

Des Moines Water Works

Financial Report

12.31.2004

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McGladrey & Pullen

Certified Public Accountants

Independent Auditor's Report

Board of Water Works Trustees
Des Moines Water Works
Des Moines, Iowa

We have audited the accompanying basic financial statements of Des Moines Water Works (Water Works) as of and for the year ended December 31, 2004, as listed in the table of contents. These financial statements are the responsibility of the Des Moines Water Works' management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America, *Government Auditing Standards* issued by the Comptroller General of the United States and Chapter 11 of the Code of Iowa. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Des Moines Water Works as of December 31, 2004 and the changes in its financial position and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

In accordance with *Government Auditing Standards*, we have also issued our report dated March 25, 2005, on our consideration of Water Work's internal control over financial reporting and our tests of compliance with certain provisions of laws, regulations, contracts and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of our audit.

The management's discussion and analysis on pages 2 through 7 and pension plan schedule on pages 24 and 25 is not a required part of the basic financial statements but are supplementary information required by accounting principles generally accepted in the United States of America. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the supplementary information. However, we did not audit the information and express no opinion on it.

McGladrey & Pullen, LLP

Davenport, Iowa
March 25, 2005

Des Moines Water Works

Management Discussion and Analysis Year Ended December 31, 2004

Our Management Discussion and Analysis (MD&A) of Des Moines Water Works' (Water Works) financial performance provides an overview of the utility's financial activities for the years ended December 31, 2004 and 2003. Please consider this information in conjunction with the financial statements and the accompanying notes to the basic financial statements that follow this section.

Overview of Business

The service area of the Water Works has expanded significantly since its emergence as a public water utility in 1919. In addition to serving customers within the City of Des Moines, Water Works provides wholesale water service based on long-term water contracts to surrounding municipalities and rural water districts, accounting for roughly 25% of total water revenues. This service area spans approximately 400 square miles, including most of Polk County and communities in eastern Dallas County and northern Warren County. The utility also provides billing and collection services on a contractual basis to wholesale customers and billing and collection services to the City of Des Moines for wastewater treatment, solid waste collection and the storm water utility.

As the utility's service area has expanded, so too has the need for water storage facilities, booster stations and additional treatment capacity to meet peak demand requirements. The most economical approach for the Water Works has involved utilizing these facilities to supply multiple customers. Contractual service users share in the cost of these joint-use facilities, which allows for meeting peak use demands and also allows some users to participate in lower off-peak or purchased capacity water rates. Financial participation in the construction of these facilities includes initial cash contributions or payments of debt service for the improvements and operating and maintenance costs. Ownership of these facilities is maintained by the Water Works.

The water sources for the system are the Raccoon River and Des Moines River, an underground infiltration gallery, and wells along the Raccoon River near Maffitt Reservoir. These four sources are used to provide adequate supply in the most cost-effective combination. The utility operates two treatment plants, with one of those plants being operated remotely. An additional treatment plant is currently being developed in the northern segment of the utility's service area to meet growing demand in that area.

Governance of the Water Works is vested in a five-member Board appointed by the Mayor of Des Moines with approval of the City Council. Trustees serve for six-year staggered terms. The Board has complete control of Water Works' management, and employs approximately 215 full-time and 15 part-time or seasonal employees.

The utility has adopted an annual activity-based budgeting methodology and performs an annual Cost of Service study to assist the Board in rate-setting policy.

Financial Highlights

- Water Works' net assets increased as a result of operations. As of December 31, 2004 and 2003, total assets were \$216,076,105 and \$210,651,439 respectively; total liabilities were \$50,601,691 and \$46,309,139, respectively, resulting in net assets of \$165,474,414 and \$164,342,300, respectively.
- Operating revenues of \$33,836,413 remained flat from 2003, while operating expenses increased approximately 17% to \$31,327,586.
- During the year, Water Works had operating income of \$2,508,827 and net earnings of \$1,132,114. This compares to operating income of \$7,105,894 and net earnings of \$6,608,750 reported in 2003.

Des Moines Water Works

Management Discussion and Analysis Year Ended December 31, 2004

Overview of the Financial Statements

Management's Discussion and Analysis (MD&A) serves as an introduction to the financial statements, and the MD&A represents management's examination and analysis of the Water Work's financial condition and performance. The financial statements report information about the utility using full accrual accounting methods as utilized by similar entities in the private sector.

The balance sheets provide information about the Water Works' assets, liabilities, and net assets, thereby measuring the Water Works' liquidity and solvency. Liquidity is a measure of the utility's ability to meet current obligations (those due within one year). Solvency is a similar concept, but measures the ongoing ability to meet obligations over a longer term.

The statement of revenues, expenses and changes in net assets present the results of the Water Works' revenues and expenses over the course of the fiscal year and provide information about the utility's recovery of costs. Water rates are established by the Board of Trustees and are based on the utility's annual Cost of Service Study. The Cost of Service Study estimates annual revenue requirements through an analysis of operational and maintenance expenses, debt service requirements, anticipated capital needs, and return on capital. The study provides a core of information not only for the trustees and staff at Des Moines Water Works, but also for the customers ultimately affected by our decisions.

The statement of cash flows presents cash receipts, cash disbursements, and net changes in cash resulting from operations, noncapital financing activities, capital and relating financing activities and investing activities. This statement details where cash resources come from and how they are used.

The notes to the basic financial statements provide required disclosures and other information that are essential to a full understanding of data provided in the statements. The notes supplement the basic financial statements by presenting information about the Water Works' accounting policies, significant account balances and activities, material risks, obligations, commitments, and contingencies.

Condensed Financial Information

The following condensed financial information serves as the key financial data and indicators for management, monitoring, and planning. Water Works adopted Governmental Accounting Standards Board Statement No. 34 effective January 1, 2003.

Des Moines Water Works

Management Discussion and Analysis Year Ended December 31, 2004

Condensed Balance Sheet Information

	2004	2003	% Change
Current assets	\$ 6,657,593	\$ 7,967,172	(16.44)%
Capital assets, net	195,002,073	192,731,149	1.18
Other noncurrent assets	14,416,439	9,953,118	44.84
Total assets	216,076,105	210,651,439	2.58
Current liabilities	12,438,321	11,137,324	11.68
Other noncurrent liabilities	6,375,370	6,428,815	(0.83)
Long-term debt	31,788,000	28,743,000	10.59
Total liabilities	50,601,691	46,309,139	9.27
Invested in capital assets, net of related debt	159,149,800	160,197,149	(0.65)
Restricted	11,087,959	5,378,900	106.14
Unrestricted	(4,763,345)	(1,233,749)	286.09
Total net assets	\$ 165,474,414	\$ 164,342,300	0.69

Condensed Revenues, Expenses and Changes in Net Assets

	2004	2003	% Change
Sale of water	\$ 28,311,841	\$ 29,610,730	(4.39)%
Billing and collection services	828,280	846,166	(2.11)
Connection fees	1,600,449	1,291,583	23.91
Purchased capacity	609,672	515,948	18.17
Other sales and services	2,486,171	1,602,070	55.18
Total operating revenues	33,836,413	33,866,497	(0.09)
Investment income	130,551	115,717	12.82
Grant proceeds	-	470,922	(100.00)
Other, net	223,090	204,120	9.29
Capital contributions	103,440	247,048	(58.13)
Total revenues	34,293,494	34,904,304	(1.75)
Labor and benefits	12,489,111	11,012,888	13.40
Chemicals and power	3,469,381	3,505,001	(1.02)
Insurance	886,855	863,735	2.68
Purchased services	3,283,872	2,402,655	36.68
Materials and supplies	2,937,966	2,585,990	13.61
Depreciation	8,024,984	6,273,042	27.93
Other	235,417	117,293	100.71
Total operating expenses	31,327,586	26,760,604	17.07
Interest expense	1,833,794	1,534,950	19.47
Total expenses	33,161,380	28,295,554	17.20
Change in net assets	1,132,114	6,608,750	(82.87)
Net assets, beginning of year	164,342,300	157,733,550	4.19
Net assets, end of year	\$ 165,474,414	\$ 164,342,300	0.69

Des Moines Water Works

Management Discussion and Analysis Year Ended December 31, 2004

Financial Analysis

Current assets decreased 16.44% due largely to lower interest-bearing cash balances at year-end compared to 2003. This decrease is due largely to the timing of investment activity, and is partially offset by increased investment balances in other noncurrent assets. In addition to the timing of investment activities, other noncurrent assets increased approximately 45% as a result of issuing \$6,930,000 Water Revenue Bonds, Series 2004 A.

Current liabilities increased 12% due primarily to an increase of \$643,000 in construction payables for water system improvements and relocating water mains for a freeway expansion project.

Noncurrent liabilities includes deferred revenue being amortized over a period of 10 to 20 years. These balances decreased 8.6% from 2003 due to continued amortization of these balances to purchase capacity revenue. Noncurrent liabilities includes the pension liability which will be paid through future pension contributions.

Long-term debt increased 10.59% in 2004 due primarily to the issuance of Water Revenue Bonds Series 2004 A totaling \$6,930,000. This increase is partially offset by principal payments made during 2004 totaling \$3,787,000, and the reclassification of scheduled 2005 debt service payments to short term, resulting in a net increase in long term debt of \$3,045,000.

Water sales decreased 4.39% as a result of slightly lower water pumpage compared to 2003, due to unseasonably wet conditions throughout the summer months of 2004.

Connection fees increased 23.91% due to connection fees of approximately \$1,600,000 received from the City of Polk City to connect to new feeder main serving customers in that area.

Purchase capacity revenues increased 18.17% as a result of the continued amortization of deferred revenue. This deferred revenue represents previous years' cash contributions from wholesale customers to fund the Maffitt Water Treatment Plant. Financial participation in the construction of the plant allows users to participate in lower off-peak or purchased capacity water rates. Deferred revenue balances are amortized to purchase capacity revenue over the length of the contract, generally 10 to 20 years.

Effective January 5, 2004, per 28E agreement with the City of Des Moines, Des Moines Water Works assumed management of operations of the Des Moines Botanical Center. Operations include room rentals, catering and café, gift shop, and special events. Other sales and services increased 55.18% due largely to the inclusion of Botanical Center revenues of \$476,000 in Water Works' financial results.

Labor and benefits increased 13.4% as a result of the following factors: 1) one additional pay period in 2004 (27 pay periods compared to the typical 26 bi-weekly pay periods, 2) rate increases averaging 5.23% across the utility, 3) less labor dedicated to capital projects in 2004, resulting in a shift from capital to operating labor, and 4) the addition of approximately 7 FTEs, largely the consequence of absorbing Botanical Center operations. The costs for additional labor were supported by additional revenue streams as indicated above.

Purchased services increased 36.68% as a result of the utility's new customer relationship management system (CRM) being placed into service in February 2004. In recent years, Water Works has contracted with outside consultants to develop the software, and during the development phase of the project, those contractor expenses were capitalized. After implementation in February 2004, consultants were still utilized during a transitional period through year-end; however, those costs were not eligible for capitalization, causing operating expenses to increase.

Des Moines Water Works

Management Discussion and Analysis Year Ended December 31, 2004

Materials and supplies increased 13.61% as a result of \$345,000 materials purchased in relation to the Botanical Center. Des Moines Water Works did not operate the Center in 2003, and consequently did not incur those expenses in the previous year. These additional costs were supported by additional revenue streams.

Des Moines Water Works implemented a new customer relationship management system (CRM) in February 2005. This system was developed by Water Works at an approximate cost of \$7.7 million, and is being depreciated over a 3-year life, causing depreciation expense to increase 27.93%.

Other expenses increased 100.71% due to an increase of approximately \$146,000 in loss on bad accounts. During 2004, the utility implemented a more aggressive write-off methodology, generally caused by a growing number of properties recognized by the County as nonlienable.

Investment income increased 12.82% due to slightly higher investment returns, coupled with higher investment balances as a result of bond proceeds received. Interest expense increased in 2004 primarily due to the refunding of the Water Revenue Bonds Series 1997. Existing deferred bond expenses and discount balances for Series 1997 were expensed upon the refunding and issuance of Water Revenue Bonds Series 2004. This increase in 2004 will be offset by decreased interest expense over the life of the new bonds.

In 2003, Des Moines Water Works received a grant of \$400,000 from the Iowa Department of Transportation for the beautification of Fleur Drive. In 2004, the project was funded by private contributions, and no such grant proceeds were received in 2004.

Capital contributions decreased 58.13% in 2004. All capital contributions in 2004 are related to contributions of water mains by subdividers. These contributions can fluctuate widely from year to year, depending on the status of construction and the timing of inspections performed by Water Works staff.

The aforementioned fluctuations result in an overall increase in net assets of .69%, the result of .09% decrease in operating revenues, an increase in operating expenses of 17.07%, and 98.89% decrease in nonoperating revenues.

Capital Assets and Debt Administration

During 2004, net capital assets increased \$2,270,924 or 1.2%. In addition to replacing deteriorating water mains, the utility is responsible for relocating mains affected by the I-235 freeway expansion project. In addition, the utility is engaged in a multi-year capital project to implement radio frequency meter reading for all customers within the City of Des Moines. There were no significant changes to the condition of infrastructure assets, nor were there any changes made to standard service lives of those assets.

Des Moines Water Works issued Water Revenue Bonds, Series 2004 A and Series 2004 B. Series 2004 A proceeds of \$6,930,000 will fund capital projects, including radio frequency, an aquifer storage and recovery (ASR) well, and the addition of a radial collector well at the Maffitt Treatment Plant. The Series 2004 B proceeds advance refunded Series 1997 bonds, and Series 2004 B proceeds were placed in escrow. Series 1997 bonds are callable on December 1, 2005. The Standard and Poor AA+ bond rating for the utility remains unchanged in 2004.

Des Moines Water Works

Management Discussion and Analysis Year Ended December 31, 2004

Economic Factors

Due to the Water Works large concentration of residential customers, weather impacts revenue to a greater degree than do economic cycles. Water Works budgets revenues and expenses based on anticipated consumption for a "normal" weather year. A water rate increase of 3% was budgeted for 2005 for two classes of customers. This was based on the results of the annual cost of service study which indicated costs to serve those customers exceeded their water rates.

Requests for Information

If the reader has questions or would like additional information, please direct the request to: Peggy Freese, Treasurer, 2201 George Flagg Parkway, Des Moines, Iowa 50321-1190.

Des Moines Water Works

Balance Sheet December 31, 2004

Assets

Current assets:	
Cash	\$ 314,576
Accounts receivable:	
Billed	3,462,075
Unbilled	997,863
Other receivables	66,517
Inventory - materials and supplies	915,248
Prepaid expenses	901,314
Total current assets	<u>6,657,593</u>
Restricted assets, cash	<u>172,392</u>
Restricted assets, investments (Notes 2 and 4):	
Water revenue bond reserve fund	10,315,567
Water revenue bond improvement fund	600,000
	<u>10,915,567</u>
Long-term investments:	
Investment in land	624,562
Board designated funds, investments (Note 2)	1,879,523
	<u>2,504,085</u>
Capital assets (Note 3):	
Land	4,835,402
Construction-in-progress	9,495,208
Buildings, equipment and machinery	114,937,413
Supply system	39,323,267
Distribution system	107,647,162
	<u>276,238,452</u>
Accumulated depreciation	<u>(81,236,379)</u>
Capital assets, net	<u>195,002,073</u>
Bond issue costs, discount and deferral	<u>345,727</u>
Other assets	<u>478,668</u>
Total assets	<u>\$ 216,076,105</u>

See Notes to Basic Financial Statements.

Liabilities and Net Assets

Current liabilities payable from current assets:	
Accounts payable	\$ 2,271,980
Accrued wages and benefits	1,358,487
Deferred revenue	612,335
Special deposits	114,992
Construction payables	3,490,159
Water revenue bonds interest payable	103,897
Current portion of long-term debt (Note 4)	4,410,000
Fees collected for other entities	76,471
Total current liabilities	<u>12,438,321</u>
Long-term debt, less current installments (Note 4)	31,788,000
Deferred revenue (Note 4)	5,816,480
Pension liability (Note 5)	558,890
	<u>38,163,370</u>
Total liabilities	<u>50,601,691</u>
Net assets:	
Invested in capital assets, net of related debt	159,149,800
Restricted (bond indentures)	11,087,959
Unrestricted	(4,763,345)
Total net assets	<u>165,474,414</u>
Commitments (Note 8)	
Total liabilities and net assets	<u>\$ 216,076,105</u>

Des Moines Water Works

Statement of Revenues, Expenses and Changes in Net Assets Year Ended December 31, 2004

Operating revenues:	
Water sales	\$ 28,921,511
Other sales and services	3,314,453
Connection fees	1,600,449
Total operating revenues	<u>33,836,413</u>
Operating expenses:	
Labor	9,880,043
Insurance	886,855
Group insurance	999,370
Pension benefits (including social security)	1,609,698
Purchased services	3,283,872
Materials, supplies and equipment	2,937,966
Chemicals	1,632,177
Utilities, net	1,837,204
Depreciation	8,022,334
Other	238,067
Total operating expenses	<u>31,327,586</u>
Operating income	<u>2,508,827</u>
Nonoperating revenue (expense):	
Investment income	130,551
Interest expense	(1,833,794)
Land use income	148,325
Gain on sale of capital assets	70,320
Other	4,445
Nonoperating revenue (expense), net	<u>(1,480,153)</u>
Income before contributions	1,028,674
Capital contributions	<u>103,440</u>
Change in net assets	1,132,114
Net assets, beginning of year	<u>164,342,300</u>
Net assets, end of year	<u>\$ 165,474,414</u>

See Notes to Basic Financial Statements.

Des Moines Water Works

Statement of Cash Flows Year Ended December 31, 2004

Cash Flows from Operating Activities:	
Cash received from customers	\$ 33,391,100
Cash paid to suppliers	(12,021,101)
Cash paid to employees and for payroll taxes	(9,924,695)
Net cash provided by operating activities	<u>11,445,304</u>
Cash Flows from Capital and Related Financing Activities:	
Principal payments on long-term debt	(22,124,484)
Proceeds from issuance of long-term debt, net of \$83,136 deferred items	25,136,864
Proceeds from sale of capital assets	75,684
Acquisition, construction and removal cost of capital assets	(9,551,815)
Interest paid	(1,849,810)
Net cash used in capital and related financing activities	<u>(8,313,561)</u>
Cash Flows from Investing Activities:	
Proceeds from maturities of investments	34,640,000
Purchase of investments	(40,441,814)
Interest received	54,056
Land use income and other	152,770
Net cash used in investing activities	<u>(5,594,988)</u>
Net decrease in cash	(2,463,245)
Cash, beginning of year	<u>2,950,213</u>
Cash, end of year	<u>\$ 486,968</u>
Reconciliation of cash to the balance sheet:	
Cash	\$ 314,576
Restricted assets, cash	172,392
Total cash at end of year	<u>\$ 486,968</u>

(Continued)

Des Moines Water Works

Statement of Cash Flows (Continued) Year Ended December 31, 2004

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

Operating income	\$ 2,508,827
Adjustments to reconcile operating income to net cash:	
Depreciation	8,022,334
Change in:	
Accounts receivable, billed	(460,497)
Accounts receivable, unbilled	36,285
Other receivables	188,050
Inventories - materials and supplies	133,714
Prepaid expense	(34,692)
Other assets	1,050,082
Accounts payable	918,125
Accrued wages and benefits and pension liability	(44,652)
Deferred revenue	(609,672)
Special deposits	4,668
Fees collected for other entities	(267,268)
Net cash provided by operating activities	<u><u>\$ 11,445,304</u></u>

Schedule of noncash capital and related financing:

Contributions of water mains from contractors in aid of construction	\$ 103,440
Acquisition of capital assets through construction payables	643,367

Schedule of noncash investing activities, net appreciation of the fair value of investments

76,495

See Notes to Basic Financial Statements.

Des Moines Water Works

Notes to Basic Financial Statements

Note 1. Nature of Business, Reporting Entity and Significant Accounting Policies

Nature of business:

Des Moines Water Works (Water Works) is managed and controlled by the Board of Water Works Trustees of the City of Des Moines, Iowa (the Board), which exists under the provisions of Chapter 388 and other relevant statutes of the Code of Iowa. The five-member Board is appointed by the Mayor of Des Moines with the approval of the City Council. Trustees serve for six-year staggered terms.

Water Works is exempt from federal income tax pursuant to Internal Revenue Code Section 115 which provides for exemption of divisions of state and local governments.

Water Works provides water and other services to retail and wholesale customers in the City of Des Moines (the City) and surrounding communities.

In September 1993, the Governmental Accounting Standards Board (GASB) issued Statement No. 20, *Accounting and Financial Reporting for Proprietary Funds and Other Governmental Entities that Use Proprietary Fund Accounting*. The statement provides that Water Works should apply all GASB pronouncements, as well as the following pronouncements issued on or before November 30, 1989, unless those pronouncements conflict with or contradict GASB pronouncements: Statements and Interpretations of the Financial Accounting Standards Board (FASB), Accounting Principles Board (APB) Opinions, and Accounting Research Bulletins (ARB) of the Committee on Accounting Procedures. In addition, Water Works may also apply all FASB Statements and Interpretations issued after November 30, 1989, except for those that conflict with or contradict GASB pronouncements. Water Works has elected to not apply all FASB, APB, and ARB materials issued after November 30, 1989.

Reporting entity:

Accounting principles generally accepted in the United States of America require that the reporting entity include (1) the primary government, (2) organizations for which the primary government is financially accountable and (3) other organizations for which the nature and significance of their relationship with the primary government are such that exclusion would cause the reporting entity's financial statements to be misleading or incomplete. The Water Works has authority to issue bonded debt without the approval of another government. It has the right to sue and be sued, and has the right to buy, sell, lease or mortgage property in its own name. Based on these criteria, the Water Works is considered a primary government and there are no other organizations or agencies whose financial statements should be combined and presented with these financial statements.

Significant accounting policies:

Basis of accounting and measurement focus: The economic measurement focus and the accrual basis of accounting are used by the Water Works. Under the accrual basis of accounting, revenue is recognized when earned and expenses are recognized when the liability has been incurred. Under this basis of accounting, all assets and all liabilities associated with the operation of the Water Works are included in the balance sheet.

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

Des Moines Water Works

Notes to Basic Financial Statements

Note 1. Nature of Business, Reporting Entity and Significant Accounting Policies (Continued)

Cash and investments: For the purpose of the statement of cash flows, Water Works considers cash balances maintained in demand deposit accounts at financial institutions to be cash. Excess cash invested temporarily in financial institutions is considered an investing activity and is not considered to be cash.

Investments as of December 31, 2004 were in U.S. government or agency obligations and are stated at fair value, based on quoted market prices.

Revenue recognition: Customers served by Water Works are billed on a monthly cyclical basis based on usage. Water Works accrues estimated unbilled water revenues for services rendered from the last billing date through year-end.

Operating revenues and expenses: Operating revenues include revenues resulting from the sale of water and related services. Operating expenses include expenses for water treatment, distribution, depreciation, customer accounts, customer service and informational, sales, and administrative and general. Nonoperating revenues and expenses include those derived from capital and related financing activities, noncapital financing activities, and investing activities. Revenues from the sale of water are based on billing rates, which are applied to customer's consumption of water.

Transactions with the City of Des Moines: Water Works provides water service to the City without charge except for the Sewage Treatment Works, Des Moines International Airport, and city golf courses. The value (computed at the commercial rate) of the service provided without charge was approximately \$706,040 and \$541,412 in 2004 and 2003, respectively.

Water Works has an agreement to pay the City a Payment in Lieu of Taxes (PILOT). This amount was calculated in 1998 by applying the City millage rate for police and fire to the value of buildings and land operated and controlled by Water Works located within the City at that time. Total PILOT payments were \$234,000 in 2004 and 2003.

Water Works has also agreed to match annual contributions of the City (up to \$50,000) toward an industrial development corporation. Payments of \$50,000 were made in 2004 and 2003.

Billings and Collection Agent Services: Water Works serves as the billing and collection agent for fees related to sewage treatment, solid waste, and storm water collection for certain political subdivisions (including the City). Separate accounting records are maintained by Water Works for these collection services. Fees collected not yet remitted by Water Works to the applicable entity totaled approximately \$76,471 and \$344,000 as of December 31, 2004 and 2003, respectively. These fees have been reflected in Water Works' balance sheet and were remitted to the City and other political subdivisions subsequent to year-end. Processing fees billed to the City and other political subdivisions for billing and collection services provided by Water Works totaled approximately \$828,000 and \$846,000 in 2004 and 2003, respectively. The City's fees reflect only the incremental expenses incurred by Water Works to bill and collect the City's charges, rather than an equal sharing of the costs. Water Works bears the total cost of meter reading, cash processing, and statement preparation and mailing.

Inventories: Inventories are stated at the lower of average cost or market. The costs of these materials and supplies are recorded as an expense at the time they are relieved from inventory for use.

Des Moines Water Works

Notes to Basic Financial Statements

Note 1. Nature of Business, Reporting Entity and Significant Accounting Policies (Continued)

Restricted assets – cash and investments: Water Works is required, under the water revenue bond resolutions, to reserve certain assets to provide for payment of the bonds and interest for protection of the bondholders, and for the improvement and extension of facilities. Disbursement of these assets is restricted by the purpose of the respective funds.

Capital assets: Capital assets are recorded at cost and depreciated utilizing the straight-line method over estimated useful lives as follows:

Buildings, equipment and machinery	3-85 years
Supply system	20-85 years
Distribution system	10-85 years

Expenditures for maintenance, repairs, and minor replacements are charged to operations. Expenditures for major repairs and betterments are capitalized. Water Works' capitalization threshold is \$500. When capital assets are retired or otherwise disposed, the cost and related accumulated depreciation are removed from the accounts and any resulting gains or losses are included in the statement of revenues, expenses and changes in net assets. Included in capital assets are the interest capitalized during construction in accordance with accounting principles generally accepted in the United States of America. No interest was capitalized in 2004.

Net assets: Net assets represent the difference between assets and liabilities in the financial statements. Net assets invested in capital assets, net of related debt, consists of capital assets, net of accumulated depreciation, reduced by the outstanding balance of any long-term debt used for acquisition, construction, or improvement of those assets. Net assets are reported as restricted when there are limitations imposed on their use through external restrictions imposed by creditors, grantors, or laws or regulations of other governments.

The Water Works' policy is to first apply restricted resources when an expense is incurred for purposes for which both restricted and unrestricted net assets are available.

Rates: The Board has full authority to establish rates. As part of the rate-setting process, Water Works performs an annual cost of service study to determine the cost of operations. This study is based on a standard water industry model. Based upon the study, rates are set to fund future operations. Costs related to operations and maintenance, depreciation based on estimated replacement cost of capital assets (which differs from depreciation expense recorded for financial reporting purposes), debt service, and return on capital are factored into the rate design as well as demand factors from various customer classes.

Deferred revenue: During 1996, Water Works entered into contractual agreements with other political subdivisions to sell treatment capacity to these entities. In subsequent years, Water Works has entered into contractual agreements with several of these same entities to sell additional capacity. In exchange for purchasing these amounts of capacity, the political subdivisions will be able to purchase water at a lower wholesale water rate. Purchasers were offered the option of cash payment or participating in a 1997 issue of water revenue bonds. Funds received are recorded as deferred revenue and are being amortized into income over periods of ten to twenty years.

Des Moines Water Works

Notes to Basic Financial Statements

Note 1. Nature of Business, Reporting Entity and Significant Accounting Policies (Continued)

Compensated absences: Vacation and personal leave are accrued as a liability as it is earned. Sick leave benefits do not vest; however, upon retirement an employee may receive pay for 90% of his or her accumulated sick leave up to a maximum of 810 hours. The maximum payable to employees who are eligible for retirement has been recorded as a liability.

Debt financing costs and discounts: Costs incurred to issue water revenue bonds and the Water Revenue Capital Loan note are capitalized. These costs, and the discounts on the water revenue bonds, are amortized over the terms of the bonds and note utilizing a method which approximates the effective interest method.

Note 2. Cash and Investments

Deposits in financial institutions as of December 31, 2004 and throughout the year are covered by federal depository insurance or the State Sinking Fund in accordance with Chapter 12C, Code of Iowa. This Chapter provides additional assessments against the depositories to ensure that there is no loss of public funds. Water Works' bank balances and book balances were \$919,419 and \$486,968 as of December 31, 2004, respectively.

Water Works classifies its investments into categories, which present an indication of the level of credit risk in relation to the nature of the investment and the custodial provisions. Category 1 securities are insured, registered, held by the Water Works or held by the Water Works' agent in the Water Works' name. Category 2 securities are uninsured and unregistered with securities held by the counterparty's trust department or agent in Water Works' name. Category 3 securities are uninsured and unregistered, with securities held by the counterparty, or by its trust department or agent but not in Water Works' name. The Water Works' investments are classified as follows as of December 31, 2004:

Investment	Category	
Water revenue bond reserve fund, U.S. Government Agency obligations	1	\$ 10,315,567
Water revenue bond improvement fund, U.S. Government Agency obligations	1	600,000
Board designated funds, U.S. Government Agency obligations	1	1,879,523

The Water Works also has investment in land purchased with the intent to sell; however, no commitment for sale exists as of December 31, 2004. The land is recorded at the lower of cost or market.

The Water Works' investments during the year did not vary substantially from those at year-end in amounts or level of risk.

Des Moines Water Works

Notes to Basic Financial Statements

Note 3. Capital Assets

Capital assets activity for the year ended December 31, 2004 is as follows:

	Beginning Balance	Increases	Decreases	Ending Balance
Capital assets not being depreciated:				
Land	\$ 4,143,463	\$ 697,303	\$ 5,364	\$ 4,835,402
Construction-in-process	18,413,826	9,517,856	18,436,474	9,495,208
Total capital assets not being depreciated	22,557,289	10,215,159	18,441,838	14,330,610
Capital assets being depreciated:				
Buildings, equipment and machinery	106,277,720	8,732,333	72,640	114,937,413
Supply system	39,323,267	-	-	39,323,267
Distribution system	97,859,558	9,787,604	-	107,647,162
Total capital assets being depreciated	243,460,545	18,519,937	72,640	261,907,842
Less accumulated depreciation for:				
Buildings, equipment and machinery	37,160,946	5,373,939	72,640	42,462,245
Supply system	9,259,509	715,719	-	9,975,228
Distribution system	26,866,230	1,932,676	-	28,798,906
Total accumulated depreciation	73,286,685	8,022,334	72,640	81,236,379
Total capital assets being depreciated, net	170,173,860	10,497,603	-	180,671,463
Net capital assets	\$ 192,731,149	\$ 20,712,762	\$ 18,441,838	\$ 195,002,073

Note 4. Noncurrent Liabilities

As of December 31, 2004, Water Works' debt consists of Revenue Refunding Bonds, Series 2001; Water Revenue Refunding Bonds, Series 2004 A & B; and Water Revenue Capital Loan Note, Series 2003 (through the Drinking Water State Revolving Fund (SRF)). Interest on these bonds and note is payable semiannually on June 1 and December 1, with principal payable on December 1. Series 2001 bonds mature on December 1, 2007 and Series 2004 Series A & B mature on December 1, 2024 and 2017, respectively. The Series 2003 note matures on December 1, 2022. The bonds and note are redeemable at the option of Water Works prior to their maturity in whole or, from time to time, in part, in any order of maturity and within a maturity by lot, at a price of par plus accrued interest to call date.

Des Moines Water Works

Notes to Basic Financial Statements

Note 4. Noncurrent Liabilities (Continued)

Changes in long-term obligations for the year ended December 31, 2004 are as follows:

	Beginning Balance	Additions	Reductions	Ending Balance	Amounts Due Within One Year
Water Revenue Bonds:					
Series 1997	\$ 18,355,000	\$ -	\$ 18,355,000	\$ -	\$ -
Series 2001	11,780,000	-	3,020,000	8,760,000	3,165,000
Series 2004 A & B	-	25,220,000	-	25,220,000	1,150,000
Water Revenue Capital,					
Series 2003	2,399,000	-	181,000	2,218,000	95,000
Compensated absences	863,242	956,941	863,242	956,941	956,941
	<u>\$ 33,397,242</u>	<u>\$ 26,176,941</u>	<u>\$ 22,419,242</u>	<u>\$ 37,154,941</u>	<u>\$ 5,366,941</u>

During 2004, the Water Works issued \$18,290,000 in Water Revenue Bonds Series 2004B with an average interest rate of 2.8 percent to advance refund \$17,680,000 of outstanding Water Revenue Bonds Series 1997 with an average interest rate of 4.6 percent. The net proceeds of \$18,253,484 were used to purchase U.S. government securities. Those securities were deposited in an irrevocable trust with an escrow agent to provide for all future debt service payments on the 1997 Series bonds. As a result, the Series 1997 bonds are considered to be defeased and the liability has been removed. The difference between the reacquisition price (funds required to refund the old debt) and the net carrying amount of the old debt resulted in a deferral of approximately \$573,000. The deferral is being amortized to expense in 2004 and 2005 using a method that approximates the effective interest method over the remaining life of the old debt. The advance refunding resulted in an economic gain (difference between the present values of the old and new debt service payments) of \$1,452,855.

A summary of the aggregate principal and interest requirements outstanding for the Water Revenue Refunding Bonds, Series 2001 is as follows:

Maturing During Year Ended December 31:	Interest Rate	Annual Principal Payment	Annual Interest Payment	Total Annual Payment
2005	3.15%	\$ 3,165,000	\$ 294,468	\$ 3,459,468
2006	3.40	3,325,000	194,770	3,519,770
2007	3.60	2,270,000	81,720	2,351,720
		<u>\$ 8,760,000</u>	<u>\$ 570,958</u>	<u>\$ 9,330,958</u>

Des Moines Water Works

Notes to Basic Financial Statements

Note 4. Noncurrent Liabilities (Continued)

A summary of the aggregate principal and interest requirements outstanding for the Water Revenue Refunding Bonds, Series 2004 A is as follows:

Maturing During Year Ended December 31:	Interest Rate	Annual Principal Payment	Annual Interest Payment	Total Annual Payment
2005	3.00%	\$ 250,000	\$ 260,681	\$ 510,681
2006	3.00	255,000	253,181	508,181
2007	3.00	260,000	245,531	505,531
2008	3.00	265,000	237,731	502,731
2009	3.00	275,000	229,781	504,781
2010-2014	3.25 - 4.00	1,515,000	1,008,431	2,523,431
2015-2019	4.00	1,830,000	695,044	2,525,044
2020-2024	4.00 - 4.25	2,280,000	299,756	2,579,756
		<u>\$ 6,930,000</u>	<u>\$ 3,230,136</u>	<u>\$ 10,160,136</u>

A summary of the aggregate principal and interest requirements outstanding for the Water Revenue Refunding Bonds, Series 2004 B is as follows:

Maturing During Year Ended December 31:	Interest Rate	Annual Principal Payment	Annual Interest Payment	Total Annual Payment
2005	2.50%	\$ 900,000	\$ 625,075	\$ 1,525,075
2006	2.50	920,000	602,575	1,522,575
2007	3.00	970,000	579,575	1,549,575
2008	3.00	1,380,000	550,475	1,930,475
2009	3.00	1,420,000	509,075	1,929,075
2010-2014	2.00 - 4.00	7,880,000	1,853,625	9,733,625
2015-2017	4.00	4,820,000	362,400	5,182,400
		<u>\$ 18,290,000</u>	<u>\$ 5,082,800</u>	<u>\$ 23,372,800</u>

Des Moines Water Works

Notes to Basic Financial Statements

Note 4. Noncurrent Liabilities (Continued)

A summary of the aggregate principal and interest requirements outstanding for the Water Revenue Capital Loan Note is as follows:

Maturing During Year Ended December 31:	Interest Rate	Annual Principal Payment	Annual Interest Payment	Total Annual Payment
2005	3.00%	\$ 95,000	\$ 66,540	\$ 161,540
2006	3.00	98,000	63,690	161,690
2007	3.00	100,000	60,750	160,750
2008	3.00	103,000	57,750	160,750
2009	3.00	107,000	54,660	161,660
2010-2014	3.00	583,000	223,320	806,320
2015-2019	3.00	675,000	130,500	805,500
2020-2022	3.00	457,000	27,690	484,690
		<u>\$ 2,218,000</u>	<u>\$ 684,900</u>	<u>\$ 2,902,900</u>

The water revenue bond and water revenue capital loan note resolutions (Resolutions) provide that net revenue (as defined in the Resolutions) of Water Works is pledged for the purpose of paying Series 2001, Series 2003 and Series 2004 bonds. The Resolutions further require that sufficient monies be set aside to meet current expenses of Water Works. All remaining monies are to be segregated and restricted in separate special reserves. These special reserves are reflected as restricted assets on the balance sheet. The Resolutions also require that the issuer maintain insurance coverage of a kind and in an amount which usually would be carried by private companies engaged in a similar kind of business. Water Works maintains fire and extended coverage insurance in the amount of \$217,085,279 per occurrence on building and contents; in addition, liability insurance is maintained.

Note 5. Pension Plan

Water Works has a noncontributory defined benefit single employer pension plan established by the Board, called the Des Moines Water Works Pension Plan (the Plan). All full-time Water Works employees and employees who work at least 1,040 hours in a calendar year or work during two consecutive calendar quarters are eligible to participate in the Plan. Benefits vest after five years of continuous service and normal retirement is allowed at or after age 65. Early retirement is allowed without a reduction in benefits beginning at age 55 if the employee's combined years of service and age are 85 or greater and is allowed with reduced benefits for vested employees with less than 30 years of service beginning at age 55. The pension benefit formula is based upon a percentage of coverage compensation and the number of years of service with Water Works, as defined by the Plan document. The amount of the contribution is determined by the Board. The Plan also provides death and disability benefits to vested employees. Benefits are established by the Plan administrator. The Plan issues a publicly available financial report that includes financial statements and required supplementary information. The report may be obtained by writing or calling to Water Works.

Des Moines Water Works

Notes to Basic Financial Statements

Note 5. Pension Plan (Continued)

Water Works' annual pension cost and net pension liability for the three years ended 2004 were as follows:

	2004	2003	2002
Annual required contribution (ARC)	\$ 896,193	\$ 931,470	\$ 735,168
Interest	36,084	22,134	2,015
Adjustment to annual required contribution	(54,822)	(32,283)	(2,939)
Annual pension cost (APC)	877,455	921,321	734,244
Contributions made	800,000	735,000	466,000
Increase in net pension liability	(77,455)	(186,321)	(268,244)
Net pension (liability) asset, beginning of year	(481,435)	(295,114)	(26,870)
Net pension liability, end of year	<u>\$ (558,890)</u>	<u>\$ (481,435)</u>	<u>\$ (295,114)</u>
Percentage of APC contributed	91.1%	79.8%	63.5%

The pension benefit liability was computed as part of the annual actuarial valuation performed as of January 1, 2004 using the aggregate actuarial cost method. The aggregate actuarial cost method does not identify or separately amortize unfunded actuarial liabilities. The actuarial assumptions used to compute the pension benefit liability included (a) 7.5% investment rate of return (net of administrative expenses) and (b) projected salary increases of 5.0%. These amounts were computed using the 1983 Group Annuity Mortality Table with a 3.0% cost of living factor increase included.

Statements of Plan Net Assets

December 31, 2004

Assets, investments, contracts with insurance companies, pooled separate accounts \$ 18,027,963

Liabilities

Net assets held in trust for pension benefits \$ 18,027,963

Des Moines Water Works

Notes to Basic Financial Statements

Note 5. Pension Plan (Continued)

Statements of Changes in Plan Net Assets Year Ended December 31, 2004

Additions:

Investment income, including net appreciation in fair value of investments, interest and dividends	\$ 3,611,599
Employer contributions	800,000
Total additions	<u>4,411,599</u>

Deductions:

Benefit payments	1,356,843
Administrative expenses	60,255
Total deductions	<u>1,417,098</u>

Change in allocated contracts	<u>862,789</u>
Net increase	3,857,290

Net assets held in trust for pension benefits:

Beginning of year	14,170,673
End of year	<u>\$ 18,027,963</u>

Note 6. Postretirement Health Care Benefits

Water Works provides certain postretirement health care benefits, in accordance with the policy established by the Board, to all employees who retire from Water Works after attaining age 55. As of December 31, 2004, 78 retirees receive postretirement healthcare benefits. Water Works provides a Medicare supplement or equivalent amount to all employees who retire after attaining age 55, if the sum of their age and years of service are at least 85, or for those who retire after attaining age 65 regardless of length of service. Employees who retire prior to attaining age 65 with the sum of their age and years of service less than 85 receive a discounted benefit as provided by the plan document. Water Works recognizes the cost of providing postretirement health care benefits by expensing the annual insurance premiums which were approximately \$88,024 and \$91,484 for 2004 and 2003, respectively.

Note 7. Risk Management

Water Works is exposed to various risks of loss related to torts, theft of, damage to and destruction of assets; errors and omissions, injuries to employees, natural disasters and malpractice.

Water Works purchases commercial insurance for property and casualty, workers' compensation, employee health, life and dental insurance. During the last three years, settled claims have not exceeded insurance coverage.

Des Moines Water Works

Notes to Basic Financial Statements

Note 8. Commitments

Approximately \$1,982,000 related to 2004 contracts has been formally committed as of December 31, 2004. In addition, the Board has approved approximately \$24,300,000 of expenditures for capital acquisitions and improvements, all of which are expected to be expended in 2005.

In 1983, Water Works determined additional water resources would be required for future customer needs. As a result, the Board has contracted with the United States of America – Army Corps of Engineers, through the state of Iowa, for water supply storage in the Saylorville Reservoir Project continuing through the life of the project. Under the contract, Water Works is required to pay a portion of future major renovation costs of the project. Water Works also pays a portion of the annual operation and maintenance costs of the project. Water Works' portion of operation and maintenance costs was approximately \$6,300 in 2004 and 2003.

On January 5, 2004, the Water Works and City of Des Moines, Iowa entered into a 28E Agreement for the operation, management and maintenance of the Botanical Center. The Water Works is responsible for the management and operation of the Botanical Center for the City. All revenues generated and expenses incurred for the operation are retained by Water Works. The agreement exists for an initial term of January 5, 2004 through December 31, 2009 and may renew on and after January 1, 2010 for not more than three successive three-year terms. Water Works and the City Council will meet jointly no later than July 1, 2007 to evaluate the agreement and determine if it will continue.

For December 31, 2004, revenues generated by the Botanical Center were approximately \$476,000 and expenses were approximately \$900,000.

Note 9. Pending GASB Statements

As of December 31, 2004, the Governmental Accounting Standards Board (GASB) also had issued several statements not yet implemented by the Water Works. The statements which might impact Water Works are as follows:

Statement No. 40, *Deposit and Investment Risk Disclosures*, issued March 2003, will be effective for Water Works beginning with its year ending December 31, 2005. This Statement establishes and modifies disclosure requirements related to investment risks related to credit risk, concentration of credit risk, interest rate risk and foreign currency risk. As an element of interest rate risk, this Statement requires certain disclosures of investments that have fair values that are highly sensitive to changes in interest rates. This Statement also establishes and modifies disclosure requirements for deposit risks.

Statement No. 42, *Accounting and Financial Reporting for Impairment of Capital Assets and for Insurance Recoveries*, issued November 2003, will be effective for Water Works beginning with its year ending December 31, 2006. This Statement requires governments to report the effects of capital asset impairment in their financial statements when it occurs and requires all governments to account for insurance recoveries in the same manner.

Statement No. 43, *Financial Reporting for Postemployment Benefit Plans Other Than Pension Plans*, issued April 2004, will be effective for Water Works beginning with its year ending December 31, 2008. This Statement establishes uniform financial reporting standards for other postemployment benefit plans (OPEB plans) and supercedes existing guidance.

Des Moines Water Works

Notes to Basic Financial Statements

Note 9. Pending GASB Statements (Continued)

Statement No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions*, issued June 2004, will be effective for Water Works beginning with its year ending December 31, 2009. This Statement establishes standards for the measurement, recognition and display of other postemployment benefits expenses and related liabilities or assets, note disclosures and, if applicable, required supplementary information in the financial reports.

Statement No. 46, *Net Assets Restricted by Enabling Legislation*, an amendment of GASB Statement No. 34, issued December 2004, will be effective for Water Works beginning with its year ending December 31, 2006. This Statement establishes and modifies requirements related to restrictions of net assets resulting from enabling legislation.

The Water Works' management has not yet determined the effect these Statements will have on Water Works' financial statements.

Des Moines Water Works

**Required Supplementary Information
Schedule of Contributions from the Employer
December 31, 2004**

Year Ended December 31:	Annual Required Contribution	Actual Contribution	Percentage Contribution
1999	\$ 536,683	\$ 536,000	99.87%
2000	629,754	547,685	86.97
2001	793,691	478,000	60.22
2002	735,168	466,000	63.39
2003	931,470	735,000	78.91
2004	896,193	800,000	89.27

See Note to Required Supplementary Information.

Des Moines Water Works

Note to Required Supplementary Information

The information presented in the required supplementary schedule was determined as part of the actuarial valuations at the dates indicated. Additional information as of the latest actuarial valuation follows:

Actuarial valuation:

Frequency	Annual
Latest date	January 1, 2005
Cost method	Aggregate cost method

Amortization Not applicable under Aggregate Cost Method. The Aggregate Cost Method does not identify or separately amortize unfounded actuarial liabilities. They are amortized through normal cost.

Asset valuation method Fair value is adjusted by spreading the expected value minus the actual value over four years. The total actuarial value of assets falls within the applicable corridor limits.

Assumptions:

Investment rate of return	7.5%
Salary increases	5.0% annual increases until retirement
Retirement age	The later of meeting the rule of 85 or age 58, but not later than age 65.

Mortality 1983 Group Annuity Table (male)
(set back 0 for males and 6 for females)

Rate of withdrawal V Table from August 1992 Pension Forum, multiplied by 0.60

Cost of living 3.0% to project benefits and compensation limitations

In addition to the above assumptions, an estimate of the Plan's expenses is included in normal cost.

Since the Plan uses the Aggregate Cost Method, a schedule of funding progress is not required as that method does not identify or separately amortize unfunded actuarial liabilities.