



MASSACHUSETTS WATER RESOURCES AUTHORITY

Financial Statements and Supplemental Schedules
and Required Supplementary Information

June 30, 2006 and 2005

(With Independent Auditors' Report Thereon)

MASSACHUSETTS WATER RESOURCES AUTHORITY

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Independent Auditors' Report

The Board of Directors
Massachusetts Water Resources Authority:

We have audited the accompanying balance sheet of the Massachusetts Water Resources Authority (the Authority) as of June 30, 2006, and the related statement 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 accompanying financial statements of the Authority as of June 30, 2005 were audited by other auditors whose report thereon dated October 21, 2005, 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 also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Authority at June 30, 2006, and the changes in net assets and cash flows for the year then ended in conformity with U.S. generally accepted accounting principles.

In accordance with *Government Auditing Standards*, we have also issued our report on page 47, dated August 25, 2006, 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.

The Management's Discussion and Analysis on pages 3 through 9 and the historical pension required supplementary information on page 40 are not a required part of the 2006 financial statements but are supplementary information required by U. S. generally accepted accounting principles. 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 for the year ended June 30, 2006 was conducted 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 for the year ended June 30, 2006 are presented for purposes of additional analysis and are not a required part of the 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 financial statements taken as a whole for the year ended June 30, 2006.

The report of the other auditors referred to above, dated October 21, 2005, stated that the supplemental schedules listed in the accompanying table of contents for the year ended June 30, 2005 was subjected to auditing procedures applied in their audit of the 2005 financial statements, and in their opinion, was fairly stated in all material respects in relation to the financial statements for the year ended June 30, 2005, taken as a whole.

KPMG LLP

August 25, 2006

MASSACHUSETTS WATER RESOURCES AUTHORITY

Required Supplementary Information Management's Discussion and Analysis

June 30, 2006 and 2005

(Unaudited)

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, 2006 and 2005. Please read it in conjunction with the Authority's financial statements, which immediately follow this section.

Financial Highlights – Fiscal 2006

The fiscal 2006 customer service revenues were approximately \$485 million. Rate revenues represent approximately 97%, or \$472 million, and were \$28 million higher than fiscal 2005. This was due to an increase in assessments.

Total operating expenses, excluding depreciation, were approximately \$224 million in fiscal 2006. The 7.1% increase in total operating expenses over fiscal 2005 is the result of increased utility expenses due to higher prices and usage of electricity and diesel fuel, and increased personnel costs.

Net nonoperating expenses increased \$9.9 million, or 4.9%, primarily due to an increase in interest expense.

Total assets at June 30, 2006 were approximately \$7.9 billion, a \$49 million, or 0.6%, increase over total assets at June 30, 2005. This increase was primarily reflected as an increase in other assets and deferred charges.

During fiscal 2006, the Authority issued 2006 Series A and B bonds in the aggregate amount of \$486.3 million to defease \$286.4 million of bonds and refinance \$186,000 of commercial paper notes outstanding.

Total capital assets (net of depreciation) were approximately \$6.4 billion at June 30, 2006, a \$54 million, or 0.8%, decrease over June 30, 2005. 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 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 \$24 million, or 0.3%, 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 \$496.7 million to defease \$500.4 million of bonds outstanding. Additionally, the 2004 Series B was issued in the amount of \$65.3 million to defease \$68.4 million of bonds outstanding.

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Required Supplementary Information Management's Discussion and Analysis

June 30, 2006 and 2005

(Unaudited)

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 CSO projects and intergovernmental loans from construction in progress to other assets.

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, 2006 were approximately \$2.2 billion, a \$45 million decrease from June 30, 2005. Total assets increased \$49 million, or 0.6%, to \$7.9 billion, and total liabilities increased 1.7% to \$5.7 billion.

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Required Supplementary Information
Management's Discussion and Analysis

June 30, 2006 and 2005

(Unaudited)

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 \$24 million, or 0.3%, to \$7.9 billion, and total liabilities increased 0.4% to \$5.7 billion.

Net Assets
(Dollars in thousands)

	<u>2006</u>	<u>2005</u>	<u>2004</u>	Percentage change 2006-2005	Percentage change 2005-2004
Current assets	\$ 93,866	90,854	91,319	3.3%	(0.5)%
Restricted assets	681,400	659,975	757,049	3.2	(12.8)
Capital assets	6,444,534	6,498,899	6,552,821	(0.8)	(0.8)
Other assets	679,748	609,690	482,228	11.5	26.4
Total assets	\$ 7,899,548	7,859,418	7,883,417	0.5%	(0.3)%
Current liabilities	\$ 303,148	409,123	419,787	(25.9)%	(2.5)%
Payable from restricted assets	90,235	91,349	89,515	(1.2)	2.0
Long-term debt	5,144,294	4,916,755	4,884,943	4.6	0.7
Long-term lease	35,651	36,058	36,436	(1.1)	(1.0)
Other liabilities	171,795	206,358	204,311	(16.7)	1.0
Total liabilities	\$ 5,745,123	5,659,643	5,634,992	1.5	0.4
Net assets:					
Invested in capital assets – net of related debt	\$ 1,554,532	1,672,624	1,805,352	(7.1)	(7.4)
Restricted	180,695	161,775	169,348	11.7	(4.5)
Unrestricted	419,198	365,376	273,725	14.7	33.5
Total net assets	\$ 2,154,425	2,199,775	2,248,425	(2.1)%	(2.2)%

Changes in Net Assets

The decrease in net assets at June 30, 2006 was \$45 million, or 2.1%, as compared to June 30, 2005. The Authority's total operating revenues increased by 7.5% to \$491 million and total operating expenses increased 5.2% to \$404 million.

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June 30, 2006 and 2005

(Unaudited)

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.

Changes in Net Assets (Dollars in thousands)					
	<u>2006</u>	<u>2005</u>	<u>2004</u>	<u>Percentage change 2006-2005</u>	<u>Percentage change 2005-2004</u>
Operating revenues:					
Customer service revenues	\$ 484,529	452,802	440,949	7.0%	2.7%
Other revenues	6,455	3,793	5,928	70.2	(36.0)
Total operating revenues	<u>490,984</u>	<u>456,595</u>	<u>446,877</u>	<u>7.5</u>	<u>2.2</u>
Operating expenses:					
Operations	93,517	83,682	77,344	11.8%	8.2%
Maintenance	19,485	20,169	18,611	(3.4)	8.4
Payments in lieu of taxes	5,920	5,077	5,029	16.6	1.0
Engineering, general, and administrative	105,034	100,110	102,334	4.9	(2.2)
Depreciation and amortization	180,217	175,128	161,492	2.9	8.4
Total operating expenses	<u>404,173</u>	<u>384,166</u>	<u>364,810</u>	<u>5.2</u>	<u>5.3</u>
Operating income	86,811	72,429	82,067	19.9	(11.7)
Nonoperating items:					
Regulatory accounting provisions	72,254	73,234	74,255	(1.3)	(1.4)
Net nonoperating expenses	(210,301)	(200,416)	(211,344)	4.9	(5.2)
Capital grants and contributions	5,886	6,103	5,667	(3.6)	7.7
Change in net assets	(45,350)	(48,650)	(49,355)	(6.8)	(1.4)
Total net assets – beginning 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>
Total net assets – end of year	<u>\$ 2,154,425</u>	<u>2,199,775</u>	<u>2,248,425</u>	<u>(2.1)%</u>	<u>(2.2)%</u>

During fiscal 2006, the increases in customer service revenues were primarily due to the 4.2% increase in the rate revenue requirement (\$19.2 million).

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

Total operating costs, before depreciation and amortization, in fiscal 2006 were \$15 million, or 7.1%, greater than in fiscal 2005. This increase is primarily due to increases in utilities expenses (\$7.3 million) and total personnel costs (\$5.3 million). Utility expenses increased as both prices and usage of electricity and diesel fuel increased, primarily at Deer Island. In addition, the John Carroll Water Treatment Plant (JCWTP) became fully operational in August 2006. The operating cost associated with this facility also contributed to the increased

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Required Supplementary Information
Management's Discussion and Analysis

June 30, 2006 and 2005

(Unaudited)

expenses. Total personnel costs increased due to union contract increases for salaries and wages and increased health insurance costs.

Total operating costs, before depreciation and amortization, in fiscal 2005 were \$5.7 million, or 2.8%, greater than in fiscal 2004. This increase was primarily due to increases in utilities expenses (\$3 million) and maintenance expenses (\$1.6 million). Utilities 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 aged and increased maintenance was required.

In fiscal 2006, net nonoperating expenses increased \$9.9 million, or 4.9%, primarily due to an increase in interest expense.

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

Operating Costs by Functionality
(Dollars in thousands)

	2006	2005	2004	Percentage change 2006-2005	Percentage change 2005-2004
Wastewater treatment and transport	\$ 91,188	85,018	79,492	7.3%	7.0%
Water treatment and transport	24,950	21,127	20,505	18.1	3.0
Water and wastewater quality	8,917	8,144	8,209	9.5	(0.8)
Metering and monitoring	4,405	3,951	3,791	11.5	4.2
Facilities planning, design, and construction	9,733	9,910	10,116	(1.8)	(2.0)
Management Information Systems	7,970	8,329	9,356	(4.3)	(11.0)
Administration and support	42,504	40,342	40,040	5.4	0.8
Total direct operating costs	189,667	176,821	171,509	7.3	3.1
Indirect operating costs	34,289	32,217	31,809	6.4	1.3
Total operating costs	\$ 223,956	209,038	203,318	7.1%	2.8%

Increases in wastewater and water treatment and transport were primarily due to increases in utilities. Increases in utilities are reflective of increased prices and usage of electricity and diesel fuel. The new JCWTP began operations in early 2006, which also contributed to the increase in operating costs.

The increase in metering and monitoring is due to increased staffing and equipment costs to provide Supervisory Control and Data Acquisition (SCADA) needs at new facilities.

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Capital Assets and Debt Administration

Capital Assets

As of June 30, 2006 and 2005, the Authority had \$6.4 and \$6.5 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 0.8%, during fiscal 2006, 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)

	<u>2006</u>	<u>2005</u>	<u>2004</u>	Percentage change 2006-2005	Percentage change 2005-2004
Land	\$ 11,036	11,036	13,932	—%	(20.8)%
Construction in progress	245,542	518,237	868,639	(52.6)	(40.3)
Plant and equipment, water, and sewer systems	6,182,573	5,961,597	5,659,271	3.7	5.3
Furniture and fixtures	4,395	6,580	9,065	(33.2)	(27.4)
Leasehold improvements	418	864	1,310	(51.6)	(34.0)
Motor vehicles and equipment	570	585	604	(2.6)	(3.1)
	<u>\$ 6,444,534</u>	<u>6,498,899</u>	<u>6,552,821</u>	<u>(0.8)%</u>	<u>(0.8)%</u>

Decreases in construction in progress are primarily due to increased transfers to fixed assets and other assets for the Metro-West tunnel, the JCWTP, and the 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 the 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, or premium or interest on, any debt outstanding and neither the faith and credit nor the 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 it 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 improvements 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.

MASSACHUSETTS WATER RESOURCES AUTHORITY

Required Supplementary Information Management's Discussion and Analysis

June 30, 2006 and 2005

(Unaudited)

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 \$5.4 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 \$0.7 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 2006, the Board approved the fiscal 2007 Current Expense Budget (CEB), which totals \$575.9 million in expenses before debt service offsets of \$18.8 million, for a net expense total of \$557.1 million. The \$18.8 million in debt service offsets is for debt service assistance.

The \$575.9 million expense total (before debt service offsets) is comprised of \$333 million (58%) in capital financing costs and \$242.9 million (42%) in operating expenses, of which \$203.7 million (84%) is for direct expenses and \$39.2 million (16%) is for indirect expenses. The total represents an increase of \$57.1 million from fiscal 2006 spending, which is comprised of \$33.4 million in higher operating costs and \$23.7 million in higher debt service costs.

The fiscal 2007 rate revenue requirement approved by the Board is \$495.4 million; an increase of 4.9% compared to the fiscal 2006 budget.

Fiscal 2007 budgeted nonrate revenue totals \$61.8 million, a decrease of \$11.5 million from actual fiscal 2006 nonrate revenue. This decrease is reflected primarily in interest income, energy revenue and entrance fees where greater than budgeted revenues were received in fiscal 2006. The nonrate revenue budget is comprised of \$37 million in investment income, \$11.6 million in other user charges and other revenue, \$12.6 million in rate stabilization, and \$0.6 million in entrance fees.

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Required Supplementary Information Management's Discussion and Analysis

June 30, 2006 and 2005

(Unaudited)

CIP 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 covered storage facilities, including Blue Hills Covered Storage, to provide safe, reliable storage for water treated at JCWTP 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.
- Completion of the long-term CSO control plan, resulting in closing of 34 of 84 CSO outfalls and the reduction of CSO discharges to Boston Harbor and the Mystic, Charles, and Neponset River systems by 85% from 1987, when MWRA accepted responsibility for CSO control, with 94% 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.
- Installation of new sewers to reduce overflows to adjacent residential areas and water bodies in West Roxbury and Newton.
- Continued rehabilitation of the water distribution system at a rate of six to seven miles per year (2% to 2.5% of the total 275 miles of Authority pipeline).
- Improvement and replacement of equipment on Deer Island to ensure that the plant continues to operate efficiently and effectively.
- Security improvements to protect the Authority's 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

June 30, 2006 and 2005

(Dollars in thousands)

Assets	2006	2005
Unrestricted current assets:		
Cash and cash equivalents (note 4)	\$ 31,774	32,737
Investments (note 4)	42,242	41,927
Intergovernmental loans (note 7)	18,499	15,147
Accounts receivable	<u>1,351</u>	<u>1,043</u>
Total unrestricted current assets	<u>93,866</u>	<u>90,854</u>
Restricted assets:		
Investments (note 4)	674,133	652,678
Interest receivable	5,914	5,944
Grants receivable:		
Billed	1,315	1,315
Unbilled	<u>38</u>	<u>38</u>
Total restricted assets	<u>681,400</u>	<u>659,975</u>
Capital assets – not being depreciated (note 8)	256,578	529,273
Capital assets – being depreciated – net (note 8)	6,187,956	5,969,626
Deferred charges (notes 3 and 9)	415,131	368,345
Other assets, net (notes 7 and 9)	<u>264,617</u>	<u>241,345</u>
Total	\$ <u><u>7,899,548</u></u>	\$ <u><u>7,859,418</u></u>
Liabilities and Net Assets		
Current liabilities:		
Accounts payable and accrued expenses (note 13)	\$ 53,095	49,882
Commercial paper notes (note 6)	164,000	289,000
Current portion of long-term debt (note 6)	<u>86,053</u>	<u>70,241</u>
Total current liabilities	<u>303,148</u>	<u>409,123</u>
Payable from restricted assets:		
Accounts payable for construction	17,010	22,552
Accrued interest on bonds payable	<u>73,225</u>	<u>68,797</u>
Total payable from restricted assets	<u>90,235</u>	<u>91,349</u>
Retainage on construction in progress	9,341	18,436
Long-term debt – less current portion (note 6)	5,144,294	4,916,755
Long-term capital lease (note 10)	35,651	36,058
Reserves (note 5)	101,050	100,184
Deferred credits (note 3)	<u>61,404</u>	<u>87,738</u>
Total liabilities	<u>5,745,123</u>	<u>5,659,643</u>
Net assets:		
Invested in capital assets, net of related debt	1,554,532	1,672,624
Restricted	180,695	161,775
Unrestricted	<u>419,198</u>	<u>365,376</u>
Total net assets	<u>2,154,425</u>	<u>2,199,775</u>
Commitments and contingencies (notes 10, 12, and 13)		
Total	\$ <u><u>7,899,548</u></u>	\$ <u><u>7,859,418</u></u>

See accompanying notes to financial statements.

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Statements of Revenues, Expenses, and Changes in Net Assets

Years ended June 30, 2006 and 2005

(Dollars in thousands)

	<u>2006</u>	<u>2005</u>
Operating revenues (note 2):		
Customer services	\$ 484,529	452,802
Other	6,455	3,793
Total operating revenues	<u>490,984</u>	<u>456,595</u>
Operating expenses:		
Operations	93,517	83,682
Maintenance	19,485	20,169
Payments in lieu of taxes	5,920	5,077
Engineering, general, and administrative	105,034	100,110
Total operating expenses	<u>223,956</u>	<u>209,038</u>
Income from operations before depreciation	267,028	247,557
Depreciation and amortization	<u>180,217</u>	<u>175,128</u>
Operating income	<u>86,811</u>	<u>72,429</u>
Regulatory accounting provisions:		
Increase in reserves	(866)	(1,000)
Increase in deferrals, net (note 3)	73,120	74,234
Total regulatory accounting provisions	<u>72,254</u>	<u>73,234</u>
Nonoperating revenues (expenses):		
Debt service grants	9,631	8,019
Investment income	30,301	37,448
Interest expense	(250,233)	(245,883)
Total nonoperating expenses	<u>(210,301)</u>	<u>(200,416)</u>
Net loss before capital contributions	(51,236)	(54,753)
Capital grants and contributions	<u>5,886</u>	<u>6,103</u>
Decrease in net assets	(45,350)	(48,650)
Total net assets, beginning of year	<u>2,199,775</u>	<u>2,248,425</u>
Total net assets, end of year	<u>\$ 2,154,425</u>	<u>2,199,775</u>

See accompanying notes to financial statements.

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Statements of Cash Flows

Years ended June 30, 2006 and 2005

(Dollars in thousands)

	<u>2006</u>	<u>2005</u>
Cash flows from operating activities:		
Cash received from customers	\$ 482,804	453,364
Cash paid to suppliers for goods and services	(108,970)	(111,764)
Cash paid to employees for services	(104,266)	(102,236)
Cash paid in lieu of taxes	(5,914)	(5,077)
Other operating receipts	6,437	3,826
Net cash provided by operating activities	<u>270,091</u>	<u>238,113</u>
Cash flows from capital and related financing activities:		
Proceeds from sale of revenue bonds, loans, and notes	371,289	114,024
Capital grants for construction	5,886	7,103
Debt service grant	9,631	8,019
Capital lease principal payments	(408)	(377)
Capital lease interest payments	(2,809)	(2,840)
Repayment of debt	(266,277)	(102,828)
Interest paid on debt	(229,885)	(231,065)
Plant expenditures	(167,040)	(166,326)
Net cash used for capital and related financing activities	<u>(279,613)</u>	<u>(374,290)</u>
Cash flows from investing activities:		
Purchases of short-term investments	(100)	(73,502)
Sales and maturities of short-term investments	37,719	89,827
(Increase) decrease in restricted cash and investments – net	(74,724)	88,512
Interest received	45,664	33,147
Net cash provided by investing activities	<u>8,559</u>	<u>137,984</u>
Net (decrease) increase in cash and cash equivalents	(963)	1,807
Cash and cash equivalents, beginning of year	<u>32,737</u>	<u>30,930</u>
Cash and cash equivalents, end of year	\$ <u><u>31,774</u></u>	\$ <u><u>32,737</u></u>
Reconciliation of operating income to net cash provided by operating activities:		
Operating income	\$ 86,811	72,429
Adjustments to reconcile operating income to net cash provided by operating activities:		
Depreciation and amortization	180,217	175,128
(Decrease) increase in other accounts	(305)	668
Increase (decrease) in accounts payable	3,368	(10,112)
Net cash provided by operating activities	\$ <u><u>270,091</u></u>	\$ <u><u>238,113</u></u>

Noncash financing activities:

In March 2006, general revenue refunding bonds in the aggregate principal amount of \$286,320 were issued to defease \$286,000 of bonds outstanding.

In April 2005, general revenue refunding bonds in the aggregate principal amount of \$496,745 were issued to defease \$500,420 of bonds outstanding.

In September 2004, general revenue refunding bonds in the aggregate principal amount of \$65,255 were issued to defease \$68,350 of bonds outstanding.

See accompanying notes to financial statements.

MASSACHUSETTS WATER RESOURCES AUTHORITY

Notes to Financial Statements

June 30, 2006 and 2005

(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 became 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 U.S. generally accepted accounting principles as applicable to government enterprises. The following is a summary of the Authority's significant accounting policies:

(a) 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 (GASB) 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 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

MASSACHUSETTS WATER RESOURCES AUTHORITY

Notes to Financial Statements

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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.

(b) 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 is eliminated from the accounts when such items are disposed of or otherwise retired.

(c) Interest Cost and Principal Payments on Construction

During fiscal 2006 and 2005, 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.

(d) 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:

	<u>Years</u>
Plant and equipment, water and sewerage systems	5-100
Motor vehicles and equipment	5
Furniture and fixtures	7
Leasehold improvements	3-5

MASSACHUSETTS WATER RESOURCES AUTHORITY

Notes to Financial Statements

June 30, 2006 and 2005

(Dollars in thousands)

(e) 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.

(f) 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.

(g) 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.

(h) Investments

Investments are recorded at fair value. Fair value is determined based on quoted market price. The Authority recorded unrealized losses of \$15,332 in fiscal 2006 and unrealized gains of \$2,358 in fiscal 2005 as part of investment income.

(i) Use of Estimates

The preparation of financial statements in conformity with U.S. generally accepted accounting principles 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.

(j) Compensated Absences

Employees of the Authority may accumulate unused sick time of which 30% will be paid in cash upon retirement from the Authority. The liability for vacation leave is based on the amount earned but not used; for sick leave, it is based on a percentage of the amount accumulated at the statement of net assets dates. The liability for both amounts is calculated based on the pay or salary rates in effect at the statements of net assets dates.

(k) Reclassifications

Certain reclassifications were made to the fiscal year 2005 financial statements to conform to the fiscal year 2006 presentation.

MASSACHUSETTS WATER RESOURCES AUTHORITY

Notes to Financial Statements

June 30, 2006 and 2005

(Dollars in thousands)

(1) Implementation of New Accounting Standards

GASB Statement Nos. 43 and 45, *Financial Reporting for Postemployment Benefit Plans Other Than Pension Plans* and *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions* are scheduled to be implemented by the Authority for the years ending June 30, 2007 and June 30, 2008, respectively.

(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 2006 and 2005 is as follows:

	<u>Sewer</u>	<u>Water</u>	<u>Total</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	8,474	(5,165)	3,309
Balance – June 30, 2005 – net	214,081	66,526	280,607
Difference between depreciation of capital assets not financed by grants or capital contributions, and debt service in excess of interest expense	55,608	11,829	67,437
Bond redemption – net	8,148	(4,564)	3,584
Rate stabilization – current year recovery	(3,023)	(5,816)	(8,839)
Rate stabilization – current year usage	7,926	2,813	10,739
Other – net	6,116	(5,917)	199
Balance – June 30, 2006 – net	\$ <u>288,856</u>	<u>64,871</u>	<u>353,727</u>

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Notes to Financial Statements

June 30, 2006 and 2005

(Dollars in thousands)

The net balance at June 30, 2006 and 2005, is presented on the balance sheets as follows:

	<u>2006</u>	<u>2005</u>	<u>Current year change</u>
Deferred charges	\$ 415,131	368,345	46,786
Deferred credits	(61,404)	(87,738)	26,334
Net change in deferrals	<u>\$ 353,727</u>	<u>280,607</u>	<u>73,120</u>

The balance in the rate stabilization reserve, which is included in deferred credits, was \$41,545 and \$43,445 at June 30, 2006 and 2005, respectively.

(4) Deposits and Investments

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 operating deposits at June 30, 2006 and 2005 were \$31,774 and \$32,737, respectively. Of these amounts, \$31,674 and \$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.

The following guaranteed investment contracts were in force as of June 30, 2006 and 2005, respectively, all of which are fully collateralized and appear as follows:

<u>Investment agreement provider</u>	<u>Rate</u>	<u>Maturity</u>	<u>2006 Amount</u>	<u>2005 Amount</u>
Bayern LLP	5.27%	December 1, 2005	\$ —	20,375
AIG financial products	5.75	November 1, 2006	10,418	10,418
AIG financial products	6.05	August 1, 2014	18,342	18,342
Wachovia Bank	5.17	August 1, 2016	14,456	14,456

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Notes to Financial Statements

June 30, 2006 and 2005

(Dollars in thousands)

(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.

The general bond resolution limits the Authority to investing in securities that are rated in the three highest rating categories as defined by Standards & Poor and Moody's.

(d) Concentration Risk

The Authority has no investments, at fair value, which exceeds 5% of the Authority's total investments as of June 30, 2006 and 2005.

(e) Interest Rate Risk

The following is a listing of the Authority's fixed income investments and related maturity schedule as of June 30, 2005 and 2006:

June 30, 2006					
Investment maturities (in years)					
Investment type	Fair value	<1	1-3	4-8	>9
Certificate of deposit	\$ 3,100	3,000	100	—	—
Money market mutual funds	389,146	389,146	—	—	—
U.S. Treasury notes and bonds	31,101	9,588	17,797	3,716	—
U.S. agency obligations	249,812	26,199	6,900	97,348	119,365
Guaranteed investment contracts	43,216	10,418	—	—	32,798
Total	<u>\$ 716,375</u>	<u>438,351</u>	<u>24,797</u>	<u>101,064</u>	<u>152,163</u>

June 30, 2005					
Investment maturities (in years)					
Investment type	Fair value	<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 obligations	281,673	—	27,325	77,002	177,346
Guaranteed investment contracts	63,591	20,375	10,418	—	32,798
Total	<u>\$ 694,605</u>	<u>344,150</u>	<u>40,743</u>	<u>95,534</u>	<u>214,178</u>

The Authority's bond resolution limits maturities to less than 15 years. The majority of the Authority's investments are long-term investments held in the debt service reserve funds where the intent is to hold until maturity. This reduces the exposure to fair value losses arising from increasing interest rates.

MASSACHUSETTS WATER RESOURCES AUTHORITY

Notes to Financial Statements

June 30, 2006 and 2005

(Dollars in thousands)

(f) Restricted Cash and Investments by Fund

The following summarizes restricted cash and investments as of June 30, 2006 and 2005 by various funds and accounts established by the Authority for debt covenants and other purposes:

	<u>2006</u>	<u>2005</u>
Restricted cash and investments:		
Construction	\$ 81,926	77,571
Debt service reserves	252,361	243,609
Debt service	161,424	152,587
Revenue redemption	33,343	33,462
Revenue	69,568	63,928
Renewal and replacement reserve	29,891	34,768
Insurance	18,997	18,997
Community obligation and revenue enhancement	19,962	20,881
Insurance related escrow deposits	6,661	6,875
Total restricted cash and investments	\$ <u>674,133</u>	<u>652,678</u>

(5) Bond Resolution Reserves

The components of the reserves required by the general and supplemental bond resolutions at June 30, 2006 and 2005 are as follows:

<u>Reserves</u>	<u>Sewer</u>	<u>Water</u>	<u>2006 Total</u>	<u>2005 Total</u>
Renewal and replacement	\$ 17,300	11,701	29,001	29,001
Insurance	9,500	9,500	19,000	19,000
Operating	24,221	8,712	32,933	32,067
Community obligation and revenue enhancement	18,399	1,717	20,116	20,116
Total	\$ <u>69,420</u>	<u>31,630</u>	<u>101,050</u>	<u>100,184</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, 2006 and 2005.

MASSACHUSETTS WATER RESOURCES AUTHORITY

Notes to Financial Statements

June 30, 2006 and 2005

(Dollars in thousands)

(6) Notes Payable and Long-Term Debt

Long-term debt at June 30, 2006 and 2005, consisted of the following:

	2006	2005
General Revenue Bonds:		
1990 Series A, 7-1/2%, issued February 15, 1990, due 2006	\$ —	23,985
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	144,815	152,565
1995 Series B, 4% to 6-1/4%, issued January 4, 1996, due 2006 to 2024	52,155	164,500
1996 Series A, 6%, issued November 5, 1996, due 2006	3,415	6,635
1998 Series A, 4-3/4% to 5-1/2%, issued January 27, 1998, due 2006 to 2032	153,490	161,025
2000 Series A, 5% to 6-1/8%, issued March 1, 2000, due 2006 to 2011	26,675	28,810
2002 Series B, 5% to 5-1/2%, issued March 15, 2002, due 2006 to 2027	87,080	89,000
2002 Series J, 5% to 5-1/2%, issued December 18, 2002, due 2008 to 2042	591,395	591,395
2003 Series D, 3% to 5%, issued January 7, 2004, due 2006 to 2028	141,705	145,510
2004 Series A, 2% to 5-1/8%, issued June 10, 2004, due 2006 to 2029	118,170	120,495
2006 Series A, 4% to 5%, issued March 16, 2006, due 2023 to 2046	200,000	—
	1,906,745	1,871,765
General Revenue Refunding Bonds:		
1997 Series D, 4-3/4% to 6%, issued December 15, 1997, due 2006 to 2020	129,920	132,135
1998 Series B, 4-1/2% to 5-1/2%, issued January 27, 1998, due 2006 to 2022	103,880	104,545
2004 Series B, 5%, issued September 29, 2004, due 2016 to 2020	65,255	65,255
2005 Series A, 2-3/8% to 5-1/4%, issued April 14, 2005, due 2006 to 2034	413,755	416,455
2005 Series B, 5%, issued April 14, 2005, due 2031 to 2035	80,290	80,290
2006 Series B, 4% to 5%, issued March 16, 2006, due 2015 to 2040	286,320	—
	1,079,420	798,680

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June 30, 2006 and 2005

(Dollars in thousands)

	<u>2006</u>	<u>2005</u>
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	5,375	6,565
1993 Series D, 4-9/10% to 5-1/4%, issued January 6, 1994, due 2006 to 2014	4,660	5,430
1995 Series A, 5% to 6%, issued November 21, 1995, due 2006 to 2015	5,720	6,580
1998 Series C, 4-1/4% to 5-3/8%, issued July 9, 1998, due 2006 to 2018	11,665	12,970
1999 Series E Sewer, 4-1/4% to 5-3/8%, issued October 6, 1999, due 2006 to 2029	9,281	9,532
1999 Series E Water, 4-1/4% to 5-3/8%, issued October 6, 1999, due 2006 to 2029	9,142	9,658
1999 Series F, 4-3/4% to 6%, issued November 3, 1999, due 2006 to 2029	350,555	359,790
2000 Series E Sewer, 4-1/2% to 5-5/8%, issued November 1, 2000, due 2006 to 2030	67,337	68,911
2000 Series E Water, 4-1/2% to 5-5/8%, issued November 1, 2000, due 2006 to 2030	10,198	10,720
2001 Series C Water, 4% to 5-1/4%, issued July 26, 2001, due 2006 to 2021	4,393	4,618
2001 Series D Sewer, 4-1/2% to 5-3/4%, issued July 26, 2001, due 2006 to 2019	6,643	6,998
2001 Series D Water, 4-1/2% to 5-3/4%, issued July 26, 2001, due 2006 to 2019	1,291	1,364
2002 Series H Sewer, 3-1/2% to 5-1/4%, issued October 31, 2002, due 2006 to 2032	85,905	87,880
2002 Series H Water, 3-1/2% to 5-1/4%, issued October 31, 2002, due 2006 to 2022	29,355	30,650
2002 Series I Sewer, 4-1/4% to 5-5/8%, issued October 31, 2002, due 2006 to 2030	2,464	2,526
2002 Series I Water, 4-1/4% to 5-5/8%, issued October 31, 2002, due 2006 to 2020	27	28
2003 Series A Water, 3% to 5-1/4%, issued October 31, 2002, due 2006 to 2022	1,355	1,415
2003 Series B Water, 4% to 5-1/4%, issued July 24, 2003, due 2006 to 2021	3,966	4,169
2003 Series C Sewer, 2% to 5-1/2%, issued November 6, 2003, due 2006 to 2033	30,766	31,481
2003 Series C Water, 2% to 5-1/2%, issued November 6, 2003, due 2006 to 2023	19,869	20,748

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Notes to Financial Statements

June 30, 2006 and 2005

(Dollars in thousands)

	<u>2006</u>	<u>2005</u>
2004 Series C Sewer, 2% to 5-1/2%, issued October 26, 2004, due 2006 to 2033	10,446	10,567
2004 Series C Water, 3% to 5-1/4%, issued October 26, 2004, due 2006 to 2022	1,611	1,692
2004 Series D Sewer, 2-1/2% to 5-1/4%, issued November 29, 2004, due 2006 to 2034	62,994	53,050
2004 Series D Water, 2-1/2% to 5-1/4%, issued November 29, 2004, due 2006 to 2024	12,891	13,375
2005 Series C Sewer, 2% to 5-1/2%, issued November 3, 2005, due 2006 to 2033	7,482	—
2005 Series C Water, 2% to 5-1/2%, issued November 3, 2005, due 2006 to 2033	1,002	—
2005 Series D Sewer, 2% to 2-3/10%, issued November 16, 2005, due 2006 to 2033	62,170	—
2005 Series C Water, 0% to 2%, issued November 16, 2005, due 2006 to 2025	12,321	—
2005 Series E Sewer, 2%, issued November 16, 2005, due 2006 to 2025	407	—
2005 Series E Water, 2%, issued November 16, 2005, due 2006 to 2025	91	—
Interim loans Sewer, 1.29%, issued November 16, 2005, due 2006	10,893	—
	<u>842,275</u>	<u>760,717</u>
General Revenue Bonds (variable rate):		
1997 Series A, 0.96% to 2.97%, issued June 18, 1997, due 2007 to 2028	77,900	79,200
1997 Series B, 1.0% to 3.0%, issued June 18, 1997, due 2007 to 2028	77,900	79,200
1999 Series A, 0.95% to 2.96%, issued January 14, 1999, due 2006 to 2028	89,000	90,400
1999 Series B, 0.96% to 2.97%, issued January 29, 1999, due 2006 to 2028	89,000	90,400
1999 Series C, 0.9% to 2.69%, issued June 8, 1999, due 2007 to 2029	68,900	69,900
1999 Series D, 1.2% to 3.08%, issued June 8, 1999, due 2007 to 2029	68,900	69,900
2001 Series A, 0.97% to 2.99%, issued September 26, 2001, due 2006 to 2023	87,100	89,200
2001 Series B, 0.95% to 3.01%, issued September 26, 2001, due 2023 to 2031	85,000	85,000
	<u>643,700</u>	<u>653,200</u>

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Notes to Financial Statements

June 30, 2006 and 2005

(Dollars in thousands)

	<u>2006</u>	<u>2005</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 2020 to 2037	133,300	133,800
2000 Series C, 1% to 3%, issued March 22, 2000, due 2020 to 2037	133,300	133,700
2002 Series C, 0.86% to 2.95%, issued August 15, 2002, due 2020	78,300	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	99,250	99,250
	<u>893,795</u>	<u>896,395</u>
General Revenue Bonds (fixed rates):		
2000 Series D, 5 1/2%, issued October 1, 2000, due 2009 to 2011	—	150,000
	<u>5,365,935</u>	<u>5,130,757</u>
Less:		
Unamortized issuance and premium/discount costs	39,305	29,899
Unamortized excess of reacquisition price over net carrying amount of defeased bonds	(174,893)	(173,660)
Current portion of long-term debt	(86,053)	(70,241)
	<u>(221,641)</u>	<u>(214,002)</u>
Long-term debt – net	\$ <u>5,144,294</u>	<u>4,916,755</u>

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(Dollars in thousands)

Long-term debt at June 30, 2006 and 2005 consisted of the following:

		2005			2006	Due
		Beginning	Additions	Reductions	Ending	within
		balance			balance	one year
General Revenue Bonds	\$	2,674,965	201,820	326,340	2,550,445	41,500
General Revenue Refunding Bonds		1,695,075	286,320	8,180	1,973,215	5,680
General Revenue Bonds with the Massachusetts Water Pollution Abatement Trust		760,717	106,247	24,689	842,275	38,873
	\$	<u>5,130,757</u>	<u>594,387</u>	<u>359,209</u>	<u>5,365,935</u>	<u>86,053</u>
		2004			2005	Due
		Beginning	Additions	Reductions	Ending	within
		balance			balance	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		701,014	81,141	21,438	760,717	24,689
	\$	<u>5,107,222</u>	<u>644,833</u>	<u>621,298</u>	<u>5,130,757</u>	<u>70,241</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 120% and 110%, respectively. For the year ended June 30, 2006, the Authority had primary and subordinated debt service coverage ratios of 179% and 110%, respectively.

The fiscal 2005 addition to the general revenue bonds represents the accretion on the capital appreciation bond that matured 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 \$6,100,000.

On March 16, 2006, the Authority issued General Revenue Bonds, 2006 Series A and General Revenue Refunding Bonds, 2006 Series B in the principal amounts of \$200,000 and \$286,320, respectively. The proceeds from the Series A bonds were used to retire \$186,000 of Commercial Paper Notes. The interest rate on these bonds is 4% to 5%.

The proceeds from the Series B bonds were used to defease \$286,400 of the 1990 Series A, 1995 Series B, and 2000 Series D bonds outstanding. The interest rate on these bonds is 5%. The cash flow required to make principal and interest payments on the refunding bonds is approximately \$173,568 more than the

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debt service requirements for the defeased bonds. The economic loss (the difference between the present values of the debt service payments on the old and new debt) obtained from this refunding was \$2,289.

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 range from 2.375% to 5.25%, 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.

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% LIBOR). The BMA rate is based on the seven-day high-grade market index of tax-exempt variable rate demand obligations.

The Authority also had one swap where it received a fixed rate of 4.9% and paid the BMA rate. This swap agreement, for the 2000 Series D bonds, was terminated on February 28, 2006 when these bonds were defeased. The proceeds from this transaction, totaling \$7,467, were used, along with the proceeds of 2006 Series B bonds, to defease debt.

Under these interest rate swap agreements, the Authority incurred net interest expense of \$1,189 and \$20,371 in fiscal 2006 and fiscal 2005, respectively.

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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, 2006	Fair value at June 30, 2006
March 22, 2000	\$ 266,600	August 1, 2030	2000 Series B & C	4.470%	BMA	N/A	Aaa	\$ (30,973)
August 1, 2030	70,400	August 1, 2037	2000 Series B & C	6.935	BMA	N/A	Aaa	(2,010)
January 14, 1999	89,000	August 1, 2006	1999 Series A	3.947	BMA	N/A	Aaa	4
January 14, 1999	89,000	August 1, 2006	1999 Series B	3.949	BMA	N/A	Aaa	4
December 22, 1998	198,895	November 1, 2026	1998 Series D	3.994	BMA	N/A	Aaa	4,469
August 15, 2002	350,000	August 1, 2015	2002 Series D, E, F, G	4.127	67% LIBOR	N/A	Aa3	(6,763)

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.

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At June 30, 2006, 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	2011–2021	100 to 102	224,630
1992 Series A	2012–2022	100 to 102	283,500
1992 Series B	2006–2020	100	408,980
1993 Series A	2006–2013	100 to 102	59,910
1993 Series B	2007–2022	100 to 102	387,655
1993 Series C	2007–2023	100 to 102	192,860
1993 Series D	2006–2014	100 to 102	42,990
1994 Series A	2006–2024	102	120,575
1995 Series A	2006–2015	100 to 102	47,015
1995 Series B	2007–2024	100	159,935
1996 Series A	2007–2026	100 to 102	124,710
1997 Series D	2007	100 to 101	1,165
1998 Series A	2007–2018	100	29,960
1998 Series B	2007	100	350
1998 Series C	2006–2018	100 to 102	83,385
2000 Series A	2006–2039	100	248,790
2000 Series D	2009–2011	100	150,000
2002 Series B	2007–2024	100	87,050
2003 Series D	2007–2021	100	19,940
2004 Series A	2007–2019	100	10,710
2005 Series A	2007	100	2,700

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.

In June 2006, the Authority deposited \$25.1 million into an escrow account with the trustee to defease \$26.2 million of the 1993C, 1995B, 1997D, 1998A, 1998B, 2000A, 2002B, 2003D, 2004A, and 2005A General Revenue bonds outstanding.

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At June 30, 2006, outstanding bonds that are redeemable before their scheduled due dates are as follows:

Description	Redemption date	Redemption price	Outstanding 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
2006 Series A	August 2018	100	200,000
2006 Series B	August 2018	100	277,025

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 2006, the Authority executed loan agreements with Massachusetts Water Pollution Abatement Trust (MWPAT) in connection with MWPAT's 2005 Series C, 2005 Series D and 2005 Series E Sewer and Water bonds to provide funds to the Authority in the amounts of \$8,519, \$81,597, and \$498, respectively. All available funds were drawn down by the Authority as of June 30, 2006, except \$35 and \$7,106, principal and premium, respectively, for 2005 Series C Water and 2005 Series D Sewer and Water. The remaining funds are expected to be drawn down in fiscal 2007.

Additionally, the Authority executed an interim loan agreement with MWPAT providing sewer loans in the principal amount of \$20,558. All proceeds of these loans were received by June 30, 2006, except \$9,665.

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.

Federal and Commonwealth subsidies for purposes of offsetting principal payments aggregating \$140,814 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

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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:

	<u>Principal</u>	<u>Interest</u>	<u>Total</u>
Year ending June 30:			
2007	\$ 86,053	242,115	328,168
2008	66,478	241,715	308,193
2009	117,504	237,588	355,092
2010	125,122	231,193	356,315
2011	162,270	221,530	383,800
2012–2016	1,049,105	967,615	2,016,720
2017–2021	1,334,932	708,378	2,043,310
2022–2026	1,123,677	423,192	1,546,869
2027–2031	669,335	214,396	883,731
2032–2036	346,144	109,492	455,636
2037–2041	184,195	44,017	228,212
2042–2046	87,635	10,338	97,973
2047–2051	13,485	270	13,755
Total	\$ <u>5,365,935</u>	<u>3,651,839</u>	<u>9,017,774</u>

The Authority issued commercial paper notes of \$164,000 to finance capital expenditures, which are secured by \$100,000 and \$250,000 irrevocable direct-pay letters of credit which expire on September 8, 2009, and May 20, 2010, respectively. These letters of credit carry a fee of 0.27% and 0.30% 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, 2006 and 2005, the amounts outstanding were \$164,000 and \$289,000, respectively. The weighted average interest rate on commercial paper outstanding at June 30, 2006 and 2005, was 3.00% and 1.77%, 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 \$26,957 and \$28,032 in fiscal 2006 and 2005, respectively, to be received in five or ten equal annual installments.

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The long-term portion of these loans at June 30, 2006 and 2005, is \$85,815 and \$77,357, 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, 2006 and 2005, consisted of the following:

	<u>2005</u>	<u>Additions</u>	<u>Disposals/ transfers</u>	<u>2006</u>
Capital assets – not being depreciated:				
Land	\$ 11,036	—	—	11,036
Construction in progress	<u>518,237</u>	<u>111,960</u>	<u>(384,655)</u>	<u>245,542</u>
Total capital assets – not being depreciated	<u>529,273</u>	<u>111,960</u>	<u>(384,655)</u>	<u>256,578</u>
Capital assets – being depreciated:				
Plant and equipment – water and sewage system	7,777,939	384,655	—	8,162,594
Furniture and fixtures	33,061	—	—	33,061
Leasehold improvements	5,081	—	—	5,081
Motor vehicles and equipment	<u>1,595</u>	<u>—</u>	<u>—</u>	<u>1,595</u>
Total capital assets – being depreciated	<u>7,817,676</u>	<u>384,655</u>	<u>—</u>	<u>8,202,331</u>
Less accumulated depreciation for:				
Plant and equipment – water and sewage system	1,816,342	163,679	—	1,980,021
Furniture and fixtures	26,481	2,185	—	28,666
Leasehold improvements	4,217	446	—	4,663
Motor vehicles and equipment	<u>1,010</u>	<u>15</u>	<u>—</u>	<u>1,025</u>
Total accumulated depreciation	<u>1,848,050</u>	<u>166,325</u>	<u>—</u>	<u>2,014,375</u>
Total capital assets – being depreciated – net	<u>5,969,626</u>	<u>218,330</u>	<u>—</u>	<u>6,187,956</u>
Capital assets – net	<u>\$ 6,498,899</u>	<u>330,290</u>	<u>(384,655)</u>	<u>6,444,534</u>

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

	<u>2004</u>	<u>Additions</u>	<u>Disposals/ transfers</u>	<u>2005</u>
Capital assets – not being depreciated:				
Land	\$ 13,932	—	(2,896)	11,036
Construction in progress	868,639	113,084	(463,486)	518,237
Total capital assets – not being depreciated	<u>882,571</u>	<u>113,084</u>	<u>(466,382)</u>	<u>529,273</u>
Capital assets – being depreciated:				
Plant and equipment – water and sewage system	7,315,246	462,657	—	7,777,903
Furniture and fixtures	32,232	829	—	33,061
Leasehold improvements	5,081	—	—	5,081
Motor vehicles and equipment	1,595	—	—	1,595
Total capital assets – being depreciated	<u>7,354,154</u>	<u>463,486</u>	<u>—</u>	<u>7,817,640</u>
Less accumulated depreciation for:				
Plant and equipment – water and sewage system	1,655,975	160,331	—	1,816,306
Furniture and fixtures	23,167	3,314	—	26,481
Leasehold improvements	3,771	446	—	4,217
Motor vehicles and equipment	991	19	—	1,010
Total accumulated depreciation	<u>1,683,904</u>	<u>164,110</u>	<u>—</u>	<u>1,848,014</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>412,460</u>	<u>(466,382)</u>	<u>6,498,899</u>

Depreciation and amortization for fiscal 2006 and 2005, was \$180,217 and \$175,128, 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.

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(10) Leases

(a) 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, 2006, are as follows:

Year ending June 30:	
2007	\$ 6,855
2008	6,229
2009	6,114
2010	6,002
2011	5,855
2012–2016	<u>21,887</u>
Total	<u>\$ 52,942</u>

The Authority renegotiated the lease agreement on its Boston office space and effective October 1, 2005, the lease on 57 square feet of the office space was 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 executed its option to terminate the lease on its backup landfill in Utah. The lease was terminated on March 31, 2006, and the remaining 14 years of the lease will be eliminated at a projected savings of \$10,887.

Rental expense was \$12,215 and \$13,185 in fiscal years 2006 and 2005, respectively.

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(b) 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, 2006, are as follows:

	<u>Principal</u>	<u>Interest</u>	<u>Total</u>
Year ending June 30:			
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	603	2,614	3,217
2012–2016	3,833	12,252	16,085
2017–2021	5,663	10,423	16,086
2022–2026	8,365	7,720	16,085
2027–2031	12,358	3,727	16,085
2032	2,837	112	2,949
Total	\$ <u>35,651</u>	<u>47,724</u>	<u>83,375</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.

The associated capital asset is reported in plant and equipment – water and sewage system at a cost of \$37,134 with \$4,953 of depreciation accumulated as of June 30, 2006.

(11) Retirement Benefits

(a) 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 \$75,497 and \$72,106, respectively, for the year ended June 30, 2006.

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

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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.

(b) 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 2006 and 2005 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 APC or \$3,882.

(c) 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.

(d) Three-Year Trend Information

	<u>Annual pension cost (APC)</u>	<u>Percentage of APC contributed</u>	<u>Net pension asset/(obligation)</u>
Fiscal year ending:			
2006	\$ 3,577	100	—
2005	3,408	100	—
2004	2,688	144	—

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(e) 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, 2006, was \$8,899.

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 \$1,556 and \$1,320 in fiscal 2006 and 2005, respectively.

(12) Commitments and Contingencies

(a) 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 \$297,835 at June 30, 2006.

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 \$6,689,000 from fiscal 1986 through fiscal 2006, including those projects required to comply with the Federal District Court's schedule. The Authority anticipates spending an additional \$1,262,000 on these projects through fiscal 2016. 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.

(b) 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.

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In March 2006, the Authority reached agreement with the United States and the Massachusetts Department of Environmental Protection (DEP) on the scope and schedule for the remaining CSO projects which was filed with the Court as part of a joint motion to amend the Court Schedule. In April 2006, the Court allowed the joint motion and issued an Order with a schedule. Under the Order, the Authority has until 2020 to complete the remaining CSO work and subsequent monitoring which will be used to verify that the long-term CSO control goals are achieved.

As part of the agreement, DEP agreed to reissue and EPA agreed to approve five (5) consecutive variances of no more than three years duration each, through the year 2020, for the Charles River and Alewife Brook/Upper Mystic River that are consistent with and limited to the requirements in the Authority's revised Long-Term CSO Control Plan. In addition, the United States and the Authority agreed to withdraw the February 27, 1987 *Stipulation of the United States and the Massachusetts Water Resources Authority on Responsibility and Legal Liability for Combined Sewer Overflows* and replace it with a Second Stipulation that requires the Authority to implement the CSO requirements set forth in the Court Schedule and to meet the levels of control described in the Authority's long-term CSO control plan. Upon completion of the long-term CSO control plan and with results that demonstrate performance parameters are as predicted, the stipulation makes the Authority responsible for only those CSO outfalls which it owns and operates. As a result of the agreement, the Authority now has 35 CSO projects, 15 of which are complete. The estimated cost to complete the Authority's long-term CSO control plan is now \$855 million, including contingency and escalation of unawarded contracts.

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.

(c) *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. Further meetings in 2006 have resulted

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in BECO and HEEC agreeing to explore options to correct the depth of the cable while reserving the right to charge back its costs to the Authority as part of its costs of furnishing electricity to MWRA.

(d) Blending

In May 2005, 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. EPA has taken no further action to date. In the past year, the Authority has been voluntarily and gradually increasing the volume of its flows directed through its secondary treatment facilities so as to test the operational limits of these facilities and to attempt to reduce the volume of diversions around secondary treatment. The Authority has kept EPA apprised of these activities.

(e) 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 2006 and 2005 were \$137 and \$66, 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.

MASSACHUSETTS WATER RESOURCES AUTHORITY

Notes to Financial Statements

June 30, 2006 and 2005

(Dollars in thousands)

The Authority participates in and pays premiums to the Commonwealth's Group Insurance Contract for employee health benefits. The Authority pays 85% 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 project was insured under an Owner's Controlled Insurance Program (OCIP). The Authority provided workers' compensation, general liability, and pollution coverage for operations of the contractors on this project. There was \$500 self-insurance retention for each coverage with the total aggregate self-insurance retention of \$1,250 for a combined claim under the OCIP. Coverage under this OCIP expired on July 1, 2003.

The Authority also instituted a second OCIP for the Walnut Hill Water Treatment Plant. The Authority provided workers' compensation, general liability, and pollution coverage for operations of the contractors on this project. There was a \$500 self-insured retention per occurrence for each coverage. Coverage under this OCIP expired on March 1, 2005.

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 2006 and 2005 were as follows:

	General liability and property	Workers' compensation	OCIP projects
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	4,259	1,484	281
Provision to record estimated losses	1,844	1,823	(49)
Payments	<u>(3,864)</u>	<u>(1,196)</u>	<u>—</u>
Liability balance – June 30, 2006	\$ <u>2,239</u>	<u>2,111</u>	<u>232</u>



REQUIRED SUPPLEMENTARY INFORMATION

MASSACHUSETTS WATER RESOURCES AUTHORITY

Schedule of Funding Progress

Required Supplementary Information

June 30, 2006

(Dollars in thousands)

Actuarial valuation	Assets (a)	Actuarial 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	—

See accompanying independent auditors' report.



SUPPLEMENTAL SCHEDULES

MASSACHUSETTS WATER RESOURCES AUTHORITY

Accounts Established by the General Revenue Bond Resolution

Year ended June 30, 2006
(comparative totals for June 30, 2005)

(Dollars in thousands)

	<u>Construction</u>	<u>Revenue</u>	<u>Debt service</u>	<u>Reserves</u>	<u>Total</u>
Balance – June 30, 2005	\$ 77,571	63,928	450,539	53,765	645,803
Proceeds from:					
Revenue bonds and loans	168,059	—	203,230	—	371,289
Cash received from customers	—	489,241	—	—	489,241
Debt service grant	—	—	9,631	—	9,631
Interest income	11,148	11,241	12,187	(4,844)	29,732
Grant receipts	—	—	5,886	—	5,886
Construction payments	(167,202)	162	—	—	(167,040)
Capital lease payments	(411)	—	(2,806)	—	(3,217)
Debt service payment	(8,693)	(1,971)	(485,498)	—	(496,162)
Other Commonwealth payments	—	(18,100)	—	—	(18,100)
Interfund transfers	868	(271,952)	271,117	(33)	—
Transfers from (to) operating account	586	(202,981)	2,804	—	(199,591)
Balance – June 30, 2006	\$ <u>81,926</u>	<u>69,568</u>	<u>467,090</u>	<u>48,888</u>	<u>667,472</u>

	<u>Sewer</u>	<u>Water</u>	<u>2006 Total</u>	<u>2005 Total</u>
Restricted cash and investments:				
Construction	\$ 37,926	44,000	81,926	77,571
Debt service reserves	172,560	79,801	252,361	243,609
Debt service	110,177	51,247	161,424	152,587
Revenue redemption	20,372	12,971	33,343	33,462
Revenue	31,060	38,508	69,568	63,928
Renewal and replacement reserve	19,406	10,485	29,891	34,768
Insurance	9,499	9,498	18,997	18,997
Community obligation and revenue enhancement	17,104	2,858	19,962	20,881
Total restricted cash and investments	\$ <u>418,104</u>	<u>249,368</u>	<u>667,472</u>	<u>645,803</u>

See accompanying independent auditors' report.

MASSACHUSETTS WATER RESOURCES AUTHORITY

Combining Balance Sheet

June 30, 2006

(Dollars in thousands)

Assets	Sewer	Water	Combined Total
Unrestricted current assets:			
Cash and cash equivalents	\$ 20,885	10,889	31,774
Investments	31,012	11,230	42,242
Intergovernmental loans	8,039	10,460	18,499
Accounts receivable	285	1,066	1,351
Total unrestricted current assets	<u>60,221</u>	<u>33,645</u>	<u>93,866</u>
Restricted assets:			
Cash and investments	420,593	253,540	674,133
Interest receivable	4,267	1,647	5,914
Grants receivable:			
Billed	1,315	—	1,315
Unbilled	38	—	38
Total restricted assets	<u>426,213</u>	<u>255,187</u>	<u>681,400</u>
Capital assets – not being depreciated	154,564	102,014	256,578
Capital assets – being depreciated – net	3,769,109	2,418,847	6,187,956
Deferred charges	313,598	101,533	415,131
Other assets – net	191,551	73,066	264,617
Total	<u>\$ 4,915,256</u>	<u>2,984,292</u>	<u>7,899,548</u>
Liabilities and Net Assets			
Current liabilities:			
Accounts payable and accrued expenses	\$ 35,815	17,280	53,095
Commercial paper notes	—	164,000	164,000
Current portion of long-term debt	65,847	20,206	86,053
Total current liabilities	<u>101,662</u>	<u>201,486</u>	<u>303,148</u>
Payable from restricted assets:			
Accounts payable for construction	13,698	3,312	17,010
Accrued interest on bonds payable	49,028	24,197	73,225
Total payable from restricted assets	<u>62,726</u>	<u>27,509</u>	<u>90,235</u>
Retainage on construction in progress	7,168	2,173	9,341
Long-term debt – less current portion	3,499,846	1,644,448	5,144,294
Long-term capital leases	24,264	11,387	35,651
Reserves	69,420	31,630	101,050
Deferred credits	24,742	36,662	61,404
Total liabilities	<u>3,789,828</u>	<u>1,955,295</u>	<u>5,745,123</u>
Net assets:			
Invested in capital assets – net of related debt	684,621	869,911	1,554,532
Restricted	115,076	65,619	180,695
Unrestricted	325,731	93,467	419,198
Total net assets	<u>1,125,428</u>	<u>1,028,997</u>	<u>2,154,425</u>
Commitments and contingencies			
Total	<u>\$ 4,915,256</u>	<u>2,984,292</u>	<u>7,899,548</u>

See accompanying independent auditors' report.

MASSACHUSETTS WATER RESOURCES AUTHORITY

Combining Balance Sheet

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	314	729	1,043
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	38	—	38
Total restricted assets	<u>437,491</u>	<u>222,484</u>	<u>659,975</u>
Capital assets – not being depreciated	117,801	411,472	529,273
Capital assets – being depreciated – net	3,850,039	2,119,587	5,969,626
Deferred charges	270,646	97,699	368,345
Other assets – net	174,613	66,732	241,345
Total	<u>\$ 4,910,589</u>	<u>2,948,829</u>	<u>7,859,418</u>
Liabilities and Net Assets			
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	54,203	16,038	70,241
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	49,491	19,306	68,797
Total payable from restricted assets	<u>62,194</u>	<u>29,155</u>	<u>91,349</u>
Retainage on construction in progress	7,155	11,281	18,436
Long-term debt – less current portion	3,456,678	1,460,077	4,916,755
Long-term capital leases	24,537	11,521	36,058
Reserves	69,420	30,764	100,184
Deferred credits	56,565	31,173	87,738
Total liabilities	<u>3,761,907</u>	<u>1,897,736</u>	<u>5,659,643</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	268,541	96,835	365,376
Total net assets	<u>1,148,682</u>	<u>1,051,093</u>	<u>2,199,775</u>
Commitments and contingencies			
Total	<u>\$ 4,910,589</u>	<u>2,948,829</u>	<u>7,859,418</u>

See accompanying independent auditors' report.

MASSACHUSETTS WATER RESOURCES AUTHORITY

Combining Statement of Revenues, Expenses, and Changes in Net Assets

Year ended June 30, 2006

(Dollars in thousands)

	<u>Sewer</u>	<u>Water</u>	<u>Combined Total</u>
Operating revenues:			
Customer services	\$ 318,029	166,500	484,529
Other	4,741	1,714	6,455
Total operating revenues	<u>322,770</u>	<u>168,214</u>	<u>490,984</u>
Operating expenses:			
Operations	61,794	31,723	93,517
Maintenance	15,801	3,684	19,485
Payments in lieu of taxes	—	5,920	5,920
Engineering, general, and administrative	73,789	31,245	105,034
Total operating expenses	<u>151,384</u>	<u>72,572</u>	<u>223,956</u>
Income from operations before depreciation	171,386	95,642	267,028
Depreciation	<u>128,620</u>	<u>51,597</u>	<u>180,217</u>
Operating income	<u>42,766</u>	<u>44,045</u>	<u>86,811</u>
Regulatory accounting provisions:			
Increase in reserves	—	(866)	(866)
Increase (decrease) in deferred credits – net	74,776	(1,656)	73,120
Total regulatory accounting provisions	<u>74,776</u>	<u>(2,522)</u>	<u>72,254</u>
Nonoperating income (expense):			
Debt service grants	8,258	1,373	9,631
Investment income	16,973	13,328	30,301
Interest expense	(171,070)	(79,163)	(250,233)
Total nonoperating expense	<u>(145,839)</u>	<u>(64,462)</u>	<u>(210,301)</u>
Net loss before capital grants	(28,297)	(22,939)	(51,236)
Capital grants	<u>5,043</u>	<u>843</u>	<u>5,886</u>
Decrease in net assets	(23,254)	(22,096)	(45,350)
Total net assets – beginning of year	<u>1,148,682</u>	<u>1,051,093</u>	<u>2,199,775</u>
Total net assets – end of year	\$ <u>1,125,428</u>	<u>1,028,997</u>	<u>2,154,425</u>

See accompanying independent auditors' report.

MASSACHUSETTS WATER RESOURCES AUTHORITY
Combining Statement of Revenues, Expenses, and Changes in Net Assets
Year ended June 30, 2005
(Dollars in thousands)

	<u>Sewer</u>	<u>Water</u>	<u>Combined Total</u>
Operating revenues:			
Customer services	\$ 313,593	139,209	452,802
Other	3,524	269	3,793
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	68,546	31,564	100,110
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:			
Increase in reserves	(500)	(500)	(1,000)
Decrease in deferred credits – net	63,887	10,347	74,234
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	(174,959)	(70,924)	(245,883)
Total nonoperating 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>

See accompanying independent auditors' report.



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**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***

The Board of Directors
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, 2006, and have issued our report thereon dated August 25, 2006. 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 audits 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 these specified parties.

KPMG LLP

August 25, 2006