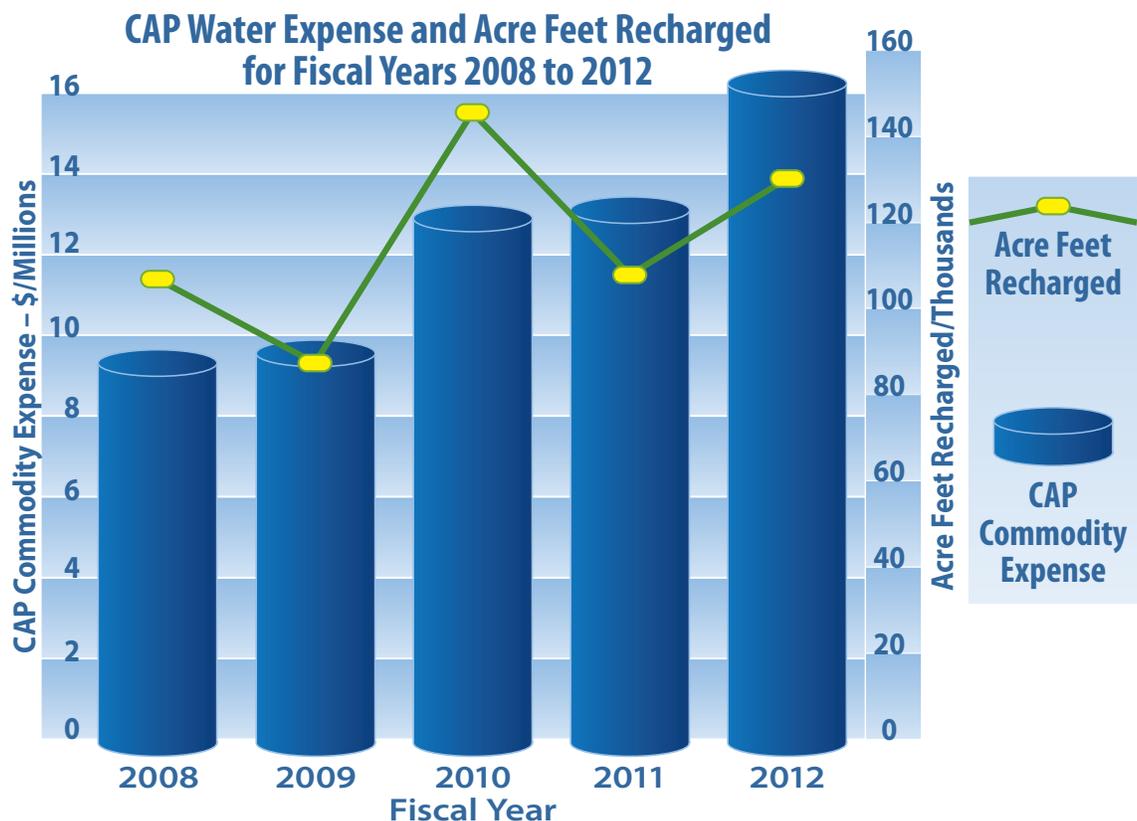
MANAGEMENT'S DISCUSSION AND ANALYSIS

our system to operate with a mix of electric and gas powered pumps. During FY 2012, we had 221 active, water producing wells, of which 186 (84%) were electric powered and 35 (16%) were gas powered.

Power costs were approximately \$14.2 million in FY 2012 and \$15.1 million in FY 2011. The decreased cost of \$1.1 million was partially the result of the 4% decrease in water sales volume (less water moved through our distribution systems); however, the main contributor was a decrease in the rates for our natural gas powered wells.

CAP water costs (\$18.4 million in FY 2012 and \$15.3 million in FY 2011) result from our purchase of Colorado River water from the CAWCD. Our FY 2012 CAP water costs consisted of two components:

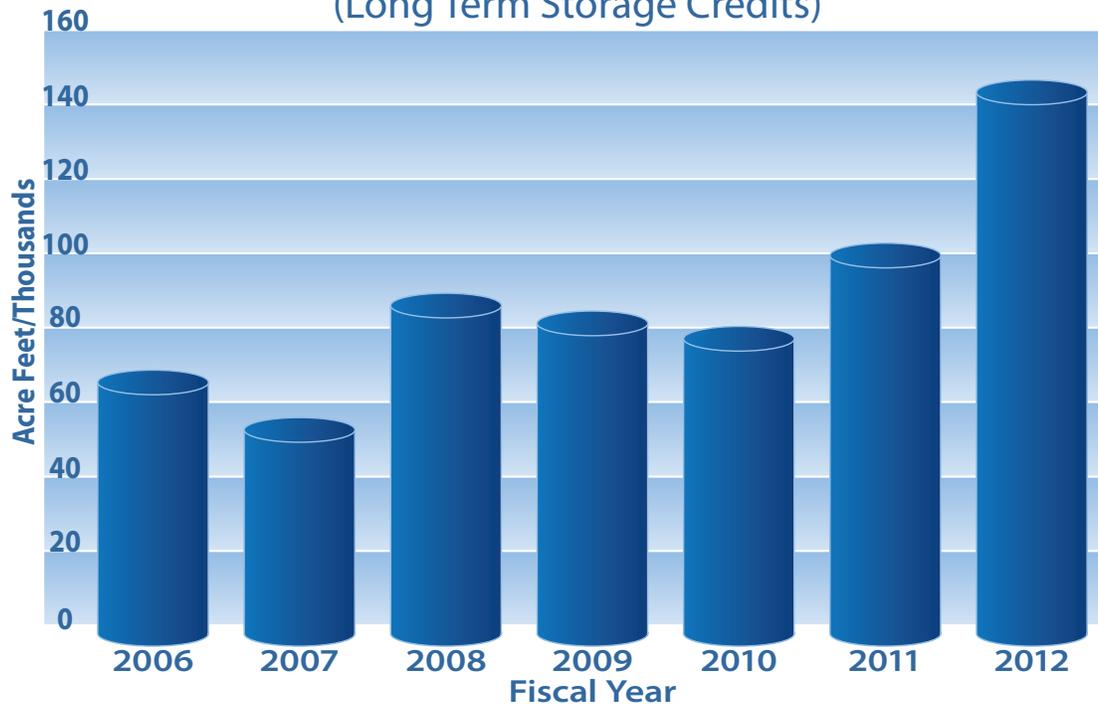
- The capital financing charge, \$2.2 million in both FY 2012 and FY 2011, is based on the Utility's annual allotment of 144,172 acre-feet and charged regardless of the amount of CAP water purchased each year.
- The commodity charge, \$16.2 million and \$13.1 million in FYs 2012 and 2011, respectively, is based on the actual amount of CAP water taken. During FY 2012 we purchased 130,787 acre-feet of CAP water and placed, for the first time, a calendar year order for our full allocation of 144,172 acre-feet. The increased expense reflects the increased acre feet purchases as well as a 3.4% increase in the commodity cost per acre-foot charged by CAWCD.



MANAGEMENT'S DISCUSSION AND ANALYSIS

By purchasing and recharging approximately 54,000 AF more CAP water than we delivered, we are banking this water for future use by our customers. This banking of water increases our systems future reliability should CAP water shortages occur in the future. As of December 2012, Tucson Water had stored enough CAP water to meet nearly 160% of our FY 2012 potable demand.

Cumulative CAP Water Stored – Calendar Year End December 31 Totals (Long Term Storage Credits)



Administrative service charges, \$9.2 million in FY 2012 and \$8.8 million in FY 2011, 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 the City to support non-Utility related purposes.

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 increased cost for CAP water. Payments for CAP water are expected to increase approximately 16% over the next five years based on projections provided by CAWCD. Additional operational cost pressures include the potential for continued volatility in power costs, increasing employee related costs, particularly those related to pension and health care, and increases associated with funding of our capital program (both pay-as-you-go and principal/interest debt service payments). We will continue to identify operational efficiencies enabling us to provide potable and reclaimed water while maintaining water rate adjustments at levels acceptable to the community we serve.

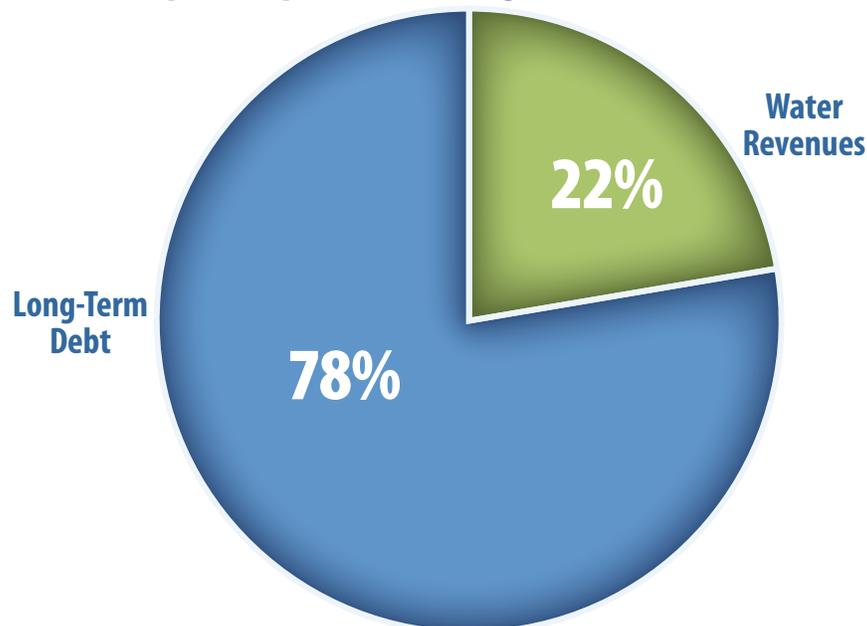
MANAGEMENT'S DISCUSSION AND ANALYSIS

CAPITAL IMPROVEMENTS

We plan, design, and construct improvements to our system infrastructure to meet the demands of our current and future customers. Our capital improvement program (CIP) is focused on the utilization of our long-term renewable water resources. At the end of FY 2012, our water system was composed of 224 active water producing wells, approximately 4,687 miles of delivery pipelines, 117 boosters to move water around our delivery area, and 65 reservoirs (57 potable and 8 reclaimed) to store water to meet peak demands.

We fund our capital program with a combination of current revenues (pay-as-you-go: cash from the sale of water to our customers) and long-term debt/bond proceeds (cash from the sale of revenue bonds/obligations). This funding practice enables both current and future customers to participate in the funding of capital improvements.

**Funding of Fiscal Year 2012
Capital Improvement Program – \$53.0 Million**



During FY 2012, we spent approximately \$53.0 million on improvements to our system compared with FY 2011 spending of \$46.7 million. Eight projects accounted for 51% (\$26.9 million) of our FY 2012 CIP spending:

- Two projects (reservoir/booster and main interconnect improvements) pertaining to our Clearwater recharge and recovery facility accounted for \$11.3 million
- Water main replacements associated with road improvements in our community accounted for \$4.5 million
- Our ongoing potable water meter replacement and reservoir/tank rehabilitation programs utilized \$3.2 million and \$2.8 million, respectively
- \$2.8 million was spent on improvements at our East Side satellite facility

MANAGEMENT’S DISCUSSION AND ANALYSIS

- \$1.3 million was spent on the continuing construction of a state-of-the-art facility to remove 1,4-dioxane from groundwater recovered within a section of the Southside wellfield
- \$1.1 million for the construction of a major transmission line project.

In accordance with accounting standards, we allocate a portion of our overall administrative costs to our CIP and capitalize interest expense. The FY 2012 total for both of these allocations was \$9.1 million.

The remaining \$17.0 million of FY 2012 CIP spending occurred on over 100 capital projects.

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 approximately \$325 million to fund important capital projects. During this five-year period, our emphasis will be \$67 million in improvements and expansion of Tucson Water’s Clearwater Renewable Resource Facility, including recovery mains, transmission mains and collector lines. The capital program will also focus on our overall system replacement and rehabilitation needs and includes \$31 million for water line relocations and/or replacements, \$8 million for meter replacements, \$12 million for reservoir improvements, and \$19 million for improvements to our water system control and communications systems.

DEBT AND DEBT SERVICE

At June 30, 2012, we had \$511.6 million in outstanding water revenue bonds or obligations. Water revenue bond interest expense on this debt (\$20.1 million in FY 2012) is reported as expenses on our income and flow of funds statements. Repayment of principal (\$21.2 million in FY 2012) is reported only on our flow of funds statement. In addition, we paid \$1.0 million in fiscal agent fees.

During FY 2012, the following bond sales or loans agreements occurred:

Amount	Interest Rate	Month
\$ 15.2 million in junior lien refundings	2.0%	January 2012
\$ 50.8 million senior lien refundings	1.0 – 5.0%	February 2012

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

	FY 2012	FY 2011
System equity fee collections	\$2.4 million	\$2.5 million
Water revenue bond/obligations debt service	\$41.3 million	\$38.3 million
System equity fee as % of debt service	6%	7%

MANAGEMENT'S DISCUSSION AND ANALYSIS

The financing of our capital program with a combination of bond proceeds/loans and water sales revenues, generates a healthy ratio of outstanding water revenue bond debt to system fixed assets.

Ratio of Outstanding Water Revenue Bonds to Fixed Assets⁽¹⁾ Fiscal Years Ending June 30 (\$ in millions)

	FY 2012	FY 2011
Land	\$49.3	\$49.3
Buildings	95.3	101.6
Water mains	1,239.5	1,276.8
Construction in progress	89.4	106.2
Machinery	41.6	41.7
Less accumulated depreciation	(402.5)	(430.8)
Total fixed assets	\$1,112.6	\$1,144.8
Water revenue bonds/obligations outstanding	495.9	511.6
Ratio water revenue bonds/fixed assets	0.45	0.45

(1) Goodwill and capitalized water rights not included

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 2012 was \$21.7 million or \$1.7 million less than the FY 2011 increase.

Change In Increase to Net Assets – Fiscal Year 2012 from Fiscal Year 2011 (\$ in millions)

Increase to net assets FY 2012	\$21.7
Increase to net assets FY 2011	23.4
Change in amount of increase	(\$1.7)

Detail of Changes - FY 2012 from FY 2011

Revenues	
Increase in water sale (potable and reclaimed)	\$6.4
Increase in other revenues	1.6
Increase in revenues	\$8.0

(Continued on next page)

MANAGEMENT'S DISCUSSION AND ANALYSIS

(Continued from previous page)

Expenses	
Increase in depreciation expense	(\$ 1.0)
Decrease in power expense	0.9
Increase in employee costs	(1.5)
Increase in debt service interest	(1.9)
Increase in CAP water costs (capital and commodity)	(3.2)
Increase in contractual services	(1.5)
Increase in operation commodities	(1.0)
Increase in other expenses	0.8
Increase in expenses	(\$ 9.7)
Capital contributions	
Increase in capital contributions	0.2
Change in Increase to net assets – FY 2012 from FY 2011	(\$ 1.7)

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

Cash Reserves – During April 2012, the Mayor and Council adopted a Financial Plan targeting cash reserve levels at approximately \$23.4 million by the end of FY 2012. At June 30, 2012, unrestricted/undesignated cash on hand was \$30.1 million.

Debt Service Coverage (the % by which revenues, after meeting operating cash needs, cover Water Revenue bond and WIFA loan principal and interest payments)

- Bond covenants require that if the Net Revenue of any fiscal year does not equal or exceed 175% of the Senior Lien Annual Debt Service Requirement for that fiscal year, the City will deposit additional monies into a reserve account. For the fiscal year ended June 30, 2012, the debt coverage on Senior Lien Annual Debt Service Requirement was 186%.
- In addition, Mayor and Council policy require us to **target** an annual average debt coverage of combined Senior and Junior lien debt of at least 1.75. Debt service coverage for FY 2012 was 1.68.

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.

MANAGEMENT'S DISCUSSION AND ANALYSIS

The following “summary flow of funds” identifies the major cash sources and uses during FY 2012:

Summary Fiscal Years 2012 Flow of Funds (\$ in millions)

CASH INFLOWS

What we received:

from sale of water ⁽¹⁾	\$ 140.3
from development/resource fees	2.7
from other revenues/sources ⁽²⁾	30.0

TOTAL	\$ 173.0
--------------	-----------------

CASH OUTFLOWS & USES

How much of our revenues we used for:

operations/maintenance ⁽³⁾	\$ 107.8
bond debt service (principal/interest) ⁽⁴⁾	42.2
capital improvements (revenue funded) ⁽⁴⁾	11.8
other purposes	1.6
increase in reserves	9.6

TOTAL OUTFLOWS/USES	\$ 173.0
----------------------------	-----------------

(1) includes CAP surcharge revenues

(2) includes taxes of \$16.6 million

(3) includes taxes of \$16.6 million and payment to City of Tucson for direct and indirect administrative support of \$9.2 million.

(4) Capitalized interest expense of \$2.2 million is reflected as a reduction to bond debt service and an increase in capital improvements.

FINANCIAL PLANNING AND OUTLOOK

Each year, we develop a rolling six-year Financial Plan (current year plus five). This plan is built on Tucson Water’s 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 2012-FY 2017, which was adopted by Mayor and Council during FY 2012, calls for annual water rate adjustments in all years of the Plan. Primary drivers behind the need for increased revenues include the projected continued reduction in water sales volumes, the increasing cost of CAP water, and the financing of our capital program. We believe our financial planning

MANAGEMENT'S DISCUSSION AND ANALYSIS

process, combined with our ongoing improved efficiencies, positions us to meet our goals of continued reduced dependence on groundwater, increased reliability, and continued delivery of affordable, high quality water to our 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, phone (520) 791-2666, or email TW_Web1@tucsonaz.gov.

**MD&A
APPENDIX
A**

SUPPLEMENTAL SCHEDULE OF FLOW OF FUNDS ⁽¹⁾

Unaudited
Year ended June 30, 2012
(\$ in thousands)

Excludes Conservation Program Fund

Revenues for operations and debt service:

Sale of potable water	\$ 125,948	
Sale of reclaimed water	9,330	
	<u> </u>	
Total Sale of Water		\$135,278
Central Arizona Project surcharge		2,293
Connection fees		1,611
System equity fees		2,398
CAP resource fee		304
Taxes (state/local business privilege taxes and City Utility taxes)		16,612
Investment income		
Operating fund interest earnings	178	
Debt service fund interest earnings	1	
Bond fund interest earnings	101	
	<u> </u>	
Total interest earnings available for operations and debt service		280
Sewer billing services –		
Pima County Sewer, City of Tucson Environmental Services		3,406
Miscellaneous revenue:		
TCE clean-up reimbursement	879	
Area development fees	214	
Service charges	3,520	
Federal non-grant contributions/other agencies	819	
Plan review and inspection fees	381	
Prior year and reimbursed expenses	1,617	
Other	122	
	<u> </u>	
Total miscellaneous revenue		7,552
Other receipts:		
Proceeds from sale of property and equipment		489
	<u> </u>	
Total revenues for operations and debt service		<u>\$ 170,223</u>

(1) This schedule presents a flow of funds under the methodology utilized by the Utility in determining needs for revenue adjustments. That methodology, approved by the American Water Works Association and reviewed by the Utility's independent rate consultant, looks at projected cash requirements for the year. This statement, based on actual results, enables the Utility to compare results with those projections.

(Continued on next page)

**MD&A
APPENDIX
A**
(Continued)

SUPPLEMENTAL SCHEDULE OF FLOW OF FUNDS ⁽¹⁾

Unaudited
Year ended June 30, 2012
(\$ in thousands)
Excludes Conservation Program Fund

Operations and maintenance expense:			
Director's office			\$ 2,684
Business services			3,540
Customer services			7,426
Water operations (excluding power)			18,750
Planning and engineering (including waterline relocation)			5,894
Water quality management (excluding CAP water purchases/ power)			9,690
CAP water:	Capital charges ⁽²⁾		3,366
	Commodity		16,218
	Total CAP water		19,584
Power:	Potable system		12,665
	Reclaimed system		1,486
	Total power		14,151
General expense (including taxes)			15,351
Total operations and maintenance expense			97,070
Debt service on water revenue bonds/loans:	Water revenue and water obligation bonds - Senior Lien ⁽³⁾	Water infrastructure finance authority loans - Junior Lien ⁽³⁾	
Interest	20,946	1,280	22,226
Principal	18,330	2,869	21,199
	<u>39,276</u>	<u>4,149</u>	43,425
Fiscal Agent Fees			998
Total debt service on water revenue bonds/loans			44,423
Capital equipment from revenue and other sources (excludes capitalized interest)			9,636
Other uses:			
Administrative service charges			9,233
Payment to General Fund: In Lieu Tax			1,600
Increase in working capital			8,261
Total other uses			19,094
Total expenses, debt service, capital outlay and other uses			\$ 170,223

(Continued on next page)

MD&A
APPENDIX
A
(Continued)

SUPPLEMENTAL SCHEDULE OF FLOW OF FUNDS ⁽¹⁾

Unaudited
Year ended June 30, 2012
(\$ in thousands)

Excludes Conservation Program Fund

(1) This schedule presents a flow of funds under the methodology utilized by the Utility in determining needs for revenue adjustments. That methodology, approved by the American Water Works Association and reviewed by the Utility's independent rate consultant, looks at projected cash requirements for the year. This statement, based on actual results, enables the Utility to compare results with those projections.

(2) Installment payment on CAP water right acquisition is included here.

(3) Debt service coverage calculation:	Revenues (excludes Bond Fund interest earnings)	\$170,122		
	Operations and maintenance expense	97,070		
	Revenues available for debt service (senior and junior lien)	73,052		
	Less principal /interest water revenue bonds senior lien)	(39,276)	Senior Lien Coverage	186%
	Revenues available for debt service (junior lien)	33,776		
	Less water Infrastructure Finance Authority Loans	(4,149)	Junior Lien Coverage	814%
			Combined Coverage	168%
	Balance available for capital investment and other uses	\$29,627		

Page intentionally left blank.

**MD&A
APPENDIX
B**

SUPPLEMENTAL SCHEDULE OF FLOW OF FUNDS ⁽¹⁾

Unaudited
Year ended June 30, 2012
(\$ in thousands)
Includes Conservation Program Fund

Revenues for operations and debt service:

Conservation program fees	\$ 2,816
Investment income	6
Prior year and reimbursed expenses	9

Total revenues	\$ 2,831
-----------------------	-----------------

Operations and maintenance expense:

Director's Office	1,495
-------------------	-------

Other Uses:

Increase in conservation program reserves	1,336
---	-------

Total expenses and other uses:	\$ 2,831
---------------------------------------	-----------------

(1) This schedule presents a flow of funds under the methodology utilized by the Utility in determining needs for revenue adjustments. That methodology, approved by the American Water Works Association and reviewed by the Utility's independent rate consultant, looks at projected cash requirements for the year. This statement, based on actual results, enables the Utility to compare results with those projections.

Page intentionally left blank.

Financial Statements

Page intentionally left blank.

STATEMENT OF NET ASSETS

June 30, 2012
(\$ in thousands)

Assets	
Current assets:	
Cash and cash equivalents	
Undesignated	\$ 30,128
Designated for customer deposits	1,227
Total cash and cash equivalents	31,355
Billed accounts receivable, net of allowance for doubtful accounts of \$71	11,754
Unbilled accounts receivable	11,224
Due from other agencies	38
Inventories, prepaids and other assets	2,662
Total current assets	57,033
Restricted assets:	
Cash and cash equivalents	39,030
Cash and investments with fiscal agents	28,097
Other restricted assets	4,233
Total restricted assets	71,360
Long-term accounts receivable	354
Capital Assets:	
Utility property, plant and equipment	1,421,252
Land and construction-in-progress	155,559
Less accumulated depreciation	(431,898)
Water rights	52,127
Net capital assets	1,197,040
Other	4,416
Total assets	\$ 1,330,203

(Continued on next page)

STATEMENT OF NET ASSETS

June 30, 2012
(\$ in thousands)
(Continued)

Liabilities and Net Assets

Current liabilities:

Accounts payable	\$ 3,400
Salaries, wages and payroll taxes payable	808
Current installments of revenue bonds payable	24,347
Current portion of compensated absences	1,596
Refundable/customer deposits	1,227
Deferred Revenue	38

Total current liabilities	31,416
----------------------------------	---------------

Liabilities payable from restricted assets

33,678

Long-term liabilities:

Revenue bonds payable	495,918
Compensated absences	1,932
Other post-employment benefits	784

Total long-term debt	498,634
-----------------------------	----------------

Total liabilities	563,728
--------------------------	----------------

Net Assets

Invested in capital assets net, of related debt	700,566
Restricted for Debt Service	28,097
Unrestricted	
Conservation Program	2,335
Other	35,478

Total unrestricted net assets	37,813
--------------------------------------	---------------

Total net assets	\$ 766,476
-------------------------	-------------------

The notes to the financial statements are an integral part of this statement.

STATEMENT OF REVENUES, EXPENSES AND CHANGES IN NET ASSETS

Year ended June 30, 2012
(\$ in thousands)

Operating revenues:	
Potable water sales	\$ 125,948
Reclaimed water sales	9,330
Total water sales	135,278
Central Arizona Project surcharge	2,293
Water Conservaton Program fees	2,816
Connection fees	1,611
Billing services -	
Pima County Sewer, City of Tucson Environmental Services	3,406
Miscellaneous:	
TCE Cleanup reimbursement	879
Service charges	3,520
Plan review and inspection fees	381
Reimbursed prior year expenses	1,626
Total miscellaneous	6,406
Total operating revenues	151,810
Operating expenses:	
Director's office:	
Personal services	1,966
Contractual services	2,009
Commodities	204
Total director's office	4,179
Business services:	
Personal services	793
Contractual services	1,547
Commodities	1,200
Total business services	3,540
Customer services:	
Personal services	6,526
Contractual services	400
Commodities	500
Total customer services	7,426
Water operations:	
Personal services	10,750
Contractual services	4,245
Commodities	3,843
Total water operations	18,838

(Continued on next page)

STATEMENT OF REVENUES, EXPENSES AND CHANGES IN NET ASSETS

Year ended June 30, 2012

(\$ in thousands)

(Continued)

Planning and engineering:	
Personal services	\$ 4,719
Contractual services	750
Commodities	430
	5,899
Water quality management:	
Personal services	6,398
Contractual services	15,487
Commodities	1,692
	23,577
CAP water charges:	
Capital charges	2,222
Commodity charges	16,218
	18,440
General expenses:	
Personal services	1,211
Contractual services	6,822
Commodities	110
	8,143
Depreciation and goodwill amortization (note 2g)	28,751
	118,793
Net operating income	33,017
Nonoperating income:	
Investment earnings	408
Gain on sale of property/equipment	489
Other agency contributions	792
Federal grants and contributions	27
	1,716
Nonoperating expenses:	
Interest expense	20,100
Amortization of issuance costs	573
Other nonoperating expenses	998
	21,671
Net income before capital contributions	13,062
Capital contributions	10,189
Net transfers in/out	(1,600)
Change in net assets	21,651
	Net assets - July 1
	744,825
	Net assets - June 30
	\$ 766,476

The notes to the financial statements are an integral part of this statement.

STATEMENT OF CASH FLOWS

Year ended June 30, 2012
(\$ in thousands)

Cash flows from operating activities:

Cash received from customers	\$ 148,189
Cash payments to suppliers for goods and services	(55,160)
Cash payments to employees for services	(32,578)

Net cash provided by operating activities	60,451
--	---------------

Cash flows from noncapital financing activities:

Subsidy from federal grant	69
Federal subsidy – Build America bonds	792
Internal activity payments to other funds	(1,600)

Net cash used by capital & noncapital financing activities	(739)
---	--------------

Cash flows from capital and related financing activities:

Bond proceeds	39,456
Acquisition and construction of capital assets	(48,014)
Principal paid on capital debt	(19,774)
Interest paid on capital debt	(20,100)
Fiscal agent fees paid on capital debt	(998)
Proceeds from sale of property and equipment	502

Net cash used in capital and related financing activities	(48,928)
--	-----------------

Cash flows from investing activities – interest received on investments

702

Net increase in cash and cash equivalents	11,486
--	---------------

Cash and cash equivalents at beginning of year	86,996
--	--------

Cash and cash equivalents at end of year	\$ 98,482
---	------------------

STATEMENT OF CASH FLOWS

Year ended June 30, 2012

(\$ in thousands)

(Continued)

Reconciliation of operating income to net cash provided by operating activities:

Operating income	\$ 33,017
------------------	-----------

Adjustments to reconcile operating income to net cash provided by operating activities:

Depreciation and amortization	28,751
-------------------------------	--------

Decrease (increase) in assets:

Accounts receivable/Due from Other Agencies	781
---	-----

Inventories	(302)
-------------	-------

Prepays and other assets	1,261
--------------------------	-------

Long-term accounts receivable	(2,845)
-------------------------------	---------

Increase (Decrease) in liabilities:

Accounts payable	156
------------------	-----

Accrued payroll liabilities	(318)
-----------------------------	-------

Accrued compensated absences	(522)
------------------------------	-------

Accrued other post employment benefits	625
--	-----

Due to other agencies	1,405
-----------------------	-------

Customers/refundable deposits/due to other agencies	(1,558)
---	---------

Net cash provided by operating activities	\$ 60,451
--	------------------

A reconciliation of cash and cash equivalents at June 30 follows:

Unrestricted cash	31,355
-------------------	--------

Restricted cash (included in restricted assets)	67,127
---	--------

Cash and cash equivalents at June 30	\$ 98,482
---	------------------

Noncash investing, capital and financing activities:

Contributions of capital assets from developers	\$ 7,272
--	-----------------

Other Capital Contributions	2,917
-----------------------------	-------

Total Capital Contributions	\$ 10,189
------------------------------------	------------------

The notes to the financial statements are an integral part of this statement.

NOTES TO THE FINANCIAL STATEMENTS

(Amounts in \$1,000s)

1. DESCRIPTION OF THE BUSINESS

Tucson Water (the Utility), an enterprise fund of the City of Tucson, Arizona (the City), is operated and maintained as a self-supporting, municipally-owned utility of the City, providing customers with potable and reclaimed water. The Utility provides water service to approximately 705,000 people within a 300 square-mile service area that encompasses approximately 85% of the greater Tucson metropolitan area's total population. Customers are classified by the type of service they receive, including residential, multifamily, mobile home park with sub-meters, commercial, and industrial services, and are located both inside and outside of the City limits.

WATER SOURCES

During FY 2012, the Utility obtained its municipal potable water – water quality meeting or exceeding all federal, state, and local drinking water standards – from two sources:

- four groundwater well fields (Central, Avra Valley, Santa Cruz, and Southside
- facilities where the Utility recharges and recovers Colorado River water.

These four well fields and the recharge and recovery facilities provide the Utility with an aggregate production capacity of 238 million gallons of water per day.

The Utility's surface water source contract with the United States Department of the Interior and the Central Arizona Water Conservation District (CAWCD) provides access to 144,172 acre-feet annually of Colorado River water, delivered via the Central Arizona Project (CAP). The CAP consists of 335 miles of waterworks and associated facilities designed to deliver water from Lake Havasu on the Colorado River to Maricopa, Pinal, and Pima Counties in central/southern Arizona.

In FY 2012, the Utility's recharge and recovery facilities pumped 60,000 acre-feet of blended recharged/recovered CAP water and groundwater into the Utility's distribution system. The Clearwater Renewable Resource Facility, constructed west of the City of Tucson, is composed of recharge basins, recovery well fields, storage and transmission facilities. These facilities permit the recharge of approximately 129 million gallons per day (144,172 acre-feet/year) of Colorado River water, a renewable source. Current recovery well capacity is 76 million gallons of water per day (85,162 acre-feet/year). Meeting nearly all of its customers' current demand for potable water with Colorado River water enables the Utility to reduce pumping groundwater from the central well field, over which the majority of the City lies, thereby easing concerns related to land subsidence. During 2012 the Utility expects to produce up to 85 million gallons of water per day from the facilities.

As part of a 1979 intergovernmental agreement (IGA) transferring the sewer system from the City to Pima County, the Utility was granted the right to use 90% of the effluent discharged from the metropolitan wastewater treatment facilities. Planning for use of this water resource was initiated in 1982. In 1984, the Utility began delivering reclaimed water, effluent treated to tertiary levels, to customers for turf irrigation. The Utility's reclaimed system currently includes:

NOTES TO THE FINANCIAL STATEMENTS

(Amounts in \$1,000s)

- a reclaimed water treatment plant which processes effluent to a quality suitable for open-access turf irrigation
- a wetlands which biologically treats secondary effluent
- basins for the effluent recharge
- wells for recovery of the recharged water for delivery in the reclaimed distribution system.

In February 2000, the IGA was amended to resolve issues related to effluent and recharge permits. The amendment contained numerous agreements, including:

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

In 2001, the City entered into agreements with the Metropolitan Domestic Water Improvement District and Oro Valley, transferring portions of its 90% allocation. In addition, in 2009 the City entered into similar effluent agreements with the Flowing Wells Irrigation District and Spanish Trail Water Company to transfer portions of its effluent allocation.

ASSURED WATER SUPPLY

The State of Arizona's Department of Water Resources' (ADWR) Assured Water Supply (AWS) Program is designed to encourage municipal water providers to shift their reliance from groundwater to renewable water sources. The AWS Program is ADWR's primary way of assuring that safe yield is reached. To demonstrate an assured water supply – AWS - means that sufficient water of adequate quality will be continuously available to meet the water needs of the proposed use for at least 100 years, and that the projected use is consistent with the management plan and achievement of the management goal for the Tucson AMA. The Utility has successfully demonstrated an AWS and has been granted a certificate of AWS Designation by ADWR.

It is important that the Utility have an AWS Designation because without it no new development beyond those lands currently platted can take place within the service area unless developers provide their own water supply. Receipt of the AWS Designation indicates a sufficient water supply is available to meet 100 years of projected demand for the existing population, committed demand (undeveloped, subdivided land within the service area) and provision for an

NOTES TO THE FINANCIAL STATEMENTS

(Amounts in \$1,000s)

increment of growth. The Utility qualified for the AWS Designation because of the construction of its recharge projects and its membership in the Central Arizona Groundwater Replenishment District (CAGRDR). The Utility's membership in the CAGRDR and the planned recharge projects enable the Utility to meet all criteria required for receipt of an AWS Designation.

Tucson Water entered into the membership agreement with the CAGRDR in December 1996 to ensure that it would meet the December 31, 1996 deadline for early application for an AWS Designation. By meeting the early filing deadline, the Utility was permitted to pump groundwater during 1998, 1999, and 2000 (about 300,000 acre feet) without being subject to the groundwater pumping limitations in the AWS rules. Pursuant to the terms of the agreement with CAGRDR, the Utility was committed to pay an annual replenishment tax for water recharged on its behalf. The first of six annual payments began in October 2002. The per acre-foot tax consisted of the current capital and commodity charges for CAP water, as established annually by CAWCD, plus an administrative fee, a CAGRDR capital facility fee and a CAGRDR recharge facility operational fee. The final payment was made in October of 2007.

During the preparation of the AWS Designation application, Tucson Water identified 42.9 million acre feet of available water supplies for the period 1997-2100. These calculations indicate that there is more than sufficient supply available for customers in its service area for approximately the next 100 years.

As the City continues to develop its water resource program, there may be changes in the way that the various supplies are used. In the future, the Utility's staff will work closely with ADWR to ensure the AWS Designation is not jeopardized.

UTILITY OPERATIONS

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

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

NOTES TO THE FINANCIAL STATEMENTS

(Amounts in \$1,000s)

- All costs associated with the operation of the Utility (operating, maintenance, renewal and replacement, capital and debt service) will be funded from revenues derived from the Utility's water rates and other water-related income sources.
- Various combinations of revenue bonds and obligations, tax-secured bonds and water revenues are used to finance Utility capital improvements; regardless of what type of bond is used, repayment of the bonds shall be made only from Utility revenues.
- Some portion of the capital improvements are required to be funded from annual revenues to comply with existing bond covenants and Mayor and Council policy and to facilitate new debt issues by maintaining adequate debt coverage. An annual average debt coverage of at least 1.75 shall be maintained. The Utility was in compliance with debt coverage requirements for the fiscal year ended June 30, 2012.
- Mayor and Council's policy is for the utility to maintain cash reserves adequate for known future obligations and provide for potential shortfall in water sales revenues.
- Charges for services will be made on a cost of service basis. Water rate design elements will reflect the cost of service areas across customer classes and seasons, and will be designed so as to encourage water conservation and to control peak demand.
- Water rates and charges will be reviewed annually.

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

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

A. GENERAL

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

NOTES TO THE FINANCIAL STATEMENTS

(Amounts in \$1,000s)

B. BASIS OF ACCOUNTING

The accounting and financial reporting treatment applied to a fund is determined by its measurement focus. Proprietary funds are accounted for on a flow of economic resources measurement focus. With this measurement focus, all assets and liabilities associated with the operation of these funds are included on the Statements of Net Assets. Net assets is segregated into components. Proprietary fund-type operating statements present increases (e.g., revenues) and decreases (e.g., expenses) in total net assets. Proprietary fund operating revenues, such as charges for services, result from exchange transactions associated with the principal activity of the fund. Exchange transactions are those in which each party receives and gives up essentially equal values. Nonoperating revenues, such as subsidies and investment earnings, result from nonexchange transactions or ancillary activities.

Basis of accounting refers to when revenues and expenses are recognized in the accounts and reported in the financial statements. Basis of accounting relates to the timing of the measurements made, regardless of the measurement focus applied. The accrual basis of accounting is utilized by proprietary fund types. Under this method, revenues are recorded when earned and expenses are recorded at the time liabilities are incurred.

C. USE OF ESTIMATES IN PREPARING FINANCIAL STATEMENTS

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make a number of estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the reporting period. Actual results could differ from those estimates.

D. INVESTMENTS/ DEPOSITS

The City maintains an investment pool that is available for use by all City funds, including Tucson Water. All assets of the investment pool are held by a single master custodian in Trust. Pooled investments are reported at fair market value. Income from pooled investments is allocated to individual funds based on each fund's monthly average daily cash balance in relation to total pooled investments.

Investments are reported at fair value. The fair value of the City's pooled investments is based on current market prices. Securities traded on a national or international exchange are valued at the last reported sales price at current exchange rates. Investments that do not have established market prices are reported at estimated fair value. Estimated fair value for real estate investments are established by third party appraisers.

The Utility's interest earnings are recognized on the accrual basis. Changes in the fair value of investments are recognized as gains or losses on a monthly basis.

NOTES TO THE FINANCIAL STATEMENTS

(Amounts in \$1,000s)

E. CASH AND CASH EQUIVALENTS

For the purpose of the statement of cash flows the City considers all highly liquid investments (including the Utility's participation in the investment pool account and appropriate restricted assets) to be cash equivalents. The Utility's investments with an initial maturity date of 12 months or less when purchased are considered to be cash equivalents.

F. BILLED ACCOUNTS RECEIVABLE

Accounts receivable are uncollateralized customers obligations for charges for services. The carrying amount of accounts receivable is reduced by a valuation allowance that reflects management's best estimate of amounts that will not be collected. The allowance of doubtful accounts is based on management's assessment of the collectability of specific customer accounts and the aging of accounts receivable.

An allowance for doubtful accounts of \$71 was recorded as of June 30, 2012.

G. UNBILLED ACCOUNTS RECEIVABLE

Unbilled accounts receivable are for charges for services not billed to the customer.

H. INCOME AND OTHER TAXES

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

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

The Utility makes an annual in-lieu-of property tax payment to the City's General Fund. The payment is reported as a Transfer Out on the *Statement of Revenues, Expenses and Changes in Net Assets* and was \$1,600 for fiscal year 2012.

NOTES TO THE FINANCIAL STATEMENTS

(Amounts in \$1,000s)

I. CAPITAL ASSETS

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

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

The Utility capitalizes interest on capital projects if it is material, based on Accounting Standards Codification 835-20, *Capitalization of Interest Costs*. Interest costs capitalized during the fiscal year ended June 30, 2012 was \$2,195. Maintenance and repairs are expensed as incurred.

J. GOODWILL

Goodwill is recorded upon the acquisition of Water companies and represents the excess of cost over fair value at the time of acquisition. Goodwill is amortized over 40 years using the straight-line method. Total goodwill of \$1,122 has been fully amortized.

K. WATER RIGHTS

The City does not place a limitation on the life on the Utility's water rights, an intangible capital asset, and does not expect to cease utilizing the water rights in the foreseeable future. Water rights are recorded at historical cost and are not amortized. The book value of the Utility's water rights was \$52,127 at June 30, 2012.

L. DEFERRED CHARGES

Deferred charges represent the unamortized costs resulting from the issuance of water revenue bonds. These deferred charges, reported under *Other Assets* on the *Statement of Net Assets*, are amortized over the life of the related bonds. Unamortized costs were \$4,416 at June 30, 2012.

NOTES TO THE FINANCIAL STATEMENTS

(Amounts in \$1,000s)

M. RESTRICTED ASSETS/ LIABILITIES

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

N. INVENTORIES/ PREPAIDS

Inventories and prepaid items are reported using the consumption method and consist primarily of expendable supplies. Inventories are maintained on a perpetual system and are primarily valued using the weighted-average cost method, which is not in excess of market. Expenses are recorded at the time inventories are consumed. Certain payments to vendors that reflect costs applicable to future periods are recorded as prepaid items.

O. LONG-TERM OBLIGATIONS

Long-term debt and other long-term obligation are reported as liabilities on the Statement of Net Assets. Bond premiums and discounts, as well as issuance costs and, on refundings, the difference between the reacquisition price and the net carrying amounts of old debt, are deferred and amortized over the life of the bonds using the straight-line method.

The costs of employee vacation leave, sick leave, accumulated compensatory time, and any salary-related amounts are expensed as earned. Accrued compensated absences not expected to be utilized by employees within the next year are recorded as long-term liabilities. The long-term liability related to accrued, compensated absences was \$1,932 at June 30, 2012.

Post-employment health care and life insurance benefits (OPEB) are provided to retired employees in addition to pension benefits (see Note 12-c). The Utility's calculated long-term portion of these benefits is recorded as a long-term liability and was \$784 at June 30, 2012.

NOTES TO THE FINANCIAL STATEMENTS

(Amounts in \$1,000s)

3. DEPOSITS/ INVESTMENTS

The Utility had \$28,097 in cash and investments held with fiscal agents at June 30, 2012, included in restricted assets in the accompanying *Statement of Net Assets*. Cash with fiscal agents was covered by collateral held in the fiscal agents' trust departments but not in the Utility's name. Each trust department pledges a pool of collateral against all trust deposits it holds.

At year-end, the Utility had \$31,355 in unrestricted cash and cash equivalents and \$39,030 in restricted cash and cash equivalents. The City Charter and State Statutes authorize the City to invest City investment pool funds in obligations of the U.S. Government, its agencies and instrumentalities, money market funds consisting of the above, repurchase agreements, bank certificates of deposit, commercial paper rated A-2/P-2 (or better), corporate bonds and notes rated AAA or AA, and the State of Arizona Local Government Investment Pool. Operating and capital projects funds may be invested for a maximum of three (3) years based on projected construction schedules. Since these funds are held by the City of Tucson in its investment pool, they are not categorized by the Utility.

The City maintains an investment pool that is available for use by all City funds. Each fund's portion of this pool is reported on the financial statements as "Pooled Cash and Investments." A single master custodian holds all assets of the investment pool. In addition, certain cash deposits and investments are also held separate by various City funds in separate accounts.

The majority of deposits and investments of the Tucson Supplemental Retirement System (TSRS), a defined benefit pension plan, are held in trust separately from those of other City funds by a master custodian. However, biweekly contributions to the fund for this plan are held in the investment pool to cover recurring expenditures.

The following is a reconciliation of the City's deposit and investment balances as of June 30, 2012:

	Pooled Cash and Investments	Reconciling Adjustments	Total
Bank Deposits	\$200,273,597	\$(20,548,641)	\$179,724,956
Investments	633,967,117	75,001	634,042,118
Total	\$834,240,714	\$(20,473,640)	\$813,767,074

	Government- wide Statement of Net Assets	Fiduciary Funds Statement of Net Assets	Total
Pooled Cash and Investments	\$134,721,763	\$5,973,029	\$140,694,792
Investments	26,918,240	607,123,878	634,042,118
Cash & Investments Restricted	39,030,164		39,030,164
Total	\$200,670,167	\$613,096,907	\$813,767,074

NOTES TO THE FINANCIAL STATEMENTS

(Amounts in \$1,000s)

A. DEPOSITS

Reconciling items in the previous table are made up of outstanding checks, deposits, in transit and other miscellaneous items. Bank balances are covered by federal depository insurance or collateral (if applicable) held by the City's agents in the City's name.

B. INVESTMENTS

For the City investment pool, the City Charter and State Statutes authorize the City to invest in obligations of the U.S. Government, its agencies and instrumentalities, money market funds consisting of the above, repurchase agreements, bank certificates of deposit, commercial paper rated A-2/P-2 (or better), corporate bonds and notes rated AAA/Aaa or AA/Aa2, and the State of Arizona Local Government Investment Pool. Operating and capital projects funds may be invested for a maximum of three years based on projected construction schedules.

The Tucson Supplemental Retirement System (TSRS) is governed by a separate management board. The City Code provides that the TSRS Board of Trustees make investments in accordance with the "prudent person rule." Trust investments are also governed by an approved investment policy. The TSRS Board of Trustees authorizes domestic and foreign investments including U.S. Government obligations and agency issues, corporate bonds, stocks, real estate infrastructure and money market funds, as well as derivative investments. The investment policy also establishes the asset mix and target allocations for each asset class permitted.

Short-term investments for this fund may be made up of commercial paper, time deposits, guaranteed insurance contracts, money market funds or any other short-term investment fund (STIF) vehicle permitted.

The City's deposits and investments for all funds at fiscal year-end are listed below. These deposits and investments are held by the City or its agents in the City's name and are either insured, registered or collateralized (if applicable). A portion of these investments are subject to credit risk (including custodial credit risk and concentrations of credit risk), interest rate risk and/or foreign currency risk which are all discussed in the sections that follow.

NOTES TO THE FINANCIAL STATEMENTS

(Amounts in \$1,000s)

	<u>Fair Value</u>
U.S. Issues not on Securities Loan:	\$185,685,590
U.S. Treasuries, Agencies & Other Governmental Bonds	30,520,359
Corporate Bonds & Other Fixed Income Instruments	255,577,481
Corporate Stock	
Non-U.S. Issues not on Securities Loan:	
International Bonds	33,183,349
International Stock	73,928,277
Sub-Total	<u>578,895,006</u>
Investments Held by Broker-Dealers Under Securities Loans with Cash Collateral:	
U.S. Treasuries, Agencies & Other Governmental Bonds	1,191,473
Corporate Bonds & Other Fixed Income Instruments	4,064,539
U.S. Stock	8,935,777
International Stock	703,951
Sub-Total	14,895,740
Securities Lending Short-Term Collateral Investment Pool	15,567,962
Money Market Funds/ Short-Term Investments	136,321,092
Real Estate Funds	49,325,380
Infrastructure Funds	39,235,534
Sub-Total	<u>240,449,968</u>
Total Deposits and Investments	<u>\$834,240,714</u>

C. CREDIT RISK

As defined by the Governmental Accounting Standards Board (GASB) in Statement 40, credit risk is the risk that an issuer or other counterparty to an investment will not fulfill its obligations. Associated with credit risk is concentration of credit risk and custodial credit risk. Concentration of credit risk is the risk of loss attributed to the magnitude of a government's investment in a single issuer. Custodial credit risk for deposits is the risk that, in the event of failure of a depository financial institution, a government will not be able to recover deposits or will not be able to recover collateral securities that are in the possession of an outside party. The custodial credit risk for investments is the risk that, in the event of the failure of the counterparty to a transaction, a government will not be able to recover the value of investment or collateral securities that are in the possession of an outside party.

The City has the following investment policies governing the City investment pool account that addresses the various credit risks defined above. Investments shall be limited to the following instruments and percentages:

- 1) Obligations of the U.S. Government, its agencies and instrumentalities,
- 2) Repurchase agreements whose underlying collateral is commercial paper rated A-1/P-1 with maturities not to exceed 180 days or rated A-2/P-2 with maturities not to exceed 60 days,

NOTES TO THE FINANCIAL STATEMENTS

(Amounts in \$1,000s)

- 3) Bonds, notes and debentures issued by U.S. corporations rated “AAA/Aaa” or “AA/Aa2” by Standard & Poor’s/ Moody’s,
- 4) Money market funds, CD’s, etc., either insured by an agency of the federal government or collateralized (if applicable), by obligations of the U.S. Government, its agencies and instrumentalities or General Obligation municipal bonds rated A/A2 or better at 105% of the amount on deposit calculated on market values. The collateral must be held by the Trust department of the financial institution or delivered to the City’s agent,
- 5) Except for direct obligations of the U.S. Treasury, not more than 25% of the portfolio shall be invested in securities issued by a single agency or instrumentality of the United States. Not more than 5% of the portfolio shall be invested in securities of any other entity,
- 6) a minimum of 15% of the portfolio shall be in highly liquid securities,
- 7) not more that 25% of the portfolio shall be invested in corporate bonds, notes and commercial paper.

The City’s investment pool account had the following credit risk structure as of June 30, 2012

Investment Type	Average Credit Rating ⁽¹⁾	Fair Value	Percent of Grand Total
Money Market Funds:			
Wells Fargo Governement MM Fund	Aaa	\$105,849,236	56.94%
Commercial Paper:			
Various Issues	P-1	14,996,150	8.07%
Federal Agency:			
<i>Federal Home Loan Mortgage Corp</i>			
FHLMC Coupon Notes	Aaa	20,010,950	10.77%
<i>Federal Home Loan Bank</i>			
FHLB Coupon Notes	Aaa	25,022,850	13.46%
<i>Federal Farm Credit Bank</i>			
FFCB Coupon Notes	Aaa	15,006,450	8.07%
<i>Federal National Mortgage Association</i>			
FNMA Coupon Note	Aaa	4,996,000	2.69%
Grand Total		\$185,881,636	100%

Footnotes:

(1) Per Moody’s Credit Rating Organization

NOTES TO THE FINANCIAL STATEMENTS

(Amounts in \$1,000s)

D. INTEREST RATE RISK

As defined by the Governmental Accounting Standards Board (GASB) in Statement 40, interest rate risk is the risk, whereby, changes in interest rates will adversely affect the fair value of investments. For fixed income securities, there is an inverse relationship between the change in interest rates and their fair value. For example, in a rising interest rate environment the value of fixed income securities will tend to fall by varying degrees depending on the length of their maturities. In general, the value of fixed income securities with a longer duration will tend to decrease more than shorter duration securities in a rising interest rate environment.

The City's investment pool account maintains the following investment policy with regard to interest rate risk:

- 1) Surplus and idle money related to the day-to-day operation of the City may be invested in authorized investments with a final maturity not exceeding two years from the date of investment,
- 2) Monies not related to the day-to-day operation of the City may be invested for periods up to three years with maturities based upon anticipated needs,
- 3) Not more than 25% of the portfolio shall be invested in securities with a maturity longer than two years,
- 4) Not more than 50% of the portfolio shall be invested in securities with a maturity longer than eighteen months.

The City's investment pool account had the following maturity structure as of June 30, 2012:

Investment Type/Maturity	Maturity Date	Next Call Date⁽¹⁾	Fair Value	Percent of Grand Total
Money Market Funds:				
Wells Fargo Government MM Fund	n/a		\$105,849,236	
			<u>105,849,236</u>	56.94%
Less Than 1 Year				
Commercial Paper:				
PB Financial Inc.	7/25/12		4,999,100	
Harley Davidson	8/3/12		4,998,600	
Danske Corp.	8/6/12		4,998,450	
Federal Agency:				
FHLB Coupon Note	11/15/12	B	5,000,900	
FHLB Coupon Note	11/28/12	B	5,029,800	
FFCB Coupon Note	12/3/12	B	5,003,650	
FHLB Coupon Note	5/14/13	11/14/12	5,002,900	
FFCB Coupon Note	5/16/13	B	4,999,300	
			<u>40,032,700</u>	21.54%

(Continued on next page)

NOTES TO THE FINANCIAL STATEMENTS

(Amounts in \$1,000s)

Investment Type/Maturity	Maturity Date	Next Call Date ⁽¹⁾	Fair Value	Percent of Grand Total
<i>Between 1 to 2 Years</i>				
Federal Agency:				
FFCB Coupon Note	10/25/13	10/25/12	5,003,500	
FHLB Coupon Note	11/22/13	6/22/12	4,996,550	
FHLMC Coupon Note	12/6/13	12/6/12	5,001,000	
FHLMC Coupon Note	2/27/14	2/27/13	5,002,700	
FHLB Coupon Note	4/30/14	B	4,992,700	
FHLMC Coupon Note	5/30/14	11/30/12	5,004,950	
			30,001,400	16.14%
<i>Between 2 to 3 Years</i>				
Federal Agency:				
FHLMC Coupon Note	1/30/15	1/30/13	5,002,300	
FNMA Coupon Note	5/29/15	5/29/13	4,996,000	
			9,998,300	5.38%
Grand Total			\$185,881,636	100%

Footnotes:

(1) B=Bullet- Not called on designated call date, will run until maturity, unless sold

4. ACCOUNTS RECEIVABLE

A. CURRENT

The Utility's current accounts receivable at June 30, 2012 were:

Billed accounts	\$ 11,825
Unbilled (estimated unbilled water sales delivered at June 30)	11,224
Less: Allowance for doubtful accounts	(71)
Total current accounts receivable	\$ 22,978

B. LONG-TERM

The Utility's long-term accounts receivable at June 30, 2012 of \$354 resulted from an infrastructure loan to a local private golf enterprise. The loan is to be repaid over a ten-year period.

NOTES TO THE FINANCIAL STATEMENTS

(Amounts in \$1,000s)

5. RESTRICTED ASSETS AND LIABILITIES PAYABLE FROM RESTRICTED ASSETS

A. RESTRICTED ASSETS

Restricted assets as of June 30, 2012 consist of the following:

Item	Restricted Purpose	\$ Amount
Restricted Cash and Cash equivalents		
Unspent revenue and obligation bond proceeds/proceeds receivable	Cash/investments held by the City of Tucson/accrued interest loans receivable/ other receivables restricted for authorized capital projects	\$ 35,965
Conservation Fund	Cash/investments held by the City of Tucson restricted for expenses in support of enhancing community conservation efforts	2,136
Area development fee proceeds		929
	Total restricted cash and cash equivalents	<u>39,030</u>
Restricted Cash and Investments with Fiscal Agent		
	Cash/investments held by the City of Tucson restricted for payment of matured revenue bond principal and interest	28,097
Other Restricted Assets		
	Accounts receivables within the above restricted accounts	4,233
	Total Restricted Assets	<u><u>\$ 71,360</u></u>

B. LIABILITIES PAYABLE FROM RESTRICTED ASSETS

Liabilities payable from restricted assets as of June 30, 2012 consist of the following:

Item	Restricted Purpose	\$ Amount
Debt service restricted assets	Matured bonds and interest payable	\$ 28,097
Unspent revenue bond/loan proceed assets	Accounts payable on authorized bond funded capital improvement projects/ due to other funds pending loan reimbursement	4,427
Construction project vendor deposited	Accounts payable, investments returnable to vendors (deposited in lieu of Utility retainage on construction payments)	1,142
Conservation fund assets	Accounts payable from Conservation Fund assets	12
	Total liabilities payable from restricted assets	<u><u>\$ 33,678</u></u>

NOTES TO THE FINANCIAL STATEMENTS

(Amounts in \$1,000s)

6. CAPITAL ASSETS

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

	Beginning Balance	Additions/ Transfers	Reductions/ Transfers	Ending Balance
Land	\$ 49,343			\$ 49,343
Construction-in-Progress	89,419	53,799	37,002	106,216
Water Rights	52,127			52,127
Capital Assets being Depreciated:				
Buildings	95,314	6,293		101,607
Equipment	41,605	577	433	41,749
Transmission & Distribution Systems	1,239,511	37,263		1,276,774
Goodwill	1,122			1,122
Total	1,568,441	97,932	37,435	1,628,938
Less Accumulated Depreciation:				
Buildings	39,525	2,592		42,117
Equipment	25,836	4,088	408	29,516
Transmission & Distribution Systems	337,072	22,071		359,143
Goodwill	1,122			1,122
Total Accumulated Depreciation	403,555	28,751	408	431,898
Capital Assets, Net	\$ 1,164,886	\$ 69,181	\$ 37,027	\$ 1,197,040

NOTES TO THE FINANCIAL STATEMENTS

(Amounts in \$1,000s)

7. CHANGES IN LONG-TERM DEBT

A summary of changes in long-term debt as of June 30, 2012 is as follows:

	Beginning Balance	Additions/ Refunded Issues	Reductions/ Refunded Issues	Ending Balance	Due Within One Year
Bonds payable	\$ 495,852	\$ 105,494	(\$ 89,765)	\$ 511,581	\$ 24,347
Deferred amounts:					
Bond sale refundings	(10,151)	(2,985)	2,783	(10,353)	
Bond sale premium	12,510	8,114	(1,587)	19,037	
Total water revenue bonds payable	498,211	110,623	(88,569)	520,265	24,347
Central arizona project loan	1,144		(1,144)	0	
Compensated absences	4,050	101	(623)	3,528	1,596
Other post employment benefits	159	625		784	
Total long term debt	\$ 503,564	\$ 111,349	(\$ 90,336)	\$ 524,577	\$ 25,943

NOTES TO THE FINANCIAL STATEMENTS

(Amounts in \$1,000s)

8. REVENUE BONDS PAYABLE

Water revenue and obligation bonds are secured by water sales revenues. The following is a summary of Water revenue bonds and obligations issued and outstanding as of June 30, 2012.

Water Utility Revenue Bonds Issued and Outstanding				Balance
Series	Interest Rates	Maturity Date	Original Amount	Outstanding June 30, 2012
1994 Series D (2000)	7.250	2013	\$ 23,740	\$ 850
1993 Refunding	5.500	2014	35,360	3,315
2000 Series A (2001)	5.000-7.500	2014	37,800	1,000
2000 Series D (2004)	4.000-4.250	2014	18,765	1,000
2001 A Refunding	5.000	2016	40,850	15,960
1994 Series A (1996)	6.000-8.000	2018	33,000	1,500
2009 Refunding	5.000	2019	2,815	2,815
2007 Refunding	5.000	2021	31,460	30,965
2005 Refunding	5.000	2022	55,110	41,090
2006 Refunding	3.500-4.250	2024	85,460	82,340
2005 Series A (2005)	3.500-4.450	2025	31,665	27,835
2005 Series C (2008)	4.000-5.000	2026	20,425	20,425
Water system obligations 2009	5.000	2029	\$ 35,635	\$ 35,635
Water system obligations 2010	6.000	2030	38,510	38,510
Water system obligations 2011	5.000	2032	30,965	30,965
2005 Series B (2007)	4.375-5.000	2032	35,765	35,765
Water system obligations 2012	3.346	2033	31,555	31,555
2012 Series A Refunding	4.000-5.000	2018	36,120	36,120
2012 Series B Refunding	0.571-1.767	2016	14,635	14,060
Junior Lien Water System Refunding Bond, Series 2012	1.900	2021	15,245	14,760
2003 Water Infrastructure Finance Authority (WIF4)	3.480	2022	8,300	5,024
2000 Water Infrastructure Finance Authority (WIF5)	3.750	2023	3,000	1,947
2004 Water Infrastructure Finance Authority (WIF6)	3.255	2023	2,500	1,632
2005 Water Infrastructure Finance Authority (WIF7)	3.113	2024	2,997	2,090
2006 Water Infrastructure Finance Authority (WIF8)	3.424	2026	2,500	1,918

(Continued on next page)

NOTES TO THE FINANCIAL STATEMENTS

(Amounts in \$1,000s)

Water Utility Revenue Bonds Issued and Outstanding

Series	Interest Rates	Maturity Date	Original Amount	Balance Outstanding June 30, 2012
2007 Water Infrastructure Finance Authority (WIF9)	3.210	2026	2,000	1,526
2007 Water Infrastructure Finance Authority (WIF10)	3.208	2026	6,500	4,960
2007 Water Infrastructure Finance Authority (WIF11)	3.552	2027	17,800	14,439
2007 Water Infrastructure Finance Authority (WIF12)	3.600	2028	1,000	852
2007 Water Infrastructure Finance Authority (WIF13)	3.375	2028	2,500	2,233
2010 Water Infrastructure Finance Authority (WIF14)	2.928	2028	2,750	1,165*
2011 Water Infrastructure Finance Authority (WIF15)	3.096	2031	16,000	7,330*
2012 Water Infrastructure Finance Authority (WIF16)	2.800	2032	4,000	_(1)
Total			\$ 726,727	\$ 511,581

(1) Water Infrastructure Finance Authority (WIFA) loans have not been fully drawn down as of June 30, 2012. The balance of the loans (\$14,255) is expected to be drawn down, and long-term debt recognized, during the next two fiscal years.

Maturities of the bonds and related interest payable after June 30, 2012 are as follows:

Year ending June 30	Principal	Interest	Total
2013	\$ 21,805	\$ 22,938	\$ 44,743
2014	23,113	21,972	45,085
2015	26,619	20,950	47,569
2016	27,907	19,834	47,741
2017	29,413	18,628	48,041
2018-2022	177,673	71,590	249,263
2023-2027	130,254	34,820	165,074
2028-2032	72,592	9,772	82,364
2033	2,205	80	2,285
Total	\$ 511,581	\$ 220,584	\$ 732,165

NOTES TO THE FINANCIAL STATEMENTS

(Amounts in \$1,000s)

9. ADVANCED REFUNDING/ DEFEASANCE OF DEBT

In prior years, the Utility has defeased various bond issues by creating irrevocable trusts. The proceeds from the advance refundings have been deposited in these trusts and invested in U.S. Governmental Securities that are designed to meet the requirements of the refunded debt. The debt associated with the refunding issues, as well as the trust assets, has been removed from the Utility's basic financial statements. As of June 30, 2012, the amount of defeased debt outstanding, but removed, was \$62,305,000

On January 11, 2012 the City issued \$15,245 Junior Lien Water System Revenue Refunding Bonds, Series 2012 to refund several Water Infrastructure Finance Authority (WIFA) loans including WIFA Series 1998A; WIFA Series 2000; Series 2000A; and Series 2001, and to pay costs relating to the issuance of the bonds. The interest rate on the bonds is 2% with a final maturity of July 1, 2021. Debt service payments are schedule semi-annually at amounts that range from \$622 to \$2,091. The economic gain resulting from the refunding is \$1,291 (based on NPV from delivery date). The difference in cash flow requirements to service the prior (refunded) debt of \$17,887 and the cash flows required to service the new debt of \$16,663 is \$1,224.

On February 15, 2012 and April 4, 2012, the City issued \$50,755 in Water System Revenue Refunding Bonds Series 2012A and 2012B, \$36,120 and \$14,635, respectively, to refund Tax Exempt Bonds Series 2002 Refunding; Taxable Water System Revenue Refunding Bonds Series 2001A; and Series 2003, and to pay costs related to the issuance of the bonds. The interest rate on the 2012 Refunding Series A and Series B bonds ranges from 4% to 5% and 1% to 2%, respectively, with a final maturity date of July 1, 2018. Debt service payments are scheduled semi-annually at amounts ranging from \$1,022 to \$13,409. The economic gain resulting from the refunds is \$6,471 (based on NPV from delivery date). The difference in cash flow requirements to service the prior (refunded) debt of \$66,449 and the cash flows required to service the new debt of \$59,674 is \$6,775.

10. DEVELOPER CONTRIBUTIONS

Developers of land within the Utility's service area are required to install water distribution systems meeting the Utility's standards. Once completed and inspected by Utility staff, the developer donates the systems to the Utility. During the year ended June 30, 2012, developers donated water systems valued at \$7,272.

NOTES TO THE FINANCIAL STATEMENTS

(Amounts in \$1,000s)

11. INSURANCE

The Utility is exposed to various risks of losses related to tort: theft of, damage to, and destruction of assets; errors and omissions; injuries to employees; and natural disasters. The City has obtained commercial coverage for property insurance, public employee, fidelity bonds, crime insurance and miscellaneous insurance (surety bonds, special event insurance as needed and fine arts coverage). The City retains all of the risk not covered by commercial carriers and has effectively managed risk through various employee education and prevention programs.

The Utility pays a premium, calculated annually based on its claims history, to the City's Self-Insurance Fund. During Fiscal Year 2012, the Utility premium was \$1,388. All risk management activities of the City are accounted for in this City fund. Additional information on the City's Self Insurance Program is provided in the City of Tucson's *Comprehensive Annual Financial Report* (<http://cms3.tucsonaz.gov/files/finance/CAFR12.pdf>).

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

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

A. PENSION PLAN

Utility employees participate in the Tucson Supplemental Retirement System (TSRS), a single-employer defined benefit plan. It was established by City Charter to provide its members with a supplement to the retirement and disability benefits of the federal social security system. TSRS is governed by a seven-member Board of Trustees consisting of a chairman who is appointed by the Mayor, the City's Director's of Human Resources and Finance, two members elected by the system's membership a retired representative elected by TSRS retirees, and a member who is appointed by the City Manager. Benefit provisions and changes in benefits or funding are recommended by the Board of Trustees and must be approved by Mayor and Council. TSRS issues a publicly available financial report that includes financial statements and required supplemental information. The financial report may be obtained from the administrative office located at 255 W. Alameda Street, Tucson, AZ 85701, or online at http://cms3.tucsonaz.gov/files/finance/TSRS_CAFR_06302012.pdf.

NOTES TO THE FINANCIAL STATEMENTS

(Amounts in \$1,000s)

A. PENSION PLAN

Currently, employees hired prior to July 1, 2006 contribute 5% of their annual covered payroll and are made through payroll deductions. Employees hired after, June 30, 2006 contribute, via payroll deduction, 40% of the total required funding rate calculated annually by the pension system actuary. Future changes to employee contributions rates are limited to a maximum annual increase not to exceed 2.5% of base pay. For fiscal year 2012 the contribution rate of contribution for employees hired after June 30, 2006 was 11.62%.

A reserve is established for contributions and earnings allocations, less amounts transferred to reserves for retirement and disability and amounts reserved for terminated employees. The City contributes the remaining amounts necessary to finance employee participation in the System and to fund the costs of administering the System. Tucson Water's contribution rate for the year ended June 2012 for employees hired before July 1, 2006 and hired after June 30, 2006 was 24.05% and 17.43%, respectively. If an employee leaves covered employment before attaining five years of service credit, the accumulated contributions plus interest are refunded to the employee or his designated beneficiary.

Tucson Water's contribution to the TSRS was as follows:

Fiscal Year	Expenditures
2010	3,895,681.09
2011	3,883,217.11
2012	4,841,285.07
Total	<u>12,620,183.27</u>

B. DEFERRED COMPENSATION

Utility employees may participate in a deferred compensation plan offered by the City and managed externally. The plan permits employees to defer a portion of their salaries until future years.

NOTES TO THE FINANCIAL STATEMENTS

(Amounts in \$1,000s)

C. POST-RETIREMENT HEALTHCARE AND LIFE INSURANCE BENEFITS

Post-employment health care and life insurance benefits are provided to retired employees in addition to pension benefits.

The City's policy on medical benefits for those retired before January 1, 2011 is to contribute 75% of the cost of retiree medical premiums prior to Medicare eligibility (age 65). Effective for retirements on or after January 1, 2011, the employer contribution changed to a flat rate. City contribution amounts vary with plan options. The benefits, benefit levels, employer and employee contributions are governed by the City and can be amended through management approval.

The City provides a life insurance benefit of \$7,500 to all retirees, regardless of age.

The costs for both the medical and life insurance retirement benefits are expended by the Utility as the appropriate premiums are paid. During the year ended June 30, 2012, the Utility's portion of retiree medical and life insurance premiums was \$1,490.

13. PLEDGED REVENUES

The City has pledged future Utility customer revenues, net of specified operating expenses, to repay \$726,727 million in utility system revenue bonds and water system revenue obligations issued since March 1993. Proceeds from these issues provided financing for the construction of various utility projects including water mains and water treatment plants. The bonds are payable solely from utility customer net revenues and are payable through June 2033. The total principal and interest remaining to be paid on the bonds is \$732,165. Fiscal year 2012 annual principal and interest payments on the bonds (\$43,425) utilized 59% of the fiscal year's net revenue (\$73,060).

14. CONTINGENCIES AND COMMITMENTS A. OPERATING LEASES

The Utility has entered into operating leases with terms in excess of one year which are not material when taken either individually or collectively and, therefore, are not disclosed in these notes. All the operating leases are cancelable. The Utility's total rent expense, resulting predominately from as needed rental of heavy equipment to support maintenance functions, was \$220 for the year ended June 30, 2012.

NOTES TO THE FINANCIAL STATEMENTS

(Amounts in \$1,000s)

B. LITIGATION

The Utility is contingently liable with respect to lawsuits and other claims incidental to the ordinary course of its operations. At June 30, 2012, it was the opinion of management, based on the advice of the City Attorney, that any pending litigation would not have a material adverse effect on the Utility's financial condition or results of operations.

C. CONSTRUCTION RETAINAGE AND OTHER COMMITMENTS

The Utility enters into numerous capital improvement project contracts. Retainage on construction contracts for contract work completed as of June 30, 2012 are appropriately identified as accounts payable. Contract commitments for future capital improvement work totaled \$1,142 as of June 30, 2012.

D. CENTRAL ARIZONA PROJECT (CAP) CONTRACTUAL OBLIGATION

The Central Arizona Water Conservation District (CAWCD) is the entity responsible for contracting with the Secretary of the Interior for CAP water and the resulting subcontracting with users within the State of Arizona. Under a contract between the City of Tucson, CAWCD and the Department of the Interior, the City currently has the right to receive 144,172 acre-feet of CAP water each year. In return, the City, via the Utility, agreed to pay a capital financing charge that is designed to recover a portion of the Federal Government's CAP construction costs. This charge, which must be paid regardless of whether the Utility orders any CAP water, is adjusted annually and is charged on a per-acre-foot of allocation basis. The CAP capital payment for the year was \$3,366, which included the final installment payment of \$1,144 for the acquisition of an additional 8,206 acre foot CAP water allocation. Also paid are commodity charges, which are designed to cover CAWCD operating and maintenance expenses, and are based on the quantity of CAP water taken by the Utility. The commodity charge for the year was \$16,218. Estimated CAP water expenses for the next five years are as follows:

CAP Payment Schedule (unaudited)

Fiscal Year	CAP Capital	CAP Commodity
2013	\$ 2,163	\$ 17,771
2014	2,604	18,697
2015	2,451	20,691
2016	2,595	21,917
2017	2,595	22,638

NOTES TO THE FINANCIAL STATEMENTS

(Amounts in \$1,000s)

E. WATER QUALITY REGULATIONS

In 2011, the EPA issued a new health advisory for 1,4-dioxane of 0.35 parts per billion, significantly lower than the previous 3.0 parts per billion. To address the new level, the Utility has planned and designed a new treatment facility with state-of-the-art technology to effectively remove 1,4-dioxane from groundwater pumped from the existing Tucson Airport Remediation Project (TARP) plant. Construction of this Advanced Oxidation Process Water Treatment Facility started in FY 2012 and is expected to be completed within two years. The facility will work in conjunction with the adjacent TARP facility to produce up to 8 million gallons of purified water a day. It is estimated the facility will cost \$18,100 to construct and require \$1,000 in annual operating costs.

F. FEDERAL GRANTS

Accounts received or receivable from federal agencies are subject to audit and adjustment by the grantor. Any disallowed claims, including amounts already collected, may constitute a liability to the Utility. The amounts, if any, of expenditures which may be disallowed by the grantor cannot be determined at this time, although the Utility expects such amounts, if any, to be immaterial.

Page intentionally left blank.

Supplementary Information

Page intentionally left blank.

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

Unaudited
Per Ordinance No. 6347
Year ended June 30, 2012
(\$ in thousands)

Revenues:

Sale of Water:

Potable water sales	\$ 128,764
Reclaimed water sales	9,330
Central arizona project surcharge	2,293
Connection fees	1,611
Environmental and sewer billing services	3,406

Tce cleanup reimbursement	879
Plan review and inspection fees	381
Other	5,145

Non-operating income:

Impact fees	\$2,917
Investment earnings – operating fund	184
Investment earnings – debt service	1
Federal non-grant contributions (babs)	792
Proceeds from sale of property/equipment	502
Proceeds from property/equipment rental	122

Total non-operating income	4,518
-----------------------------------	-------

Total revenues	156,327
-----------------------	----------------

Operation and Maintenance Expenses:

Director's Office	4,179
Business services	3,728
Customer services	7,426
Water operations	18,749
Planning and engineering	8,687
Quality management	9,690
Power - potable system	12,664
Power - reclaimed system	1,486

Cap water purchases:

Commodity	16,218
Capital charges ⁽²⁾	3,366

Total CAP Water Purchases	19,584
----------------------------------	--------

General Expenses	4,009
Capitalized Operation and Maintenance Expense	(6,935)

Total operation and maintenance expense	83,267
--	---------------

Net revenue available after operations⁽²⁾	\$ 73,060
---	------------------

(Continued on next page)

SUPPLEMENTAL SCHEDULE OF NET REVENUES AVAILABLE FOR DEBT SERVICE

Unaudited
Per Ordinance No. 6347
Year ended June 30, 2012
(\$ in thousands)
(Continued)

Bond Debt Service:⁽³⁾⁽⁴⁾

Senior liens		
Interest		\$20,946
Principal		18,330
Total debt service for water revenue bonds		39,276
Junior liens (Water Infrastructure Finance Authority)		
Interest		1,280
Principal		2,869
Total Debt Service for Water Infrastructure Finance Authority		4,149
Combined senior and junior liens		
Interest		22,226
Principal		21,199
Total Debt Service		43,425
Net revenue available after operations bond debt service for senior liens		\$ 33,784
Net revenue available after operations and bond debt service for combined liens		\$ 29,635

Notes:

- (1) This is a special purpose financial statement intended to show compliance with City of Tucson Ordinance 6347. It is not prepared in accordance with Generally Accepted Accounting Principles (GAAP). Financials statements are presented on a GAAP basis.
- (2) Installment payment on CAP water right allocation is included for purposes of Ordinance 6347.
- (3) Capitalized interest is not deducted from debt interest expense for interest expense for purpose of Ordinance 6347.
- (4) Section 5.02 (b) of Ordinance 6347 covenants that the City will issue additional senior lien bonds only if Net Revenue Available After Operations has been at least equal to 120% of the maximum future annual debt service requirement of \$44,072,700. The City's experience has shown that more favorable interest rates (and thus lower debt service costs) can be attained if such coverage is 150% to 200%. For the year ended June 30, 2012, maximum future annual debt service coverage of senior lien debt is 166%.

An amendment to Section 7.01 of Ordinance 6347 further requires that if the Net Revenue of any fiscal year does not equal or exceed 175% of the Senior Lien Annual Debt Service Requirement for that fiscal year, the City will deposit additional monies into a reserve account. For the fiscal year ended June 30, 2012, the debt coverage on Senior Lien Annual Debt Service Requirement was 186%

The Water Utility's Junior Lien Debt has requirements that Net Revenues Available After Operations and Senior Lien debt service payments for any fiscal year must equal or exceed 175% of the Annual Debt Service Requirement for that fiscal year. If this requirement is not met, the City will deposit additional monies into a reserve account. For the fiscal year ended June 30, 2012, the debt coverage for the Annual Debt Service Requirement for the Junior Lien was 814%.

RATE SCHEDULE FY 2012

Unaudited

POTABLE WATER SERVICE RATES

A. MONTHLY MINIMUM CHARGE ⁽¹⁾

Meter Size Inches	Minimum Charge	Meter Size Inches	Minimum Charge
5/8"	\$ 7.53	3"	\$ 80.58
3/4"	9.97	4"	136.58
1"	14.84	6"	276.83
1 1/2"	27.01	8"	416.59
2"	41.62	10"	635.73
2 1/2"	61.10	12"	1,049.66

B. MONTHLY WATER USE CHARGES

Customer Class		Winter (per Ccf) ⁽²⁾	Summer (per Ccf) ⁽³⁾
Single family:	1-15 Ccf	\$ 1.60	\$ 1.60
	16-30 Ccf	6.05	6.05
	31-45 Ccf	8.67	8.67
	Over 45 Ccf	11.85	11.85
Duplex-triplex:	1-20 Ccf	1.60	1.60
	21-35 Ccf	6.05	6.05
	36-50 Ccf	8.67	8.67
	Over 50 Ccf	11.85	11.85
Multifamily:	Basic Volume Charge ⁽⁴⁾	2.40	2.40
Sub-metered mobile home parks:	Basic Volume Charge ⁽⁴⁾	1.90	1.90
Commercial:	Basic Volume Charge ⁽⁴⁾	2.41	2.41
	Summer Surcharge - Tier 1 ⁽⁵⁾		0.95
	Summer Surcharge - Tier 2 ⁽⁶⁾		0.25
Industrial:	Basic Volume Charge ⁽⁴⁾	2.23	2.23
	Summer Surcharge - Tier 1 ⁽⁵⁾		0.95
	Summer Surcharge - Tier 2 ⁽⁶⁾		0.25
Construction water:	Basic Volume Charge ⁽⁴⁾	2.51	2.51

C. CENTRAL ARIZONA PROJECT CHARGE ⁽⁷⁾

Winter (per Ccf)⁽²⁾

Summer (per Ccf)⁽³⁾

\$0.05

\$0.05

D. CONSERVATION FEE ⁽⁸⁾

Winter (per Ccf)⁽²⁾

Summer (per Ccf)⁽³⁾

\$0.07

\$0.07

(Continued on next page)

(Continued)

RATE SCHEDULE FY 2012

Unaudited

The customer's monthly bill is calculated by adding together the monthly service charge, all monthly water use charges for the customer's class, the Central Arizona Project charge, and the conservation fee.

FIRE SPRINKLER SERVICE MONTHLY CHARGES

Monthly Service Charge:

Connection Size (Inches)	Minimum Charge	Connection Size (Inches)	Minimum Charge
2	\$ 7.33	8	\$ 52.15
3	12.00	10	78.77
4	18.54	12	128.26
6	35.35		

RECLAIMED WATER RATES

A. MONTHLY SERVICE CHARGE:

Meter Size (Inches)	Rates	Meter Size (Inches)	Rates
5/8	\$ 5.99	4	\$ 94.10
1	10.98	6	189.87
1 1/2	19.29	8	285.30
2	29.26	10	434.93
2 1/2	42.56	12	717.56
3	55.87		

B. MONTHLY RECLAIMED USE CHARGE

Winter (per Ccf)⁽²⁾

Summer (per Ccf)⁽³⁾

Reclaimed water charge \$ / Ccf	\$1.83	(\$797 per acre foot)
---------------------------------	--------	-----------------------

The customer's monthly bill is calculated by adding together the monthly service charge and the monthly reclaimed use charge. The monthly reclaimed use charge is applied to all use.

Notes:

- (1) The monthly service charge is applicable to all customer classes.
- (2) Winter rates are applicable to water use from November through April.
- (3) Summer rates are applicable to water use from May through October.
- (4) Basic volume charges are applicable to all usage.
- (5) Summer surcharge - Tier 1 is applied to all use during a summer month which is in excess of the actual average monthly use during the previous six winter months. This surcharge is added to the basic volume charge.
- (6) Summer surcharge - Tier 2 is applied to all use during a summer month which exceeds 145 percent of the actual average monthly use during the previous six winter months. This surcharge is added to the basic volume and to the summer surcharge - Tier 1 charges.
- (7) The Central Arizona Project charge is applied to all potable water use.
- (8) The Conservation Fee is applied to all potable water use.

STATEMENT OF NET ASSETS

Unaudited
June 30, 2011
(\$ in thousands)

Assets

Current assets:

Cash and cash equivalents

Undesignated \$ 17,844

Designated for customer deposits 2,785

Total cash and cash equivalents 20,629

Billed accounts receivable, net of allowance for doubtful accounts

\$217 13,801

Unbilled accounts receivable 9,362

Due from other agencies 80

Inventories, prepaids and other assets 3,617

Total current assets 47,489

Restricted assets:

Cash and cash equivalents 38,676

Cash and Investments with fiscal agents 27,691

Other restricted assets 708

Total restricted assets 67,075

Long-term accounts receivable

519

Capital Assets:

Utility property, plant and equipment 1,377,551

Land and construction-in-progress 138,763

Less accumulated depreciation (403,555)

Water rights 52,127

Net capital assets 1,164,886

Other

4,027

Total assets \$ 1,283,996

(Continued on next page)

(Continued)

STATEMENT OF NET ASSETS

Unaudited
 June 30, 2011
 (\$ in thousands)

Liabilities and Net Assets

Current liabilities:

Accounts payable	\$ 1,839
Salaries, wages and payroll taxes payable	1,126
Current installments of revenue bonds payable	21,531
Current portion of compensated absences	1,900
Refundable/customer deposits	2,785
Deferred revenue	27

Total current liabilities	29,208
----------------------------------	---------------

Liabilities payable from restricted assets	30,974
---	---------------

Long-term liabilities:

Revenue bonds payable	476,681
Compensated absences	2,149
Other post-employment benefits	159

Total long-term debt	478,989
-----------------------------	----------------

Total liabilities	539,171
--------------------------	----------------

Net Assets

Invested in capital assets net of related debt	692,101
Restricted for debt service	27,691
Unrestricted:	
Conservation Program	\$ 999
Other	24,034

Total unrestricted net assets	25,033
--------------------------------------	---------------

Total net assets	\$ 744,825
-------------------------	-------------------

STATEMENT OF REVENUES, EXPENSES AND CHANGES IN NET ASSETS

Unaudited
Year ended June 30, 2011
(\$ in thousands)

Operating revenues:

Potable water sales	\$ 119,162
Reclaimed water sales	9,674
	Total water sales
	128,836
Central Arizona Project surcharge	2,149
Water Conservaton Program fees	2,125
Connection fees	1,855
Billing services - Pima County Sewer, City of Tucson Environmental Services	2,903
Miscellaneous:	
TCE cleanup reimbursement	982
Service charges	3,386
Plan review and inspection fees	422
Reimbursed prior year expenses	1,334
	Total miscellaneous
	15,156
	Total operating revenues
	143,992

Operating expenses:

Director's office:	
Personal services	2,189
Contractual services	1,798
Commodities	270
	Total director's office
	4,257
Business services:	
Personal services	990
Contractual services	1,510
Commodities	1,280
	Total business services
	\$ 3,780

(Continued)

STATEMENT OF REVENUES, EXPENSES AND CHANGES IN NET ASSETS

Unaudited
Year ended June 30, 2011
(\$ in thousands)

Customer services:	
Personal services	\$ 5,672
Contractual services	294
Commodities	435
Total customer services	6,401
Water operations:	
Personal services	10,041
Contractual services	4,293
Commodities	2,803
Total water operations	17,137
Planning and engineering:	
Personal services	4,866
Contractual services	694
Commodities	279
Total planning and engineering	5,839
Water quality management:	
Personal services	6,344
Contractual services	16,424
Commodities	1,675
Total water quality	24,443
CAP water charges:	
Capital charges	2,163
Commodity charges	13,105
Total CAP water charges	15,268
General expenses:	
Personal services	753
Contractual services	5,263
Commodities	86
Total general expenses	6,102
Depreciation and goodwill amortization	27,769
Total operating expenses	\$ 110,996

(Continued on next page)

(Continued)

STATEMENT OF REVENUES, EXPENSES AND CHANGES IN NET ASSETS

Unaudited
Year ended June 30, 2011
(\$ in thousands)

Net operating income	\$ 32,996
Nonoperating income:	
Investment earnings	275
Gain on sale of property/equipment	340
Other agency contributions	797
Federal grants and contributions	81
Total nonoperating income	1,493
Nonoperating expenses:	
Interest expense	18,211
Amortization of issuance costs	308
Other nonoperating expenses	971
Total nonoperating expenses	19,490
Net income before capital contributions	14,999
Capital contributions	9,976
Net transfers in/out	(1,600)
Change in net assets	23,375
Net assets - July 1	721,450
Net assets - June 30	\$ 744,825

Page intentionally left blank.

STATEMENT OF CASH FLOWS

Unaudited
Year ended June 30, 2011
(\$ in thousands)

Cash flows from operating activities:	
Cash received from customers	\$ 144,017
Cash payments to suppliers for goods and services	(54,728)
Cash payments to employees for services	(30,845)
Net cash provided by operating activities	58,444
Cash flows from noncapital financing activities:	
Subsidy from federal grant	114
Internal activity payments to other funds	(1,600)
Net cash used by capital & noncapital financing activities	(1,486)
Cash flows from capital and related financing activities:	
Bond proceeds	30,967
Acquisition and construction of capital assets	(39,931)
Principal paid on capital debt	(20,147)
Interest paid on capital debt	(17,661)
Fiscal agent fees paid on capital debt	(855)
Proceeds from sale of property and equipment	345
Net cash used in capital and related financing activities	(47,282)
Cash flows from investing activities – interest received on investments	1,543
Net increase in cash and cash equivalents	11,219
Cash and cash equivalents at beginning of year	75,777
Cash and cash equivalents at end of year	\$ 86,996

(Continued on next page)

(Continued)

STATEMENT OF CASH FLOWS

Unaudited
 Year ended June 30, 2011
 (\$ in thousands)

Reconciliation of operating income to net cash provided by operating activities:

Operating income	\$ 32,996
Adjustments to reconcile operating income to net cash provided by operating activities:	
Depreciation and amortization	27,769
Decrease (increase) in assets:	
Accounts receivable/due from other agencies	(121)
Inventories	(113)
Prepays and other assets	(802)
Long-term accounts receivable	(188)
Increase (Decrease) in liabilities:	
Accounts payable	(86)
Accrued payroll liabilities	147
Accrued compensated absences	(199)
Accrued other post employment benefits	61
Due to other agencies	(1,355)
Customers/refundable deposits/due to other agencies	335
Net cash provided by operating activities	\$ 58,444

A reconciliation of cash and cash equivalents at June 30 follows:

Unrestricted cash	\$ 20,629
Restricted cash (included in restricted assets)	66,367
Cash and cash equivalents at June 30	\$ 86,996

Noncash investing, capital and financing activities:

Contributions of capital assets from developers	\$ 6,816
---	----------

**FY 2012
ANNUAL REPORT
CONTRIBUTORS**

Belinda Oden, Business Services Administrator

Theresa Bourne, Staff Assistant

Susan Valdez, Staff Assistant

David Cormier, CPA

Pat Eisenberg, PE, Chief Engineer

Tom Victory, PE, Engineering Manager



City of Tucson Water Department

P.O. Box 27210
Tucson, Arizona 85726-7210

CLICK

Tucsonaz.gov/water

WATCH

[Youtube.com
/user/tucsonwater](https://www.youtube.com/user/tucsonwater)

SCAN



CALL

English & Español:
(520) 791-4331

TDD

(520) 791-2639