

Massachusetts Water Resources Authority

*Financial Statements and Supplemental
Schedules as of and for the Years Ended
June 30, 2005 and 2004, Required
Supplementary Information as of June 30,
2005, and Independent Auditors' Reports*

MASSACHUSETTS WATER RESOURCES AUTHORITY

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INDEPENDENT AUDITORS' REPORT

To the Board of Directors of
Massachusetts Water Resources Authority:

We have audited the balance sheet of the Massachusetts Water Resources Authority (the "Authority") as of June 30, 2005, and the related statements of revenues, expenses, and changes in net assets, and cash flows for the year then ended. These financial statements are the responsibility of the Authority's management. Our responsibility is to express an opinion on these financial statements based on our audit. The financial statements of the Authority for the year ended June 30, 2004, were audited by other auditors whose report, dated August 16, 2004, expressed an unqualified opinion on those statements.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of 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 consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Authority's internal control over financial reporting. Accordingly, we express no such opinion. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the respective financial statements, 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, such financial statements present fairly, in all material respects, the financial position of the Authority as of June 30, 2005, and its changes in net assets and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

The Management's Discussion and Analysis on pages 3 through 10 and the historical pension required supplementary information on page 38 are not a required part of the basic financial statements but are supplementary information required by the Government Accounting Standards Board. The supplementary information is the responsibility of the Authority's management. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit the information and express no opinion on it.

Our audit was made for the purpose of forming an opinion on the financial statements taken as a whole. The supplemental schedules listed in the accompanying table of contents are presented for purposes of additional analysis and are not a required part of the basic financial statements. Such information has been subjected to the auditing procedures applied by us in the audit of the financial statements and, in our opinion, is fairly stated, in all material respects, in relation to the basic financial statements taken as a whole.

In accordance with *Government Auditing Standards*, we have also issued our report on page 47, dated October 21, 2005, on our consideration of the Authority's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts and grant agreements, and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of our audit.

Deloitte Touche LLP

October 21, 2005

MASSACHUSETTS WATER RESOURCES AUTHORITY

MANAGEMENT'S DISCUSSION AND ANALYSIS (UNAUDITED) REQUIRED SUPPLEMENTARY INFORMATION

This section of the Authority's annual financial report presents our discussion and analysis of the Authority's financial performance during the fiscal years ended June 30, 2005 and 2004. Please read it in conjunction with the Authority's financial statements, which immediately follow this section.

FINANCIAL HIGHLIGHTS—FISCAL 2005

The fiscal 2005 customer service revenues were approximately \$453 million. Rate revenues represent approximately 98% or \$444 million and were \$12.5 million higher than fiscal 2004. This was due to an increase in assessments.

Total operating expenses, excluding depreciation, were approximately \$209.0 million in fiscal 2005. The 2.8% increase in total operating expenses over fiscal 2004 is the result of increased utility expenses due to higher prices and usage of electricity and diesel fuel and increased maintenance costs at the Deer Island treatment plant.

Net nonoperating expenses decreased \$10 million or 5.2% primarily due to an increase in investment income.

Total assets at June 30, 2005, were approximately \$7.9 billion, a \$33 million or 0.4% decrease over total assets at June 30, 2004. This decrease was primarily reflected as a decrease in net capital assets.

During fiscal 2005, the Authority issued three series of bonds. The 2005 Series A and B were issued in the aggregate amount of \$496,745 to defease \$500,420 of bonds outstanding. Additionally, the 2004 Series B was issued in the amount of \$65,255 to defease \$68,350 of bonds outstanding.

Total capital assets (net of depreciation) were approximately \$6.5 billion at June 30, 2005, a \$54 million or 0.82% decrease over June 30, 2004. The decrease was due to the transfer of combined sewer overflow ("CSO") projects and intergovernmental loans from construction in progress to other assets.

FINANCIAL HIGHLIGHTS—FISCAL 2004

The fiscal 2004 customer service revenues were approximately \$441 million. Rate revenues represent approximately 98% or \$432 million and were \$15.1 million higher than fiscal 2003 rate revenues, due to an increase in assessments. This was offset by a decrease in revenues from other user charges of \$1.3 million or 16%. This decrease was primarily due to Marlborough and Southborough becoming rate base communities in fiscal 2004.

Total operating expenses, excluding depreciation, were approximately \$203.3 million in fiscal 2004. The 2.6% decrease in total operating expenses over 2003 is the result of lower salaries and wages caused by the Authority's early retirement program and staff reductions. Operating expenses for fiscal 2004 were 0.4% less than the annual operating budget.

Net nonoperating expenses increased \$28 million or 15% primarily due to a \$24 million change in unrealized losses recorded on the Authority's investments.

Total assets at June 30, 2004, were approximately \$7.9 billion, a \$171 million or 2.2% increase over total assets at June 30, 2003.

Total capital assets (net of depreciation) were approximately \$6.6 billion at June 30, 2004, a \$1.6 million or 0.03% increase over June 30, 2003. The increase in total capital assets is primarily the result of the ongoing water system construction projects, including the MetroWest Water Supply Tunnel, the Walnut Hill Water Treatment Plant, and the Norumbega Covered Storage Project.

OVERVIEW OF THE FINANCIAL STATEMENTS

The financial section of this annual report consists of three parts: management's discussion and analysis (this section), the financial statements and related notes to the financial statements, and other supplementary information.

The financial statements provide both long-term and short-term information about the Authority's overall financial status. The financial statements also include notes that explain some of the information in the financial statements and provide more detailed data. The statements are followed by a section of other supplementary information that further explains and supports the information in the financial statements.

FINANCIAL ANALYSIS OF THE AUTHORITY

Net Assets—The Authority's total net assets at June 30, 2005 were approximately \$2.2 billion, a \$49 million decrease from June 30, 2004. Total assets decreased \$33 million or 0.4% to \$7.9 billion, and total liabilities increased 0.3% to \$5.7 billion.

The Authority's total net assets at June 30, 2004 were approximately \$2.2 billion, a \$49 million decrease from June 30, 2003. Total assets increased \$171 million or 2.2% to \$7.9 billion, and total liabilities increased 4.1% to \$5.6 billion.

	Net Assets (Dollars in thousands)			Percentage Change 2005-2004	Percentage Change 2004-2003
	2005	2004	2003		
Current assets	\$ 90,854	\$ 91,319	\$ 100,019	(0.5)%	(8.7)%
Restricted assets	659,975	757,049	662,407	(12.8)	14.3
Capital assets	6,498,899	6,552,821	6,551,209	(0.8)	0.0
Other assets	<u>600,852</u>	<u>482,228</u>	<u>398,513</u>	<u>24.6</u>	<u>21.0</u>
Total assets	<u>7,850,580</u>	<u>7,883,417</u>	<u>7,712,148</u>	<u>(0.4)</u>	<u>2.2</u>
Current liabilities	409,123	419,787	413,848	(2.5)	1.4
Payable from restricted assets	91,349	89,515	108,840	2.0	(17.8)
Long-term debt	4,907,917	4,884,943	4,607,288	0.5	6.0
Long-term lease	36,058	36,436	36,785	(1.0)	(0.9)
Other liabilities	<u>206,358</u>	<u>204,311</u>	<u>247,607</u>	<u>1.0</u>	<u>(17.5)</u>
Total liabilities	<u>5,650,805</u>	<u>5,634,992</u>	<u>5,414,368</u>	<u>0.3</u>	<u>4.1</u>
Net assets:					
Invested in capital assets—net of related debt	1,672,624	1,805,352	1,956,432	(7.4)	(7.7)
Restricted	161,775	169,348	123,409	(4.5)	37.2
Unrestricted	<u>365,376</u>	<u>273,725</u>	<u>217,939</u>	<u>33.5</u>	<u>25.6</u>
Total net assets	<u>\$2,199,775</u>	<u>\$2,248,425</u>	<u>\$2,297,780</u>	<u>(2.2)%</u>	<u>(2.1)%</u>

CHANGES IN NET ASSETS

The decrease in net assets at June 30, 2005, was \$49 million or 2.2% as compared to June 30, 2004. The Authority's total operating revenues increased by 2.2% to \$457 million and total operating expenses increased 5.3% to \$384 million.

The decrease in net assets at June 30, 2004, was \$49 million or 2.1% as compared to June 30, 2003. The Authority's total operating revenues increased by 4.2% to \$447 million and total operating expenses increased 0.3% to \$365 million.

**Change in Net Assets
(Dollars in thousands)**

	2005	2004	2003	Percentage Change 2005-2004	Percentage Change 2004-2003
Operating revenues:					
Customer services revenues	\$ 452,802	\$ 440,949	\$ 426,666	2.7 %	3.3 %
Other revenue	<u>3,793</u>	<u>5,928</u>	<u>2,381</u>	<u>(36.0)</u>	<u>149.0</u>
Total operating revenues	<u>456,595</u>	<u>446,877</u>	<u>429,047</u>	<u>2.2</u>	<u>4.2</u>
Operating expenses:					
Operations	83,682	77,344	78,417	8.2	(1.4)
Maintenance	20,169	18,611	17,214	8.4	8.1
Payments in lieu of taxes	5,077	5,029	4,966	1.0	1.3
Engineering, general, and administrative	100,110	102,334	108,101	(2.2)	(5.3)
Depreciation	<u>175,128</u>	<u>161,492</u>	<u>155,159</u>	<u>8.4</u>	<u>4.1</u>
Total operating expenses	<u>384,166</u>	<u>364,810</u>	<u>363,857</u>	<u>5.3</u>	<u>0.3</u>
Operating income	72,429	82,067	65,190	(11.7)	25.9
Nonoperating items:					
Regulatory accounting provisions	73,234	74,255	63,124	(1.4)	17.6
Net nonoperating expenses	(200,416)	(211,344)	(183,256)	(5.2)	15.3
Capital grants and contributions	<u>6,103</u>	<u>5,667</u>	<u>5,920</u>	<u>7.7</u>	<u>(4.3)</u>
Change in net assets	(48,650)	(49,355)	(49,022)	(1.4)	0.7
Total net assets—beginning of year	<u>2,248,425</u>	<u>2,297,780</u>	<u>2,346,802</u>	<u>(2.1)</u>	<u>(2.1)</u>
Total net assets—end of year	<u>\$ 2,199,775</u>	<u>\$ 2,248,425</u>	<u>\$ 2,297,780</u>	<u>(2.2)%</u>	<u>(2.1)%</u>

During fiscal 2005, the increases in customer services revenues were primarily due to the 2.7% increase in the rate revenue requirement (\$12.5 million).

During fiscal 2004, the increases in customer services revenues were primarily due to the increase in the rate revenue requirement (\$15.1 million). This was offset by a decrease in other customer services revenues of \$1.3 million or 16%. This decrease was primarily due to the towns of Marlborough and Southborough becoming rate base communities in fiscal 2004.

Total operating costs in fiscal 2005 were \$5.7 million or 2.8% greater than in fiscal 2004. This increase is primarily due to increases in utilities expenses (\$3 million) and maintenance expenses (\$1.6 million). Utility expenses increased as both prices and usage of electricity and diesel fuel increased, primarily at Deer Island. Maintenance expenses increased, primarily at Deer Island, as the plant ages and increased maintenance is required.

Total operating costs in fiscal 2004 were \$5.4 million or 2.6% less than in fiscal 2003. This decrease is the total of \$3.6 million in lower direct operating costs and \$1.8 million in lower indirect expenses. Total wages and salaries expenses were \$1.9 million less than in fiscal 2003, primarily because of lower staffing levels resulting from staff reductions. Overall operating expense decreases are also attributable to a directed slowdown in all areas of spending resulting from the loss of debt service assistance.

In fiscal 2005, net nonoperating expenses decreased \$10 million or 5.2% primarily due to an increase in investment income.

Fiscal 2004 net nonoperating expenses increased \$28 million or approximately 15%. This was attributable to a \$24 million change in the unrealized losses of the Authority's investments.

**Operating Costs by Functionality
(Dollars in thousands)**

	2005	2004	2003	Percentage Change 2005-2004	Percentage Change 2004-2003
Direct operating costs:					
Wastewater treatment and transport	\$ 85,018	\$ 79,492	\$ 78,064	7.0 %	1.8 %
Water treatment and transport	21,127	20,505	18,087	3.0	13.4
Water and wastewater quality	8,144	8,209	9,356	(0.8)	(12.3)
Metering and monitoring	3,951	3,791	3,778	4.2	0.3
Facilities planning, design, and construction	9,910	10,116	10,133	(2.0)	(0.2)
MIS	8,329	9,356	8,710	(11.0)	7.4
Administration and support	<u>40,342</u>	<u>40,040</u>	<u>46,981</u>	<u>0.8</u>	<u>(14.8)</u>
Total direct operating costs	176,821	171,509	175,109	3.1	(2.1)
Indirect operating costs	<u>32,217</u>	<u>31,809</u>	<u>33,589</u>	<u>1.3</u>	<u>(5.3)</u>
Total operating costs	<u>\$ 209,038</u>	<u>\$ 203,318</u>	<u>\$ 208,698</u>	<u>2.8 %</u>	<u>(26.0)%</u>

Increases in wastewater and water treatment and transport were primarily due to increases in utilities and maintenance expenses. Increases in utilities are reflective of increased prices and usage of electricity and diesel fuel. Increases in maintenance are primarily for work performed at the Deer Island treatment plant.

The increase in metering and monitoring is due to increased staffing and equipment costs to provide SCADA needs at new facilities.

Decreases in MIS are due to the decrease of computer hardware purchases in fiscal 2005 as compared to fiscal 2004. Computer hardware and equipment purchases were higher in fiscal 2004 as budget constraints in prior years had caused the delay of these purchases.

CAPITAL ASSET AND DEBT ADMINISTRATION

Capital Assets—As of June 30, 2005 and 2004, the Authority had \$6.5 and \$6.6 billion of capital assets (net of depreciation), respectively. This includes land, construction in progress, plant and equipment for the water and sewer systems, furniture and fixtures, leasehold improvements, and motor vehicles and equipment. The Authority’s net capital assets decreased approximately \$54 million or 0.08% during fiscal 2005 primarily due to the transfer from construction in progress to other assets for CSOs and intergovernmental loans.

Capital Assets (Net of depreciation, dollars in thousands)					
	2005	2004	2003	Percentage Change 2005-2004	Percentage Change 2004-2003
Land	\$ 11,036	\$ 13,932	\$ 16,806	(20.8)%	(17.1)%
Construction in progress	518,237	868,639	822,349	(40.3)	5.6
Plant and equipment, water, and sewer systems	5,961,597	5,659,271	5,699,757	5.3	(0.7)
Furniture and fixtures	6,580	9,065	9,917	(27.4)	(8.6)
Leasehold improvements	864	1,310	1,756	(34.0)	(25.4)
Motor vehicles and equipment	<u>585</u>	<u>604</u>	<u>624</u>	<u>(3.1)</u>	<u>(3.2)</u>
Total net assets	<u>\$6,498,899</u>	<u>\$ 6,552,821</u>	<u>\$ 6,551,209</u>	<u>(0.8)%</u>	<u>0.0 %</u>

Decreases in construction in progress are primarily due to increased transfers to fixed assets and other assets for MetroWest Tunnel, Braintree/Weymouth Relief Facilities, Framingham Extension Relief Sewer, the Norumbega Covered Storage Facility, and the Combined Sewer Overflow (“CSO”) Program.

Debt Administration—The Authority’s bond sales must be approved by its Board of Directors (the “Board”) and must comply with rules and regulations of the United States Treasury Department and United States Securities and Exchange Commission. Neither the Commonwealth of Massachusetts (the “Commonwealth”) nor any political subdivision thereof shall be obligated to pay the principal of, premium or interest on any debt outstanding and neither faith and credit nor taxing power of the Commonwealth or any political subdivision thereof is pledged to such payment.

Bond Resolutions—Pursuant to its General Bond Resolution, the Authority must comply with a rate covenant that requires the Authority to set rates to maintain revenues sufficient to pay current expenses; debt service on indebtedness; required deposits to reserves; costs of maintenance, replacement, and/or improvement to the wastewater and water systems that are considered current expenses and any additional amounts the Authority may be required to pay by any law or contract.

In addition to the rate covenant, the Authority is required to meet two covenants with respect to debt service coverage. The primary debt service coverage requires that the Authority fix and adjust rates and charges to provide revenues available for bond debt service in an amount equal to 1.2 times that required for debt service on all outstanding bonds, not including subordinated bonds. The subordinated debt service coverage requires that the Authority fix and adjust rates and charges to provide revenues available for bond debt service in an amount equal to 1.1 times that required for debt service on all outstanding bonds, including subordinated bonds.

Credit Rating—Of the \$5.1 billion of revenue bonds the Authority currently has outstanding, \$3.8 billion is credit enhanced by a combination of bond insurance, liquidity, or letters of credit. The Authority’s enhanced revenue bonds are rated “AAA” by FITCHRATINGS, “Aaa” by Moody’s Investors Service, and “AAA” by Standard and Poor’s. The Authority’s unenhanced \$0.6 billion long-term, senior debt is rated “AA” by FITCHRATINGS, “Aa2” by Moody’s Investors Service, and “AA” by Standard and Poor’s.

Economic Factors and Next Year’s Budget—In June 2005, the Board approved the fiscal 2006 Current Expense Budget (“CEB”), which totals \$549.3 million in expenses before debt service offsets of \$24.4 million, for a net expense total of \$524.9 million. The \$24.4 million in debt service offsets is composed of \$10 million in debt service assistance and use of \$14.4 million of bond redemption funds to defease debt due in future years.

The \$549.3 million expense total (before debt service offsets) is composed of \$326.6 million (59%) in capital financing costs and \$222.7 million (41%) in operating expenses, of which \$185.7 million (83%) is for direct expenses and \$37 million (17%) is for indirect expenses. The total represents an increase of \$40.3 million from fiscal 2005 spending, composed of \$12.1 million in higher operating costs and \$28.2 million in higher debt service.

The fiscal 2006 rate revenue requirement approved by the Board is \$472.2 million, an increase of 4.2% compared to the fiscal 2005 budget.

Fiscal 2006 nonrate revenue totals \$52.7 million, an increase of \$5.4 million from actual fiscal 2005 nonrate revenue. The increase is due to budgeted use of rate stabilization funds. The nonrate revenue budget is composed of \$30.1 million in investment income, including swap receipts, \$11.5 million in other user charges and other revenue, \$10.7 million in rate stabilization, and \$0.4 million in entrance fees.

Construction in Progress 10-Year Plan—The Authority’s planned spending for capital improvements in future years reflects the continuation and completion of projects now underway. These include:

- Completion of the Walnut Hill Water Treatment Plant to ensure continued provision of high quality drinking water to all customers.
- Completion of covered storage facilities, including Blue Hills Covered Storage, to provide safe, reliable storage for water treated at Walnut Hill and transported through the MetroWest Tunnel and Hultman Aqueduct.
- Rehabilitation of the Wachusett and Hultman Aqueducts as well as rehabilitation of top shaft structures on the Quabbin Tunnel, Dorchester Tunnel, City Tunnel, Southborough Tunnel, and City Tunnel Extension.
- Rehabilitation of a significant portion of the West Roxbury Tunnel.

- Completion of the long-term CSO control plan, resulting in closing of 35 of 84 CSO outfalls and reducing CSO discharges to Boston Harbor and the Mystic, Charles, and Neponset River systems by 88% from 1987, when MWRA accepted responsibility for CSO control, with 95% of remaining discharges receiving treatment.
- Construction of new interceptor facilities to serve Braintree, Hingham, Holbrook, Randolph, Weymouth, and sections of Quincy, and to reduce sewage overflows into the Weymouth Fore River.
- Continued rehabilitation of the water distribution system at a rate of seven to ten miles per year (2.5% to 3% of the total 265 miles of MWRA pipeline).
- Improvement and replacement of equipment on Deer Island to ensure that the plant continues to operate efficiently and effectively.
- Security improvements to protect MWRA facilities.

CONTACTING THE AUTHORITY'S FINANCIAL MANAGEMENT

This report is designed to provide our bondholders, member communities and other interested parties with a general overview of the Authority's finances and to demonstrate the Authority's accountability for the revenue it receives. If you have questions about this report or need additional information, contact the Massachusetts Water Resources Authority, Finance Division, 100 First Avenue, Boston, MA 02129.

MASSACHUSETTS WATER RESOURCES AUTHORITY

BALANCE SHEETS

AS OF JUNE 30, 2005 AND 2004

(Dollars in thousands)

ASSETS	2005	2004
UNRESTRICTED CURRENT ASSETS:		
Cash and cash equivalents (Note 4)	\$ 32,737	\$ 30,930
Investments (Note 4)	41,927	46,464
Intergovernmental loans (Note 7)	15,147	12,248
Accounts receivable	<u>1,043</u>	<u>1,677</u>
Total unrestricted current assets	<u>90,854</u>	<u>91,319</u>
RESTRICTED ASSETS:		
Cash and investments (Note 4)	652,678	748,094
Interest receivable	5,944	6,526
Grants receivable:		
Billed	1,315	2,221
Unbilled	<u>38</u>	<u>208</u>
Total restricted assets	<u>659,975</u>	<u>757,049</u>
CAPITAL ASSETS—Not being depreciated (Note 8)	<u>529,273</u>	<u>882,571</u>
CAPITAL ASSETS—Being depreciated—net (Note 8)	<u>5,969,626</u>	<u>5,670,250</u>
DEFERRED CHARGES (Notes 3 and 9)	<u>368,345</u>	<u>292,088</u>
OTHER ASSETS—Net (Notes 7 and 9)	<u>232,507</u>	<u>190,140</u>
TOTAL	<u>\$ 7,850,580</u>	<u>\$ 7,883,417</u>

(Continued)

MASSACHUSETTS WATER RESOURCES AUTHORITY

BALANCE SHEETS

AS OF JUNE 30, 2005 AND 2004

(Dollars in thousands)

LIABILITIES AND NET ASSETS	2005	2004
CURRENT LIABILITIES:		
Accounts payable and accrued expenses (Note 13)	\$ 49,882	\$ 60,259
Commercial paper notes (Note 6)	289,000	307,000
Current portion of long-term debt (Note 6)	<u>70,241</u>	<u>52,528</u>
Total current liabilities	<u>409,123</u>	<u>419,787</u>
PAYABLE FROM RESTRICTED ASSETS:		
Accounts payable for construction	22,552	21,478
Accrued interest on bonds payable	<u>68,797</u>	<u>68,037</u>
Total payable from restricted assets	<u>91,349</u>	<u>89,515</u>
RETAINAGE ON CONSTRUCTION IN PROGRESS	<u>18,436</u>	<u>19,412</u>
LONG-TERM DEBT—Less current portion (Note 6)	<u>4,907,917</u>	<u>4,884,943</u>
LONG-TERM CAPITAL LEASE (Note 10)	<u>36,058</u>	<u>36,436</u>
RESERVES (Note 5)	<u>100,184</u>	<u>99,184</u>
DEFERRED CREDITS (Note 3)	<u>87,738</u>	<u>85,715</u>
Total liabilities	<u>5,650,805</u>	<u>5,634,992</u>
NET ASSETS:		
Invested in capital assets—net of related debt	1,672,624	1,805,352
Restricted	161,775	169,348
Unrestricted	<u>365,376</u>	<u>273,725</u>
Total net assets	<u>2,199,775</u>	<u>2,248,425</u>
COMMITMENTS AND CONTINGENCIES (Notes 10, 12, and 13)		
TOTAL	<u>\$7,850,580</u>	<u>\$7,883,417</u>

See notes to financial statements.

(Concluded)

MASSACHUSETTS WATER RESOURCES AUTHORITY

STATEMENTS OF REVENUES, EXPENSES, AND CHANGES IN NET ASSETS FOR THE YEARS ENDED JUNE 30, 2005 AND 2004

(Dollars in thousands)

	2005	2004
OPERATING REVENUES (Note 2):		
Customer services	\$ 452,802	\$ 440,949
Other	<u>3,793</u>	<u>5,928</u>
Total operating revenues	<u>456,595</u>	<u>446,877</u>
OPERATING EXPENSES:		
Operations	83,682	77,344
Maintenance	20,169	18,611
Payments in lieu of taxes	5,077	5,029
Engineering, general, and administrative	<u>100,110</u>	<u>102,334</u>
Total operating expenses	<u>209,038</u>	<u>203,318</u>
INCOME FROM OPERATIONS BEFORE DEPRECIATION AND AMORTIZATION	247,557	243,559
DEPRECIATION AND AMORTIZATION	<u>175,128</u>	<u>161,492</u>
OPERATING INCOME	<u>72,429</u>	<u>82,067</u>
REGULATORY ACCOUNTING PROVISIONS:		
(Increase) decrease in reserves	(1,000)	20,000
Increase in deferrals—net (Note 3)	<u>74,234</u>	<u>54,255</u>
Total regulatory accounting provisions	<u>73,234</u>	<u>74,255</u>
NONOPERATING REVENUES (EXPENSE):		
Debt service grants	8,019	4,063
Investment income	37,448	14,107
Interest expense	<u>(245,883)</u>	<u>(229,514)</u>
Total nonoperating revenues (expense)	<u>(200,416)</u>	<u>(211,344)</u>
NET LOSS BEFORE CAPITAL GRANTS AND CONTRIBUTIONS	(54,753)	(55,022)
CAPITAL GRANTS AND CONTRIBUTIONS	<u>6,103</u>	<u>5,667</u>
DECREASE IN NET ASSETS	(48,650)	(49,355)
TOTAL NET ASSETS—Beginning of year	<u>2,248,425</u>	<u>2,297,780</u>
TOTAL NET ASSETS—End of year	<u>\$ 2,199,775</u>	<u>\$ 2,248,425</u>

See notes to financial statements.

MASSACHUSETTS WATER RESOURCES AUTHORITY

STATEMENTS OF CASH FLOWS FOR THE YEARS ENDED JUNE 30, 2005 AND 2004 (Dollars in thousands)

	2005	2004
CASH FLOWS FROM OPERATING ACTIVITIES:		
Cash received from customers	\$ 453,364	\$ 446,209
Cash paid to suppliers for goods and services	(111,764)	(92,639)
Cash paid to employees for services	(102,236)	(96,580)
Cash paid in lieu of taxes	(5,077)	(5,029)
Other operating receipts	<u>3,826</u>	<u>5,895</u>
Net cash provided by operating activities	<u>238,113</u>	<u>257,856</u>
CASH FLOWS FROM CAPITAL AND RELATED FINANCING ACTIVITIES:		
Proceeds from sale of revenue bonds, loans, and notes	114,024	369,222
Net proceeds from refundings	626,047	10,860
Payment to escrow agent	(626,047)	(10,860)
Capital grants for construction	7,103	5,684
Debt service grant	8,019	4,063
Capital lease principal payments	(377)	(349)
Capital lease interest payments	(2,840)	(2,868)
Repayment of debt	(102,828)	(103,787)
Interest paid on debt	(231,065)	(213,185)
Plant expenditures	<u>(166,326)</u>	<u>(236,140)</u>
Net cash used for capital and related financing activities	<u>(374,290)</u>	<u>(177,360)</u>
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchases of short-term investments	(73,502)	(69,066)
Sales and maturities of short-term investments	89,827	47,271
Decrease (increase) in restricted cash and investments—net	88,512	(87,542)
Interest received	<u>33,147</u>	<u>29,522</u>
Net cash provided by (used in) investing activities	<u>137,984</u>	<u>(79,815)</u>
NET INCREASE IN CASH AND CASH EQUIVALENTS	1,807	681
CASH AND CASH EQUIVALENTS—Beginning of year	<u>30,930</u>	<u>30,249</u>
CASH AND CASH EQUIVALENTS—End of year	<u>\$ 32,737</u>	<u>\$ 30,930</u>

(Continued)

MASSACHUSETTS WATER RESOURCES AUTHORITY

STATEMENTS OF CASH FLOWS FOR THE YEARS ENDED JUNE 30, 2005 AND 2004 (Dollars in thousands)

	2005	2004
RECONCILIATION OF OPERATING INCOME TO NET CASH PROVIDED BY OPERATING ACTIVITIES:		
Operating income	\$ 72,429	\$ 82,067
Adjustments to reconcile operating income to net cash provided by operating activities:		
Depreciation and amortization	175,128	161,492
Decrease in other accounts	668	5,486
(Decrease) increase in accounts payable	<u>(10,112)</u>	<u>8,811</u>
Net cash provided by operating activities	<u>\$ 238,113</u>	<u>\$ 257,856</u>

(Concluded)

See notes to financial statements.

MASSACHUSETTS WATER RESOURCES AUTHORITY

NOTES TO FINANCIAL STATEMENTS

AS OF AND FOR THE YEARS ENDED JUNE 30, 2005 AND 2004

(Dollars in thousands)

1. ORGANIZATION

The Massachusetts Water Resources Authority (the “Authority”) was established in January 1985 pursuant to Chapter 372 (the “Enabling Act”) of the Act of 1984 of the Commonwealth of Massachusetts (the “Commonwealth”). The Authority, a successor agency to certain functions of the Metropolitan District Commission (the “MDC”) (which had become part of the Department of Conservation and Recreation (the “DCR”) in July 2003), is a public instrumentality and, effective July 1, 1985, provides water supply services and sewage collection, treatment, and disposal services to areas of the Commonwealth.

The Authority is governed by an 11-member board of directors (the “Board”) chaired by the Secretary of Environmental Affairs for the Commonwealth. The Secretary and four other members are appointed by the Governor, one upon recommendation of the Mayor of Quincy and one upon recommendation of the Selectmen of Winthrop. Three members of the Board are appointed by the Mayor of Boston and three are appointed by the Authority’s Advisory Board.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The accounting policies of the Authority conform to accounting principles generally accepted in the United States of America as applicable to government enterprises. The following is a summary of the Authority’s significant accounting policies:

Basis of Presentation—The Authority is required by the Enabling Act to establish user rates for its water and sewer services which provide sufficient funds to recover the costs of operations (excluding depreciation), debt service, maintenance, replacements, improvements to its facilities, and appropriate reserves. The Authority’s financial statements are reported on the accrual basis of accounting and the economic measurement focus as specified by the Governmental Accounting Standards Board’s requirements for an enterprise fund.

The Authority distinguishes operating revenues and expenses from nonoperating items. Operating revenues and expenses generally result from providing water and sewer services to its member communities. All revenues and expenses not meeting this definition are reported as nonoperating revenues and expenses. All operating revenues are pledged for repayment of outstanding debt service.

Under the Governmental Accounting Standards Board (“GASB”) Statement No. 20, *Accounting and Reporting for Proprietary Funds and Other Governmental Entities That Use Proprietary Fund Accounting*, the Authority has adopted the option to apply all Financial Accounting Standards Board (“FASB”) Statements and Interpretations issued before November 30, 1989, except for those that conflict with or contradict GASB pronouncements.

In addition, the Authority has adopted the provisions of FASB No. 71, *Accounting for the Effects of Certain Types of Regulation*, to provide a better matching of revenues and expenses. The effect of this policy has been to defer certain costs, which will be recovered through future revenues in accordance with the Authority's rate model, and to record deferred credits for revenue collected through current rates for costs expected to be incurred in the future. The effects of the Authority's accounting policies under Statement No. 71 are discussed further in Notes 3 and 9.

Capital Assets—On July 1, 1985, ownership of the MDC's sewer and waterworks personal property was transferred to the Authority. Pursuant to the Enabling Act, ownership of the real property of the MDC sewer and waterworks systems was not transferred from the Commonwealth to the Authority; however, the Authority has the right to use, improve, maintain, and manage that property. In addition, ownership of the real and personal property of the watershed system remains with the Commonwealth; however, the Authority has the right to utilize the water therefrom for water supply purposes.

The personal property, together with the rights to the real property and watershed system, was recorded at its estimated fair market value of \$2,331,465 (including certain construction projects which were in progress as of July 1, 1985), based upon an appraisal performed by valuation specialists. Property, plant, and equipment acquired or constructed since July 1, 1985, is stated at historical cost, and includes the expenditure of capital grants in aid of construction.

Betterments and major renewals are capitalized and included in capital asset accounts, while expenditures for maintenance and repairs are charged to expense when incurred. The cost of depreciable assets and related accumulated depreciation are eliminated from the accounts when such items are disposed of or otherwise retired.

Interest Cost and Principal Payments on Construction—During fiscal 2005 and 2004, none of the Authority's interest expense was capitalized to construction in progress in accordance with its current policy of recovering such costs through rates as incurred. Rates collected for principal payments on debt related to assets under construction are deferred until the related asset is completed and depreciation commences.

Depreciation—The Authority provides for depreciation by use of the straight-line method. Depreciation is intended to distribute the cost of depreciable properties, including those financed by capital grants in aid of construction, over the following estimated average useful lives:

	Years
Plant and equipment, water and sewerage systems	5–100
Motor vehicles and equipment	5
Furniture and fixtures	7
Leasehold improvements	3–5

Revenue Recognition—The Authority recognizes revenue as amounts become collectible from its customers for water and sewer services provided. The majority of the Authority's billings to cities and towns are subject to, in the event of nonpayment, the local aid intercept allowed by the Enabling Act.

Cash and Cash Equivalents—The Authority's policy is to treat unrestricted investments with a maturity date of three months or less when purchased as cash equivalents for purposes of the statements of cash flows. Restricted cash and cash equivalents are combined with investments on the balance sheets, and shown separately on the statements of cash flows as an investing activity.

Payments in Lieu of Taxes—The Enabling Act authorizes and directs the Authority to pay to the DCR (formerly the MDC) Division of Watershed Management an amount for payment to each city or town in which land of the Quabbin watershed and Ware River watershed is located. Each such payment is equal to the amount which the respective city or town would receive in property taxes, based upon the fair value of such land if such land were not tax-exempt.

Investments—Investments are recorded at fair value. Fair value is determined based on quoted market price. The Authority recorded unrealized gains of \$2,358 in fiscal 2005 and unrealized losses of \$15,375 in 2004 as part of investment income.

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

Reclassifications—Certain reclassifications were made to the fiscal year 2004 financial statements to conform to the fiscal year 2005 presentation.

3. DEFERRED CHARGES AND CREDITS

In accordance with FASB No. 71, deferred charges and credits result primarily from differences between depreciation on property, plant, and equipment not financed by grants or capital contributions, which is recovered through rates as principal payments on debt service and from amounts determined by the Board to be utilized in a subsequent year to reduce customer billings (rate stabilization).

A summary of the activity of FASB No. 71 charges (credits) for fiscal 2005 and 2004 is as follows:

	Sewer	Water	Total
Balance—June 30, 2003—net	\$ 96,841	\$ 55,277	\$ 152,118
Difference between depreciation of capital assets not financed by grants or capital contributions, and debt service in excess of interest expense	51,725	8,655	60,380
Bond redemption—net	13,408	(7,289)	6,119
Other—net	<u>(11,780)</u>	<u>(464)</u>	<u>(12,244)</u>
Balance—June 30, 2004—net	150,194	56,179	206,373
Difference between depreciation of capital assets not financed by grants or capital contributions, and debt service in excess of interest expense	58,989	17,268	76,257
Bond redemption—net	(2,235)	(1,097)	(3,332)
Rate stabilization—current year recovery	(1,341)	(659)	(2,000)
Other—net	<u>8,474</u>	<u>(5,165)</u>	<u>3,309</u>
Balance—June 30, 2005—net	<u>\$ 214,081</u>	<u>\$ 66,526</u>	<u>\$ 280,607</u>

The net balance at June 30, 2005 and 2004, is presented on the balance sheets as follows:

	2005	2004	Current Year Change
Deferred charges	\$ 368,345	\$ 292,088	\$ 76,257
Deferred credits	<u>(87,738)</u>	<u>(85,715)</u>	<u>(2,023)</u>
Net change in deferrals	<u>\$ 280,607</u>	<u>\$ 206,373</u>	<u>\$ 74,234</u>

The balance in the rate stabilization reserve which is included in deferred credits was \$43,445 and \$41,445 at June 30, 2005 and 2004, respectively.

4. DEPOSITS AND INVESTMENTS

For the year ended June 30, 2005, the Authority has adopted GASB No. 40, *Deposit and Investment Risk Disclosures*. The standard requires that entities disclose essential risk information about deposits and investments.

(a) **Custodial Credit Risk—Deposits**—The custodial credit risk for deposits and certificates of deposit is the risk that in the event of a bank failure the Authority’s deposits may not be recovered. The deposits in the bank in excess of the insured amount are uninsured and uncollateralized. The deposits at June 30, 2005, were \$32,737. Of these, \$32,637 were exposed to custodial credit risks as uninsured and uncollateralized.

(b) **Investments**—The Authority is authorized by its general bond resolution to invest in obligations of the U.S. Treasury, its agencies and instrumentalities, bonds, or notes of public agencies or municipalities, bank time deposits, guaranteed interest contracts, money market accounts, interest rate swap agreements, and repurchase agreements. These investments are recorded at fair value.

There are four guaranteed investment contracts in force as of June 30, 2005, all of which are fully collateralized and appear as follows:

Investment Agreement Provider	Rate	Maturity	Amount
Bayern LP	5.27 %	December 1, 2005	\$ 20,375
AIG Financial Products	5.75	November 1, 2006	10,418
AIG Financial Products	6.05	August 1, 2014	18,342
Wachovia Bank	5.17	August 1, 2016	14,456

(c) **Credit Ratings**—All securities purchased, such as FNMA, FHLMC, and FHLB issues have an implied credit rating of AAA or they have been collateralized to AAA. This includes the guaranteed investment contracts.

(d) **Concentration Risk**—The Authority has no investments at fair value that exceed 5% of the Authority’s net assets as of June 30, 2005.

The Authority's investments at June 30, 2005 are presented below. All investments are presented by investment type and debt securities are presented by maturity.

Investment Type	Fair Value	Investment Maturities (in years)			
		<1	1-3	4-8	>9
Certificate of deposit	\$ 3,100	\$ 100	\$ 3,000	\$ -	\$ -
Money market mutual funds	314,424	314,424	-	-	-
U. S. Treasury notes and bonds	31,817	9,251	-	18,532	4,034
U. S. agency obligation	281,673	-	27,325	77,002	177,346
Guaranteed investment contracts	63,591	20,375	10,418	-	32,798

(e) **Restricted Cash and Investments by Fund**—The following summarizes restricted cash and investments as of June 30, 2005 and 2004, by various funds and accounts established by the Authority for debt covenants and other purposes:

	2005	2004
Restricted cash and investments:		
Construction	\$ 77,571	\$ 129,076
Debt service reserves	243,609	243,378
Debt service	152,587	198,259
Revenue redemption	33,462	32,016
Revenue	63,928	71,616
Renewal and replacement reserve	34,768	28,379
Insurance	18,997	17,997
Community obligation and revenue enhancement	20,881	20,778
Insurance related escrow deposits	<u>6,875</u>	<u>6,595</u>
Total restricted cash and investments	<u>\$ 652,678</u>	<u>\$ 748,094</u>

5. BOND RESOLUTION RESERVES

The components of the reserves required by the general and supplemental bond resolutions at June 30, 2005 and 2004, are as follows:

Reserves	Sewer	Water	2005 Total	2004 Total
Renewal and replacement	\$ 17,300	\$ 11,701	\$ 29,001	\$ 29,001
Insurance	9,500	9,500	19,000	18,000
Operating	24,221	7,846	32,067	32,067
Community obligation and revenue enhancement	<u>18,399</u>	<u>1,717</u>	<u>20,116</u>	<u>20,116</u>
Total	<u>\$ 69,420</u>	<u>\$ 30,764</u>	<u>\$ 100,184</u>	<u>\$ 99,184</u>

A renewal and replacement reserve of \$6,000 was established through grant receipts transferred from the Commonwealth in 1985 and is included in restricted net assets at June 30, 2005 and 2004.

6. NOTES PAYABLE AND LONG-TERM DEBT

Long-term debt at June 30, 2005 and 2004, consisted of the following:

	2005	2004
General Revenue Bonds:		
1990 Series A, 7-1/2%, issued February 15, 1990, due 2006	\$ 23,985	\$ 22,293
1992 Series A, 6-1/2%, issued April 8, 1992, due 2007 to 2019	387,845	387,845
1993 Series C, 5-1/4% to 6%, issued December 2, 1993, due 2006 to 2015	152,565	272,810
1994 Series A, 5-1/10% to 5-6/10%, issued August 16, 1994		3,255
1995 Series B, 4-3/4% to 6-1/4%, issued January 4, 1996, due 2006 to 2024	164,500	217,705
1996 Series A, 6%, issued November 5, 1996, due 2005 to 2006	6,635	25,295
1998 Series A, 4-3/4% to 5-1/2%, issued January 27, 1998, due 2005 to 2032	161,025	190,445
2000 Series A, 5% to 6-1/8%, issued March 1, 2000, due 2006 to 2011	28,810	277,315
2002 Series B, 5% to 5-1/2%, issued March 15, 2002, due 2006 to 2027	89,000	175,875
2002 Series J, 5% to 5-1/2%, issued December 18, 2002, due 2008 to 2042	591,395	591,395
2003 Series D, 2% to 5%, issued January 7, 2004, due 2005 to 2028	145,510	165,000
2004 Series A, 2% to 5-1/8%, issued June 10, 2004, due 2005 to 2029	<u>120,495</u>	<u>130,000</u>
	<u>1,871,765</u>	<u>2,459,233</u>
General Revenue Refunding Bonds:		
1997 Series D, 4-3/4% to 6%, issued December 15, 1997, due 2005 to 2020	132,135	133,135
1998 Series B, 4-1/2% to 5-1/2%, issued January 27, 1998, due 2005 to 2022	104,545	104,545
2004 Series B, 5%, issued September 29, 2004, due 2016 to 2020	65,255	
2005 Series A, 2-3/8% to 5-1/4%, issued April 14, 2005, due 2006 to 2034	416,455	
2005 Series B, 5%, issued April 14, 2005, due 2031 to 2035	<u>80,290</u>	
	<u>798,680</u>	<u>237,680</u>

	2005	2004
Subordinated debt:		
General Revenue Bonds with the Massachusetts Water Pollution Abatement Trust:		
1993 Series A, 5-1/10% to 5-1/2%, issued March 18, 1993, due 2005 to 2013	\$ 6,565	\$ 7,840
1993 Series D, 4-9/10% to 5-1/4%, issued January 6, 1994, due 2005 to 2014	5,430	6,230
1995 Series A, 5% to 6%, issued November 21, 1995, due 2005 to 2015	6,580	7,460
1998 Series C, 4-1/4% to 5-3/8%, issued July 9, 1998, due 2005 to 2018	12,970	14,300
1999 Series E Sewer, 4-1/4% to 5-3/8%, issued October 6, 1999, due 2005 to 2029	9,532	9,777
1999 Series E Water, 4-1/4% to 5-3/8%, issued October 6, 1999, due 2005 to 2029	9,658	10,158
1999 Series F, 4-3/4% to 6%, issued November 3, 1999, due 2005 to 2029	359,790	368,435
2000 Series E Sewer, 4-1/2% to 5-5/8%, issued November 1, 2000, due 2005 to 2030	68,911	70,377
2000 Series E Water, 4-1/2% to 5-5/8%, issued November 1, 2000, due 2005 to 2030	10,720	11,228
2001 Series C Water, 4% to 5-1/4%, issued July 26, 2001, due 2006 to 2021	4,618	4,839
2001 Series D Sewer, 4-1/2% to 5-3/4%, issued July 26, 2001, due 2005 to 2019	6,998	7,347
2001 Series D Water, 4-1/2% to 5-3/4%, issued July 26, 2001, due 2005 to 2019	1,364	1,435
2002 Series H Sewer, 3-1/2% to 5-1/4%, issued October 31, 2002, due 2005 to 2032	87,880	89,790
2002 Series H Water, 3-1/2% to 5-1/4%, issued October 31, 2002, due 2005 to 2022	30,650	31,905
2002 Series I Sewer, 4-1/4% to 5-5/8%, issued October 31, 2002, due 2005 to 2030	2,526	2,586
2002 Series I Water, 4-1/4% to 5-5/8%, issued October 31, 2002, due 2005 to 2020	28	29
2003 Series A Water, 3% to 5-1/4%, issued October 31, 2002, due 2005 to 2022	1,415	1,474
2003 Series B Water, 4% to 5-1/4%, issued July 24, 2003, due 2006 to 2021	4,169	4,368
2003 Series C Sewer, 2% to 5-1/2%, issued November 6, 2003, due 2005 to 2033	31,481	29,806
2003 Series C Water, 2% to 5-1/2%, issued November 6, 2003, due 2005 to 2023	20,748	21,630
2004 Series C Sewer, 2% to 5-1/2%, issued October 26, 2004, due 2005 to 2033	10,567	
2004 Series C Water, 3% to 5-1/4%, issued October 26, 2004, due 2005 to 2022	1,692	
2004 Series D Sewer, 2-1/2% to 5-1/4%, issued November 29, 2004, due 2005 to 2034	53,050	
2004 Series D Water, 2-1/2% to 5-1/4%, issued November 29, 2004, due 2005 to 2024	13,375	
	<u>760,717</u>	<u>701,014</u>

(Continued)

	2005	2004
General Revenue Bonds (variable rate):		
1997 Series A, 0.96% to 2.97%, issued June 18, 1997, due 2005 to 2028	\$ 79,200	\$ 80,400
1997 Series B, 1.0% to 3.0%, issued June 18, 1997, due 2005 to 2028	79,200	80,400
1999 Series A, 0.95% to 2.96%, issued January 14, 1999, due 2005 to 2028	90,400	91,700
1999 Series B, 0.96% to 2.97%, issued January 29, 1999, due 2005 to 2028	90,400	91,700
1999 Series C, 0.9% to 2.65%, issued June 8, 1999, due 2005 to 2029	69,900	70,800
1999 Series D, 1.2% to 3.08%, issued June 8, 1999, due 2005 to 2029	69,900	70,800
2001 Series A, 0.97% to 2.99%, issued September 26, 2001, due 2005 to 2023	89,200	91,200
2001 Series B, 0.95% to 3.01%, issued September 26, 2001, due 2023 to 2031	<u>85,000</u>	<u>85,000</u>
	<u>653,200</u>	<u>662,000</u>
General Revenue Refunding Bonds (variable rate):		
1998 Series D, 1% to 3%, issued December 22, 1998, due 2008 to 2026	198,895	198,895
2000 Series B, 1% to 3%, issued March 22, 2000, due 2005 to 2037	133,800	134,200
2000 Series C, 1% to 3%, issued March 22, 2000, due 2005 to 2037	133,700	134,200
2002 Series C, 0.86% to 2.95%, issued August 15, 2002, due 2020	80,000	80,000
2002 Series D, 0.90% to 3.05%, issued August 15, 2002, due 2008 to 2017	76,450	76,450
2002 Series E, 0.95% to 2.6%, issued August 15, 2002, due 2010 to 2011	83,400	83,400
2002 Series F, 0.95% to 2.7%, issued August 15, 2002, due 2012 to 2013	90,900	90,900
2002 Series G, 0.90% to 2.55%, issued August 15, 2002, due 2014 to 2015	<u>99,250</u>	<u>99,250</u>
	<u>896,395</u>	<u>897,295</u>
General Revenue Bonds (fixed rates):		
2000 Series D, 5-1/2%, issued October 1, 2000, due 2009 to 2011	<u>150,000</u>	<u>150,000</u>
	<u>5,130,757</u>	<u>5,107,222</u>

(Continued)

	2005	2004
Less:		
Unamortized issuance and premium/discount costs	21,061	(30,175)
Unamortized excess of reacquisition price over net carrying amount of defeased bonds	(173,660)	(139,576)
Current portion of long-term debt	<u>(70,241)</u>	<u>(52,528)</u>
	<u>(222,840)</u>	<u>(222,279)</u>
Long-term debt—net	<u>\$4,907,917</u>	<u>\$4,884,943</u>

(Concluded)

Long-term debt at June 30, 2005 and 2004, consisted of the following:

	2004 Beginning Balance	Additions	Reductions	2005 Ending Balance	Due Within One Year
General Revenue Bonds	\$ 3,271,233	\$ 1,692	\$ 597,960	\$ 2,674,965	\$ 41,587
General Revenue Refunding Bonds	1,134,975	562,000	1,900	1,695,075	3,965
General Revenue Bonds with the Massachusetts Water Pollution Abatement Trust	<u>701,014</u>	<u>81,141</u>	<u>21,438</u>	<u>760,717</u>	<u>24,689</u>
	<u>\$ 5,107,222</u>	<u>\$ 644,833</u>	<u>\$ 621,298</u>	<u>\$ 5,130,757</u>	<u>\$ 70,241</u>
	2003 Beginning Balance	Additions	Reductions	2004 Ending Balance	Due Within One Year
General Revenue Bonds	\$ 3,035,391	\$ 296,572	\$ 60,730	\$ 3,271,233	\$ 29,190
General Revenue Refunding Bonds	1,136,735		1,760	1,134,975	1,900
General Revenue Bonds with the Massachusetts Water Pollution Abatement Trust	<u>664,341</u>	<u>56,002</u>	<u>19,329</u>	<u>701,014</u>	<u>21,438</u>
	<u>\$ 4,836,467</u>	<u>\$ 352,574</u>	<u>\$ 81,819</u>	<u>\$ 5,107,222</u>	<u>\$ 52,528</u>

The Authority is required to establish water and sewer rates and charges at a level sufficient to provide, among other things, primary and subordinated debt service coverage ratios of 110% and 120%, respectively. For the year ended June 30, 2005, the Authority had primary and subordinated debt service coverage ratios of 191% and 113%, respectively.

The fiscal 2005 addition to the general revenue bonds represents the accretion on the capital appreciation bond that matures in fiscal year 2006.

The Act of 1984 imposes a limitation of \$600,000 on the total amount of bonds and notes which may be outstanding at any one time. The Authority has requested increases in its debt limit as necessary to allow for issuances of bonds in amounts required to finance the capital program. The state legislature increased the debt limit to \$5,800,000.

On April 14, 2005, the Authority issued General Revenue Refunding Bonds, 2005 Series A and 2005 Series B in the principal amounts of \$416,455 and \$80,290, respectively. The proceeds from these bonds, along with other available funds, were used to defease \$500,420 of bonds outstanding. The Authority recorded losses in the amount of approximately \$31,589 and \$8,507, respectively, on these refundings. These amounts are being amortized over the life of the original debt. The interest rate on these bonds ranges from 2.375% to 5.25%, and the cash flow required to make principal and interest on the refunding bonds is approximately \$69,295 less than the debt service requirements for the defeased bonds. The economic gain (the difference between the present values of the debt service payments on the old and new debt) obtained from this refunding was \$25,506.

On September 29, 2004, the Authority issued General Revenue Refunding Bonds, 2004 Series B in the principal amount of \$65,255. The proceeds from these bonds, along with other available funds, were used to defease \$68,350 of bonds outstanding. The Authority recorded a loss of approximately \$3,954 on this transaction. These amounts are being amortized over the life of the original debt. The interest rate on these bonds is 5%. The cash flow required to make principal and interest payments on the refunding bonds is approximately \$8,815 less than the debt service requirements for the defeased bonds. The economic gain (the difference between the present values of the debt service payments on the old and new debt) obtained from this refunding was \$5,209.

On January 7, 2004, the Authority issued General Revenue Bonds, 2003 Series D in the principal amount of \$165,000. The proceeds from these bonds were used to fund ongoing capital projects. The interest rate on these bonds ranges from 2% to 5%.

On June 10, 2004, the Authority issued General Revenue Bonds, 2004 Series A in the principal amount of \$130,000. The proceeds from these bonds were used to fund ongoing capital projects and to defease \$10,860 of bonds outstanding. The interest rate on these bonds ranges from 2% to 5-1/8%. The cash flow required to make principal and interest payments on the refunding bonds is approximately \$478 less than the debt service requirements for the defeased bonds. The economic gain (the difference between the present value of the debt service payments on the old and new debt) obtained from this refunding was \$470.

In connection with several of its bond issues, the Authority has entered into various interest rate swap agreements to reduce the impact of changes in interest rates on its variable rate debt. Under these agreements, the Authority pays a fixed interest rate (ranging from 3.9% to 6.9%) and receives interest from the swap counterparties at a variable rate (either Bond Market Association ("BMA") rate or 67% of LIBOR). The BMA rate is based on the seven-day high-grade market index of tax-exempt variable rate demand obligations. The Authority also has one swap where it receives a fixed rate of 4.9% and pays the BMA rate. Under these agreements, the Authority incurred net interest expense of \$20,371 and \$32,174 in fiscal 2005 and fiscal 2004, respectively.

Summary of Swap Transactions by Category:

Synthetic Fixed Rate Swap Transactions

Date of Execution	Notional Amount	Termination Date	Associated Bonds	Fixed Payable Swap Rate	Variable Receivable Swap Rate	Lump-Sum Payment From Counterparty	Counterparty Credit Rating at June 30, 2005	Fair Value at June 30, 2005
March 22, 2000	\$267,500	August 1, 2030	2000 Series B & C	5.130 %	BMA	N/A	Aaa	\$(51,819)
August 1, 2030	70,400	August 1, 2037	2000 Series B & C	6.935	BMA	N/A	Aaa	(2,422)
January 14, 1999	90,400	August 1, 2006	1999 Series A	3.947	BMA	N/A	Aaa	(1,125)
January 14, 1999	90,400	August 1, 2006	1999 Series B	3.949	BMA	N/A	Aaa	(1,127)
December 22, 1998	198,895	November 1, 2026	1998 Series D	3.994	BMA	N/A	Aaa	(8,567)
August 15, 2002	350,000	August 1, 2015	2002 Series D, E, F, G	4.127	67 % LIBOR	N/A	A+	(27,199)

Synthetic Variable Rate Swap Transactions

Date of Execution	Notional Amount	Termination Date	Associated Bonds	Fixed Payable Swap Rate	Variable Receivable Swap Rate	Lump-Sum Payment From Counterparty	Counterparty Credit Rating at June 30, 2005	Fair Value at June 30, 2005
October 26, 2000	\$150,000	August 1, 2011	2000 Series D	4.906%	BMA	N/A	A+	\$12,020

Risk Disclosure:

Credit Risk—Because all of the Authority’s swaps rely upon the performance of the third parties who serve as swap counterparties, the Authority is exposed to credit risk, or the risk that a swap counterparty fails to perform according to its contractual obligations. The appropriate measurement of this risk at the reporting date is the fair value of the swaps, as shown in the columns labeled fair value in the tables above. All fair values have been calculated using the mark-to-market or par value method. To mitigate credit risk, the Authority maintains strict credit standards for swap counterparties. All swap counterparties for longer term swaps are rated in the A+ category or higher by at least two of the three rating agencies (FITCHRATINGS, Moody’s Investors Service, and Standard and Poor’s).

Basis Risk—The Authority is exposed to basis risk if the relationship between the floating index the Authority receives on the swaps (BMA or 67% of LIBOR) falls short of the variable rate on the associated bonds. Should this occur, the expected savings may not be realized.

Rollover Risk—Because the swaps for the 1999 A and B bonds terminate prior to the maturity of such bonds, the Authority is exposed to rollover risk. Upon the termination of the swaps, the Authority will no longer realize the synthetic rate on these bonds and will be exposed to the floating rate risk on the underlying bonds if no new swap is put in place.

At June 30, 2005, the following bonds outstanding are considered defeased in substance:

Description	Redemption Date	Redemption Price	Outstanding Principal Amount
1990 Series A	2009–2020	102 %	\$ 602,975
1991 Series A	2005–2021	100 to 102	232,365
1992 Series A	2012–2022	100 to 102	283,500
1992 Series B	2005–2020	100	413,145
1993 Series A	2005–2013	100 to 102	66,905
1993 Series B	2006–2022	100 to 102	398,680
1993 Series C	2005–2020	100 to 102	197,785
1993 Series D	2005–2014	100 to 102	46,295
1994 Series A	2006–2024	101.5	120,575
1995 Series A	2005–2015	100 to 102	50,055
1995 Series B	2005–2016	100	53,515
1996 Series A	2007–2026	100 to 102	124,710
1998 Series A	2015–2018	100	26,010
1998 Series C	2005–2018	100 to 102	86,610
2000 Series A	2005–2039	100	248,595
2002 Series B	2005–2024	100	86,925
2003 Series D	2014–2021	100	18,010
2004 Series A	2015–2019	100	9,505

The proceeds and available funds were deposited in irrevocable trusts with escrow agents in an amount which will provide for payment of interest due to the redemption date and redemption of the defeased bonds outstanding on such date. The defeased portion of such debt, accrued interest thereon, and related unamortized issuance and discount costs were removed from the balance sheet in an in-substance defeasance transaction.

At June 30, 2005, outstanding bonds that are redeemable before their scheduled due dates are as follows:

Description	Redemption Date	Redemption Price	Principal Amount
1995 Series B	December 2005	100%–102%	\$ 132,140
1997 Series D	August 2008	100–101	113,375
1998 Series A	August 2008	100	115,280
1998 Series B	August 2008	100	72,945
2002 Series B	August 2011	100–101	76,755
2002 Series J	August 2012	100	200,000
2003 Series D	August 2013	100	127,160
2004 Series A	August 2014	100	107,075
2004 Series B	August 2014	100	65,255
2005 Series A	August 2017	100	285,000
2005 Series B	August 2017	100	80,290

The variable rate General Revenue Bonds are subject to redemption prior to maturity at the option of the Authority, in whole or in part, on any interest payment date.

During fiscal 2005, the Authority executed loan agreements with Massachusetts Water Pollution Abatement Trust (“MWPAT”) providing for 2004 Series C Sewer and Water and 2004 Series D Sewer and Water loans in the principal amounts of \$10,567, \$1,692, \$64,932, and \$13,375, respectively. All proceeds for these loans were received by June 30, 2005, except \$11,882 and \$1,617, principal and premium, respectively, for 2004 Series D Sewer.

During fiscal 2004, the Authority executed loan agreements with MWPAT providing for 2003 Series B Water and 2003 Series C Sewer and Water loans in the principal amounts of \$4,566, \$29,806, and \$21,630, respectively. All proceeds for these loans were received by June 30, 2004, except \$2,386 and \$661, principal and premium, respectively, for 2003 Series C Sewer.

Federal and Commonwealth subsidies for purposes of offsetting principal payments aggregating \$139,901 will be recognized as capital grants in aid of construction over the term of the loans.

Interest is payable semiannually on all debt, except on the commercial paper and capital appreciation bonds, on which interest is payable upon maturity, and the General Revenue Bonds with variable interest rates on which interest is payable monthly. The Senior General Revenue Bonds and the General Revenue Refunding Bonds are collateralized equally and ratably by a lien and pledge on substantially all of the Authority’s cash and revenues, except the operating fund. The subordinated debt series, including the commercial paper, are collateralized equally and ratably by a subordinated pledge on substantially all of the Authority’s revenues and cash and investments, except the operating, debt service, and debt service reserve funds. Premiums, discounts, issuance costs, and the excess of reacquisition price over the carrying amount of the defeased debt are being amortized over the lives of the respective issues.

The amounts of long-term debt, principal, and interest payable in future fiscal years are as follows:

Year Ending June 30	Principal	Interest	Total
2006	\$ 70,241	\$ 223,847	\$ 294,088
2007	70,677	226,145	296,822
2008	88,470	222,625	311,095
2009	114,593	217,945	332,538
2010	172,211	211,604	383,815
2011–2015	1,063,423	917,390	1,980,813
2016–2020	1,219,259	668,733	1,887,992
2021–2025	1,236,122	389,667	1,625,789
2026–2030	688,869	171,619	860,488
2031–2035	262,017	70,616	332,633
2036–2040	104,115	21,663	125,778
2041–2044	40,760	3,123	43,883
Total	<u>\$5,130,757</u>	<u>\$3,344,977</u>	<u>\$8,475,734</u>

The Authority issued commercial paper notes of \$289,000 to finance capital expenditures, which are secured by \$102,466 and \$256,164 of irrevocable direct-pay letters of credit which expire on September 8, 2009, and November 30, 2015, respectively. These letters of credit carry a fee of 0.27% and 0.3% per annum, respectively, on the amount available.

The maximum aggregate principal amount of commercial paper which may be outstanding at any one time is \$350,000. At June 30, 2005 and 2004, the amounts outstanding were \$289,000 and \$307,000, respectively. The weighted-average interest rate on commercial paper outstanding at June 30, 2005 and 2004, was 1.77% and 0.97%, respectively.

7. ACCOUNTS RECEIVABLE/INTERGOVERNMENTAL LOANS

The Authority has entered into various interest-free loan agreements with certain member communities. Under these agreements, the Authority loaned these communities \$28,032 and \$23,365 in fiscal 2005 and 2004, respectively, to be received in five or ten equal annual installments.

The long-term portion of these loans at June 30, 2005 and 2004, is \$77,357 and \$64,472, respectively, and is included in other assets. This program is designed to assist member communities with sewer and water systems rehabilitation.

8. CAPITAL ASSETS

Capital assets at June 30, 2005 and 2004, consisted of the following:

	2004	Additions	Disposals/ Transfers	2005
Capital assets—not being depreciated:				
Land	\$ 13,932	\$ -	\$ (2,896)	\$ 11,036
Construction in progress	<u>868,639</u>	<u>167,657</u>	<u>(518,059)</u>	<u>518,237</u>
Total capital assets—not being depreciated	<u>882,571</u>	<u>167,657</u>	<u>(520,955)</u>	<u>529,273</u>
Capital assets—being depreciated:				
Plant and equipment—water and sewage system	7,315,246	462,693		7,777,939
Furniture and fixtures	32,232	829		33,061
Leasehold improvements	5,081			5,081
Motor vehicles and equipment	<u>1,595</u>			<u>1,595</u>
Total capital assets—being depreciated	<u>7,354,154</u>	<u>463,522</u>	<u>-</u>	<u>7,817,676</u>
Less accumulated depreciation for:				
Plant and equipment—water and sewage system	1,655,975	160,367		1,816,342
Furniture and fixtures	23,167	3,314		26,481
Leasehold improvements	3,771	446		4,217
Motor vehicles and equipment	<u>991</u>	<u>19</u>		<u>1,010</u>
Total accumulated depreciation	<u>1,683,904</u>	<u>164,146</u>	<u>-</u>	<u>1,848,050</u>
Total capital assets—being depreciated—net	<u>5,670,250</u>	<u>299,376</u>	<u>-</u>	<u>5,969,626</u>
Capital assets—net	<u>\$ 6,552,821</u>	<u>\$ 467,033</u>	<u>\$ (520,955)</u>	<u>\$ 6,498,899</u>

Capital assets at June 30, 2004 and 2003, consisted of the following:

	2003	Additions	Disposals/ Transfers	2004
Capital assets—not being depreciated:				
Land	\$ 16,806	\$ 22	\$ (2,896)	\$ 13,932
Construction in progress	<u>822,349</u>	<u>194,124</u>	<u>(147,834)</u>	<u>868,639</u>
Total capital assets—not being depreciated	<u>839,155</u>	<u>194,146</u>	<u>(150,730)</u>	<u>882,571</u>
Capital assets—being depreciated:				
Plant and equipment—water and sewage system	7,207,416	107,830		7,315,246
Furniture and fixtures	29,151	3,081		32,232
Leasehold improvements	5,081			5,081
Motor vehicles and equipment	<u>1,595</u>			<u>1,595</u>
Total capital assets—being depreciated	<u>7,243,243</u>	<u>110,911</u>	<u>-</u>	<u>7,354,154</u>
Less accumulated depreciation for:				
Plant and equipment—water and sewage system	1,507,659	148,316		1,655,975
Furniture and fixtures	19,234	3,933		23,167
Leasehold improvements	3,325	446		3,771
Motor vehicles and equipment	<u>971</u>	<u>20</u>		<u>991</u>
Total accumulated depreciation	<u>1,531,189</u>	<u>152,715</u>	<u>-</u>	<u>1,683,904</u>
Total capital assets—being depreciated—net	<u>5,712,054</u>	<u>(41,804)</u>	<u>-</u>	<u>5,670,250</u>
Capital assets—net	<u>\$ 6,551,209</u>	<u>\$ 152,342</u>	<u>\$ (150,730)</u>	<u>\$ 6,552,821</u>

Depreciation and amortization for fiscal 2005 and 2004, was \$175,128 and \$161,492, respectively.

9. OTHER ASSETS

On December 17, 1997, the Authority sold to Massachusetts Heavy Industries, Inc. (“MHI”) certain land, buildings, machinery, equipment, and other items located within a former shipbuilding facility, known as the Fore River Shipyard, for a total purchase price of \$10,000. The Authority received \$3,000 in December 1997. The remaining balance of \$7,000 was due to be received beginning in December 1999. In accordance with FASB No. 71, the original loss of \$28,303 was accounted for as a deferred charge and is expected to be recovered through future rates. During fiscal 2000, the \$7,000 receivable was determined to be uncollectible, increasing the deferred loss on the original sale to \$35,303.

During fiscal 2005 and 2004, the Authority incurred an additional \$2.7 million in losses as land in the Fore River Shipyard was sold at a loss.

10. LEASES

Operating—The Authority leases electrical power assets, office space in Boston, and other property under long-term operating leases. Future minimum rental payments required under operating leases having initial or remaining noncancelable lease terms in excess of one year at June 30, 2005, are as follows:

Year Ending June 30	
2006	\$ 9,486
2007	6,824
2008	5,705
2009	5,533
2010	5,364
2011–2015	24,057
2016–2020	<u>3,180</u>
Total	<u>\$ 60,149</u>

The Authority is in the process of amending the lease agreement on the Boston office space. Effective October 1, 2005, the lease on 57 square feet of the office space will be extended until September 30, 2015. The lease on the remaining 27 square feet of the office space will expire on September 30, 2006, and the space will be vacated.

In addition, the Authority is in the process of executing its option to terminate the lease on its backup landfill in Utah. The lease will terminate on March 31, 2006, and the remaining 14 years of the lease will be eliminated at a projected savings of \$11,287.

Rental expense was \$13,185 and \$14,177 in fiscal years 2005 and 2004, respectively.

Capital—In fiscal 2003, the Authority entered into a 30-year capital lease agreement for the new maintenance facility. The interest rate for the capital lease is 7.83%. Future minimum lease payments for the capital lease at June 30, 2005, are as follows:

Year Ending June 30	Principal	Interest	Total
2006	\$ 408	\$ 2,809	\$ 3,217
2007	441	2,776	3,217
2008	477	2,740	3,217
2009	516	2,701	3,217
2010	558	2,659	3,217
2011–2015	3,545	12,540	16,085
2016–2020	5,237	10,848	16,085
2021–2025	7,737	8,348	16,085
2026–2030	11,431	4,655	16,086
2031–2032	<u>5,708</u>	<u>458</u>	<u>6,166</u>
Total	<u>\$ 36,058</u>	<u>\$ 50,534</u>	<u>\$ 86,592</u>

Under this lease, the Authority is also responsible for “Additional Rent,” as defined in the lease. The Additional Rent includes real estate taxes, assessments, and other government charges.

11. RETIREMENT BENEFITS

Plan Description—The Enabling Act provided for the establishment of the Massachusetts Water Resources Authority Employees’ Retirement System (the “Plan”), a contributory single-employer retirement system that is separate from the State Employees Retirement System. The Plan is a defined benefit pension plan covering those employees not employed by the MDC prior to July 1, 1985. Total payroll and covered payroll for all Authority employees in the Plan were \$73,143 and \$69,606, respectively, for the year ended June 30, 2005.

Under the provisions of the Plan, pension benefits vest after 10 years of full-time employment. An employee may retire after 20 years of service or at age 55 and completion of 10 years of service. At age 65, annual pension benefits equal 2–1/2% of the employee’s average regular compensation earned during the last three years of employment or any three consecutive years when compensation was higher, multiplied by each year of creditable service. The benefit is reduced if retirement occurs before age 65 or if survivor’s benefits are elected. The Plan also provides death and disability benefits. Ordinary disability benefits are available only to employees under age 55 with at least 10 years of service. Complete financial statements for the Plan can be obtained from the Authority’s administrative offices at Charlestown Navy Yard, 100 First Avenue, Boston, MA 02129.

Funding Policy—Contributions made by employees are based upon a percentage of employee base pay (5% for employees hired before December 31, 1974; 7% for employees hired between January 1, 1975, and December 31, 1983; 8% for employees hired between December 31, 1983, and June 30, 1996; and 9% for employees hired after July 1, 1996). Additionally, certain employees earning in excess of \$30 contribute an extra 2% of their salary effective January 1, 1979. Employees receive full payment of contributions upon withdrawal from the Plan and 50% of interest earned for employees with five to nine years of service or 100% of interest earned for employees with 10 or more years of service.

The 2005 and 2004 contributions to the Plan were based on an amount approved by the Retirement Board and the Authority’s board of directors. The Authority’s Enabling Act requires funding to be made in accordance with the Retirement Board’s recommendation. In 2004, the Authority contributed \$1,194 more than the annual pension cost (“APC”) or \$3,882.

Annual Pension Cost—The annual required contribution for the current year was determined as part of the January 1, 2001, actuarial valuation using the entry age normal cost method. The actuarial assumptions included (a) 8% investment rate of return and (b) projected salary increase of 5.5% per year. Liabilities for cost-of-living increases have been assumed at an annual increase of 3%, on the first \$12 of benefit payments. Although, the Authority has a net pension asset, they have elected to reserve 100% against these balances. This balance is reserved because this net pension asset resulted from the timing of payments according to the funding schedule and cannot be accessed by the Authority unless the plans are terminated. The likelihood of such an event has been deemed to be remote. Assets are valued at market value.

Three-Year Trend Information—

Fiscal Year Ending	Annual Pension Cost (APC)	Percentage of APC Contributed	Net Pension Obligation
2005	\$ 3,408	100 %	\$ -
2004	2,688	144	-
2003	2,560	100	-

Other Benefits—All MDC personnel who became employees of the Authority on July 1, 1985, and were members of the State Employees Retirement System, retained their membership in that system. The Authority is not liable for retirement allowances paid to or on account of these employees. Funding of the pension liability of the State Employees Retirement System is the obligation of the Commonwealth. Employees covered by this plan become 100% vested after 10 years of service. The Authority’s covered payroll for members of this plan for the year ended June 30, 2005, was \$8,744.

The Authority’s policy is to provide certain health care and life insurance benefits for retired employees. Substantially all of the Authority’s employees may become eligible for those benefits if they reach normal retirement age while working for the Authority. Those and similar benefits for active employees are provided through an insurance company whose premiums are based on the benefits paid during the year. Premiums for retired employees were \$1,320 and \$992 in fiscal 2005 and 2004, respectively.

12. COMMITMENTS AND CONTINGENCIES

General—The Authority’s capital improvement program continues to proceed. As part of this program, the Authority has entered into a number of contracts for the design and construction of infrastructure and improvements to its facilities. Commitments under these contracts aggregated approximately \$388,829 at June 30, 2005.

The Authority’s operating and construction plans are designed to comply with the Federal District Court’s schedule of actions. The Authority has incurred capital expenditures of approximately \$6,533,000 from fiscal 1986 through fiscal 2005, including those projects required to comply with the Federal District Court’s schedule. The Authority anticipates spending an additional \$1,314,000 on these projects through fiscal 2014. These capital expenditures have been forecasted based upon certain preliminary assumptions and estimates, which may change significantly as design and construction of the necessary facilities proceed. Funding is expected to come from various federal and state grants, as available and approved, and from the Authority’s debt proceeds. To date, federal appropriations for the Boston Harbor Project have aggregated \$810,000.

Boston Harbor Case—The Authority continues to be a defendant, along with Boston Water and Sewer Commission (“BWSC”) and the Commonwealth, in the federal Boston Harbor Case. The federal action was originally brought in 1985 by the United States on behalf of the United States Environmental Protection Agency (“EPA”) and by certain citizens groups for Clean Water Act violations. As part of the Boston Harbor Case, the Authority was required to undertake certain corrective actions to meet wastewater treatment, discharge and combined sewer overflow (“CSO”) requirements. The only corrective action remaining is CSO-related which is currently scheduled for completion in 2015.

The Authority completed its Final CSO Facilities Plan and Environmental Impact Report in July 1997 which included 25 site-specific projects (the “Plan”). The Authority currently estimates the total cost of the Plan to be \$834 million including contingencies and escalation of unawarded contracts. Fourteen of the projects are complete, and the remaining projects are either in construction or design. The Authority is currently in discussions with EPA and the Massachusetts Department of Environmental Protection (“DEP”) regarding the completion of additional CSO projects that will satisfy regulatory expectations for the foreseeable future. These discussions relate both to the scope of such additional projects and to a mutually agreeable long-term regulatory framework that will afford long-term CSO controls (through 2020) acceptable to the Authority, and state and federal regulators for three principal CSO areas: (i) East Boston, which was the subject of a design and cost reassessment, (ii) the Charles River, and (iii) the Upper Mystic River/Alewife Brook, the latter two of which are subject to water quality variances issued by the DEP. The Authority anticipates that it will need to spend an additional \$20 million in order to reach agreement upon a long-term CSO control plan with regulators. If final agreement upon these projects and all regulatory issues is reached and the agreement is accepted by the Court, the Court Schedule will be amended to reflect the scope and schedule of work for East Boston, the Charles River, and the Upper Mystic River/Alewife Brook.

In addition, the Court always retains the right to order further remedial action and assess penalties. The Court has issued no penalties in the Boston Harbor Case to date.

Deer Island Submarine Power Cable—In 2004, the United States Army Corps of Engineers (“Corps”) notified Boston Edison Co. (“BECo”), its subsidiary Harbor Energy Electric Company (“HEEC”), and the Authority that they were in violation of a permit (MA BOSS 198900530, dated August 31, 1989) which authorized the installation of a submarine power cable running under Boston Harbor from South Boston to Deer Island, because the power cable, in places, had allegedly been installed at depths less than those required by permit. The Corps has demanded that the permittees develop plans and an implementation schedule for bringing the cable into compliance with the permit. The Authority responded, stating that it had become a co-permittee only to facilitate issuance of the permit, that it did not install or own the cable, and therefore, it had neither the right nor the ability to move or alter the position of the cable. In 2005, the Corps referred the matter to the United States Department of Justice. In May 2005, the Department of Justice notified the permittees that the matter had been referred to it, *inter alia*, for the purpose of commencing a lawsuit to compel the relocation of the cable and to otherwise bring it into compliance with the permit’s conditions. The Authority has reiterated its position to the Department of Justice in its Compliance and Progress report to the federal court as of June 15, 2005. The Department of Justice and the permittees met on October 11, 2005, to discuss this matter. At the meeting, BECo and HEEC outlined conceptual plans with respect to the cable while the Authority repeated its view that it had no responsibility for the cable or for any future efforts by BECo or HEEC to come into compliance with the terms of the permit. A follow-up meeting has been scheduled for January 2006.

Blending—In May 2005, the EPA sent a letter to the Authority stating that, in its view, certain of the Authority’s operational practices involving temporary diversions of portions of the flow around secondary treatment facilities (blending) at its Deer Island Wastewater Treatment Plant (“DITP”) constituted unwarranted by-passes, and constituted violations of the Authority’s NPDES permit. The Authority has responded that the DITP has been operated in a manner that optimizes the end-quality of treated effluent streams following primary and secondary treatment, that operational strategies are gauged to avoid adverse upsets in the biological treatment process, and that blending practices have never resulted in exceedances of permit limits. EPA requested detailed information concerning the operations of DITP and the Authority supplied the information. The EPA has taken no further action to date.

Miscellaneous—The Authority is also a defendant in several legal actions and administrative proceedings arising out of its operation, maintenance, and improvement of the water and sewer systems under its care. It is the opinion of management that any judgments or settlements that may result from these actions will not have a materially adverse effect upon the Authority.

13. RISK MANAGEMENT

The Authority is exposed to various risks of loss. The risk management program involves insurance and self-insurance related to property, general liability (including automobile, marine and employers' liability), excess liability, public officials' liability, workers' compensation, unemployment liability, and employee health care and life insurance.

Buildings, plants, and equipment are fully insured on an all risk replacement basis to the extent that losses exceed \$2,500 per occurrence. The Authority maintains insurance coverage for general liability, automobile liability, marine liability, and employers' liability to the extent that losses exceed \$2,500 per occurrence, up to a limit of \$35,000. In addition to the primary liability insurance, the Authority maintains an excess liability policy with an additional limit of \$65,000. The Authority also maintains public officials' errors and omissions insurance with a limit of \$5,000 per occurrence with a \$1,000 deductible. All insurance policies are renewed on an annual basis.

The Authority reimburses the Commonwealth on a paid-claims basis for unemployment claims. Claims expensed during fiscal 2005 and 2004 were \$66 and \$417, respectively. The Authority is a licensed self-insurer for workers' compensation. Excess loss insurance is carried on workers' compensation as required by law in excess of \$500 per occurrence retention, with a limit of \$25,000 per occurrence.

The Authority participates in and pays premiums to the Commonwealth's Group Insurance Contract for employee health benefits. The Authority pays 80% of these health premiums, with employees paying the balance.

Insurance claims have not exceeded insurance coverage in any of the last three fiscal years.

The MetroWest Water Supply Tunnel is being insured under an Owner's Controlled Insurance Program ("OCIP"). The Authority provides workers' compensation, general liability, and pollution coverage for operations of the contractors on this project. There is a \$500 self-insurance retention for each coverage with a total aggregate self-insurance retention of \$1,250 for a combined claim under the OCIP.

The Authority also instituted a second OCIP for the Walnut Hill Water Treatment Plant. The Authority provides workers' compensation, general liability, and pollution coverage for operations of the contractors on this project. There is a \$500 self-insured retention per occurrence for each coverage.

GASB Statement No. 10 requires that liabilities for self-insured claims be reported if it is probable that a loss has been incurred and the amount can be reasonably estimated. These losses include an estimate of claims that have been incurred but not reported. The Authority records such liabilities in accrued expenses.

Changes in the claims liability insurance reserves in fiscal 2005 and 2004 were as follows:

	General Liability and Property	Workers' Compensation	OCIP Projects
Liability balance—June 30, 2003	\$ 3,663	\$ 2,010	\$ 4,354
Provision to record estimated losses	3,192	1,687	307
Payments	<u>(1,656)</u>	<u>(1,817)</u>	<u>(4,156)</u>
Liability balance—June 30, 2004	5,199	1,880	505
Provision to record estimated losses	486	1,038	232
Payments	<u>(1,426)</u>	<u>(1,434)</u>	<u>(456)</u>
Liability balance—June 30, 2005	<u>\$ 4,259</u>	<u>\$ 1,484</u>	<u>\$ 281</u>

14. SUBSEQUENT EVENTS

On November 16, 2005, the Authority executed loan agreements with MWPAT providing for Sewer and Water loans in the principal amounts of \$76,500 and \$15,000, respectively. As of December 5, 2005, \$56,172 of these loan proceeds were received.

* * * * *

REQUIRED SUPPLEMENTARY INFORMATION

MASSACHUSETTS WATER RESOURCES AUTHORITY

SCHEDULE OF FUNDING PROGRESS (UNAUDITED)

AS OF JUNE 30, 2005

(Dollars in thousands)

Actuarial Valuation	Assets (a)	Actuarial Accrued Liability (AAL)– Entry Age (b)	Unfunded AAL (UAAL) (b-a)	Funded Ratio (a/b)	Covered Payroll (c)	UAAL as a Percentage of Covered Payroll ((b-a)/c)
January 1, 2005	\$ 172,512	\$ 172,512	-	100%	\$ 65,790	-
January 1, 2003	146,188	146,188	-	100	66,711	-
January 1, 2002	141,069	141,069	-	100	66,322	-
January 1, 2001	128,385	128,385	-	100	65,955	-
January 1, 1999	96,318	96,318	-	100	66,782	-
January 1, 1998	77,712	77,712	-	100	63,579	-
January 1, 1997	58,185	58,185	-	100	60,120	-

SUPPLEMENTAL SCHEDULES

MASSACHUSETTS WATER RESOURCES AUTHORITY

ACCOUNTS ESTABLISHED BY THE GENERAL REVENUE BOND RESOLUTION FOR THE YEAR ENDED JUNE 30, 2005 AND COMPARATIVE TOTALS AS OF JUNE 30, 2004

(Dollars in thousands)

	Construction	Revenue	Debt Service	Reserves	Total
Balance—June 30, 2004	\$ 129,076	\$ 71,616	\$ 494,431	\$ 46,376	\$ 741,499
Proceeds from:					
Revenue bonds and loans	114,024				114,024
Cash received from customers		457,190			457,190
Debt service grant			8,019		8,019
Interest income	1,765	12,554	20,757	1,405	36,481
Grant receipts	1,071		6,032		7,103
Construction payments	(166,416)	90			(166,326)
Capital lease payments	(380)		(2,837)		(3,217)
Debt service payment	(1,291)		(332,602)		(333,893)
Other Commonwealth payments		(19,798)			(19,798)
Interfund transfers	(667)	(254,221)	253,904	984	-
Transfers from (to) operating account	389	(203,503)	2,835	5,000	(195,279)
Balance—June 30, 2005	<u>\$ 77,571</u>	<u>\$ 63,928</u>	<u>\$ 450,539</u>	<u>\$ 53,765</u>	<u>\$ 645,803</u>
				2005	2004
				Total	Total
Restricted cash and investments:					
Construction		\$ 42,205	\$ 35,366	\$ 77,571	\$ 129,076
Debt service reserves		174,839	68,770	243,609	243,378
Debt service		106,884	45,703	152,587	198,259
Revenue redemption		20,246	13,216	33,462	32,016
Revenue		35,105	28,823	63,928	71,616
Renewal and replacement reserve		22,487	12,281	34,768	28,379
Insurance		9,499	9,498	18,997	17,997
Community obligation and revenue enhancement		17,880	3,001	20,881	20,778
Total restricted cash and investments		<u>\$ 429,145</u>	<u>\$ 216,658</u>	<u>\$ 645,803</u>	<u>\$ 741,499</u>

MASSACHUSETTS WATER RESOURCES AUTHORITY

COMBINING BALANCE SHEET

AS OF JUNE 30, 2005

(Dollars in thousands)

ASSETS	Sewer	Water	Combined Total
UNRESTRICTED CURRENT ASSETS:			
Cash and cash equivalents	\$ 22,504	\$ 10,233	\$ 32,737
Investments	30,825	11,102	41,927
Intergovernmental loans	6,356	8,791	15,147
Accounts receivable	<u>314</u>	<u>729</u>	<u>1,043</u>
Total unrestricted current assets	<u>59,999</u>	<u>30,855</u>	<u>90,854</u>
RESTRICTED ASSETS:			
Cash and investments	431,848	220,830	652,678
Interest receivable	4,290	1,654	5,944
Grants receivable:			
Billed	1,315		1,315
Unbilled	<u>38</u>	<u> </u>	<u>38</u>
Total restricted assets	<u>437,491</u>	<u>222,484</u>	<u>659,975</u>
CAPITAL ASSETS—Not being depreciated	<u>117,801</u>	<u>411,472</u>	<u>529,273</u>
CAPITAL ASSETS—Being depreciated—net	<u>3,850,039</u>	<u>2,119,587</u>	<u>5,969,626</u>
DEFERRED CHARGES	<u>270,646</u>	<u>97,699</u>	<u>368,345</u>
OTHER ASSETS—Net	<u>168,841</u>	<u>63,666</u>	<u>232,507</u>
TOTAL	<u><u>\$4,904,817</u></u>	<u><u>\$2,945,763</u></u>	<u><u>\$7,850,580</u></u>

(Continued)

MASSACHUSETTS WATER RESOURCES AUTHORITY

COMBINING BALANCE SHEET AS OF JUNE 30, 2005 (Dollars in thousands)

LIABILITIES AND NET ASSETS	Sewer	Water	Combined Total
CURRENT LIABILITIES:			
Accounts payable and accrued expenses	\$ 31,155	\$ 18,727	\$ 49,882
Commercial paper notes		289,000	289,000
Current portion of long-term debt	<u>54,203</u>	<u>16,038</u>	<u>70,241</u>
Total current liabilities	<u>85,358</u>	<u>323,765</u>	<u>409,123</u>
PAYABLE FROM RESTRICTED ASSETS:			
Accounts payable for construction	12,703	9,849	22,552
Accrued interest on bonds payable	<u>49,491</u>	<u>19,306</u>	<u>68,797</u>
Total payable from restricted assets	<u>62,194</u>	<u>29,155</u>	<u>91,349</u>
RETAINAGE ON CONSTRUCTION IN PROGRESS	<u>7,155</u>	<u>11,281</u>	<u>18,436</u>
LONG-TERM DEBT—Less current portion	<u>3,450,906</u>	<u>1,457,011</u>	<u>4,907,917</u>
LONG-TERM CAPITAL LEASES	<u>24,537</u>	<u>11,521</u>	<u>36,058</u>
RESERVES	<u>69,420</u>	<u>30,764</u>	<u>100,184</u>
DEFERRED CREDITS	<u>56,565</u>	<u>31,173</u>	<u>87,738</u>
Total liabilities	<u>3,756,135</u>	<u>1,894,670</u>	<u>5,650,805</u>
NET ASSETS:			
Invested in capital assets—net of related debt	767,991	904,633	1,672,624
Restricted	112,150	49,625	161,775
Unrestricted	<u>268,541</u>	<u>96,835</u>	<u>365,376</u>
Total net assets	<u>1,148,682</u>	<u>1,051,093</u>	<u>2,199,775</u>
COMMITMENTS AND CONTINGENCIES			
TOTAL	<u>\$4,904,817</u>	<u>\$2,945,763</u>	<u>\$7,850,580</u>

(Concluded)

MASSACHUSETTS WATER RESOURCES AUTHORITY

COMBINING BALANCE SHEET AS OF JUNE 30, 2004 (Dollars in thousands)

ASSETS	Sewer	Water	Combined Total
UNRESTRICTED CURRENT ASSETS:			
Cash and cash equivalents	\$ 22,522	\$ 8,408	\$ 30,930
Investments	34,267	12,197	46,464
Intergovernmental loans	5,395	6,853	12,248
Accounts receivable	<u>546</u>	<u>1,131</u>	<u>1,677</u>
Total unrestricted current assets	<u>62,730</u>	<u>28,589</u>	<u>91,319</u>
RESTRICTED ASSETS:			
Cash and investments	500,462	247,632	748,094
Interest receivable	4,815	1,711	6,526
Grants receivable:			
Billed	2,242	(21)	2,221
Unbilled	<u>208</u>	<u> </u>	<u>208</u>
Total restricted assets	<u>507,727</u>	<u>249,322</u>	<u>757,049</u>
CAPITAL ASSETS—Not being depreciated	<u>333,974</u>	<u>548,597</u>	<u>882,571</u>
CAPITAL ASSETS—Being depreciated—net	<u>3,706,470</u>	<u>1,963,780</u>	<u>5,670,250</u>
DEFERRED CHARGES	<u>211,656</u>	<u>80,432</u>	<u>292,088</u>
OTHER ASSETS—Net	<u>137,008</u>	<u>53,132</u>	<u>190,140</u>
TOTAL	<u>\$4,959,565</u>	<u>\$2,923,852</u>	<u>\$7,883,417</u>

(Continued)

MASSACHUSETTS WATER RESOURCES AUTHORITY

COMBINING BALANCE SHEET

AS OF JUNE 30, 2004

(Dollars in thousands)

LIABILITIES AND NET ASSETS	Sewer	Water	Combined Total
CURRENT LIABILITIES:			
Accounts payable and accrued expenses	\$ 38,324	\$ 21,935	\$ 60,259
Commercial paper notes		307,000	307,000
Current portion of long-term debt	<u>39,067</u>	<u>13,461</u>	<u>52,528</u>
Total current liabilities	<u>77,391</u>	<u>342,396</u>	<u>419,787</u>
PAYABLE FROM RESTRICTED ASSETS:			
Accounts payable for construction	12,566	8,912	21,478
Accrued interest on bonds payable	<u>47,695</u>	<u>20,342</u>	<u>68,037</u>
Total payable from restricted assets	<u>60,261</u>	<u>29,254</u>	<u>89,515</u>
RETAINAGE ON CONSTRUCTION IN PROGRESS	<u>5,357</u>	<u>14,055</u>	<u>19,412</u>
LONG-TERM DEBT—Less current portion	<u>3,486,411</u>	<u>1,398,532</u>	<u>4,884,943</u>
LONG-TERM CAPITAL LEASES	<u>24,784</u>	<u>11,652</u>	<u>36,436</u>
RESERVES	<u>68,920</u>	<u>30,264</u>	<u>99,184</u>
DEFERRED CREDITS	<u>61,462</u>	<u>24,253</u>	<u>85,715</u>
Total liabilities	<u>3,784,586</u>	<u>1,850,406</u>	<u>5,634,992</u>
NET ASSETS:			
Invested in capital assets—net of related debt	902,985	902,367	1,805,352
Restricted	74,572	94,776	169,348
Unrestricted	<u>197,422</u>	<u>76,303</u>	<u>273,725</u>
Total net assets	<u>1,174,979</u>	<u>1,073,446</u>	<u>2,248,425</u>
COMMITMENTS AND CONTINGENCIES			
TOTAL	<u>\$4,959,565</u>	<u>\$2,923,852</u>	<u>\$7,883,417</u>

(Concluded)

MASSACHUSETTS WATER RESOURCES AUTHORITY

COMBINING STATEMENT OF REVENUES, EXPENSES, AND CHANGES IN NET ASSETS FOR THE YEAR ENDED JUNE 30, 2005 (Dollars in thousands)

	Sewer	Water	Combined Total
OPERATING REVENUES:			
Customer services	\$ 313,593	\$ 139,209	\$ 452,802
Other	<u>3,524</u>	<u>269</u>	<u>3,793</u>
Total operating revenues	<u>317,117</u>	<u>139,478</u>	<u>456,595</u>
OPERATING EXPENSES:			
Operations	55,006	28,676	83,682
Maintenance	16,180	3,989	20,169
Payments in lieu of taxes		5,077	5,077
Engineering, general, and administrative	<u>68,546</u>	<u>31,564</u>	<u>100,110</u>
Total operating expenses	<u>139,732</u>	<u>69,306</u>	<u>209,038</u>
INCOME FROM OPERATIONS BEFORE DEPRECIATION	177,385	70,172	247,557
DEPRECIATION	<u>128,620</u>	<u>46,508</u>	<u>175,128</u>
OPERATING INCOME	<u>48,765</u>	<u>23,664</u>	<u>72,429</u>
REGULATORY ACCOUNTING PROVISIONS:			
Decrease in reserves	(500)	(500)	(1,000)
Decrease in deferred credits—net	<u>63,887</u>	<u>10,347</u>	<u>74,234</u>
Total regulatory accounting provisions	<u>63,387</u>	<u>9,847</u>	<u>73,234</u>
NONOPERATING INCOME (EXPENSE):			
Debt service grants	6,816	1,203	8,019
Investment income	24,379	13,069	37,448
Interest expense	<u>(174,959)</u>	<u>(70,924)</u>	<u>(245,883)</u>
Total nonoperating income (expense)	<u>(143,764)</u>	<u>(56,652)</u>	<u>(200,416)</u>
NET LOSS BEFORE CAPITAL GRANTS	(31,612)	(23,141)	(54,753)
CAPITAL GRANTS	<u>5,315</u>	<u>788</u>	<u>6,103</u>
DECREASE IN NET ASSETS	(26,297)	(22,353)	(48,650)
TOTAL NET ASSETS—Beginning of year	<u>1,174,979</u>	<u>1,073,446</u>	<u>2,248,425</u>
TOTAL NET ASSETS—End of year	<u>\$ 1,148,682</u>	<u>\$ 1,051,093</u>	<u>\$ 2,199,775</u>

MASSACHUSETTS WATER RESOURCES AUTHORITY

COMBINING STATEMENT OF REVENUES, EXPENSES, AND CHANGES IN NET ASSETS FOR THE YEAR ENDED JUNE 30, 2004

(Dollars in thousands)

	Sewer	Water	Combined Total
OPERATING REVENUES:			
Customer services	\$ 310,791	\$ 130,158	\$ 440,949
Other	<u>5,710</u>	<u>218</u>	<u>5,928</u>
Total operating revenues	<u>316,501</u>	<u>130,376</u>	<u>446,877</u>
OPERATING EXPENSES:			
Operations	52,011	25,333	77,344
Maintenance	15,072	3,539	18,611
Payments in lieu of taxes		5,029	5,029
Engineering, general, and administrative	<u>73,009</u>	<u>29,325</u>	<u>102,334</u>
Total operating expenses	<u>140,092</u>	<u>63,226</u>	<u>203,318</u>
INCOME FROM OPERATIONS BEFORE DEPRECIATION	176,409	67,150	243,559
DEPRECIATION	<u>117,498</u>	<u>43,994</u>	<u>161,492</u>
OPERATING INCOME	<u>58,911</u>	<u>23,156</u>	<u>82,067</u>
REGULATORY ACCOUNTING PROVISIONS:			
Decrease in reserves	13,750	6,250	20,000
Decrease in deferred credits—net	<u>53,353</u>	<u>902</u>	<u>54,255</u>
Total regulatory accounting provisions	<u>67,103</u>	<u>7,152</u>	<u>74,255</u>
NONOPERATING INCOME (EXPENSE):			
Debt service grants	3,421	642	4,063
Investment income	9,121	4,986	14,107
Interest expense	<u>(170,389)</u>	<u>(59,125)</u>	<u>(229,514)</u>
Total nonoperating income (expense)	<u>(157,847)</u>	<u>(53,497)</u>	<u>(211,344)</u>
NET LOSS BEFORE CAPITAL GRANTS	(31,833)	(23,189)	(55,022)
CAPITAL GRANTS	<u>5,186</u>	<u>481</u>	<u>5,667</u>
DECREASE IN NET ASSETS	(26,647)	(22,708)	(49,355)
TOTAL NET ASSETS—Beginning of year	<u>1,201,626</u>	<u>1,096,154</u>	<u>2,297,780</u>
TOTAL NET ASSETS—End of year	<u>\$ 1,174,979</u>	<u>\$ 1,073,446</u>	<u>\$ 2,248,425</u>

REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING AND ON COMPLIANCE AND OTHER MATTERS BASED ON AN AUDIT OF FINANCIAL STATEMENTS PERFORMED IN ACCORDANCE WITH *GOVERNMENT AUDITING STANDARDS*

To the Board of Directors of
Massachusetts Water Resources Authority:

We have audited the financial statements of the Massachusetts Water Resources Authority (the “Authority”) as of and for the year ended June 30, 2005, and have issued our report thereon dated October 21, 2005. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States of America.

Internal Control Over Financial Reporting

In planning and performing our audit, we considered the Authority’s internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide assurance on the internal control over financial reporting. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control over financial reporting that might be material weaknesses. A material weakness is a reportable condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements caused by error or fraud in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We noted no matters involving the internal control over financial reporting or its operation that we consider to be material weaknesses.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the Authority’s financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit and, accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*.

This report is intended solely for the information and use of the Authority's Board of Directors, management, the United States Environmental Protection Agency, and pass-through entities, and is not intended to be and should not be used by anyone other than the specified parties.

Deloitte Touche LLP

October 21, 2005