

2005 FINANCIAL INFORMATION

MANAGEMENT DISCUSSION AND ANALYSIS

This Management Discussion and Analysis (MD&A) provides a narrative overview and analysis of the financial activities and performance of the San Antonio Water System (the System) for the fiscal year ending December 31, 2005. Please read it in conjunction with the financial statements and accompanying footnotes that follow the MD&A.

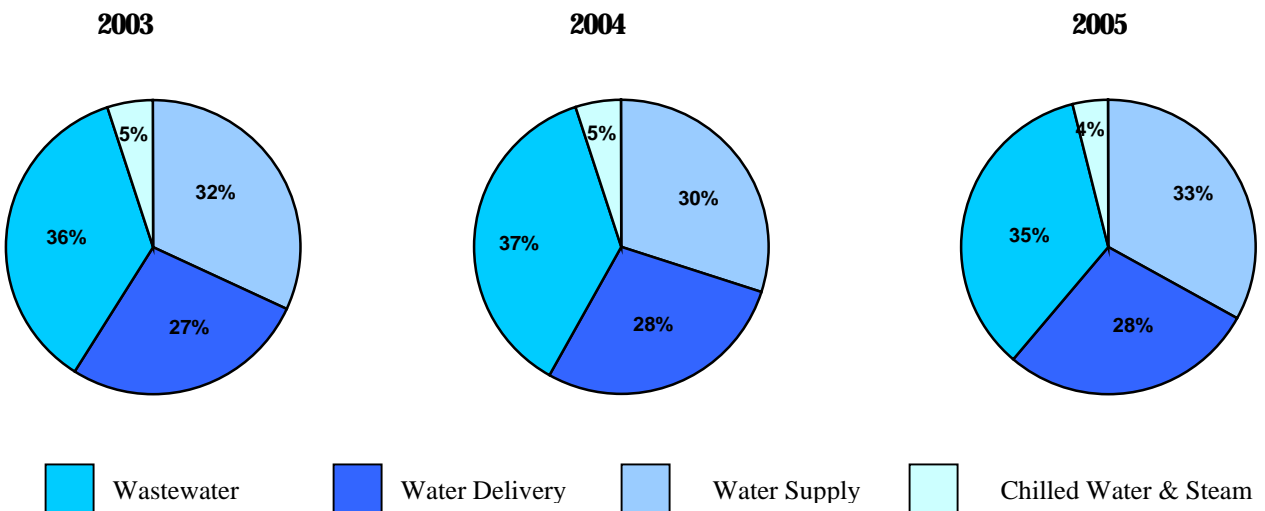
RESULTS OF OPERATIONS

During 2005, the System experienced an increase in equity of \$117.0 million as compared to the increase in 2004 of \$64.6 million. The 2005 increase consisted of income before capital contributions of \$35.6 million and capital contributions of \$81.4 million.

Revenues

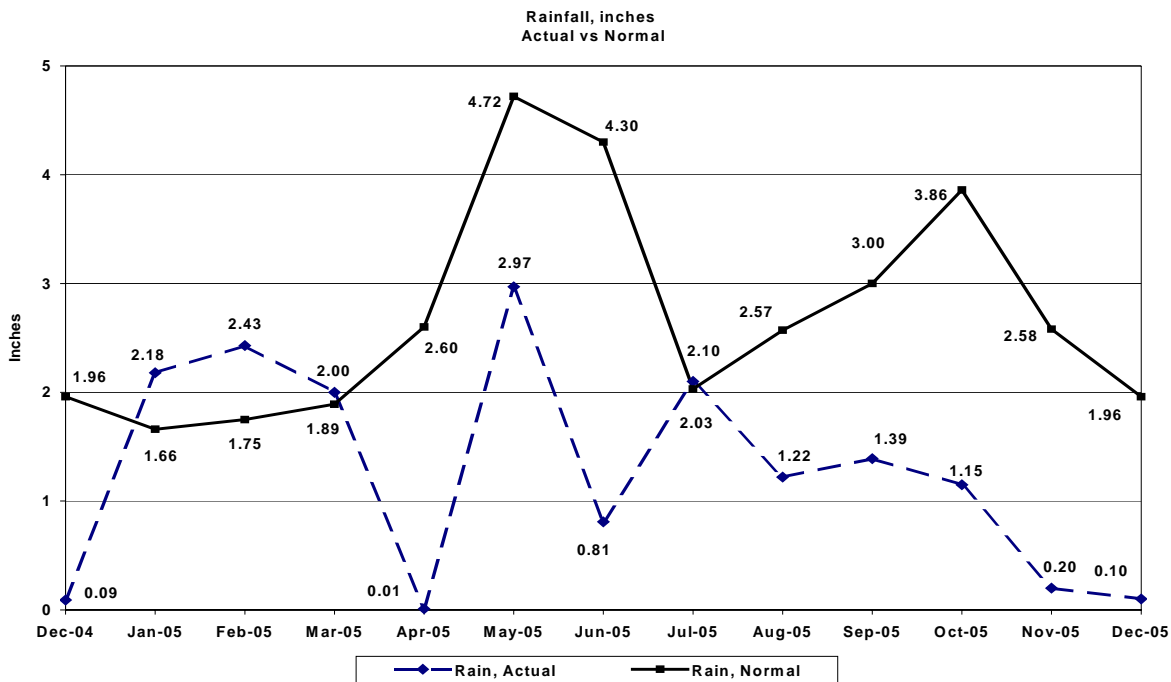
Operating revenues of \$328.2 million for 2005 rose \$65.5 million, or 24.9%. This dramatic increase in revenues resulted primarily from a 4% increase in customers, the dry weather experienced in San Antonio during 2005, and rate increases that were effective on January 1, 2005. The System's operating revenues are provided by its four core businesses; Water Delivery, Water Supply, Wastewater, and Chilled Water and Steam. As would be expected, the two businesses whose revenues are most directly correlated to the amount of rainfall received in a given year, Water Delivery and Water Supply, showed the largest increases in revenues, with the Wastewater and Chilled Water and Steam businesses showing smaller increases. Total operating revenues provided by each of these four businesses for fiscal years 2003-2005 are as follows:

OPERATING REVENUE



The Water Delivery core business is responsible for the actual distribution of water from its source to the customer's premise. Revenues for this business are derived through a combination of a monthly service charge that is dependent upon the size of the customer's water meter and a volume charge that relates to the customer's actual water usage. In 2005, Water Delivery revenues increased \$20.5 million to \$93.4 million. This increase over the prior year is the result of a combination of three factors; an increase in the average gallons of water used per customer per day of more than 8%, a growth in the number of water customers of more than 3%, and the 8.8% rate increase that took effect on February 1, 2005.

The increase in the average gallons of water used per customer per day is the first such increase in the last five years and results entirely from the lack of rainfall experienced within the San Antonio region during 2005. As can be seen per review of the following chart, San Antonio has experienced consistently below normal rainfall for the last nine months of 2005, with total rainfall for 2005 of 16.6 inches falling well short of both the normal annual rainfall total of 32.9 inches and the 2004 level of 45.3 inches.



The Water Supply core business is responsible for all functions related to the development and provision of additional water resources. In order to support the costs associated with these initiatives, in October 2000, the System implemented a separate funding mechanism, known as the Water Supply Fee, for water supply development and water quality protection. In 2005, Water Supply revenues were \$108.1 million, or 37.6% higher than the prior year. This increase was largely driven by the implementation of the fifth increment of the Water Supply Fee that resulted in a 25.3% increase in this rate and the increased customer usage and customer number levels discussed previously. As the System includes the pass through of Edwards Aquifer Authority fees in its Water Supply revenues, the increase in these fees also served to increase the reported Water Supply revenue amounts.

The collection and treatment of wastewater is the primary function of the Wastewater core business. In 2005, Wastewater revenues increased by \$14.1 million or 14.2% over the prior year. The majority of this increase relates to the 11.0% rate increase that was implemented effective January 1, 2005. Wastewater revenues were also impacted by the 3.5% growth in the number of wastewater customers that took place during 2005. Finally, while the residential portion of wastewater revenues are based upon the winter average water usage, and are therefore not as directly impacted by the low rainfall totals experienced during 2005, the commercial portion of these

revenues are computed based upon the amount of water used. The increase in water usage experienced during 2005 has also served to increase this portion of wastewater revenues.

The Chilled Water and Steam core business is responsible for providing heating and cooling to customers of the System, including various downtown hotels, City of San Antonio facilities, the Alamodome, Port Authority of San Antonio, "aka" (Kelly USA) tenants and HemisFair Plaza tenants. Revenues for this segment increased by \$1.3 million or 11.2% as compared to the prior year. This increase reflects almost entirely an increase in the cost of the utilities associated with generating the chilled water and steam that is a pass-through component of the rate charged for these services.

Non-operating revenues, which primarily represent interest income earned on investments, increased by approximately \$4.1 million during 2005 primarily as a result of the impact of rising interest rates on the average yield earned on the System's investment portfolio. During 2005, the average yield on the System's portfolio was 2.98% as compared to 1.67% for 2004. This increase in average yield of approximately 131 basis points combined with the System's average investment balance of \$314.4 million generated approximately \$4.1 million in increased interest earnings for the System

Expenses

Total 2005 operating expenses of \$241.4 million in 2005 increased by \$26.9 million or 12.6% over 2004 levels. This increase reflects primarily a significant increase in contractual services combined with smaller increases in personal services and depreciation expense. These increases have been partially mitigated by an increase in the total dollar amount of costs capitalized in connection with the System's construction initiatives.

The increase in contractual services as compared to the prior year of \$18.1 million or 26.2% was driven primarily by increased costs associated with the procurement of water supplies. Contractual payments associated with the procurement of existing water supplies or the development of future water supplies increased by almost \$11 million during 2005 with an additional \$4.8 million of expense being recognized as a result of a legal settlement relating to a water supply project and a contingent accrual established with respect to another water supply initiative. Another driver behind the increase in contractual services was a \$4.6 million increase in utilities costs as compared to 2004. This increase was primarily driven by the increased energy consumption associated with a 4.1% increase in the amount of water pumped from the Edwards Aquifer in 2005 as compared to 2004, as well as the increase associated with generating the chilled water and steam discussed above.

Personal services costs increased by approximately \$3.0 million during 2005 while depreciation and amortization expense increased approximately \$7.3 million during the year. The increase in personal services reflects the 3.5% cost of living increase that was effective in January 2005 as well as some cost increases associated with employee insurance and retirement. The increase also reflects the costs associated with providing all employees other than the executive management team a one time productivity bonus of \$500. The increase in depreciation and amortization expense reflects the 8.8% increase in utility plant in service that has taken place over the course of 2005.

Non-operating expenses of the System increased approximately \$8.3 million during 2005. The primary component of non-operating expenses, interest expense, increased by approximately \$5.2 million over 2004 levels. This increase in interest expense results from the increased interest rates paid on the System's commercial paper balances during 2005 as a result of the rising short term interest rates experienced during 2005 as well as a slight increase in average debt outstanding during the course of the year. Also contributing to the increased level of non-operating expenses was the increased payment made to the City of San Antonio as a result of the increased revenue levels. The final contributing factor to the increase was a loss on the sale of capital assets of approximately \$1.2 million that was recognized during 2005, primarily as a result of the sale of a prefabricated wastewater treatment facility that was no longer useful to the System's operations

Capital Contributions

During the year ended December 31, 2005, the System recorded plant contributions from developers in the amount of \$48.2 million as capital contributions. Additionally, the System assessed capital recovery fees of \$33.2 million that were also recorded as capital contributions. In 2004, plant contributions totaled \$45.3 million, while impact fee assessments totaled \$24.2 million. The amount of these capital contributions can vary from year to year depending on the level of development in the System's service territory. The amount of capital contributions received by the System in both periods reflects the continued strong growth in development being experienced within the San Antonio region. The amount of impact fees collected in 2005 was also favorably impacted by an increase in the assessment level of one of these fees.

BALANCE SHEET

The equity of the System results from recording total liabilities against total assets. This amount has been broken down into component categories in accordance with the GASB Statement No. 34 requirements.

	3-Dec-05	3-Dec-04	3-Dec-03 (Restated)
Total Assets	\$ 2,740,430,296	\$ 2,547,480,868	\$ 2,393,692,904
Total Liabilities	1,505,328,364	1,429,413,858	1,340,216,984
Total Equity	<u>1,235,101,932</u>	<u>1,118,067,010</u>	<u>1,053,475,920</u>
Invested in Capital Assets net of related debt	1,057,177,560	973,541,023	897,339,142
Restricted for:			
Debt Service	15,977,687	11,705,961	5,156,111
Conservation	2,409,363	2,503,665	5,823,169
Unrestricted	159,537,322	130,316,361	145,157,498
Equity	<u>\$ 1,235,101,932</u>	<u>\$ 1,118,067,010</u>	<u>\$ 1,053,475,920</u>

Over time, increases or decreases in equity may serve as a useful indicator of whether the financial position of the System is improving or deteriorating. As can be seen, the System's equity increased \$117.0 million or 10.5% from 2004 to 2005.

The largest portion of the System's equity reflects its investment in capital assets, less the related net debt to acquire those assets. The capital assets reflected on this line represent the utility plant assets that the System utilizes to generate revenues to service the debt obligations and pay the operating costs of the System. Any cash and investment amounts restricted for construction purposes are also reflected in these totals. The \$83.6 million increase from 2004 to 2005 reflects \$48.2 million of plant contributions from developers and \$35.4 million of 2005 capital expenditures that were funded with renewal and replacement funds or impact fees.

As of December 31, 2005, the System maintains \$16.0 million of cash and investments net of restricted liabilities that is restricted for debt service purposes and \$2.4 million of investments that must be utilized in connection with the System's conservation program. The increase in the amount of cash and investments, net of restricted liabilities, that is restricted for debt purposes has increased over the 2004 level as a result of increases in the annual debt service requirements for 2006 as compared to 2005.

The remaining balance of the System's equity represents unrestricted equity and may be used for any allowable purpose as outlined in City Ordinance No. 75686. The \$29.2 million increase in unrestricted equity reflects the strong financial performance of the System during 2005 partially offset by the funding of capital additions with renewal and replacement funds. The \$14.8 million reduction in unrestricted equity during 2004 results from the net loss before capital contributions of \$4.9 million and the funding of 2004 capital additions with renewal and replacement funds.

Current Assets

Current assets of the System have increased during 2005 by \$47.3 million to 379.9 million. This increase is entirely attributable to an increase in the balance of cash and short-term investments of \$40.0 million over the prior year and an increase in accounts receivable of \$8.3 million over 2004 levels. The increase in cash and short-term investments reflects the strong operating performance of the System during 2005, while the 25.9% increase in accounts receivable is a direct result of the 24.9% increase in operating revenues experienced by the System during 2005. As the latter half of the year, in particular, was drier and warmer than normal, the level of the System's accounts receivable did increase as compared to the prior year.

Capital Assets

During 2005, the System's total capital assets net of accumulated depreciation grew from \$2.2 billion to \$2.3 billion, while during 2004, net capital assets increased from \$2.0 billion to \$2.2 billion. Capital asset additions broken down by type for 2005 and 2004 were as follows:

(Amounts in millions)	Year Ended December	
	31,	
	2005	2004
Distribution System	\$ 10.6	\$ 9.2
Governmental Program	31.3	22.3
Main Replacements	31.7	23.9
Production System	3.0	11.8
Corporate & Miscellaneous	8.1	8.7
Facilities	4.4	29.1
Collection System	9.2	2.2
Treatment	6.5	18.0
Chilled Water and Steam	0.9	1.7
Recycle	17.5	7.7
Water Resources	45.6	44.5
Capitalized interest and overhead	14.8	12.6
Trilaterals	48.2	45.3
Total	<u>\$ 231.8</u>	<u>\$ 237.0</u>

For further detail information on capital assets, refer to Note E of the Notes to the Financial Statements.

Current Liabilities

During 2005, the System experienced an \$8.8 million increase in its current liabilities as compared to 2004. One of the primary drivers behind this increase is the increase in the current maturities of the System's revenue bond obligations of \$5.9 million. The other significant variations in the System's current liabilities relate to a reduction in the balance of accounts payable of \$6.9 million and an increase in sundry payables and accruals of \$11.7 million. In an effort to close its books at year end 2005 in a more timely fashion, accounts payable was closed earlier than in the prior year. As a result, several charges that in 2004 would have been classified as accounts payable, are residing in sundry payables and accruals at December 31, 2005. The net increase in these two balances, \$4.8 million, pertains primarily to the accrual of a contingent obligation at year-end 2005. For further discussion of this item, see Note I.

Long Term Debt

Consistent with its debt maturity schedule, in May 2005, the System repaid \$16.5 million of outstanding revenue bond principal obligations. During the first nine months of 2005, the System issued \$86.6 million of commercial paper to fund its ongoing construction initiatives. In December 2005, the System issued \$298.2 million worth of senior lien bonds. The proceeds from the sale of the bonds were used to advance refund \$70.2 million worth of higher coupon senior lien bonds, refund \$227 million of outstanding commercial paper notes, and pay the costs of issuance. These bonds, which bear interest at rates ranging from 4.25% - 5.00% were issued at a premium to yield an overall weighted average interest rate of 4.86%. At the same time that it issued the bonds, the System expanded its commercial paper program from \$350 to \$500 million. At December 31, 2005, the System had a total of \$98 million issued under this program.

In December 2005, the three major rating agencies, Fitch Ratings, Moody's Investor Services, Inc. and Standard & Poor's Ratings Services (S&P) reaffirmed the System's excellent debt ratings. The high quality ratings are based on the System's large, diverse, and growing service area, sound financial performance, positive actions towards developing long-term water supplies, sound system operations with a manageable capital improvements program, and competitive water and sewer rates.

	Bond and Commercial Paper Ratings			
			Subordinate Lien Debt	
	Senior Lien Debt	Junior Lien Debt	Variable Rate Demand Obligations	Tax-Exempt Commercial Paper
Fitch Ratings	AA-	A+	A	F1+
Moody's Investors Service, Inc	Aa3	A1	A1	P-1
Standard & Poor's Ratings Service	AA-	A+	A+	A1+

The System's bond ordinance requires the System to maintain a debt coverage ratio of at least 1.25x the annual debt service on outstanding senior lien debt. The System's debt coverage ratio for the senior lien bonds was 2.03x for 2005 and 1.64x for 2004. The coverage ratios for the annual debt service on all outstanding bonded debt were 1.68x and 1.30x in 2005 and 2004, respectively. The System's equity to total debt and equity ratio was 45.07% at December 31, 2005, as compared to 43.89% at December 31, 2004. As of December 31, 2004 and 2005, the System was in compliance with the terms and provisions of the ordinances and documents related to its outstanding bonds and tax-exempt commercial paper.

STATEMENTS OF CASH FLOWS

During 2005, the System generated strong operating cash flows of \$152.6 million. This amount, supported by the strong growth in operating revenues, represents a 40.4% increase over 2004 levels. The strong operating cash flows for 2005 combined with \$33.2 million of impact fee collections and \$10.9 million in proceeds from the sale of fixed assets, allowed the System to fund capital spending of \$177.7 million while only incurring net additional indebtedness of approximately \$73 million. Total capital spending declined by approximately \$6.9 million over 2004 levels as 2004 spending included charges of \$27.6 million associated with the purchase of the System's new corporate headquarters. A rise in short term interest rates coupled with slightly increased debt levels over the prior year resulted in increased interest payments of approximately \$5.3 million in 2005. This amount was almost completely offset by a \$3.7 million increase in interest income driven primarily by the rise in short-term interest rates. The end result of the System's strong 2005 financial performance was a net increase of \$34.0 million in investments and a \$1.4 million increase in the System's cash holdings over 2004.



PADGETT, STRATEMANN & CO., L.L.P.

Certified Public Accountants and Business Advisors

Independent Auditors' Report

To the Members of the Board
San Antonio Water System
San Antonio, Texas

We have audited the accompanying balance sheet of the San Antonio Water System (the "System"), a component unit of the City of San Antonio, Texas, as of and for the year ended December 31, 2005, and the related statements of revenues, expenses, and changes in equity and cash flows for the year then ended. These financial statements are the responsibility of the System's management. Our responsibility is to express an opinion on these financial statements based on our audit. The financial statements of the System as of December 31, 2004, were audited by other auditors whose report dated May 6, 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. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and the 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 2005 financial statements referred to above present fairly, in all material respects, the financial position of the System as of December 31, 2005, and the results of its operations and its cash flows for the year then ended, in conformity with accounting principles generally accepted in the United States of America.

The Management's Discussion and Analysis and the Pension and Retirement Plans – Schedules of Funding Progress are not a required part of the financial statements but are supplementary information required by the Governmental Accounting Standards Board. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit the information and express no opinion on it.

Padgett, Stratemann & Co., L.L.P.

Certified Public Accountants

March 15, 2006

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**San Antonio Water System
BALANCE SHEETS**

	December 31,	
	2005	2004
CURRENT ASSETS		
Unrestricted Current Assets		
Cash and cash equivalents - Note C	\$ 11,890,888	\$ 2,847,132
Investments - Note C	109,949,199	88,664,975
Accrued interest receivable	879,877	1,211,378
Accounts receivable, net of allowances - Note D for uncollectable accounts of \$734,769 and \$568,848, respectively	40,530,254	32,197,921
Inventory - materials and supplies	4,786,265	4,537,892
Prepaid expenses and other assets	2,111,117	3,034,787
Total unrestricted current assets	170,147,600	132,494,085
Restricted Current Assets:		
Debt Service Fund:		
Cash and cash equivalents - Note C	38,620	72,704
Investments - Note C	24,219,332	18,784,661
Construction Funds:		
Cash and cash equivalents - Note C	5,327,803	12,890,834
Investments - Note C	171,508,841	154,067,731
Conservation:		
Investments - Note C	2,409,363	2,503,665
Other:		
Common stock - Note C	-	5,819,192
Customers' deposits:		
Investments - Note C	6,211,381	5,952,486
Total restricted current assets	209,715,340	200,091,273
Total current assets	379,862,940	332,585,358
NONCURRENT ASSETS		
Unrestricted Assets:		
Investments - Note C	5,766,822	16,004,413
Total unrestricted noncurrent assets	5,766,822	16,004,413
Assets Held for Resale - Note N	2,760,000	8,210,012
Unamortized Refunding Bond Expenses	13,760,572	10,659,959
Capital Assets:		
Utility plant in service - Note E	2,607,372,575	2,396,554,144
Less allowance for depreciation	861,162,744	798,456,941
	1,746,209,831	1,598,097,203
Land and water rights - Note E	108,869,520	82,338,637
Construction in progress	483,200,611	499,585,286
Total capital assets (net of accumulated depreciation)	2,338,279,962	2,180,021,126
Total Noncurrent Assets	2,360,567,356	2,214,895,510
TOTAL ASSETS	\$ 2,740,430,296	\$ 2,547,480,868

The accompanying notes to financial statements form an integral part of this statement.

**San Antonio Water System
BALANCE SHEETS**

	December 31,	
	2005	2004
LIABILITIES		
Current Liabilities to be paid from Unrestricted Assets		
Accounts payable	\$ 5,925,941	\$ 12,830,587
Sewer service collections payable	276,325	256,013
Capital leases payable	35,616	311,215
Notes payable - Note F	389,668	315,885
Accrued vacation payable - Note G	2,943,341	2,816,887
Accrued payroll and benefits	2,345,906	2,539,894
Accrued claims payable - Note G	2,552,429	2,477,402
Accrued stormwater services	2,041,051	1,669,929
Sundry payables and accruals - Note G	17,731,181	6,049,273
Total	34,241,458	29,267,085
Current Liabilities to be paid from Restricted Assets		
Debt Service Fund:		
Accrued interest payable	8,280,265	7,151,404
Construction Funds:		
Contract retainage payable	5,763,840	9,446,172
Advances for construction	1,736,285	1,550,392
Customers' deposits	6,211,381	5,952,486
Revenue bonds payable within one year - Note H	22,415,000	16,505,000
Total Restricted Current Liabilities	44,406,771	40,605,454
Total Current Liabilities	78,648,229	69,872,539
Noncurrent Liabilities		
Capital leases payable	35,615	7,553
Notes payable - Note F	990,952	1,380,619
Accrued vacation payable - Note G	2,014,743	1,879,465
Commercial paper notes - Note H	98,000,000	238,400,000
Revenue bonds payable after one year - Note H	1,351,510,000	1,145,905,000
Unamortized premium	14,139,190	9,078,394
Less unamortized loss	(26,242,755)	(22,727,392)
Less unamortized discount	(13,767,610)	(14,382,320)
Total Noncurrent liabilities	1,426,680,135	1,359,541,319
TOTAL LIABILITIES	1,505,328,364	1,429,413,858
EQUITY		
Restricted:		
Restricted for debt service fund	15,977,687	11,705,961
Restricted for conservation	2,409,363	2,503,665
Total Restricted	18,387,050	14,209,626
Invested in capital assets, net of related debt	1,057,177,560	973,541,023
Unrestricted	159,537,322	130,316,361
TOTAL EQUITY	1,235,101,932	1,118,067,010
TOTAL LIABILITIES AND EQUITY	\$ 2,740,430,296	\$ 2,547,480,868

The accompanying notes to financial statements form an integral part of this statement.

San Antonio Water System
STATEMENTS OF REVENUES, EXPENSES
AND CHANGES IN EQUITY
For the Years Ended December 31,

OPERATING REVENUES	<u>2005</u>	<u>2004</u>
Water delivery system	\$ 93,419,939	\$ 72,888,054
Water supply system	108,045,245	78,546,461
Wastewater system	113,333,959	99,224,713
Chilled water and steam system	13,370,759	12,027,528
Total operating revenues	<u>328,169,902</u>	<u>262,686,756</u>
 OPERATING EXPENSES		
Personal services	77,440,762	74,416,616
Contractual services	87,272,198	69,126,680
Material and supplies	15,035,269	14,144,227
Other charges	15,752,184	15,474,823
Less: Costs capitalized to Construction in Progress	(22,714,359)	(19,052,929)
Internal service fund - net (gain)/loss	<u>703,836</u>	<u>(249,453)</u>
Total operating expenses before depreciation	173,489,890	153,859,964
Depreciation expense	<u>67,957,900</u>	<u>60,645,869</u>
Total operating expenses	<u>241,447,790</u>	<u>214,505,833</u>
 Operating income	 86,722,112	 48,180,923
 NONOPERATING REVENUES		
Interest earned and miscellaneous	11,280,590	6,703,218
Net increase (decrease) in the fair value of investments	<u>(112,729)</u>	<u>357,459</u>
Total nonoperating revenues	11,167,861	7,060,677
 NONOPERATING EXPENSES		
Amortization of refunding bond expense	537,339	499,745
Other finance charges	931,097	1,144,437
Interest expense:		
Revenue bonds and commercial paper	45,178,837	39,933,414
Amortized discount/premium/loss/expense	1,480,454	1,485,132
Capital leases	129,234	174,478
(Gain)/Loss on sale of capital assets	1,226,777	(131,277)
Payments to the City of San Antonio	8,982,657	7,101,972
Payments to other entities	<u>213,362</u>	<u>184,100</u>
Total nonoperating expenses	<u>58,679,757</u>	<u>50,392,001</u>
 Special items - Note N	 <u>(3,584,164)</u>	 <u>(9,786,120)</u>
 Increase/(Decrease) in equity, before capital contributions	 35,626,052	 (4,936,521)
 Capital contributions	 <u>81,408,870</u>	 <u>69,527,611</u>
 CHANGE IN EQUITY	 117,034,922	 64,591,090
 EQUITY, BEGINNING OF YEAR (as restated - Note O)	 <u>1,118,067,010</u>	 <u>1,053,475,920</u>
 EQUITY, END OF YEAR	 <u>\$ 1,235,101,932</u>	 <u>\$ 1,118,067,010</u>

The accompanying notes to financial statements form an integral part of this statement.

San Antonio Water System
STATEMENTS OF CASH FLOWS
For the years ended December 31,

	2005	2004
CASH FLOWS FROM OPERATING ACTIVITIES		
Cash received from customers	\$ 320,096,463	\$ 259,090,890
Cash paid to vendors for operations	(103,260,052)	(85,583,074)
Cash paid to employees for services	(64,243,072)	(64,820,555)
Net cash provided by operating activities	152,593,339	108,687,261
CASH FLOWS FROM NONCAPITAL FINANCING ACTIVITIES		
Payments to the City of San Antonio	(5,798,739)	(4,417,485)
Payments to other entities	(155,598)	(139,163)
Net cash used for noncapital financing activities	(5,954,337)	(4,556,648)
CASH FLOWS FROM CAPITAL AND RELATED FINANCING ACTIVITIES		
Proceeds from sale of capital assets	10,911,373	289,065
Proceeds from developers for plant construction	33,171,028	24,842,110
Proceeds from commercial paper	86,600,000	-
Proceeds from Revenue bonds	298,220,000	121,700,000
Proceeds from grants	273,016	829,187
Payment to employees for construction of plant	(13,129,945)	(8,837,070)
Payment to vendors for construction of plant	(9,584,414)	(10,427,963)
Payments for acquisition of equipment and furniture	(7,425,726)	(8,079,640)
Payments for acquisition of property and plant	(147,546,373)	(157,288,601)
Payment for retirement of commercial paper	(227,000,000)	(30,600,000)
Payment on Defeasement on Revenue bonds	(70,200,000)	-
Payment for retirement of Revenue Bonds	(16,505,000)	(7,735,000)
Payment for bond related expenses	(2,958,262)	(2,669,066)
Payment of interest on tax exempt commercial paper	(5,362,882)	(2,805,893)
Payment of interest on revenue bonds	(54,986,959)	(52,204,800)
Payment for bank charges	(931,097)	(1,144,437)
Payment on capital leases	(328,234)	(338,179)
Payment on note payable	(480,000)	(480,000)
Net cash used for capital and related financing activities	(127,263,475)	(134,950,287)
CASH FLOWS FROM INVESTING ACTIVITIES		
Purchase of investments	(691,852,553)	(503,966,635)
Maturity of investments	657,863,251	505,626,029
Proceeds from sale of stock	5,608,754	-
Interest income and other	10,451,662	6,573,753
Net cash provided by/(used for) investing activities	(17,928,886)	8,233,147
NET INCREASE/(DECREASE) IN CASH AND CASH EQUIVALENTS	1,446,641	(22,586,527)
CASH AND CASH EQUIVALENTS, AT BEGINNING OF YEAR	15,810,670	38,397,197
CASH AND CASH EQUIVALENTS, AT END OF PERIOD	\$ 17,257,311	\$ 15,810,670

The accompanying notes to financial statements form an integral part of this statement.

San Antonio Water System
STATEMENTS OF CASH FLOWS
For the years ended December 31,

	2005	2004
RECONCILIATION OF CASH AND CASH EQUIVALENTS PER STATEMENTS OF CASH FLOWS TO THE BALANCE SHEETS		
Cash and Cash Equivalents		
Unrestricted		
System Fund	\$ 3,544,244	\$ 2,152,932
Construction Fund	8,346,644	694,200
Restricted		
Debt Service Fund	38,620	72,704
Construction Fund	5,327,803	12,890,834
	\$ 17,257,311	\$ 15,810,670

RECONCILIATION OF OPERATING INCOME TO NET CASH PROVIDED BY OPERATING ACTIVITIES

Operating Income	\$ 86,722,112	\$ 48,180,923
Adjustments to reconcile operating income to net cash provided by operating activities:		
Depreciation expense	67,957,900	60,645,869
Change in assets and liabilities:		
(Increase) in accounts receivable	(8,332,333)	(3,920,951)
(Increase) in inventory	(248,373)	(490,909)
Decrease in prepaid expenses	923,670	256,893
(Decrease)/Increase in accounts payable	(6,904,645)	308,751
Increase in amount due for sewer collections	20,312	46,353
(Decrease)/Increase in accrued payroll and benefits	(193,988)	388,673
Increase in accrued vacation payable	261,732	370,319
Increase in sundry payables and accruals	11,681,908	778,569
Increase in accrued stormwater services	371,122	1,637,520
Increase in claims payables	75,027	160,166
Increase in customers' deposits	258,895	325,085
Total Adjustments	65,871,227	60,506,338
Net cash provided by operating activities	\$ 152,593,339	\$ 108,687,261

NONCASH CAPITAL AND FINANCING ACTIVITIES

The System recorded a non cash payment of \$3,183,918 for the water, reuse, supply and sewer billings to the City of San Antonio.

The system received contributions in the amount of \$48,237,842 from various developers in aid of construction. This amount is recorded as capital contributions.

NOTES TO FINANCIAL STATEMENTS

A. Summary of Significant Accounting Policies

Reporting Entity
Annual Budget
Accounting Standards
Fund Accounting
Business Segments
Basis of Accounting
Money Market and Investments
Inventory
Unamortized Refunding Bond Expense
Compensated Absences
Self-Insurance
Cash Flows Statement
Capital Assets
Capital Contributions
Estimates
Reclassifications

B. City Ordinance No. 75686

Funds Flow
No Free Service

C. Deposits and Investments

D. Accounts Receivable

E. Capital Assets

F. Note Payable

G. Other Liabilities

Accrued Vacation Payable
Risk Management

H. Long-Term Debt

Revenue Bonds
Debt Covenants
Commercial Paper Program

I. Contingencies and Commitments

J. Capitalized Interest Costs

K. Stormwater Program

L. Pension and Retirement Plans

M. Other Post Employment Benefits

N. Special Items

O. Restated Equity

P. New Accounting Pronouncements

NOTES TO FINANCIAL STATEMENTS

NOTE A - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Reporting Entity: On April 30, 1992, the City Council approved Ordinance No. 75686 which effectuated the consolidation of all city owned utilities related to water including the water, wastewater, and water reuse systems as the San Antonio Water System (the System).

The System has been defined in City Ordinance No. 75686 as all properties, facilities, and plants currently owned, operated and maintained by the City and/or the Board of Trustees, for the supply, treatment, transmission and distribution of treated potable water, chilled water and steam, for the collection and treatment of wastewater and for water reuse, together with all future extensions, improvements, purchases, repairs, replacements and additions thereto, and any other projects and programs of the System provided, however, that the City retains the right to incorporate a stormwater system as provided by the Texas Local Government Code.

The pension and retirement plans described in Note L are administered by third parties and are not a part of the reporting entity.

This Comprehensive Annual Financial Report of the System includes no component units. However, the operations of the System as reported herewith are included as a component unit of the City of San Antonio.

Annual Budget: Sixty days prior to the beginning of each fiscal year, the System presents an annual budget prepared on an accrual basis to serve as a tool in controlling and administering the management and operation of the System. The annual budget reflects an estimate of Gross Revenues and disposition of these revenues in accordance with the flow of funds required by Ordinance No. 75686 (See Note B). The annual Budget is submitted to City Council for review and consultation.

Accounting Standards: The System applies all applicable Governmental Accounting Standards Board (GASB) pronouncements as well as any Financial Accounting Standards Board (FASB) statements and interpretations, Accounting Principles Board (APB) opinions and Accounting Research Bulletin's (ARB) issued on or before November 30, 1989, unless those pronouncements conflict with or contradict GASB pronouncements.

Fund Accounting: Within the System's enterprise fund accounts, separate self-balancing funds are maintained to account for resources for various purposes, thereby distinguishing balances restricted by management or outside sources from unrestricted resources. Interfund receivable and payable accounts have been eliminated in the financial statements.

Business Segments: System Fund operations are segregated into four core businesses as follows:

- Water Supply – the functions related to the development and provision of additional water resources
 - Water Delivery – the function of distributing water to the customer
 - Wastewater – the functions of collecting and treating wastewater from the user customer
-
-

NOTES TO FINANCIAL STATEMENTS

- Chilled Water and Steam – the function related to providing chilled water and steam to specific customers of the System

Basis of Accounting: The financial statements are prepared using the accrual basis of accounting and the flow of economic resources measurement focus. Under this method, revenues are recorded when earned and expenses are recorded at the time liabilities are incurred. Proprietary Funds distinguish operating revenues and expenses from non-operating items. Operating revenues and expenses generally result from providing services in connection with a proprietary fund's principal ongoing operations. The principal operating revenues of the System are charges to customers for water, wastewater, water supply and chilled water and steam services. Operating expenses include the cost of service, administrative expenses and depreciation on capital assets. All revenues and expenses not meeting this definition are reported as non-operating revenues and expenses.

Investments: City Ordinance No. 75686, the System's Investment Policy, and Texas State law allow the System to invest in direct obligations of the United States or its agencies and instrumentalities. Other allowable investments include direct obligations of the State of Texas or its agencies and instrumentalities; secured certificates of deposit issued by state and national banks domiciled in the State of Texas; defined bankers acceptances and commercial paper; collateralized direct repurchase agreements, reverse repurchase agreements; no-load money market mutual funds; investment pools; and other types of secured or guaranteed investments. These investments are subject to market risk, interest rate risk, and credit risk which may affect the value at which these investments are recorded. Investments other than money market investments are reported at fair value.

Money Market Investments: Under the provisions of GASB Statement No. 31, money market investments with a remaining maturity at time of purchase of one year or less are reported at cost.

Inventory: Inventories are valued at the lower of average cost or market.

Unamortized Refunding Bond Expense: Expenses relating to the sale of revenue refunding bonds are amortized on a straight-line basis over the life of the issue.

Compensated Absences: It is the policy of the System to accrue employee vacation pay as earned and to accrue an additional amount for its portion of Social Security taxes. Sick leave is not accrued as a terminating employee is not paid for accumulated sick leave.

Self-Insurance: The System is self-insured for a portion of workers' compensation, employee's health, employer's liability, public officials' liability, property damage, and certain elements of general liability. A liability has been recorded for the estimated amount of eventual loss which will be incurred on claims arising prior to the end of the period.

NOTES TO FINANCIAL STATEMENTS

Cash Flows Statement: For purposes of the statement of cash flows, the System considers all investments and time deposits with an original maturity of 90 days or less to be cash equivalents.

Capital Assets: Capital assets in service are recorded on the unit cost equal to or greater than \$1,000. Assets acquired through capital leases are recorded on the cost basis and included in utility plant in service. Assets acquired through contributions, such as those from land developers, are capitalized and recorded in the plant accounts at estimated fair market value at date of donation. It is the policy of the System to capitalize certain interest costs on revenue bonds and commercial paper associated with newly constructed utility plant additions. Maintenance, repairs, and minor renewals are charged to operating expense; major plant replacements are capitalized. Capital assets are depreciated and property under capital lease is amortized on the straight-line method. This method is applied to all individual assets except distribution mains. Groups of mains are depreciated on the straight-line method using rates estimated to fully depreciate the costs of the asset group over their estimated average useful lives. The table below shows an estimated average of useful lives used in providing for depreciation of capital assets:

Structures and improvements	50 years
Pumping and purification equipment	10 - 50 years
Distribution and transmission system	25 - 50 years
Collection system	50 years
Treatment facilities	25 years
Equipment and machinery	5 - 20 years
Furniture and fixtures	10 years
Computer equipment	5 years
Software	3 years

Capital Contributions: The State of Texas allows the assessment of system development fees or capital recovery fees that may be used only for additional infrastructure capacity. In accordance with GASB No.33 these fees are recorded as revenues.

Estimates: The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect certain reported amounts and disclosures. Accordingly, actual results could differ from those estimates.

NOTES TO FINANCIAL STATEMENTS

Reclassifications: Certain amounts presented in the prior year data have been reclassified in order to be consistent with the current year's presentation.

NOTE B - CITY ORDINANCE NO. 75686

Funds Flow: City Ordinance No. 75686 requires that Gross Revenues of the System be applied in sequence to: (1) System Fund for payment of current maintenance and operating expenses including a two-month reserve amount based upon the budgeted amount of maintenance and operating expenses for the current Fiscal year; (2) Debt Service Fund requirements of Senior Lien Obligations; (3) Reserve Fund requirements of Senior Lien Obligations; (4) Interest and Sinking Fund and Reserve Fund requirements of Junior Lien Obligations; (5) Interest and Sinking Fund and Reserve Fund requirements of Subordinate Lien Obligations; (6) Payment of amounts required on Inferior Lien Obligations, and (7) Transfers to the City's General Fund and to the Renewal and Replacement Fund.

Reuse Contract: The System has a contract with CPS Energy, the city owned electricity and gas utility, for the provision of reuse water. According to City Ordinance No. 75686, the revenues derived from the contract have been restricted in use to only reuse activities and are excluded from the calculation of Gross Revenue, and are not included in any transfers to the City's General Fund.

No Free Service: City Ordinance No. 75686 also provides for no free services except for municipal fire-fighting purposes.

NOTE C - DEPOSITS AND INVESTMENTS

Deposits: All funds of the System are deposited at JP Morgan Chase Bank N.A., the System's general depository bank. The System's general depository agreement does not require the system to maintain an average monthly balance. As required by state law, all System deposits are fully collateralized and/or are covered by federal depository insurance. At December 31, 2005, the collateral pledged is being held by the Federal Reserve Bank of New York under the System's name so the System incurs no custodial credit risk. As of December 31, 2005, the bank balance of the System's demand and savings account was \$12,870,613 and the reported amount was \$8,711,355 which includes \$238,814 of cash on hand. As of December 31, 2004, the bank balance of the System's demand and savings account was \$9,582,614 and the reported amount was \$7,243,108 which included \$191,353 of cash on hand.

Investments: As of December 31, 2005, all investments of the System, with the exception of those held in escrow, are in securities of the U.S. Treasury or Agencies of the United States and are held in safekeeping by the System's general depository bank, JP Morgan Chase Bank N.A., registered as accounts of the System. Funds held in escrow, are Money Market Funds managed by Wachovia Bank and JP Morgan Chase Bank N.A. and are

NOTES TO FINANCIAL STATEMENTS

invested in U.S. Treasury Obligations. Investments are classified as current and non-current based on the maturity dates as of the end of the fiscal year.

The System had the following investments and maturities at December 31, 2005 and 2004:

December 31, 2005						
Investment Type	Investment Maturities (in Days)				Fair Value	Reported Amount
	90 days or less	91 to 180	181 to 365	Greater Than 365		
U.S. Treasury Bills	\$ 37,817,203	\$ 33,309,694	\$ -	\$ -	\$ 71,126,897	\$ 71,157,626
U.S. Treasury Notes	19,878,538	8,955,180	-	-	28,833,718	28,846,685
U.S. Agency Discount Notes	101,000,040	65,942,671	-	-	166,942,711	167,078,657
U.S. Agency Coupon Notes	24,048,328	10,786,242	9,858,146	5,734,320	50,427,036	50,453,526
Money Market Funds held in Escrow:						
Wachovia Bank	8,080,228	-	-	-	8,080,228	8,080,228
JP Morgan Chase Bank N.A.	2,994,172	-	-	-	2,994,172	2,994,172
	<u>\$193,818,509</u>	<u>\$118,993,787</u>	<u>\$ 9,858,146</u>	<u>\$ 5,734,320</u>	<u>\$ 328,404,762</u>	<u>\$ 328,610,894</u>

December 31, 2004						
Investment Type	Investment Maturities (in Days)				Fair Value	Reported Amount
	Less Than 90	91 to 180	181 to 365	Greater Than 365		
U.S. Treasury Bills	\$ 14,181,074	\$ 13,695,009	\$ -	\$ -	\$ 27,876,083	\$ 27,892,405
U.S. Treasury Notes	-	13,939,432	54,912,338	882,938	69,734,758	69,852,710
U.S. Agency Discount Notes	50,757,518	36,970,336	4,266,338	-	91,994,191	92,125,632
U.S. Agency Coupon Notes	27,270,378	15,836,412	32,542,433	15,147,150	93,796,372	93,871,887
Money Market Funds held in Escrow:						
Wachovia Bank	7,876,911	-	-	-	7,876,911	7,876,911
JP Morgan Chase/Bank One	2,925,948	-	-	-	2,925,948	2,925,948
	<u>\$103,011,829</u>	<u>\$ 80,441,189</u>	<u>\$91,721,109</u>	<u>\$ 16,030,088</u>	<u>\$ 294,204,263</u>	<u>\$ 294,545,493</u>

Interest Rate Risk: As a means of limiting its exposure to fair value losses due to rising interest rates, the System's investment policy limits its investments maturities to no more than five years. As of December 31, 2005 more than 98% of the System's investment portfolio is invested in maturities less than one year. Investment maturities are as follows:

<u>Maturity</u>	<u>Percent of Portfolio</u>
Zero to 90 days	59%
91 to 180 days	36%
181 to 365 days	3%
More than one year	2%

NOTES TO FINANCIAL STATEMENTS

Credit Risk. The System's investments in government-sponsored entities such as Federal Home Loan Bank Federal National Mortgage Association, Federal Home Loan Mortgage Corporation and Federal Farm Credit Bank were rated Aaa by Moody's Investors Service and AAA by Standard & Poor's and Fitch Ratings. The investments in money market funds were rated Aaa by Moody's Investor Service and AAA by Standard & Poor's.

Concentration of Credit Risk: The investment policy of the System does not limit the amount it may invest in U.S. Treasury securities, government-guaranteed securities, or government-sponsored entity securities. However, in order to manage its exposure to credit risk, the System's investment policy does limit the amount it can invest in any one government-sponsored issuer to no more than 50% of the total investment portfolio, and no more than 5% of the total investment portfolio on any non-government issuer unless it is fully collateralized. As of December 31, 2005, the System has invested more than five percent of its investments in the following government-sponsored entities, in the form of discount or coupon notes:

Federal Home Loan Bank	11.19%
Federal National Mortgage Association	27.46%
Federal Home Loan Mortgage Corporation	27.21%

Stock Investment: The demutualization of Metropolitan Life Insurance on April 7, 2000, made the System, a policyholder, eligible to receive compensation for the membership interest for the dental plan provided as a benefit for employees. The demutualization compensation consisted of a distribution of 7,567 shares of MetLife, Inc. Common Stock. On the date of issue, the stock was priced at \$14.25 per share for a total value to the System of \$107,830.

On October 26, 2001, with the demutualization of Principal Financial Group, Inc. the System received compensation for the membership interest for the life insurance provided as a benefit for employees and retirees. The demutualization compensation consisted of a distribution of 134,652 shares of Principal Financial Group, Inc. Common Stock. On the date of issuance, the stock was priced at \$23.35 per share for a total value to the System of \$3,144,124. Upon the identification of these securities, these two stock transactions were recorded on the System's financial records as of December 31, 2004. Given the appreciation in these securities subsequent to the demutualization, in accordance with GASB 31, an unrealized gain was recorded in the amount of \$2,368,529 for Principal Financial Group, Inc. and \$198,709 for Metlife, Inc. In 2005, the System sold its stock for \$5,608,754 and realized a gain on the sale of \$2,356,801.

NOTES TO FINANCIAL STATEMENTS

The following is a reconciliation of deposits and investments from the note to the balance sheets for 2005 and 2004:

	<u>2005</u>	<u>2004</u>
Reported Amounts from Notes as presented above:		
Deposits	\$ 8,711,355	\$ 7,243,108
Investments	328,610,894	294,545,493
Common Stock:		
PFG	-	5,512,653
MET	-	306,539
	<u>\$ 337,322,249</u>	<u>\$ 307,607,793</u>
Totals from Balance Sheets:		
Cash and Cash Equivalents:		
Unrestricted Cash and Cash Equivalents	\$ 11,890,888	\$ 2,847,132
Restricted - Cash and Cash Equivalents:		
Construction Funds	5,327,803	12,890,834
Debt Service Fund	38,620	72,704
Total Cash and Cash Equivalents	<u>17,257,311</u>	<u>15,810,670</u>
Investments:		
Unrestricted current investments	109,949,199	88,664,975
Restricted current investments:		
Debt Service Fund	24,219,332	18,784,661
Construction Funds	171,508,841	154,067,731
Common Stock	-	5,819,192
Customer Deposits	6,211,381	5,952,486
Conservation	2,409,363	2,503,665
Total current restricted investments	<u>204,348,917</u>	<u>187,127,735</u>
Total current investments	314,298,116	275,792,710
Unrestricted noncurrent investments	5,766,822	16,004,413
Total Cash, Cash Equivalents and Investments	<u>\$ 337,322,249</u>	<u>\$ 307,607,793</u>

NOTE D – ACCOUNTS RECEIVABLE

Accounts receivable, net of allowance for uncollectible accounts, totaling \$40.5 million and \$32.2 million as of December 31, 2005 and 2004 are broken down by core business as follows: Water Delivery \$11.8 million, Wastewater \$14.2 million, Water Supply \$13.0 million and Chilled Water & Steam \$1.6 million. The corresponding amounts as of December 31, 2004 are as follows: Water Delivery \$10.5 million, Wastewater \$12.1 million, Water Supply \$8.3 million and Chilled Water & Steam \$1.3 million. Accounts receivable are comprised of water, sewer, water supply fee and EAA (Edwards Aquifer Authority) receivables as well as sundry charges receivables.

NOTES TO FINANCIAL STATEMENTS

NOTE E – CAPITAL ASSETS

A summary of capital asset activity for the years ended December 31, 2005 is as follows:

	December 31, 2004	Increases	Transfers	Decreases	December 31, 2005
Capital Assets, not being depreciated:					
Land	\$ 63,536,938	\$ 9,968,334	\$ -	\$ 682,698	\$ 72,822,574
Acquisition of Water Rights	18,801,699	17,245,247	-	-	36,046,946
Construction in Progress	499,585,286	219,821,215	-	236,205,890	483,200,611
Total capital assets, not being depreciated	<u>581,923,923</u>	<u>247,034,796</u>	<u>-</u>	<u>236,888,588</u>	<u>592,070,131</u>
Capital assets, being depreciated					
Structures and improvements	291,262,309	24,807,183	-	4,092,504	311,976,988
Pumping and purification equipment	58,181,543	21,342,860	-	-	79,524,403
Distribution and transmission system	916,771,326	105,907,863	70,200	1,804,824	1,020,944,565
Treatment facilities	1,027,287,298	60,382,430	(70,200)	2,436,830	1,085,162,698
Equipment and machinery	79,107,044	4,709,050	-	1,067,745	82,748,349
Furniture and fixtures	3,468,609	1,383,560	(8,981)	20,297	4,822,891
Computer equipment	14,018,476	927,707	8,981	517,349	14,437,815
Software	6,457,539	1,515,758	-	218,431	7,754,866
Total capital assets being depreciated/amortized	<u>2,396,554,144</u>	<u>220,976,411</u>	<u>-</u>	<u>10,157,980</u>	<u>2,607,372,575</u>
Less accumulated depreciation					
Structures and improvements	(63,402,359)	(6,264,419)	-	(1,363,141)	(68,303,637)
Pumping and purification equipment	(13,808,308)	(2,208,547)	-	-	(16,016,855)
Distribution and transmission system	(276,510,664)	(24,023,267)	(602)	(1,767,606)	(298,766,927)
Treatment facilities	(381,833,226)	(26,969,190)	602	(440,551)	(408,361,263)
Equipment and machinery	(46,116,535)	(5,201,266)	-	(959,741)	(50,358,060)
Furniture and fixtures	(2,405,279)	(337,063)	2,607	(19,075)	(2,720,660)
Computer equipment	(8,967,154)	(1,871,766)	(2,607)	(483,240)	(10,358,287)
Software	(5,413,416)	(1,082,381)	-	(218,742)	(6,277,055)
Total accumulated depreciation	<u>(798,456,941)</u>	<u>(67,957,899)</u>	<u>-</u>	<u>(5,252,096)</u>	<u>(861,162,744)</u>
Total capital assets, being depreciated	<u>\$ 1,598,097,203</u>	<u>\$ 153,018,512</u>	<u>\$ -</u>	<u>\$ 4,905,884</u>	<u>\$ 1,746,209,831</u>
Capital assets, net	<u>\$ 2,180,021,126</u>	<u>\$ 400,053,308</u>	<u>\$ -</u>	<u>\$ 241,794,472</u>	<u>\$ 2,338,279,962</u>

NOTES TO FINANCIAL STATEMENTS

A summary of capital asset activity for the years ended December 31, 2004 is as follows:

	December 31, 2003	Increases	Transfers	Decreases	December 31, 2004
Capital Assets, not being depreciated:					
Land	\$ 68,976,930	\$ 8,814,849	\$ (9,788)	\$ 14,245,051	\$ 63,536,938
Acquisition of Water Rights	18,077,019	724,680	-	-	18,801,699
Construction in Progress	418,448,809	224,216,061	-	143,079,587	499,585,286
Total capital assets, not being depreciated	505,502,758	233,755,590	(9,788)	157,324,638	581,923,923
Capital assets, being depreciated					
Structures and improvements	251,595,913	39,666,396	-	-	291,262,309
Pumping and purification equipment	46,936,042	12,130,200	(765,475)	119,223	58,181,543
Distribution and transmission system	873,001,075	44,937,004	(42,449)	1,124,305	916,771,326
Treatment facilities	973,782,115	52,830,146	691,585	16,548	1,027,287,298
Equipment and machinery	76,504,366	5,345,701	150,526	2,893,550	79,107,044
Furniture and fixtures	3,432,803	48,327	-	12,521	3,468,609
Computer equipment	13,486,014	2,273,878	(24,399)	1,717,017	14,018,476
Software	5,812,451	1,028,779	-	383,691	6,457,539
Total capital assets being depreciated/amortized	2,244,550,779	158,260,433	9,788	6,266,855	2,396,554,144
Less accumulated depreciation for:					
Structures and improvements	(58,053,687)	(5,348,672)	-	-	(63,402,358)
Pumping and purification equipment	(12,866,561)	(941,747)	-	-	(13,808,308)
Distribution and transmission system	(256,396,877)	(21,238,141)	51	(1,124,303)	(276,510,665)
Treatment facilities	(356,276,285)	(25,563,400)	(51)	(6,509)	(381,833,225)
Equipment and machinery	(43,945,815)	(4,886,927)	-	(2,716,206)	(46,116,536)
Furniture and fixtures	(2,057,314)	(359,366)	-	(11,401)	(2,405,279)
Computer equipment	(8,692,837)	(1,912,932)	-	(1,638,596)	(8,967,154)
Software	(5,402,426)	(394,682)	-	(383,691)	(5,413,416)
Total accumulated depreciation	(743,691,802)	(60,645,867)	-	(5,880,706)	(798,456,941)
Total capital assets, being depreciated	1,500,858,977	97,614,566	9,788	386,149	1,598,097,203
Capital assets, net	\$ 2,006,361,734	\$ 331,370,154	\$ -	\$ 157,710,787	\$ 2,180,021,126

NOTES TO FINANCIAL STATEMENTS

NOTE F - NOTE PAYABLE

During fiscal year 2000, a contract was entered into between the System and CPS Energy whereby the System acquired water rights valued at \$3,592,678 from certain CPS Energy owned properties. In exchange for these water rights, a note was signed for 116 payments of \$40,000 at an interest rate of 7.5%. The liability as of December 31, 2005, is reflected on the balance sheet for both the current portion of \$389,668 and long-term amount of \$990,952. The following is a summary of future obligations under this note payable:

CPS Energy Note Payable			
<u>Year Ending</u>			
<u>December 31,</u>	<u>Principal</u>	<u>Interest</u>	<u>Requirements</u>
2006	\$ 389,668	\$ 90,332	\$ 480,000
2007	419,918	60,082	480,000
2008	452,518	27,482	480,000
2009	118,516	1,484	120,000
Total	<u>\$ 1,380,620</u>	<u>\$ 179,380</u>	<u>\$ 1,560,000</u>

NOTE G – OTHER LIABILITIES

Accrued Vacation Payable: The System records an accrual for vacation payable for all full time employees and pays unused vacation hours available at the end of employment with the final paycheck.

	Liability Balance at Beginning of Fiscal Year	Current-Year Accruals	Payments	Liability Balance at End of Fiscal Year	Estimated Due Within One Year
Year Ended December 31, 2004	\$ 4,326,032	\$ 3,187,207	\$(2,816,887)	\$ 4,696,352	\$ 2,816,887
Year Ended December 31, 2005	\$ 4,696,352	\$ 3,205,073	\$(2,943,341)	\$ 4,958,084	\$ 2,943,341

NOTES TO FINANCIAL STATEMENTS

Sundry Payable and Accruals: The System had sundry payables and accruals totaling \$17,731,181 and \$6,049,273 as of December 31, 2005 and 2004, respectively. A detailed breakdown of amounts included in these totals is provided in the table below:

Sundry payables and accruals		
<u>Account Description</u>	<u>2005</u>	<u>2004</u>
Accrued Ordinance Payments to City	\$ 651,030	\$ 448,044
Payroll Liabilities	3,086,392	2,254,390
Miscellaneous accruals	8,167,589	2,958,920
Contingency accrual	3,896,594	-
Utility accrual	1,364,279	-
Undaïmed Property	140,319	91,490
Unearned Accruals	424,978	296,429
	<u>\$17,731,181</u>	<u>\$ 6,049,273</u>

Risk Management: The System is exposed to various risks of loss related to torts; theft of, damage to, and destruction of assets; errors and omissions; injuries to employees; and natural disasters. The System is self administered and self-insured for the first \$500,000 of each worker's compensation and general liability, automobile liability and public official's liability claim and \$250,000 for each pollution legal liability claim. Claims that exceed the self-insured retention limit are covered through the System's comprehensive commercial insurance program. For the year ended December 31, 2005, there were no reductions in insurance coverage from the previous year and there were no claims that exceeded the self-insured retention limit. Settled claims have never exceeded the insurance coverage in any year for the System. The System has recorded accrued claims liability in the amount of \$2,552,429 as of December 31, 2005, which is reported as a current liability of the System. The claims liability, including incurred but not reported claims, is based on the estimated ultimate cost of settling the claims. The claims liability includes medical and rehabilitation costs, which are considered incremental claim adjustment expenses. Changes in the liability amount for the last two fiscal years were as follows:

	Balance at		Balance at		
	Beginning of	Current-Year	Fiscal	Year-End	Estimated
Year Ended	<u>Liability</u>	<u>Accruals</u>	<u>Payments</u>	<u>Liability</u>	<u>Due Within</u>
					<u>One Year</u>
December 31, 2004	\$2,317,236	\$ 1,674,745	\$(1,514,579)	\$ 2,477,402	\$2,477,402
Year Ended					
December 31, 2005	\$2,477,402	\$ 1,541,697	\$(1,466,670)	\$ 2,552,429	\$2,552,429

NOTES TO FINANCIAL STATEMENTS

NOTE H – LONG TERM DEBT

REVENUE BONDS: On December 15, 2005, the System issued \$298,220,000 City of San Antonio, Texas Water System Revenue Refunding Bonds, Series 2005. The proceeds from the sale of the Bonds were used to (i) advance refund the \$70,200,000 City of San Antonio, Texas Water System Revenue and Refunding Bonds, Series 1999, (ii) refund \$227,000,000 in outstanding commercial paper notes, and (iii) pay the cost of issuing the bonds. The bonds are secured together with other outstanding Senior Lien Obligations solely by a lien on and pledge of net revenues. The advance refunding reduced the System’s total debt service payments over the next 20 years by approximately \$7.9 million and the System obtained an economic gain (difference between the present values of the old and new debt service payments) of approximately \$5.9 million.

Senior Lien Water System Revenue Bonds, comprised of Series 1996, Series 1997, Series 2001, Series 2002, Series 2002-A, Series 2004 and Series 2005, outstanding in the amounts of \$1,041,400,000 at December 31, 2005, are collateralized by a senior lien and pledge of the Gross Revenues of the System after deducting and paying the current expenses of operation and maintenance of the System and maintaining an operating reserve for operating and maintenance expenses.

Junior Lien Water System Revenue Bonds, comprised of Series 1999, Series 1999-A, Series 2001, Series 2001-A, Series 2002, Series 2002-A, Series 2003, Series 2004, and Series 2004-A outstanding in the amount of \$214,090,000 at December 31, 2005, are collateralized by a junior lien and pledge of the Gross Revenues of the System after deducting and paying the current expenses of operation and maintenance of the System, maintaining an operating reserve for operating and maintenance expenses, and debt service on senior lien debt.

Subordinate Lien Water System Revenue Bonds, comprised of Series 2003-A and 2003-B, outstanding in the amount of \$118,435,000 at December 31, 2005, are collateralized by a subordinate lien and pledge of the Gross Revenues of the System after deducting and paying the current expenses of operation and maintenance of the System maintaining an operating reserve for operating and maintenance expenses, and debt service on senior lien and junior lien debt.

Revenue bonds currently outstanding are as follows:

<u>Purpose</u>	<u>Interest Rates</u>	<u>Amount</u>
Build, improve, extend enlarge, and repair the System	0.10-6.25%	\$1,373,925,000

NOTES TO FINANCIAL STATEMENTS

The following summarizes transactions of the revenue bonds for the years ended December 31, 2005 and 2004:

	Balance Jan. 1, 2005	Additions	Reductions	Balance Dec. 31, 2005	Due Within One Year
Bonds Payable	\$ 1,162,410,000	\$ 298,220,000	\$ 86,705,000	\$ 1,373,925,000	\$ 22,415,000
Less Deferred Amounts:					
For issuance discounts/ premiums/losses	\$ (28,031,318)	\$ 3,141,614	\$ 5,301,758	\$ (25,871,175)	\$ -
Total Bonds Payable, Net	\$ 1,134,378,682	\$ 295,078,386	\$ 81,403,242	\$ 1,348,053,825	\$ 22,415,000

	Balance Jan. 1, 2004	Additions	Reductions	Balance Dec. 31, 2004	Due Within One Year
Bonds Payable	\$ 1,048,445,000	\$ 121,700,000	\$ 7,735,000	\$ 1,162,410,000	\$ 16,505,000
Less Deferred Amounts:					
For issuance discounts/ premiums/losses	\$ (29,801,798)	\$ 285,347	\$ 2,055,827	\$ (28,031,318)	\$ -
Total Bonds Payable, Net	\$ 1,018,643,202	\$ 121,414,653	\$ 5,679,173	\$ 1,134,378,682	\$ 16,505,000

The following table shows the annual debt service requirements on the System's debt obligations for each of the next five years and then in five year increments after that.

<u>Year Ended</u> <u>December 31,</u>	<u>Annual Debt Service Requirements</u> <u>Revenue Bonds</u>					
	<u>Subordinate Lien</u>		<u>Junior Lien</u>		<u>Senior Lien</u>	
	<u>Revenue and</u> <u>Refunding Bonds</u>		<u>Revenue and</u> <u>Refunding Bonds</u>		<u>Revenue and</u> <u>Refunding Bonds</u>	
	<u>Principal</u>	<u>Interest</u>	<u>Principal</u>	<u>Interest</u>	<u>Principal</u>	<u>Interest</u>
2006	\$ 2,170,000	\$ 4,950,583	\$ 5,100,000	\$ 7,246,806	\$ 15,145,000	\$ 52,748,229
2007	2,275,000	4,859,877	7,850,000	7,044,521	14,755,000	51,931,242
2008	2,375,000	4,764,782	8,085,000	6,796,530	18,705,000	51,044,716
2009	2,485,000	4,665,507	10,285,000	6,519,580	19,585,000	50,046,683
2010	2,600,000	4,561,634	12,555,000	6,186,217	20,065,000	49,024,502
2011 - 2015	14,880,000	21,075,769	69,455,000	24,549,866	110,435,000	229,077,572
2016 - 2020	18,590,000	17,669,696	74,690,000	11,185,581	144,450,000	195,778,191
2021 - 2025	23,235,000	13,413,829	26,070,000	1,504,213	233,570,000	147,103,298
2026 - 2030	29,035,000	8,093,943	-	-	200,335,000	83,997,747
2031 - 2035	20,790,000	1,763,751	-	-	71,145,000	58,069,321
2036 - 2040	-	-	-	-	193,210,000	24,801,818
	<u>\$ 118,435,000</u>	<u>\$ 85,819,371</u>	<u>\$ 214,090,000</u>	<u>\$ 71,033,314</u>	<u>\$ 1,041,400,000</u>	<u>\$ 993,623,319</u>

NOTES TO FINANCIAL STATEMENTS

Pay-Fixed, Receive-Variable Interest Rate Swap

Objective of the Interest Rate Swap: On March 27, 2003, the System entered into an interest rate swap agreement in connection with its City of San Antonio, Texas, Water System Subordinate Lien Revenue and Refunding Bonds, Series 2003-A and 2003-B (the Series 2003 Bonds) issued in a variable interest rate mode. The Series 2003 Bonds were issued to provide funds for the System's Capital Improvements Program and to refund certain outstanding commercial paper notes. The swap was used to hedge interest rates on the Series 2003 Bonds to a synthetic fixed rate that produced a lower than expected interest rate cost to the System than traditional long term fixed rate bonds.

Terms: The terms, including the counterparty credit ratings of the outstanding swap, as of December 31, 2005, are included in the table below. The System's swap agreement contains scheduled reductions to the outstanding notional amounts that are expected to follow scheduled reductions in the associated bonds. The Series 2003 Bonds were issued on March 27, 2003, with a principal amount of \$122,500,000. The swap was structured to match the principal amortization structure and dates of the Series 2003 Bonds. The counterparty to the swap is Bear Stearns Financial Products, Inc. (Bear Stearns FPI), with the index for the variable rate leg of the SWAP being the Bond Market Association (BMA) Municipal Swap Index.

Related Bonds	Maturity	Counterparty	CP Moody's/S&P/Fitch	Rating by	Variable Rate Received	Fixed Rate Paid	Market Value at December 31, 2005
Series 2003 Bonds	May 1, 2033	Bear Stearns FPI	Aaa/AAA/AAA		BMA	4.18%	\$(2,614,855)

The combination of variable rate bonds and a floating-to-fixed swap creates a synthetic fixed-rate issue for the System. The synthetic fixed-rate protects against the potential of rising interest rates in conjunction with the System's Series 2003 Bonds issued in a weekly mode and achieved a lower fixed rate than in the traditional fixed rate bond market at the time of issuance.

Fair Value: The swap had a negative fair value as of December 31, 2005, of \$2,614,855. This value was calculated using the zero-coupon method. This method calculates the future net settlement payments required by the swap, assuming that the current forward rates implied by the yield curve correctly anticipated future spot interest rates. These net payments are then discounted using the spot rates implied by the current yield curve for hypothetical zero-coupon bonds due on the date of each future net settlement on the swap.

Credit Risk: As of December 31, 2005, the System was not exposed to credit risk on its outstanding swap because the swap had a negative fair value. However, should interest rates change and the fair value of the swap become positive, the System would be exposed to credit risk in the amount of the swap's fair value. The swap

NOTES TO FINANCIAL STATEMENTS

counterparty, Bear Stearns FPI, was rated AAA by Fitch Ratings and Standard & Poor's and Aaa by Moody's Investors Services as of December 31, 2005. The swap agreement contains a collateral agreement with the counterparty. Collateralization of the fair value of the swap is required should Bear Stearns FPI credit rating fall below the applicable thresholds in the agreement.

Basis Risk: The System is exposed to basis risk to the extent that the interest payments on its variable-rate bonds do not match the variable-rate payments received on the associated swap. The System mitigates this risk by (a) matching the notional amount and amortization schedule of the swap to the principal amount and amortization schedule of the Series 2003 Bonds, and (b) selecting an index for the variable-rate leg of the swap that is reasonably expected to closely match the interest rate resets on the Series 2003 Bonds over the life of the issue.

Termination Risk: The System may terminate for any reason. Bear Stearns FPI may terminate the swap if the System fails to perform under the terms of the agreement. The System's ongoing payment obligations under the swap are insured, and Bear Stearns FPI cannot terminate as long as the insurer does not fail to perform. If the swap should be terminated, the Series 2003 Bonds would no longer carry synthetic fixed interest rates. Also, if at the time of the termination the swap has a negative fair value, the System would be liable to the counterparty for a payment equal to the swap's fair value.

Swap Payments and Associated Debt: As of December 31, 2005, debt service requirements of the variable-rate debt and net swap payments, assuming current interest rates remain the same, are as detailed below. As rates vary, variable-rate bond interest payments and net swap payments will vary.

Pay-Fixed, Receive-Variable Interest Rate Swap
Estimated Debt Service Requirements of Variable-Rate
Debt Outstanding and Net Swap Payments

Year	Variable-Rate Bonds		Interest Rate	Total
	Principal	Interest	Swap, Net	
2006	\$ 2,170,000	\$ 4,141,387	\$ 783,822	\$ 7,095,209
2007	2,275,000	4,062,091	768,814	7,105,905
2008	2,375,000	3,979,196	753,125	7,107,321
2009	2,485,000	3,892,525	736,721	7,114,246
2010	2,600,000	3,801,842	719,558	7,121,400
2011 - 2015	14,880,000	17,497,689	3,311,709	35,689,398
2016 - 2020	18,590,000	14,525,564	2,749,189	35,864,753
2021 - 2025	23,235,000	10,811,691	2,046,281	36,092,972
2026 - 2030	29,035,000	6,169,453	1,167,665	36,372,118
2031 - 2033	20,790,000	1,003,059	189,845	21,982,904
Total	<u>\$118,435,000</u>	<u>\$69,884,497</u>	<u>\$13,226,729</u>	<u>\$201,546,226</u>

NOTES TO FINANCIAL STATEMENTS

OTHER DEBT MATTERS

Debt Covenants: The System is required to comply with various provisions included in the ordinances, which authorized the bond issuances. The System is in compliance with all significant provisions of the ordinances.

Prior Year Defeasance of Debt: In 2005 and prior years, the System defeased certain revenue bonds by placing revenues or proceeds of new bond issues in an irrevocable trust to provide for all future debt service payments on the old bonds. Accordingly, the trust account assets and liability for the defeased bonds are not included in the System's financial statements. At December 31, 2005, \$112,040,000 of bonds outstanding are considered defeased.

COMMERCIAL PAPER PROGRAM

The System maintains a Tax Exempt Commercial Paper (TECP) Program that is used to provide funds for the interim financing of a portion of the capital improvements to the System.

On November 17, 2005, the City Council of the City of San Antonio approved the expansion of the TECP Program from \$350 million to \$500 million. The increase in the program provides additional interim financing capacity for the increased level of future expenditures on water resource projects. Notes payable under the program cannot exceed maturities of 270 days and scheduled maturities of the short-term borrowing under the Commercial Paper Program may not extend past June 28, 2041.

The City has covenanted in the Ordinance authorizing the Commercial Paper Program (the Note Ordinance) to maintain at all times credit facilities with banks or other financial institutions which would provide available borrowing sufficient to pay the principal of the Commercial Paper Program. The credit facility is maintained under the terms of a revolving credit agreement.

The issuance of the Notes is further supported by the following agreements and related participants:

- Dealer Agreements with Goldman, Sachs & Co., J.P. Morgan Securities Inc., and Ramirez & Co., Inc.
- Revolving Credit Agreement with Bank of America, N.A.
- Issuing and Paying Agency Agreement with JPMorgan Trust Company, National Association.

The borrowings under the Commercial Paper Program are equally and ratably secured by and are payable from (i) the proceeds from the sale of bonds or additional borrowing under the Commercial Paper Program and (ii) borrowing under and pursuant to the revolving credit agreement.

Commercial paper notes of \$98,000,000 are outstanding as of December 31, 2005. The proceeds of the notes have been used solely for financing of capital improvements of the System. The tax exempt commercial paper notes have been classified as long-term in accordance with the refinancing terms of the Credit Agreement and because management intends to continue the remarketing of the tax exempt commercial paper notes to maintain a

NOTES TO FINANCIAL STATEMENTS

portion of its debt in variable rates. Interest rates on the notes outstanding at year end range from 2.72% to 3.17% and maturities range from 65 to 155 days. The outstanding notes at December 31, 2005, had an average rate of 3.02% and averaged 81 days to maturity.

The following summarizes transactions of the commercial paper program for the year ended December 31, 2005 and 2004:

	Balance Jan. 1, 2005	Additions	Reductions	Balance Dec. 31, 2005
Commercial Paper Notes	\$ 238,400,000	\$ 86,600,000	\$ 227,000,000	\$ 98,000,000

	Balance Jan. 1, 2004	Additions	Reductions	Balance Dec. 31, 2004
Commercial Paper Notes	\$ 269,000,000	\$ -	\$ 30,600,000	\$ 238,400,000

NOTE I - CONTINGENCIES AND COMMITMENTS

The System is the subject of various claims and litigation, which have risen in the ordinary course of its operations. Management, in consultation with legal counsel, is of the opinion that the System's liabilities in these cases, if decided adversely to the System, will not be material.

The System is committed under various contracts for completion of construction or acquisition of utility plant totaling approximately \$158.94 million as of December 31, 2005. Funding of this amount will come from excess revenues of the System, contributions from developers, and restricted assets.

As of December 31, 2005, the System has recorded a contingent liability of approximately \$3.9 million related to contractual and/or legal expenditures that are expected to be incurred in the future as a result of actions taken by the System during 2005. While the exact amount of any potential liability that may arise from these actions is indeterminable, management believes that the amount recorded is a reasonable estimate.

In January, 2006, the System settled a legal claim regarding the amount of water pumped under one of its existing water rights agreements. As part of this settlement, the System agreed to pay \$924,140 related to past damages claimed and further modified the existing agreement to require the System to make minimum annual ground water payments of \$337,500 on a take or pay basis. Under the terms of this agreement, the System is required to make

NOTES TO FINANCIAL STATEMENTS

total payments under this contract of \$4.7 million between 2006 and 2020. Additionally, the System has agreed to make payments quarterly in arrears for any residential customers within a defined geographical area that begin taking water service from the System. While it is impossible to estimate the exact amount of any potential future payments associated with this provision of the agreement, management estimates of this potential contingent liability are less than \$5 million.

NOTE J - CAPITALIZED INTEREST COSTS

Interest costs incurred on revenue bonds and commercial paper totaled \$61,478,704 during the year ended December 31, 2005, of which \$16,299,867 was capitalized as part of the cost of the System's utility plant additions.

NOTE K - STORMWATER PROGRAM

The Stormwater Program is a federally mandated program, under the Environmental Protection Agency, for the monitoring of the quality and quantity of pollution found in rain runoff.

The City of San Antonio and the System have administrative responsibility for the Stormwater Program and have entered into an interlocal agreement, which establishes the entities' respective responsibilities. The System's responsibility is in various aspects of data collection and analysis related to the water quality of stormwater and responsibility for customer billings and collection. Costs incurred by the System related to the Stormwater Program are reflected as expenses and are reimbursed by the City.

The following information provides a summary of the operations of the Stormwater Program for the years ended December 31, 2005 and 2004:

	<u>December 31, 2005</u>	<u>December 31, 2004</u>
Operating Revenue	\$ 2,938,366	2,746,327
Operating Expenses	<u>2,730,033</u>	<u>3,097,367</u>
Revenues over (under) Expenses	<u>\$ 208,333</u>	<u>\$ (351,040)</u>

As defined in City Ordinance No. 75686, the Stormwater Program is not considered a part of the System and as such, revenues generated by the Stormwater Program are used to pay expenses of the Stormwater Program but are not available for debt service of the System or for transfer to the City of San Antonio.

NOTES TO FINANCIAL STATEMENTS

NOTE L - PENSION AND RETIREMENT PLANS

The System's retirement program includes benefits provided by the Texas Municipal Retirement System, the San Antonio Water System Retirement Plan, the San Antonio Water System Deferred Compensation Plan, and Social Security.

Covered employees are eligible to retire upon attaining the normal retirement age of 65. An employee may elect early retirement, with reduced benefits, upon attainment of,

1. 20 Years of credited service regardless of age, or
2. 5 years of credited service and at least age 60.

The normal retirement benefit is based upon two factors, average compensation and years of credited service. Average Compensation is defined as the monthly average of total compensation received for the three consecutive years ending December 31, out of the last ten compensation years prior to normal retirement date which gives the highest average. The normal retirement benefit under the Principal contract is equal to the following:

1. 1.2% of the Average Compensation, times years of credited service not in excess of 25 years, plus
2. 0.75% of the Average Compensation, times years of credited service in excess of 25 years but not in excess of 35 years, plus
3. 0.375% of the Average Compensation, times years of credited service in excess of 35 years.

Upon retirement, an employee must select from one of seven alternative payment plans. Each payment plan provides for monthly payments as long as the retired employee lives. The options available address how plan benefits are to be distributed to the designated beneficiary of the retired employee. The program also provides death and disability benefits. The following information related to the Texas Municipal Retirement System was prepared as of December 31, 2004, while the information related to the San Antonio Water Systems Retirement Plan has been prepared as of January 1, 2005.

Texas Municipal Retirement System

The Texas Municipal Retirement System (TMRS) was established in 1948 as a retirement and disability pension system for municipal employees in the State of Texas. It is administered in accordance with the Texas Municipal Retirement System Act (the Act), Subtitle G of Title 110B, Revised Civil Statutes of Texas, 1925 as amended, and is governed by a Board of Directors appointed by the Governor of Texas in accordance with the Act. TMRS issues a publicly available financial report that includes financial information related to participating municipalities.

The report may be obtained by writing to:

TMRS, P.O. Box 149153, Austin, Texas 78714-9153 or calling (512) 476-7577.

NOTES TO FINANCIAL STATEMENTS

Plan Description: The System provides pension benefits for all of its full-time employees through a nontraditional, joint contributory, defined benefit plan in the state-wide Texas Municipal Retirement System (TMRS), one of 794 administered by TMRS, an agent multiple-employer public employee retirement system.

Benefits depend upon the sum of the employee's contributions to the plan, with interest, and the System financed monetary credits, with interest. At the date the plan began, the System granted monetary credits for service rendered before the plan began of a theoretical amount equal to two times what would have been contributed by the employee, with interest, prior to the establishment of the plan. Monetary credits for service since the plan began are a percentage (100%, 150%, 200%) of the employee's accumulated contributions. In addition, the System can grant as often as annually another type of monetary credit referred to as an updated service credit which is a theoretical amount that when added to the employee's accumulated contributions and the monetary credits for service since the plan began, would be the total monetary credits and employee contributions accumulated with interest if the current employee contribution rate and System matching percent had always been in existence and if the employee's salary had always been the average of his salary in the last three years that are one year before the effective date. At retirement, the benefit is calculated as if the sum of the employee's accumulated contributions with interest and the employer-financed monetary credits with interest were used to purchase an annuity.

Members can retire at ages 60 and above with 5 or more years of service or with 20 years of service regardless of age. A member is vested after 5 years. The plan provisions are adopted by the System within the options available in the state statutes governing TMRS and within the actuarial constraints also in the statutes.

Contributions: The contribution rate for the employees is 3% of salary. The System's matching percent ratio is currently 1 to 1, as adopted by the System. Under the state law governing TMRS, the actuary annually determines the System contribution rate. This rate consists of the normal cost contribution rate and the prior service cost contribution rate, both of which are calculated to be a level percent of payroll from year to year.

The normal cost contribution rate finances the currently accruing monetary credits due to the System matching percent, which are the obligation of the System as of an employee's retirement date, not at the time the employee's contributions are made. The normal cost contribution rate is the actuarially determined percent of payroll necessary to satisfy the obligation of the System to each employee at the time his/her retirement becomes effective. The prior service contribution rate amortizes the unfunded (overfunded) actuarial liability (asset) over the remainder of the plan's 25-year amortization period.

The unit credit actuarial cost method is used for determining the System contribution rate. Both the employees and the System make contributions monthly. Since the System needs to know its contribution rate in advance for

NOTES TO FINANCIAL STATEMENTS

budgetary purposes, there is a one-year delay between the actuarial valuation that is the basis of the rate and the calendar year when the rate goes into effect (i.e. December 31, 2004, valuation is effective for rates beginning January 2005).

Texas Municipal Retirement System				
Calculation of Net Pension Obligation (NPO)				
Year	Annual Required Contribution (ARC)	Annual Pension Cost (APC)	Percentage of APC Contributed	NPO Balance
2003	\$ 1,904,671	\$ 1,904,671	100%	\$ -
2004	\$ 2,012,732	\$ 2,012,732	100%	\$ -
2005	\$ 2,100,567	\$ 2,100,567	100%	\$ -

Texas Municipal Retirement System			
Schedule of Contributions			
	<u>2005</u>	<u>2004</u>	<u>2003</u>
Employer Contribution	\$ 2,100,567	\$ 2,012,732	\$ 1,904,671
Employee Contribution	\$ 1,916,701	\$ 1,829,799	\$ 1,736,196
Employer Contribution Rate	3.31%	3.30%	3.29%

Required Three - Year Trend Information:

The Schedules of Funding Progress for the last three fiscal years as required under GASB Statement No. 27 are located in the "Required Supplementary Information" section of this report. The Schedules are designed to provide information about the System's progress in accumulating sufficient assets to pay benefits due. A summary of the actuarial assumptions utilized in preparing these schedules is as follows:

NOTES TO FINANCIAL STATEMENTS

Texas Municipal Retirement System	
<u>Actuarial Assumptions</u>	
Actuarial Cost Method	Unit Credit
Amortization Method	Level Percent of Payroll
Remaining Amortization	25 Years - Open Period
Asset Valuation Method	Amortized Cost
Investment Rate of Return	7%
Projected Salary Increases	None
Includes Inflation At	None
Cost of Living Adjustments	None

San Antonio Water System Retirement Plan

Plan Description: The San Antonio Water System Retirement Plan is a single-employer defined benefit pension plan controlled by the provisions of Ordinance No. 75686, which serves as a supplement to the TMRS and Social Security benefits. The plan is governed by the System which may amend plan provisions and which is responsible for the management of plan assets. The System has delegated the authority to manage certain plan assets to Principal Life Insurance Company. The System's covered payroll for employees at January 1, 2005, under this contract was \$59,475,734 .

The System provides supplemental pension benefits for all persons customarily employed at least 20 hours per week and five months per year through this defined benefit pension plan. Employees are eligible to participate in the plan on January 1 of the calendar year following date of hire. The plan allows an employee to accrue vesting benefits as follows:

Principal Life Insurance	
<u>Years of Service</u>	<u>Vested Percentage</u>
Less than 5	0%
5 or More	100%

An employee is automatically 100% vested upon attainment of age 65 or upon becoming totally and permanently disabled. Benefits for retired employees are fully guaranteed at retirement. The pension plan's unallocated insurance contracts are valued at contract value. Contract value represents contributions made under the contract, plus interest at the contract rate, less funds used to purchase annuities or pay administrative expenses charged by

NOTES TO FINANCIAL STATEMENTS

Principal Life Insurance Company. Funds under the contract that have been allocated and applied to purchase annuities are excluded from the pension plan’s assets. The pension plan’s unallocated separate accounts are valued at fair value.

Actuarially Determined Contribution Requirements and Contributions Made: The plan's funding policy provides for actuarially determined periodic contributions so that sufficient assets will be available to pay benefits when due. The actuarial cost method is known as the Entry Age Normal-Frozen Initial Liability Method. This method estimates the total cost of the projected pension benefits for each employee evenly from the date the employee is first eligible for the plan to the employee's assumed retirement age. As plan benefits are related to compensation, the cost is spread as a level percentage of compensation. The total of annual amounts for all employees combined is called the Normal Cost. The employee’s Entry Age is determined as if the plan had always been in existence. As of the plan effective date, there are some accumulated Normal Costs for past years that have not been paid. The value of these costs is called the Frozen Initial Liability.

In subsequent years the Frozen Initial Liability is reduced by employer deposits to the plan in excess of employer Normal Cost and interest requirements. This reduced amount is known as the Unfunded Frozen Initial Liability. Contribution requirements are established and may be amended by the System. Active members are not required to contribute to the plan. Any obligation with respect to the pension plan shall be paid by the System. The actuarial valuation which was performed for the plan year ended December 31, 2004, reflects an unfunded frozen initial liability of \$10,592,377.

San Antonio Water System Retirement Plan Calculation of Net Pension Obligation (NPO)				
Plan Year	Annual Required Contribution (ARC)	Annual Pension Cost (APC)	Percentage of APC Contributed	NPO Balance
2003	\$ 3,323,862	\$ 3,323,862	100%	\$ -
2004	\$ 3,485,618	\$ 3,485,618	100%	\$ -
2005	\$ 3,689,167	\$ 3,689,167	100%	\$ -

If the Normal Cost or Unfunded Frozen Initial Liability becomes negative through the normal operation of the plan, the Unfunded Frozen Initial Liability will be reestablished using the Entry Age Normal method. If the reestablishment would result in a negative Normal Cost or Unfunded Frozen Initial Liability, the method will be changed to the aggregate method. If the actuarial value of assets exceeds the total present value of benefits, the

NOTES TO FINANCIAL STATEMENTS

Aggregate Normal Cost will be zero. Then the Frozen Initial Liability will be reestablished when a positive Entry Age Normal un-funded liability results from a change in assumptions or a plan amendment. A summary of the actuarial assumptions utilized in determining the System’s contribution requirements is as follows:

San Antonio Water System Retirement Plan	
<u>Actuarial Assumptions</u>	
Actuarial Cost Method	Entry Age Normal - Frozen Initial Liability Period
Amortization Method	Level Dollar
Remaining Amortization Period	35 Years - Closed Period
Asset Valuation Method	Amortized Cost
Investment Rate of Return	8.25%
Inflation Rate	None
Salary Scale	Table S-5 from the Actuary's Pension Handbook plus 3.4%
Cost of Living Adjustments	None
Wage base increase	4% each year until retirement
Post Employment Benefits	None

Required Three -Year Trend Information: The Schedule of Funding Progress for the last three fiscal years are required under GASB Statement No. 27 and are located in the “Required Supplementary Information” section of this report. The Schedules are designed to provide information about the System’s progress in accumulating sufficient assets to pay benefits due.

The Pension Fund issues a publicly available financial report that includes financial statements and required supplemental information. That report may be obtained by writing to: Principal Life Insurance Company, Pension Diversified Retirement Services, Des Moines, Iowa 50392-0001 or by calling (515) 247-5111.

San Antonio Water System Deferred Compensation Plan: The System has a deferred compensation plan for its employees, created in accordance with Internal Revenue Code Section 457. The plan, available to all regular employees, permits them to defer a portion of their salary until future years. The compensation deferred under this plan is not available to employees until termination, retirement, death, or qualifying unforeseeable emergency. Participation in the plan is voluntary, and the System does not make any contributions. The System has no liability for losses under the plan but does have the usual fiduciary responsibilities of a plan sponsor.

NOTES TO FINANCIAL STATEMENTS

NOTE M - OTHER POST EMPLOYMENT BENEFITS

In addition to providing retirement benefits described in Note L, the System provides certain health care and life insurance benefits for retired employees. Substantially all full-time employees who retire from the System may become eligible for those benefits. On December 31, 2005, there were 488 retirees with life insurance and 465 retirees with medical coverage.

The System provides medical and life insurance for retirees and recognizes the cost of providing these benefits on a pay-as-you-go basis by expensing the annual insurance. Premiums for medical and life insurance for retirees amounted to \$4,735,407 and \$92,072 respectively for January 1, 2005, through December 31, 2005. Medical benefits are provided to retiree and active employees through a self-insured health plan administered by Blue Cross Blue Shield of Texas. Other similar benefits for active employees are provided through insurance companies.

NOTE N – SPECIAL ITEMS

During 2005 and 2004, the System recorded special items as shown in the table below.

	<u>2005</u>	<u>2004</u>
ERP Project Writeoff	(7,858,742)	\$ -
Main Office Sale	6,263,175	-
Buttercrust/Playland	(1,988,597)	-
Inventory write-off	-	(811,289)
Applewhite sale	-	(12,195,231)
La Semana sale	-	<u>3,220,400</u>
	<u>\$ (3,584,164)</u>	<u>\$ (9,786,120)</u>

During 2005, the System wrote off \$7.8 million of previously incurred capital costs related to an Enterprise Resource Planning (ERP) system. The System discontinued the ERP Project which consisted of implementing an enterprise wide software system, during fiscal year 2004. A new project was started during 2005 for the selection of an integrated software system. The new system will integrate data processing for customer service, financial, human resources, payroll, and work order applications. During 2005, it was determined that the amounts previously expended would not be able to be utilized in connection with the current project to implement an integrated software system and were written off.

The System purchased property known as Buttercrust/Playland for the construction of a corporate headquarter facility during 2003. The opportunity to purchase another building which resulted in a cost savings to the System and its ratepayers presented itself during 2005. As such, the System discontinued plans to renovate the

NOTES TO FINANCIAL STATEMENTS

Buttercrust/Playland property. The appraisal of the property and the subsequent sale of the Buttercrust property resulted in a loss of \$1.9 million in 2005. The Playland property remains on the System's records at its adjusted value as land held for resale.

The move to the new corporate headquarters in late 2005 resulted in the sale of the previous "main office" to the City of San Antonio. This transaction resulted in a gain in the amount of \$6.3 million.

In 2004 during the annual inventory count, \$881,289 of inventory was written off. This included \$466,950 of obsolete inventory and \$344,339 due to inventory shrinkage. In 2004 the System reached an agreement with the City of San Antonio for property exchanges. Land known as the Applewhite property that had a historical cost of \$14,244,842 was exchanged for easements and other consideration in the amount of \$2,049,611. The exchange resulted in a loss to the System in the amount of \$12,195,231. Also in 2004, land known as the La Semana property was exchanged for water rights and other consideration and resulted in a gain of \$3,220,400. The net effect to gain and loss for the inventory write-off and the property exchange resulted in a loss to the System of \$9,786,120.

NOTE O – RESTATED EQUITY

Capitalized interest is calculated and recorded into a "pool" account by Bond Issue and Commercial Paper Outstanding. The calculation is based on the net difference between interest expense and interest income and is applied to a CIP job as it is closed to capital assets. In prior years, the calculation was based on the original bond issue amount and not the remaining funds available for CIP expenditures. This caused a larger "pool" balance that needed to be applied to remaining construction. During 2005, an analysis was performed to bring the capitalized interest balance to a reasonable level based on remaining construction. This analysis indicates that a significant portion of the over capitalization of interest relates to periods prior to 2004. An entry was recorded in the amount of \$9,776,829 to reverse prior period capitalized interest expense based on the analysis.

Balance, December 31, 2003 as previously reported	\$ 1,063,252,749
Reversal of capitalized interest	<u>(9,776,829)</u>
Balance, December 31, 2003 as restated	<u><u>\$ 1,053,475,920</u></u>

NOTE P– NEW ACCOUNTING PRONOUNCEMENTS

In May 2004, GASB issued Statement No. 44, "*Economic Condition Reporting: The Statistical Section – an Amendment of NCGA Statement 1*". This Statement is effective for the System beginning in the year ending December 31, 2006.

NOTES TO FINANCIAL STATEMENTS

In June 2004, GASB issued Statement No. 45, *“Accounting and Financial Reporting by Employers for Post Employment Benefits Other Than Pension”*. This Statement is effective for the System beginning in the year ending December 31, 2007.

In December 2004, GASB issued Statement No. 46, *Net Assets Restricted by Enabling Legislation – an Amendment of GASB Statement No. 34*. This Statement is effective for the System beginning in the year ending December 31, 2006.

In June 2005, GASB issued Statement No. 47, *Accounting for Terminated Benefits*. This Statement is effective for the System beginning in the year ending December 31, 2006 or 2007, depending on the nature of the benefits (if any) that will be subject to this pronouncement.

Management has not yet determined the impact of these statements on the basic financial statements.

San Antonio Water System
REQUIRED SUPPLEMENTARY INFORMATION – (Unaudited)
Pension and Retirement Plans
Schedules of Funding Progress - Last Three Fiscal Years

Historical trend information about the plans is presented herewith as required supplementary information. It is intended to help users assess the plans' funding status on an on-going basis, assess progress made in accumulating assets to pay benefits when due, and make comparisons with other utility retirement systems.

San Antonio Water System Texas Municipal Retirement System Schedule of Actuarial Liabilities and Funding Progress			
Actuarial Valuation Date	12/31/2004	12/31/2003	12/31/2002
Actuarial Value of Assets	\$ 52,985,324	\$ 48,964,377	\$ 46,492,000
Actuarial Accrued Liability	\$ 66,465,564	\$ 61,425,263	\$ 57,634,557
Percentage Funded	79.7%	79.7%	80.7%
Unfunded (Overfunded) Accrued Liability (UAAL)	\$ 13,480,240	\$ 12,460,886	\$ 11,142,557
Annual Covered Payroll	\$ 60,588,012	\$ 57,596,176	\$ 51,888,680
UAAL as a Percentage of covered Payroll	22.2%	21.6%	21.5%

San Antonio Water System Pension Plan Administered by Principal Life Insurance Schedule of Actuarial Liabilities and Funding Progress			
Actuarial Valuation Date	1/1/2005	1/1/2004	1/1/2003
Actuarial Value of Assets	\$ 52,411,873	\$ 47,249,214	\$ 42,827,430
Actuarial Accrued Liability	\$ 63,064,456	\$ 57,241,389	\$ 52,602,146
Percentage Funded	83.0%	83.0%	81.0%
Unfunded (Overfunded) Accrued Liability (UAAL)	\$ 10,652,583	\$ 9,992,175	\$ 9,774,716
Annual Covered Payroll	\$ 59,475,734	\$ 56,931,548	\$ 55,364,166
UAAL as a Percentage of covered Payroll	18.0%	18.0%	18.0%