

★ Roll Call Number

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Date September 24, 2007

Agenda Item Number

37

Receipt of Des Moines Water Works' 2006 Audit Reports.

Moved by _____ to receive and file.

COUNCIL ACTION	YEAS	NAYS	PASS	ABSENT
COWNIE				
COLEMAN				
HENSLEY				
KIERNAN				
MAHAFFEY				
MEYER				
VLASSIS				
TOTAL				

CERTIFICATE

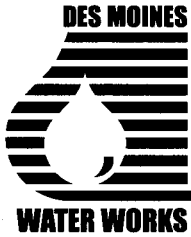
I, DIANE RAUH, City Clerk of said City hereby certify that at a meeting of the City Council of said City of Des Moines, held on the above date, among other proceedings the above was adopted.

IN WITNESS WHEREOF, I have hereunto set my hand and affixed my seal the day and year first above written.

MOTION CARRIED APPROVED

_____ Mayor

_____ City Clerk



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DES MOINES WATER WORKS

Board of Water Works Trustees
L.D. McMullen, Ph.D., P.E., CEO and General Manager

2201 George Flagg Parkway • Des Moines, Iowa 50321-1190 • (515) 283-8755 • www.dmww.com

September 7, 2007

Ms. Diane Rauh, City Clerk
City of Des Moines
East 1st & Locust Street
Des Moines, IA 50307

SUBJECT: Des Moines Water Works - 2006 Audit Reports

Dear Diane:

Audited financial statements and accompanying reports for Des Moines Water Works for the 2006 calendar year are enclosed. These reports were prepared by McGladrey & Pullen. The enclosed information was presented and received by the Board of Water Works Trustees at their meeting held July 24, 2007.

Sue Huppert, DMWW Board Chair, has asked that you please distribute a copy to the Mayor and to each City Council member.

Sincerely,

Peggy Freese, CPA
Director of Finance

Enclosures

#51

Des Moines Water Works

Financial Report
12.31.2006

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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, 2006, 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 and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States. 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, based on our audit, the financial statements referred to above present fairly, in all material respects, the financial position of Des Moines Water Works as of December 31, 2006 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 June 1, 2007, 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 3 through 7 and pension plan schedule on pages 29 and 30 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
June 1, 2007

Des Moines Water Works

Management's Discussion and Analysis Year Ended December 31, 2006

Our Management's 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, 2006 and 2005. Please consider this information in conjunction with the financial statements and the accompanying notes to 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 percent 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 the City 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, 2006 and 2005, total assets were \$290,201,832 and \$229,668,231, respectively, and total liabilities were \$109,306,723 and \$61,009,355, respectively, resulting in net assets of \$180,895,109 and \$168,658,876, respectively.
- Operating revenues of \$39,659,080 increased 13.25 percent over 2005, while operating expenses increased approximately 4.47 percent to \$34,591,868.
- During the year, Water Works had operating income of \$5,067,212 and change in net assets of \$12,236,233. This compares to operating income of \$1,907,125 and change in net assets of \$3,184,462 reported in 2005.

Des Moines Water Works

Management's Discussion and Analysis Year Ended December 31, 2006

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 sheet provides 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 presents the results of the Water Works' revenues and expenses over the course of the fiscal year and provides 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 related financing activities and investing activities. This statement details where cash resources come from and how they are used.

The notes to 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.

Condensed Balance Sheet Information

	2006	2005	% Change
Current assets	\$ 38,185,510	\$ 7,515,627	408.08%
Capital assets, net	216,030,583	198,755,238	8.69
Other noncurrent assets	35,985,739	23,397,366	53.80
Total assets	290,201,832	229,668,231	26.36
Current liabilities	16,679,862	14,063,412	18.60
Other noncurrent liabilities	18,346,861	19,755,943	(7.13)
Long-term debt	74,280,000	27,190,000	173.19
Total liabilities	109,306,723	61,009,355	79.16
Invested in capital assets, net of related debt	180,520,412	167,080,017	8.04
Restricted	17,136,157	19,372,427	(11.54)
Unrestricted	(16,761,460)	(17,793,568)	(5.80)
Total net assets	\$ 180,895,109	\$ 168,658,876	7.26

Des Moines Water Works

Management's Discussion and Analysis Year Ended December 31, 2006

	2006	2005	% Change
Water sales	\$ 33,964,194	\$ 30,001,396	13.21%
Billing and collection services	892,455	807,839	10.47
Connection fees	591,950	500,542	18.26
Purchased capacity	1,321,967	968,347	36.52
Other sales and services	2,888,514	2,740,760	5.39
Total operating revenues	39,659,080	35,018,884	13.25
Investment income	3,001,447	517,567	479.91
Other	166,722	173,043	(3.65)
Capital contributions	6,904,658	2,116,739	226.19
Total revenues	49,731,907	37,826,233	31.47
Labor and benefits	13,146,601	13,566,345	(3.09)
Chemicals and power	5,100,647	4,162,646	22.53
Insurance	940,458	899,619	4.54
Purchased services	3,179,056	2,559,800	24.19
Materials, supplies and equipment	3,127,030	3,003,276	4.12
Depreciation	8,891,789	8,734,782	1.80
Other	206,287	185,291	11.33
Total operating expenses	34,591,868	33,111,759	4.47
Interest expense	2,903,806	1,530,012	89.79
Total expenses	37,495,674	34,641,771	8.24
Change in net assets	12,236,233	3,184,462	284.25
Net assets, beginning of year	168,658,876	165,474,414	1.92
Net assets, end of year	\$ 180,895,109	\$ 168,658,876	7.26

Condensed Revenues, Expenses and Changes in Net Assets Financial Analysis

Current assets increased 408.08 percent. Other noncurrent assets increased approximately 53.80 percent. Both of these are a result of receiving \$52,435,000 in water revenue bond proceeds which were not all spent as of December 31, 2006.

Current liabilities increased 18.60 percent due to increases in construction contracts payable of \$1,350,182. The current portion of long-term debt also increased due to the issuance of Water Revenue Bonds, Series 2006. Fees collected for other entities also increased \$102,022 over 2005 due to the timing of year-end remittances.

Noncurrent liabilities include deferred revenue being amortized over a period of 10 to 20 years. Noncurrent liabilities include the pension liability which will be paid through future pension contributions.

Des Moines Water Works

Management's Discussion and Analysis Year Ended December 31, 2006

Long-term debt increased 173.19 percent in 2006 due to the issuance of the Water Revenue Bonds, Series 2006.

Water sales increased 13.21 percent. Two retail service areas, Southeast Polk and Runnells, were added in 2006. Both of these areas previously purchased water on a wholesale basis. In addition, debt service reimbursement increased \$2.6 million due to the issuance of Water Revenue Bonds, Series 2006.

Connection fees increased 18.26 percent due to more connection fees after the takeover of the Southeast Polk Rural Water District. These fees can fluctuate widely from year to year depending on the level of development experienced within the utility's service areas.

Purchased capacity revenues increased 36.52 percent as a result of the continued amortization of deferred revenue. This deferred revenue represents current year cash contributions to fund the Saylorville Water Treatment Plant and previous years' cash contributions from wholesale customers to fund the Maffitt Water Treatment Plant. Financial participation in the construction of the plants allows users to participate in lower 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. Botanical Center revenues of \$684,642 and \$492,942 for 2006 and 2005, respectively, are included in Water Works' financial results.

Chemicals and power increased 22.53 percent due to an increase in chemical costs.

Purchased services increased 24.19 percent compared to 2005 due to repairs to the Botanical Center dome and service line installations in the Southeast Polk service area.

Other expenses increased 11.33 percent due to an increase in casualty losses of \$10,569 over 2005. Loss on bad debt decreased \$17,511 from 2005.

Investment income increased 479.91 percent due to higher investment balances as a result of funds received from the issuance of the 2006 Series Bonds and slightly higher investment returns. Interest expense increased 89.79 percent in 2006 primarily due to the interest due on the Water Revenue Bonds Series 2006.

Capital contributions increased 226.19 percent in 2006 due to funds received from Polk County in the purchase of the Southeast Polk Rural Water District. All other capital contributions of \$1,795,062 in 2006 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 7.26 percent, the result of a 13.25 percent increase in operating revenues, an increase in operating expenses of 4.47 percent, and a 258.80 percent increase in nonoperating revenues.

Des Moines Water Works

Management's Discussion and Analysis Year Ended December 31, 2006

Capital Assets and Debt Administration

During 2006, net capital assets increased \$17,275,345 or 8.69 percent. In addition to replacing deteriorating water mains, the utility is responsible for relocating mains affected by the I-235 freeway expansion project. The utility is also 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.

Water Works' long-term debt was \$79,050,000 and \$31,788,000 as of December 31, 2006 and 2005, respectively. The increase was due to the issuance of the Water Revenue Bonds, Series 2006.

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 15.3 percent was budgeted for 2006 for one class of wholesale customer. 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, 2006

Assets

Current assets:	
Cash	\$ 1,452,914
Restricted assets:	
Cash	1,759,264
Investments, water revenue bond reserve fund	27,885,273
Accounts receivable:	
Billed	3,484,132
Unbilled	1,093,455
Other receivables	474,224
Inventory, materials and supplies	1,241,741
Prepaid expenses	794,507
Total current assets	<u>38,185,510</u>
Restricted assets, investments (Notes 2 and 4):	
Water revenue bond reserve fund	29,826,367
Water revenue bond improvement fund	600,000
	<u>30,426,367</u>
Long-term investments:	
Investment in land	624,562
Board designated funds, investments (Note 2)	4,029,879
	<u>4,654,441</u>
Capital assets (Note 3):	
Land	4,911,351
Construction-in-progress	13,872,969
Buildings, equipment and machinery	118,022,971
Supply system	39,643,628
Distribution system	138,399,220
	<u>314,850,139</u>
Accumulated depreciation	(98,819,556)
Capital assets, net	<u>216,030,583</u>
Bond issue costs, discount and deferral	<u>605,082</u>
Other assets	299,849
Total assets	<u>\$ 290,201,832</u>

See Notes to Basic Financial Statements.

Liabilities and Net Assets

Current liabilities:

Accounts payable	\$ 2,801,027
Accrued wages and benefits	422,181
Compensated absences (Note 4)	1,283,031
Deferred revenue (Note 1)	1,330,632
Special deposits	105,712
Construction payables	5,352,632
Water revenue bonds interest payable	273,397
Current portion of long-term debt (Note 4)	4,770,000
Fees collected for other entities	341,250
Total current liabilities	<u>16,679,862</u>

Long-term debt, less current installments (Note 4)	74,280,000
Compensated absences (Note 4)	731,103
Deferred revenue (Note 1)	17,058,120
Pension liability (Note 5)	557,638
	<u>92,626,861</u>
Total liabilities	<u>109,306,723</u>

Net assets:

Invested in capital assets, net of related debt	180,520,412
Restricted (bond indentures)	17,136,157
Unrestricted	(16,761,460)
Total net assets	<u>180,895,109</u>

Total liabilities and net assets	<u>\$ 290,201,832</u>
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Des Moines Water Works

Statement of Revenues, Expenses and Changes in Net Assets
Year Ended December 31, 2006

Operating revenues:	
Water sales	\$ 35,286,161
Other sales and services	3,780,969
Connection fees	591,950
Total operating revenues	<u>39,659,080</u>
Operating expenses:	
Labor	9,956,210
Insurance	940,458
Group insurance	1,369,792
Pension benefits (including social security)	1,820,599
Purchased services	3,179,056
Materials, supplies and equipment	3,127,030
Chemicals	2,673,600
Utilities, net	2,427,047
Depreciation	8,891,789
Other	206,287
Total operating expenses	<u>34,591,868</u>
Operating income	<u>5,067,212</u>
Nonoperating revenue (expense):	
Investment income	3,001,447
Interest expense	(2,903,806)
Land use income	162,132
Other	4,590
Nonoperating revenue (expense), net	<u>264,363</u>
Income before contributions	<u>5,331,575</u>
Capital contributions	<u>6,904,658</u>
Change in net assets	<u>12,236,233</u>
Net assets, beginning of year	<u>168,658,876</u>
Net assets, end of year	<u>\$ 180,895,109</u>

See Notes to Basic Financial Statements.

Des Moines Water Works

Statement of Cash Flows
Year Ended December 31, 2006

Cash flows from operating activities:	
Cash received from customers	\$ 37,983,371
Cash paid to suppliers	(11,168,903)
Cash paid to employees and for payroll taxes	(13,981,547)
Net cash provided by operating activities	<u>12,832,921</u>
Cash flows from capital and related financing activities:	
Proceeds from long-term debt	52,435,000
Principal payments on long-term debt	(5,173,000)
Acquisition, construction and removal cost of capital assets	(23,021,890)
Contributions received	5,109,596
Interest paid	(3,215,563)
Net cash provided by capital and related financing activities	<u>26,134,143</u>
Cash flows from investing activities:	
Proceeds from maturities of investments	127,005,089
Purchase of investments	(167,840,750)
Interest received	2,765,656
Land use income and other	166,722
Net cash used in investing activities	<u>(37,903,283)</u>
Net increase in cash	1,063,781
Cash, beginning of year	2,148,397
Cash, end of year	<u>\$ 3,212,178</u>
Reconciliation of cash to the balance sheet:	
Cash	\$ 1,452,914
Restricted assets, cash	1,759,264
Total cash at end of year	<u>\$ 3,212,178</u>

(Continued)

Des Moines Water Works

Statement of Cash Flows (Continued)

Year Ended December 31, 2006

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

Operating income	\$ 5,067,212
Adjustments to reconcile operating income to net cash, depreciation	8,891,789
Change in:	
Accounts receivable, billed	(355,829)
Accounts receivable, unbilled	(132,739)
Other receivables	(40,198)
Inventories - materials and supplies	(205,085)
Prepaid expense	32,480
Other assets	70,651
Accounts payable	616,722
Accrued wages and benefits and compensated absences	130,914
Pension liability	(25,402)
Deferred revenue	(1,312,216)
Special deposits	(7,400)
Fees collected for other entities	102,022
Net cash provided by operating activities	<u><u>\$ 12,832,921</u></u>

Schedule of noncash capital and related financing activities:

Contributions of water mains from contractors in aid of construction	\$ 1,795,062
Acquisition of capital assets through construction payables	1,350,182

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

15,332

See Notes to Basic Financial Statements.

Des Moines Water Works
Pension Plan

Statement of Plan Net Assets
December 31, 2006

Assets

Investments, contracts with insurance companies, pooled separate accounts	\$ 42,053,324
Employer contributions receivable	<u>221,385</u>
	42,274,709

Liabilities

Net assets held in trust for pension benefits

\$ 42,274,709

See Notes to Basic Financial Statements.

Des Moines Water Works
Pension Plan

Statement of Changes in Plan Net Assets
Year Ended December 31, 2006

Additions:

Investment income:

Net appreciation in the fair value of pooled separate accounts,
interest and dividends (Note 2)

\$ 4,985,894

Gain on sale of stock

323,002

Employer contributions

885,990

Total additions

6,194,886

Deductions:

Benefit payments

1,549,594

Administrative expenses

67,174

Total deductions

1,616,768

Net increase

4,578,118

Net assets held in trust for pension benefits:

Beginning of year

37,696,591

End of year

\$ 42,274,709

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, 2006 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 service, and sales, 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 \$660,282 and \$646,432 in 2006 and 2005, 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 2006 and 2005.

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 2006 and 2005.

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 \$341,250 and \$239,228 as of December 31, 2006 and 2005, 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 \$892,000 and \$808,000 in 2006 and 2005, 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. Capitalized interest was a negative \$44,236 in the current year.

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. As of December 31, 2006, Water Works had unspent bond proceeds of \$42,934,747.

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 and years subsequent, Water Works entered into contractual agreements with other political subdivisions to sell treatment capacity to these entities. 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 issues of water revenue bonds. For entities choosing to pay cash in advance, Water Works records these amounts as deferred revenue and amortizes the amounts into income over periods of ten to twenty years. For entities participating in the bond issues, Water Works recognizes this revenue on a monthly basis as the entities are billed and as the principal and interest payments become due on the bonds. As of December 31, 2006, Water Works has \$18,388,752 of deferred revenue and has recognized \$6,595,968 of revenue during 2006.

