CITY OF CLEVELAND, OHIO

DEPARTMENT OF PUBLIC UTILITIES
DIVISION OF WATER

REPORT ON AUDITS OF FINANCIAL STATEMENTS
For the years ended December 31, 2006 and 2005

CITY OF CLEVELAND, OHIO

DEPARTMENT OF PUBLIC UTILITIES
DIVISION OF WATER

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Mary Taylor, CPA
Auditor of State

INDEPENDENT ACCOUNTANTS' REPORT

Division of Water
Department of Public Utilities
City of Cleveland
Cuyahoga County
601 Lakeside Avenue
Cleveland, Ohio 44114

To the Honorable Frank G. Jackson, Mayor, Members of Council, and the Audit Committee:

We have audited the accompanying basic financial statements of the Division of Water, Department of Public Utilities, City of Cleveland, Cuyahoga County, Ohio, (the Division) as of and for the years ended December 31, 2006 and December 31, 2005, as listed in the table of contents. These financial statements are the responsibility of the Division's management. Our responsibility is to express opinions on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audits to reasonably assure 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 audits provide a reasonable basis for our opinions.

As described in Note A, the financial statements present only the Division and do not purport to, and do not, present fairly the financial position of the City of Cleveland as of December 31, 2006 and December 31, 2005, and the respective changes in its financial position and cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

In our opinion, the financial statements referred to above present fairly, in all material respects, the respective financial position of the Division of Water, Department of Public Utilities, City of Cleveland, Cuyahoga County, Ohio, as of December 31, 2006 and December 31, 2005, and the respective changes in financial position and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

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Management's Discussion and Analysis is not a required part of the basic financial statements but is supplementary information the accounting principles generally accepted in the United States of America requires. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit the information and express no opinion on it.

Mary Taylor

Mary Taylor, CPA
Auditor of State

June 29, 2007

CITY OF CLEVELAND, OHIO
DEPARTMENT OF PUBLIC UTILITIES
DIVISION OF WATER

MANAGEMENT'S DISCUSSION AND ANALYSIS

GENERAL

As management of the City of Cleveland's (the "City") Department of Public Utilities, Division of Water (the "Division"), we offer readers of the Division's financial statements this narrative overview and analysis of the financial activities of the Division for the years ended December 31, 2006 and 2005. Please read this information in conjunction with the Division's financial statements and footnotes that begin on page 15.

The Division was created in 1853 and charged with the responsibility of collecting, treating, pumping and distributing potable water and providing related water service to customers within its service areas. The Division operates a major public water supply system, the eighth largest in the United States, that serves not only the City, but also 70 suburban municipalities in Cuyahoga, Medina, Summit and Geauga counties. The Division is an emergency standby provider for systems in three other counties. The present service area covers over 640 square miles and serves over 1.5 million people. In 2006, the aggregate metered consumption of water in the City constituted 34% of the total metered consumption in the service area, while consumption in the direct service communities and master meter communities constituted 55% and 11%, respectively.

COMPARISON OF CURRENT YEAR'S AND PRIOR YEARS' DATA

FINANCIAL HIGHLIGHTS

- The assets of the Division exceeded its liabilities (net assets) by $900,779,000, $880,787,000 and $837,530,000 at December 31, 2006, 2005 and 2004, respectively. Of these amounts, $243,388,000, $246,355,000 and $248,497,000 (unrestricted net assets) at December 31, 2006, 2005 and 2004, respectively, may be used to meet the Division's ongoing obligations to customers and creditors.

- In 2006, the operating revenues of the Division decreased by $12,657,000 due to a decrease in billed consumption of 5%. However, despite the billed consumption decrease, several major users, such as Mittal Steel, Ford Motor Company, North East Ohio Regional Sewer District and Stouffer Company, experienced an increase of needed services. In 2005, the operating revenues of the Division increased by $13,042,000 due to a combined rate increase of approximately 3.5% and an increase in billed consumption of 2.11%. Several major users, such as Mittal Steel, Ford Motor Company, Stouffer Company and the North East Ohio Regional Sewer District, experienced an increase of needed services. In 2004, the operating revenues increased by $5,771,000 due to a combined rate increase of approximately 3.4% which was offset by a drop in billed consumption of 2.14%. However, despite the billed consumption decrease, several major users, such as ISG Steel, North East Ohio Regional Sewer District and the Cleveland Clinic, experienced an increase of needed services.

- The Division's overall net assets increased by $19,992,000, $43,257,000 and $26,940,000 in 2006, 2005 and 2004, respectively.

- The Division had increases in capital assets, net of accumulated depreciation, of $67,540,000, $81,596,000 and $65,518,000 in 2006, 2005 and 2004, respectively. The major additions during these years were related to the continuing renovation projects at the Morgan, Baldwin and Nottingham sites.

FINANCIAL HIGHLIGHTS (Continued)

- The total long-term debt of the Division decreased by $1,937,000 in 2006 This decrease is attributed to $20,209,000 of debt retired and $11,770,000 debt defeased, which was offset by the receipt of four Ohio Water Development Authority Loans totaling $30,042,000. In 2005, the total long-term debt decreased by $5,506,000. This decrease is attributed to $21,516,000 of debt retired, $10,000,000 debt defeased and $65,510,000 of debt refunded which was offset by the receipt of three Ohio Water Development Authority Loans totaling $27,040,000 and the issuance of $64,480,000 of new bonds. In 2004, total long-term debt decreased by $15,230,000 or 1.7%. This decrease is attributed to $47,550,000 of debt retired and $163,305,000 of debt refunded offset by the receipt of an Ohio Water Development Authority Loan of $20,625,000 and the issuance of $175,000,000 of new bonds.

OVERVIEW OF THE FINANCIAL STATEMENTS

This discussion and analysis is intended to serve as an introduction to the Division's basic financial statements. The accompanying financial statements present financial information for the City's Division of Water Fund, in which the City accounts for the operations of the Department of Public Utilities Division of Water.

A fund is a grouping of related accounts that is used to maintain control over resources that have been segregated for specific activities or objectives. The City, like other state and local governments, uses fund accounting to ensure and demonstrate compliance with finance-related legal requirements.

The Division of Water Fund is considered an enterprise fund because the operations of the Division are similar to a private-sector business enterprise. Accordingly, in accounting for the activities of the Division, the economic resources measurement focus and the accrual basis of accounting is used. This is similar to businesses in the private sector.

The basic financial statements of the Division can be found on pages 15 - 20 of this report.

The notes to the financial statements provide additional information that is essential to a full understanding of the data provided in the basic financial statements. The notes to the financial statements can be found on pages 21 - 37 of this report.

CONDENSED BALANCE SHEET INFORMATION

Provided below is condensed balance sheet information for the Division as of December 31, 2006, 2005 and 2004:

	2006	2005	2004
		(In thousands)	
Assets:			
Capital assets, net	$ 1,260,991	$ 1,193,451	$ 1,111,855
Restricted assets	222,739	267,979	314,307
Unamortized bond issuance costs	5,704	6,337	6,694
Current assets	292,640	294,997	280,738
Total assets	1,782,074	1,762,764	1,713,594
Net Assets and Liabilities:			
Net assets:			
Invested in capital assets, net of related debt	431,663	363,969	277,756
Restricted for capital projects	141,994	188,110	229,791
Restricted for debt service	83,734	82,353	81,486
Unrestricted	243,388	246,355	248,497
Total net assets	900,779	880,787	837,530
Liabilities:			
Long-term obligations	810,767	813,762	812,542
Current liabilities	70,528	68,215	63,522
Total liabilities	881,295	881,977	876,064
Total net assets and liabilities	$ 1,782,074	$ 1,762,764	$ 1,713,594

Total Assets: The Division's investment in capital assets as of December 31, 2006 amounted to $1,260,991,000 (net of accumulated depreciation) which is an increase of $67,540,000. The Division's plant enhancements continue to be the primary reason for the increase in capital assets. Utility plant had net additions of $54,723,000, buildings, structures and improvements had a net reduction of $834,000 and furniture, fixtures, equipment and vehicles had net additions of $12,495,000. Also, net construction in progress increased by $33,420,000 due to continuing renovations to the Morgan, Baldwin and Nottingham plants.

The Division's investment in capital assets as of December 31, 2005 amounted to $1,193,451,000 (net of accumulated depreciation) which is an increase of $81,596,000. The Division's plant enhancements continue to be the primary reason for the increase in capital assets. Utility plant had net additions of $24,137,000, buildings, structures and improvements had additions of $47,000 and furniture, fixtures, equipment and vehicles had net additions of $8,959,000. Also, net construction in progress increased by $81,889,000 due to continuing renovations to the Morgan, Baldwin and Nottingham plants.

The reduction in restricted assets of $45,240,000 is mainly attributed to payments for plant enhancement projects that significantly reduced cash and investment balances.

CONDENSED BALANCE SHEET INFORMATION (Continued)

The reduction in current assets of $2,357,000 was primarily due to a reduction of $2,156,000 in amounts due from other City departments.

Capital Assets: The Division's investment in capital assets, as of December 31, 2006 amounted to $1,260,991,000 (net of accumulated depreciation). The total increase in the Division's investment in net capital assets for the current year was approximately 5.7%. The Division's investment in capital assets, as of December 31, 2005 amounted to $1,193,451,000 (net of accumulated depreciation). The total increase in the Division's investment in net capital assets for the current year was approximately 7.3%. A summary of the activity in the Division's capital assets during the years ended December 31, 2006 and 2005 is as follows:

	Balance January 1, 2006	Additions	Reductions	Balance December 31, 2006
	(In thousands)			
Land	$ 5,463	$	$	$ 5,463
Land improvements	16,406	567		16,973
Utility plant	1,001,469	58,861	(4,138)	1,056,192
Buildings, structures and improvements	205,354	107	(941)	204,520
Furniture, fixtures, equipment and vehicles	118,785	13,267	(772)	131,280
Construction in progress	282,472	104,290	(70,870)	315,892
Total	1,629,949	177,092	(76,721)	1,730,320
Less: Accumulated depreciation	(436,498)	(37,581)	4,750	(469,329)
Capital assets, net	$ 1,193,451	$ 139,511	$ (71,971)	$ 1,260,991

	Balance January 1, 2005	Additions	Reductions	Balance December 31, 2005
	(In thousands)			
Land	$ 5,463	$	$	$ 5,463
Land improvements	16,406			16,406
Utility plant	977,332	25,360	(1,223)	1,001,469
Buildings, structures and improvements	205,307	47		205,354
Furniture, fixtures, equipment and vehicles	109,826	10,741	(1,782)	118,785
Construction in progress	200,583	112,459	(30,570)	282,472
Total	1,514,917	148,607	(33,575)	1,629,949
Less: Accumulated depreciation	(403,062)	(36,259)	2,823	(436,498)
Capital assets, net	$ 1,111,855	$ 112,348	$ (30,752)	$ 1,193,451

CONDENSED BALANCE SHEET INFORMATION (Continued)

Major events during 2006 affecting the Division's capital assets included the following:

- The construction, renovations, and plant enhancements on the Morgan, Baldwin and Nottingham facilities and the rehabilitation of water mains amounted to $56,595,000. The major programs are: Security Enhancements Program, Plant Enhancement Program, Electrical Power Reliability Program and the coordinated Graphical Information System.

- The purchase of office equipment and vehicles for $1,796,000 and water main rehabilitation for $7,510,000.

Major events during 2005 affecting the Division's capital assets included the following:

- The Euclid Corridor project; construction, renovations, and plant enhancements on the Morgan, Baldwin and Nottingham facilities; the coordinated Geographical Information System (GIS) and the electrical power reliability project amounted to $86,977,000.

- The purchase of office equipment and vehicles for $2,012,000, water main rehabilitation for $5,200,000, the tower painting program for $7,969,000 and the plant enhancement program for $6,654,000.

Additional information on the Division's capital assets, including commitments made for future capital expenditures, can be found in Notes A and D to the basic financial statements.

Liabilities:

In 2006, the factors for the Division's net decrease in long-term obligations of $2,995,000 is attributed to the receipt of an Ohio Water Development Authority Loans of $30,042,000, a decrease in the unamortized discount and premium of $1,269,000 and a decrease in long-term accrued wages and benefits of $342,000. These amounts were offset by $20,209,000 of debt retirement, $11,770,000 of debt defeased, and a decrease in unamortized loss on debt refunding of $3,052,000. There was also an increase in the current portion of long-term obligations of $2,499,000.

In 2005, the factors for the Division's net increase in long-term obligations of $1,220,000 is attributed to the receipt of an Ohio Water Development Authority Loan of $27,040,000, an issuance of $64,480,000 of new bonds, an increase in the unamortized discount and premium of $3,707,000 and an increase in long-term accrued wages and benefits of $134,000. These amounts were offset by $21,516,000 of debt retirement, $10,000,000 of debt defeased, debt refunding of $65,510,000 and a decrease in unamortized loss on debt refunding of $331,000. There was also a decrease in the current portion of long-term obligations of $3,216,000.

CONDENSED BALANCE SHEET INFORMATION (Continued)

Current Liabilities: In 2006, total current liabilities increased by $2,313,000. The significant components of the change were increases to the current portion of long-term debt of $2,499,000, and customer deposits and other liabilities of $705,000. These increases were offset by reductions of $986,000 in accrued interest payable.

In 2005, total current liabilities increased by $4,693,000. The significant components for the increase were an increase in accrued interest payable of $7,340,000, which was related to the defeasance of bonds, and an increase in current payables from restricted assets of $4,275,000, which was mainly due to construction retainage pertaining to the North Royalton pump and Nottingham plant renovation projects. These were offset by a decrease in the current portion of long-term debt of $3,216,000 and a decrease in due to other City of Cleveland departments, divisions or funds of $4,499,000.

Long-term Debt: At the end of 2006, the Division had total long-term debt outstanding of $855,825,000. All bonds and notes are backed by the revenues generated by the Division. The Ohio Water Development Authority (OWDA) loans do not have a lien on revenues of the Division.

At the end of 2005, the Division had total long-term debt outstanding of $857,762,000. All bonds and notes are backed by the revenues generated by the Division. The Ohio Water Development Authority (OWDA) loans do not have a lien on revenues of the Division.

The activity in the Division's debt obligations outstanding during the years ended December 31, 2006 is summarized below (excluding unamortized discounts, premiums and losses on debt refundings):

	Balance January 1, 2006	Debt Issued	Debt Defeased	Debt Retired	Balance December 31, 2006
			(In thousands)		
Water Revenue Bonds:					
Series G, 1993	$ 133,045	$	$ (11,770)	$ -	$ 121,275
Series H, 1996	18,190			(3,720)	14,470
Series I, 1998	165,115			(3,240)	161,875
Series J, 2001	70,110			(6,765)	63,345
Series K, 2002	69,725				69,725
Series L, 2002	90,000				90,000
Series M, 2004	174,095			(1,760)	172,335
Series N, 2005	64,480				64,480
Ohio Water Development Authority Loan	73,002	30,042		(4,724)	98,320
Total	$ 857,762	$ 30,042	$ (11,770)	$ (20,209)	$ 855,825

CONDENSED BALANCE SHEET INFORMATION (Continued)

The activity in the Division's debt obligations outstanding during the years ended December 31, 2005 is summarized below (excluding unamortized discounts, premiums and losses on debt refundings):

	Balance January 1, 2005	Debt Issued	Debt Refunded	Debt Retired	Balance December 31, 2005
			(In thousands)		
Water Revenue Bonds:					
Series G, 1993	$ 149,542	$	$ (10,000)	$ (6,497)	$ 133,045
Series H, 1996	31,968		(8,465)	(5,313)	18,190
Series I, 1998	223,753		(57,045)	(1,593)	165,115
Series J, 2001	76,550			(6,440)	70,110
Series K, 2002	69,725				69,725
Series L, 2002	90,000				90,000
Series M, 2004	175,000			(905)	174,095
Series N, 2005		64,480			64,480
Ohio Water Development Authority Loan	46,730	27,040		(768)	73,002
Total	$ 863,268	$ 91,520	$ (75,510)	$ (21,516)	$ 857,762

The bond ratings for the Division's outstanding revenue bonds are as follows and remain unchanged since 2001. In May 2007 the bond ratings for Moody's was upgraded to Aa2 and Standard and Poor's rating was upgraded to AA.

Moody's Investors Service	Standard & Poor's
Aa3	AA-

The ratio of net revenue available for debt service to debt service requirements (revenue bond coverage) is a useful indicator of the Division's debt position to management, customers and creditors. The Division's revenue bond coverage for 2006, 2005 and 2004 was 172%, 204%, and 173%, respectively.

Additional information on the Division's long-term debt can be found in Note B on pages 24 - 31.

Net Assets: Net assets serve as a useful indicator of a government's financial position. In the case of the Division, assets exceed liabilities by $900,779,000, $880,787,000 and $837,530,000 at December 31, 2006, 2005 and 2004, respectively.

CONDENSED BALANCE SHEET INFORMATION (Continued)

Of the Division's net assets, $431,663,000, or 48% and $363,969,000, or 41% at December 31, 2006 and 2005, respectively, reflects its investment in capital assets (e.g., land, buildings, utility plant, machinery and equipment), net of accumulated depreciation, less any related, still-outstanding debt used to acquire those assets. The Division uses these capital assets to provide services to its customers; consequently, these assets are not available for future spending. Although the Division's investment in capital assets is reported net of related debt, it should be noted that the resources needed to repay this debt must be provided from other resources since the capital assets themselves cannot be used to liquidate these liabilities.

An additional portion of the Division's net assets, $225,728,000, or 25% and $270,463,000, or 31% at December 31, 2006 and 2005, respectively, represents resources that are subject to external restrictions. These funds are set aside for the payment of revenue bonds or represent unspent bond proceeds relating to capital projects. The remaining balance of unrestricted net assets, $243,388,000, or 27% and $246,355,000, or 28% at December 31, 2006 and 2005, respectively, may be used to meet the Division's ongoing obligations to customers and creditors.

CONDENSED STATEMENT OF REVENUES, EXPENSES AND CHANGES IN NET ASSETS INFORMATION

The Division's operations during 2006 and 2005 increased its net assets by $19,992,000 and $43,257,000, respectively. Provided below are the key elements of the Division's results of operations as of and for the years ended December 31, 2006, 2005 and 2004:

CONDENSED STATEMENT OF REVENUES, EXPENSES AND CHANGES IN NET ASSETS INFORMATION (Continued)

	2006	2005	2004
		(In thousands)	
Operating revenues	$ 209,978	$ 222,635	$ 209,593
Operating expenses	170,461	160,190	161,626
Operating income	39,517	62,445	47,967
Non-operating revenue (expense):			
Investment income	13,925	7,719	5,420
Interest expense	(33,690)	(31,838)	(26,276)
Amortization of bond issuance costs premiums and discounts	637	269	(204)
Workers' compensation refund	11	2	5
Gain (Loss) on disposal of capital assets	(894)	(29)	28
Total non-operating revenue (expense), net	(20,011)	(23,877)	(21,027)
Income (loss) before other contributions	19,506	38,568	26,940
Capital and other contributions	486	4,689	
Increase in net assets	19,992	43,257	26,940
Net assets, beginning of year	880,787	837,530	810,590
Net assets, end of year	$ 900,779	$ 880,787	$ 837,530

Operating revenue:

In 2006, total operating revenues decreased by $12,657,000 due to a decrease in billed consumption of 5.0%. However, despite the billed consumption decrease, several major users, such as Mittal Steel, Ford Motor Company, North East Ohio Regional Sewer District and Stouffer Company, experienced an increase of needed services.

In 2005, total operating revenues increased by $13,042,000 due to a combined rate increase of approximately 3.5% and an increase in billed consumption of 2.11%. Several major users, such as Mittal Steel, Ford Motor Company, Stouffer Company and the North East Ohio Regional Sewer District, experienced an increase of needed services.

Operating expenses:

In 2006, the overall increase in operating expenses of $10,271,000 was primarily due to a $6,057,000 increase in operations expense, $2,891,000 increase in maintenance expenses and $1,323,000 increase for depreciation expense in 2006 due to an increase in plant and equipment additions.

CONDENSED STATEMENT OF REVENUES, EXPENSES AND CHANGES IN NET ASSETS INFORMATION (Continued)

In 2005, the overall decrease in operating expenses of $1,436,000 were primarily due to a $2,754,000 decrease in maintenance expenses which was offset by $1,654,000 increase for depreciation expense in 2005 due to an increase in plant and equipment additions.

Non-operating revenue (expense):

In 2006, total net non-operating revenue (expense) decreased by $3,866,000, primarily due to an increase of $6,206,000 in interest income, which was offset by an increase of $1,852,000 in interest expense.

In 2005, total net non-operating revenue (expense) increased by $2,850,000 primarily due to a $5,562,000 increase in interest expense which was offset by an increase of $2,299,000 in investment income.

FACTORS EXPECTED TO IMPACT THE DIVISION'S FUTURE FINANCIAL POSITION OR RESULTS OF OPERATIONS

Water rate increases will continue to have a positive impact on the financial position of the Division:

CLEVELAND - PER MCF (Thousand cubic feet)		
EFFECTIVE	**REGULAR**	**HOMESTEAD**
January 1, 2006	$8.71	$3.37
January 1, 2007	$9.62	$4.27
January 1, 2008	$10.63	$4.72

DIRECT SERVICE SUBURBS - PER MCF (Thousand cubic feet)		
EFFECTIVE	**REGULAR**	**HOMESTEAD**
January 1, 2006	$15.50-$20.93	$6.77-$11.09
January 1, 2007	$16.35-$21.55	$7.26-$ 9.56
January 1, 2008	$17.54-$23.17	$7.79-$10.29

Legislation was passed in June 2006 for annual rate increases for the next four years which will increase operating revenue to adequately cover anticipated operating expenditures.

On February 5, 2007, legislation was passed by City Council authorizing the issuance of not to exceed $185,000,000 of Water Revenue Bonds. Bonds were sold in the amount of $143,570,000 on June 12, 2007 with an expected delivery date of June 28, 2007. The proceeds of these will be used to pay costs of improvements to the Water system. Effective June 28, 2007, the City issued $143,570,000 Water Revenue Bonds, Series O, 2007. In conjunction with the issuance, Moody's Investors Service and Standard & Poor's Ratings Services upgraded their ratings on all of the Division's bonds to Aa2 and AA respectively.

ADDITIONAL INFORMATION

This financial report is designed to provide a general overview of the Division's finances. Questions concerning any of the information provided in this report or requests for additional information should be addressed to the Office of the Finance Director, City Hall, Room 104, 601 Lakeside Avenue, Cleveland, Ohio 44114.

BASIC FINANCIAL STATEMENTS

CITY OF CLEVELAND, OHIO

DEPARTMENT OF PUBLIC UTILITIES
DIVISION OF WATER
BALANCE SHEETS
December 31, 2006 and 2005

	(*In thousands*) 2006	2005
ASSETS		
CAPITAL ASSETS		
Land	$ 5,463	$ 5,463
Land improvements	16,973	16,406
Utility plant	1,056,192	1,001,469
Buildings, structures and improvements	204,520	205,354
Furniture, fixtures, equipment and vehicles	131,280	118,785
	1,414,428	1,347,477
Less: Accumulated depreciation	(469,329)	(436,498)
	945,099	910,979
Construction in progress	315,892	282,472
CAPITAL ASSETS, NET	1,260,991	1,193,451
RESTRICTED ASSETS		
Cash and cash equivalents	220,111	263,291
Investments	1,998	3,973
Accrued interest receivable	630	715
TOTAL RESTRICTED ASSETS	222,739	267,979
UNAMORTIZED BOND ISSUANCE COSTS	5,704	6,337
CURRENT ASSETS		
Cash and cash equivalents	94,524	48,655
Restricted cash and cash equivalents	12,982	12,853
Investments	125,054	168,637
Receivables:		
Accounts receivable - net of allowance for doubtful accounts of $11,547,000 in 2006 and $9,128,000 in 2005	26,700	26,065
Unbilled revenue	24,153	25,334
Due from other City of Cleveland departments, divisions or funds	3,563	5,719
Accrued interest receivable	1,065	1,225
Materials and supplies - at average cost, net of allowance for obsolescence of $600,000 in 2006 and $600,000 2005	2,916	4,810
Prepaid expenses	1,683	1,699
TOTAL CURRENT ASSETS	292,640	294,997
TOTAL ASSETS	$ 1,782,074	$ 1,762,764

(Continued)

CITY OF CLEVELAND, OHIO

DEPARTMENT OF PUBLIC UTILITIES
DIVISION OF WATER
BALANCE SHEETS
December 31, 2006 and 2005

	(In thousands) 2006	2005
NET ASSETS AND LIABILITIES		
NET ASSETS		
Invested in capital assets, net of related debt	$ 431,663	$ 363,969
Restricted for capital projects	141,994	188,110
Restricted for debt service	83,734	82,353
Unrestricted	243,388	246,355
TOTAL NET ASSETS	900,779	880,787
LIABILITIES		
LONG-TERM OBLIGATIONS-excluding amounts due within one year:		
Revenue bonds	713,313	740,995
OWDA loans	95,175	70,146
Accrued wages and benefits	2,279	2,621
TOTAL LONG-TERM OBLIGATIONS	810,767	813,762
CURRENT LIABILITIES		
Current portion of long-term debt, due within one year	20,840	18,341
Accounts payable	2,617	2,519
Current payable from restricted assets	12,982	12,853
Due to other City of Cleveland departments, divisions or funds	2,614	2,466
Accrued interest	16,379	17,365
Current portion of accrued wages and benefits	10,092	10,372
Other accrued expenses	393	393
Customer deposits and other liabilities	4,611	3,906
TOTAL CURRENT LIABILITIES	70,528	68,215
TOTAL LIABILITIES	881,295	881,977
TOTAL NET ASSETS AND LIABILITIES	$ 1,782,074	$ 1,762,764

See notes to financial statements. (Concluded)

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CITY OF CLEVELAND, OHIO

DEPARTMENT OF PUBLIC UTILITIES
DIVISION OF WATER
STATEMENTS OF REVENUES, EXPENSES AND CHANGES IN NET ASSETS
For the Years Ended December 31, 2006 and 2005

	(In thousands) 2006	2005
OPERATING REVENUES		
Charges for services	$ 209,978	$ 222,635
TOTAL OPERATING REVENUES	209,978	222,635
OPERATING EXPENSES		
Operations	84,371	78,314
Maintenance	48,508	45,617
Depreciation	37,582	36,259
TOTAL OPERATING EXPENSES	170,461	160,190
OPERATING INCOME	39,517	62,445
NON-OPERATING REVENUE (EXPENSE)		
Investment income	13,925	7,719
Interest expense	(33,690)	(31,838)
Amortization of bond issuance costs, premiums, and discounts	637	269
Worker's compensation refund	11	2
Gain (loss) on disposal of capital assets	(894)	(29)
TOTAL NON-OPERATING REVENUE (EXPENSE), NET	(20,011)	(23,877)
Income (Loss) before other Contributions	19,506	38,568
CAPITAL AND OTHER CONTRIBUTIONS	486	4,689
INCREASE IN NET ASSETS	19,992	43,257
NET ASSETS, beginning of year	880,787	837,530
NET ASSETS, end of year	$ 900,779	$ 880,787

See notes to financial statements.

CITY OF CLEVELAND, OHIO

DEPARTMENT OF PUBLIC UTILITIES
DIVISION OF WATER
STATEMENTS OF CASH FLOWS
For the Years Ended December 31, 2006 and 2005

	(In thousands) 2006	2005
CASH FLOWS FROM OPERATING ACTIVITIES		
Cash received from customers	$ 208,456	$ 216,485
Cash payments to suppliers for goods or services	(51,913)	(51,878)
Cash payments to employees for services	(74,504)	(73,492)
NET CASH PROVIDED BY OPERATING ACTIVITIES	82,039	91,115
CASH FLOWS FROM NONCAPITAL FINANCING ACTIVITIES		
Capital and other contributions	1,908	3,219
Workers compensation refund	12	2
NET CASH PROVIDED BY NONCAPITAL FINANCING ACTIVITIES	1,920	3,221
CASH FLOWS FROM CAPITAL AND RELATED FINANCING ACTIVITIES		
Acquisition and construction of capital assets	(104,670)	(106,895)
Proceeds of OWDA loan	29,978	24,813
Principal paid on long-term debt	(18,321)	(21,437)
Interest paid on long-term debt	(41,011)	(31,443)
Cash paid to escrow agent for refunding	(12,417)	(78,879)
Proceeds of bonds, premiums and discounts	-	69,085
NET CASH PROVIDED BY (USED FOR) CAPITAL AND RELATED FINANCING ACTIVITIES	(146,441)	(144,756)
CASH FLOWS FROM INVESTING ACTIVITIES		
Purchase of investment securities	(76,724)	(38,644)
Proceeds from sale and maturity of investment securities	122,282	14,184
Interest received on investments	19,742	14,733
NET CASH PROVIDED BY (USED FOR) INVESTING ACTIVITIES	65,300	(9,727)
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	2,818	(60,147)
CASH AND CASH EQUIVALENTS, beginning of year	324,799	384,946
CASH AND CASH EQUIVALENTS, end of year	$ 327,617	$ 324,799

(Continued)

CITY OF CLEVELAND, OHIO

DEPARTMENT OF PUBLIC UTILITIES
DIVISION OF WATER
STATEMENTS OF CASH FLOWS
For the Years Ended December 31, 2006 and 2005

	(In thousands) 2006	2005
RECONCILIATION OF OPERATING INCOME TO NET CASH PROVIDED BY OPERATING ACTIVITIES		
OPERATING INCOME	$ 39,517	$ 62,445
Adjustments to reconcile operating income to net cash provided by operating activities:		
Depreciation	37,582	36,259
Changes in assets and liabilities:		
Accounts receivable, net	(635)	(805)
Unbilled revenue	1,181	(662)
Due from other City of Cleveland departments, divisions or funds	2,156	(1,663)
Materials and supplies, net	1,894	95
Prepaid expenses	16	(982)
Accounts payable	98	578
Due to other City of Cleveland departments, divisions or funds	148	(4,499)
Accrued wages and benefits	(623)	660
Customer deposits and other liabilities	705	(311)
TOTAL ADJUSTMENTS	42,522	28,670
NET CASH PROVIDED BY OPERATING ACTIVITIES	$ 82,039	$ 91,115

(Concluded)

See notes to financial statements.

NOTES TO FINANCIAL STATEMENTS
For the Years Ended December 31, 2006 and 2005

NOTE A – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The Division of Water (Division) is reported as an enterprise fund of the City of Cleveland's Department of Public Utilities and is a part of the City of Cleveland's (City) primary government. The Division was created for the purpose of supplying water services to customers within the metropolitan area. The following is a summary of the more significant accounting policies.

Reporting Model and Basis of Accounting: The accounting policies and financial reporting practices of the Division comply with accounting principles generally accepted in the United States of America applicable to governmental units. Effective January 1, 2005, the Division implemented GASB Statement No. 40, *Deposit and Investment Risk Disclosures*. In November 2003, the GASB issued Statement No. 42, *Accounting and Financial Reporting for Impairment of Capital Assets and for Insurance Recoveries*, which is effective for the year ended December 31, 2005. The Division has determined that GASB Statement No. 42 has no impact on its financial statements as of December 31, 2006. In May 2004, the GASB issued Statement No. 44, *Economic Condition Reporting: The Statistical Section*, which is effective for the year ended December 31, 2006. The Division has determined that GASB Statement No. 44 has no impact on its financial statements as of December 31, 2006. In June 2005, the GASB issued Statement No. 47, *Accounting for Termination Benefits*, which is effective for the year ended December 31, 2006. The Division has determined that GASB Statement No. 47 has no impact on its financial statements as of December 31, 2006

The Division's net assets are accounted for in the accompanying balance sheets and the net assets are divided into the following categories:

- Amount invested in capital assets, net of related debt.
- Amount restricted for capital projects.
- Amount restricted for debt service.
- Remaining unrestricted amount.

In addition, certain additional financial information regarding the Division is included in these footnotes. The implementation of the new GASB statements did not result in a change in the Division's beginning net asset/equity balance as previously reported.

Basis of Accounting: The Division's financial statements are prepared under the accrual basis of accounting. Under this method, revenues are recognized when earned and measurable and expenses are recognized as incurred. Under GASB Statement No. 20, *Accounting and Financial Reporting for Proprietary Activities*, all Proprietary Funds will continue to follow Financial Accounting Standards Board (FASB) standards issued on or before November 30, 1989. However, from that date forward, Proprietary Funds will have the option of either 1) choosing not to apply future FASB standards (including amendments of earlier pronouncements), or 2) continuing to follow new FASB pronouncements (unless they conflict with GASB pronouncements). The City has chosen not to apply future FASB standards.

NOTE A – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Revenues: Revenues are derived primarily from sales of water to residential, commercial and industrial customers based upon actual water consumption. Water rates are authorized by City Council and billings are made on a cyclical basis. Estimates for services between the ends of the various cycles and the end of the year are recorded as unbilled revenue.

Statement of Cash Flows: The Division utilizes the direct method of reporting for the statement of cash flows as defined by GASB Statement No. 9, *Reporting Cash Flows of Proprietary and Non-expendable Trust Funds and Governmental Entities That Use Proprietary Fund Accounting*. In a statement of cash flows, cash receipts and cash payments are classified according to operating, non-capital financing, capital and related financing, and investment activities.

Cash and Cash Equivalents: Cash and cash equivalents represent cash on hand and cash deposits maintained by the City Treasurer on behalf of the Division. Cash equivalents are defined as highly liquid investments with a maturity of three months or less when purchased and include certificates of deposit, U.S. Treasury bills, State Treasury Asset Reserve of Ohio (STAROhio) and repurchase agreements. The City's policy is to enter into repurchase agreements with local commercial banks and to obtain confirmation of securities pledged.

Investments: The Division follows the provisions of GASB Statement No. 31, *Accounting and Financial Reporting for Certain Investments and External Investment Pools*, which requires governmental entities to report certain investments at fair value in the balance sheet and recognize the corresponding change in the fair value of investments in the year in which the change occurred. The fair value is based on quoted market prices.

The City has invested funds in STAROhio during 2006 and 2005. STAROhio is an investment pool managed by the State Treasurer's Office, which allows governments within the State to pool their funds for investment purposes. STAROhio is not registered with the SEC as an investment company, but does operate in a manner consistent with Rule 2a7 of the Investment Company Act of 1940. Investments in STAROhio are valued at STAROhio's share price, which is the price the investment could be sold for on December 31, 2006 and 2005.

Restricted Assets: Proceeds from debt and amounts set aside in various fund accounts for payment of revenue bonds are classified as restricted assets since their use is limited by the bond indentures.

NOTE A – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Capital Assets and Depreciation: Capital assets are stated on the basis of historical cost, or if contributed, at fair market value as of the date received. Depreciation is computed by allocating the cost of capital assets over the estimated useful lives of the assets using the straight-line method. A capital asset is defined as a tangible item with a useful life in excess of one year and an individual cost of more than $5,000 for furniture, fixtures, equipment and vehicles and $10,000 for all other assets. When capital assets are disposed, the cost and related accumulated depreciation are removed from the accounts with gains or losses on disposition being reflected in operations. The estimated useful lives are as follows:

Utility plant	10 to 100 years
Land improvements	38 to 100 years
Buildings, structures and improvements	20 to 60 years
Furniture, fixtures, equipment and vehicles	5 to 50 years

The Division's policy is to capitalize interest on construction projects up to the point in time that the project is substantially completed. Capitalized interest is included in the cost of the assets and is depreciated on the straight-line basis over the estimated useful lives of such assets. The Division applies Statement of Financial Accounting Board Standards No. 62, *Capitalization of Interest Cost in Situations Involving Certain Tax-Exempt Borrowings and Certain Gifts and Grants,* for its revenue bonds. This statement requires capitalization of interest cost of eligible borrowings, less interest earned on investment of the related bond proceeds from the date of borrowing until the assets constructed from the bond proceeds are ready for their intended use.

For 2006 and 2005, total interest costs incurred amounted to $42,349,000 and $40,536,000, respectively, of which $3,086,000 and $2,083,000, respectively, was capitalized, net of interest income of $5,573,000 in 2006 and $6,615,000 in 2005.

Bond Issuance Costs, Discounts and Unamortized Losses on Debt Refundings: Bond issuance costs are recorded as deferred expenses, and unamortized original issuance discounts are netted against long-term debt. Both are amortized over the lives of the related bonds. Unamortized losses on debt refundings are netted against long-term debt and are amortized over the shorter of the remaining life of the defeased bond or the newly issued bond.

Compensated Absences: The Division accrues for compensated absences such as vacation, sick leave and compensatory time using the termination payment method specified under GASB Statement No. 16, *Accounting for Compensated Absences*. These amounts are recorded as accrued wages and benefits in the accompanying balance sheets. The portion of the compensated absence liability that is not expected to be paid or utilized within one year is reported as a long-term liability.

Normally, all vacation time is to be taken in the year available. The Division allows employees to carryover up to 80 hours of vacation time from one year to the next with proper approval. Sick days not taken may be accumulated until retirement. An employee is paid one-third of accumulated sick leave upon retirement, calculated at the three year average base salary rate, with the balance being forfeited.

NOTE B – LONG-TERM DEBT

Long-term debt outstanding at December 31, 2006 and 2005 is as follows:

	Interest Rate	Original Issuance	2006	2005
			(In thousands)	
Water Revenue Bonds:				
Series G, 1993, due through 2021	5.40%-5.50%	$ 228,170	$ 121,275	$ 133,045
Series H, 1996, due through 2026	5.20%-6.00%	204,885	14,470	18,190
Series I, 1998, due through 2028	4.30%-5.25%	305,650	161,875	165,115
Series J, 2001, due through 2016	4.00%-5.375%	92,595	63,345	70,110
Series K, 2002, due through 2021	3.50%-5.25%	138,050	69,725	69,725
Series L, 2002, due through 2033	Variable	90,000	90,000	90,000
Series M, 2004, due through 2033	3.533%	175,000	172,335	174,095
Series N, 2005, due through 2023	3.00%-5.00%	64,480	64,480	64,480
Ohio Water Development Authority Loans payable annually through 2028	3.20%-4.14%	121,438	98,320	73,002
		$ 1,420,268	855,825	857,762
Adjustments:				
Unamortized discount and premium			7,311	8,580
Unamortized loss on debt refunding			(33,808)	(36,860)
Current portion			(20,840)	(18,341)
Total Long-Term Debt			$ 808,488	$ 811,141

NOTE B – LONG-TERM DEBT (Continued)

Summary: Changes in long-term obligations for the year ended December 31, 2006 are as follows:

	Balance January 1, 2006	Increase	Decrease	Balance December 31, 2006	Due Within One Year
			(In thousands)		
Water Revenue Bonds:					
Series G, 1993, due through 2021	$ 133,045	$	$ (11,770)	$ 121,275	$ 1,225
Series H, 1996, due through 2026	18,190		(3,720)	14,470	190
Series I, 1998, due through 2028	165,115		(3,240)	161,875	5,190
Series J, 2001, due through 2016	70,110		(6,765)	63,345	7,105
Series K, 2002, due through 2021	69,725			69,725	3,985
Series L, 2002, due through 2033	90,000			90,000	
Series M, 2004, due through 2033	174,095		(1,760)	172,335	
Series N, 2005, due through 2023	64,480			64,480	
Ohio Water Development Authority Loans payable annually through 2028	73,002	30,042	(4,724)	98,320	3,145
Total revenue bonds/loans	857,762	30,042	(31,979)	855,825	20,840
Accrued wages and benefits	12,993		(622)	12,371	10,092
Total	$ 870,755	$ 30,042	$ (32,601)	$ 868,196	$ 30,932

NOTE B – LONG-TERM DEBT (Continued)

Summary: Changes in long-term obligations for the year ended December 31, 2005 are as follows:

	Balance January 1, 2005	Increase	Decrease	Balance December 31, 2005	Due Within One Year
			(In thousands)		
Water Revenue Bonds:					
Series G, 1993, due through 2021	$ 149,542	$	$ (16,497)	$ 133,045	
Series H, 1996, due through 2026	31,968		(13,778)	18,190	3,720
Series I, 1998, due through 2028	223,753		(58,638)	165,115	3,240
Series J, 2001, due through 2016	76,550		(6,440)	70,110	6,765
Series K, 2002, due through 2033	69,725			69,725	
Series L, 2002, due through 2033	90,000			90,000	
Series M, 2004, due through 2033	175,000		(905)	174,095	1,760
Ohio Water Development Authority Loans		64,480		64,480	
payable annually through 2024					
Total revenue bonds/loans	46,730	27,040	(768)	73,002	2,856
Accrued wages and benefits	863,268	91,520	(97,026)	857,762	18,341
Total	12,333	660		12,993	10,372
	$ 875,601	$ 92,180	$ (97,026)	$ 870,755	$ 28,713

NOTE B – LONG-TERM DEBT (Continued)

Minimum principal and interest payments on long-term debt for the next five years and thereafter are as follows:

	Principal	Interest	Total
		(In thousands)	
2007	$ 20,840	$ 37,927	$ 58,767
2008	24,207	37,739	61,946
2009	44,338	36,148	80,486
2010	46,454	33,975	80,429
2011	48,696	31,666	80,362
2012-2016	231,857	123,864	355,721
2017-2021	202,925	72,957	275,882
2022-2026	156,034	35,725	191,759
2027-2031	72,167	11,704	83,871
2032-2033	26,245	1,056	27,301
Total	$ 873,763	$ 422,761	$ 1,296,524

The above schedule of minimum principal and interest payments on long-term debt includes the amortization on seven loans provided to the City of Cleveland by the Ohio Water Development Authority (OWDA).

OWDA provided the City with the amount expected to be financed, the interest rate, initial repayment date and other significant items(s) for each of the seven loans. From the information received, the City prepared a detailed amortization schedule for each loan based upon the amount expected to be financed. However, the amortization schedule is tentative and will be adjusted if, and when, OWDA revises the amount to be financed.

Further, OWDA requires the City to begin making semi-annual payments for each loan based on the agreed upon initial repayment date, regardless of whether the City has received all loan proceeds or has completed the project(s).

Therefore, at December 31, 2006, the amount financed on these seven loan projects, less the principal payments made to date, totaled $116,258,000 and was reflected in the debt service payment schedule. However, the total on the actual loan balances received by the City was $98,320,000 as reflected on the schedules of long-term debt outstanding and changes in long-term debt obligations as of December 31, 2006. The difference of $17,938,000 will be received or accrued in future years(s).

NOTE B – LONG-TERM DEBT (Continued)

In prior years, the Division defeased certain Revenue Bonds by placing the proceeds of new bonds in an irrevocable trust to provide for all future debt service payments on the old bonds. In 2006, the Division deposited cash in the amount of $12,417,000 in an escrow account for the payment of future debt service requirements. Accordingly, the trust account assets and the liability for the defeased bonds are not included in the Division's financial statements. The aggregate amount of defeased debt outstanding at December 31, 2006 and 2005 is as follows:

Bond Issue	2006	2005
	(In thousands)	
Series G, 1993	$ 21,770	$ 20,265
Series H, 1996		137,640
Series I, 1998	129,925	129,925
Series K, 2002	68,325	68,325

In 1996, the City authorized the adoption of the eighth supplemental indenture to amend and restate the existing indenture, subject to the receipt of consent of the requisite number of bondholders. With the issuance of the Series J bonds, the City reached the 66 2/3% consent required to enact the Amended and Restated Indenture. Effective October 5, 2001, all outstanding bonds and any future bonds are secured by the Amended and Restated Indenture. Under the new indenture, the bonds are no longer secured by a mortgage lien. All bonds are secured by the Division's net revenues and by the pledged funds.

The Division's indentures have certain restrictive covenants and principally require that bond reserve funds be maintained and charges for fees to customers be in sufficient amounts, as defined, to satisfy the obligations under the indenture agreements. In addition, special provisions exist regarding covenant violations, redemption of principal and maintenance of properties in good condition.

The indenture requires that at all times the Division will charge rates and fees for the products and services of the waterworks system, so that revenues will be at least sufficient to provide funds for the payment in each year of the necessary operating and maintenance expenses of the waterworks system and the greater of (1) an amount equal to 1.25 times the payments of principal, premium, if any, and interest on the revenue bonds then outstanding due in that year or (2) an amount sufficient to maintain the required balances in all funds and accounts created under the indenture.

The indenture establishes the following fund accounts for the application of revenues:

Revenue Fund: All revenues will be deposited into this fund and will be used for payment of current operating expenses and deposits into other funds. An amount equal to one-sixth of the operating expenses, before depreciation, for the preceding fiscal year must be maintained in this fund.

Debt Service Fund: Deposits will be made from the revenue fund to cover succeeding principal and interest payments as they become due on the revenue bonds.

NOTE B – LONG-TERM DEBT (Continued)

Debt Service Reserve Fund: Deposits will be made to this fund if the amount in the debt service fund at any time is less than the debt service reserve requirement. Amounts in the fund were deposited from the proceeds of the revenue bonds and represent the maximum annual debt service requirement of these bonds.

Contingency Fund: The balance in this fund must be maintained at $3,500,000.

Construction Fund: Proceeds from the revenue bonds were deposited into this fund to be used, along with earnings from investments of amounts held therein, for the payment of capital costs. As of December 31, 2006 and 2005, the Division had $137,122,000 and $282,472,000, respectively, of outstanding commitments for future construction costs which will be funded by available bond proceeds and operating revenues. Capital costs include all costs of additions, extensions, renewals, replacements, alterations, betterments and any other capital improvements to the waterworks system. Amounts held in this fund are subject to a lien in favor of bondholders and may be used to pay principal of outstanding revenue bonds to the extent that amounts in all other funds are insufficient. No payment need be made into a fund if the amounts in such fund are equal to the required fund balance, if any.

Amounts held in any fund may be invested by the City Treasurer or the trustee in permitted investments, however, the use of funds is limited by the bond indenture and, accordingly, are classified as restricted assets in the accompanying financial statements.

On July 7, 2005, the City issued $64,480,000 of Water Revenue Bonds, Series N, 2005. The Bonds were issued to advance refund a portion of the outstanding Series H and Series I Water Revenue Bonds. Proceeds were used to fund an escrow deposit that will refund the bonds and to pay costs of issuance. Net proceeds of $68,329,574 were placed in an irrevocable escrow account which will be used to pay the principal, interest and premium on the refunded bonds. As a result, the refunded bonds are considered to be defeased and the liability for these bonds has been removed from long term debt. The total aggregate amount of the bonds refunded by the Series 2005 Bonds was $65,510,000. The City completed the refunding to reduce its total debt service payments by $2,737,000 and to obtain an economic gain (the difference between the present values of the old and new debt service payments) of approximately $2,601,000.

In 2006, the Division utilized cash on hand to defease $11,770,000 principal amount of outstanding Series G bonds. The Division placed $12,417,000 in an irrevocable trust account which will be used to pay principal and interest on the defeased bonds. As a result the bonds are considered defeased and the liability for the bonds has been removed from long term debt.

Interest Rate Swap Transaction:

<u>Terms:</u> Simultaneously with the issuance of the City's $175,000,000 Series M Water Revenue Bonds on August 10, 2004, the City entered into floating to fixed rate swap agreements with notional amounts equal to the total declining balance of the Series M Bonds. Bear Stearns Financial Products Inc. is the counterparty on a two-thirds pro rata share of the transaction and Morgan Stanley Capital Services Inc. is the counterparty on a one-third pro rata share of the transaction.

NOTE B – LONG-TERM DEBT (Continued)

Under the swap agreements for the Series M Bonds, the Water System will be the fixed rate payer, paying a fixed rate of 3.533%. Each counterparty is a floating rate payer, with each paying the Water System 61.25% of one month LIBOR plus a spread of 28 basis points. Net payments are exchanged semiannually on January 1 and July 1. The obligation of the Water System to make periodic payments (but not any termination payment) is secured by a pledge of and lien on the Net Revenues of the Water System on a parity with the pledge and lien securing the payment of debt service on the bonds.

Both the bond debt service payments on the Series M bonds and the periodic swap payments are insured by Financial Security Assurance (FSA).

Objective: The City entered into the swaps in order to maximize the savings associated with the refunding of the bonds. The actual savings to be realized by the Water System will depend upon the payments made on the variable rate bonds and the payments received under the swap agreement.

Basis Risk: By entering into swaps based upon the 30 day LIBOR rate of interest, the City has undertaken basis risk associated with a change in tax rates and structure. While the average relationship between LIBOR (taxable) and BMA (tax-exempt) interest rates has been 67%, this relationship may not continue to apply. If the payments received from the counterparties are less than the amount paid on the variable rate bonds, the Water System must make up the difference in addition to paying the fixed rate resulting from the swap. In addition, a reduction in federal income tax rates would increase the percentage relationship between BMA and LIBOR and would potentially increase the cost of the financing.

Counterparty Risk: The City selected highly rated counterparties in order to minimize this risk. However, over the long term it is possible that the credit strength of Bear Stearns and Morgan Stanley could change and this event could trigger a termination payment on the part of the City.

Termination Risk: The swap agreement may be terminated prior to its stated termination date under certain circumstances. Upon termination, a payment may be owed by the City to Bear Stearns and Morgan Stanley, or by Bear Stearns and Morgan Stanley to the City, depending upon the prevailing economic circumstances at the time of the termination. The City obtained insurance to mitigate much of the risk associated with termination due to the event of a rating downgrade of the Water System.

Fair Value: The fair value of the swaps at December 31, 2006 as reported by Bear Stearns and Morgan Stanley totaled $1,823,000 which would be payable by the City to Bear Stearns and Morgan Stanley.

Ohio Water Development Authority (OWDA) Loans: These loans are payable from net revenues derived from the waterworks. These obligations do not have a lien on revenues of the Division. The Division received an increase in OWDA loans in the amount of $30,042,000 and $27,040,000 during 2006 and 2005, respectively. The current loans are being paid directly to the contractor by the State of Ohio, but accounted for as if the Division received and disbursed those monies.

NOTE C – DEPOSITS AND INVESTMENTS

Deposits: The carrying amount of the Division's deposits at December 31, 2006 and 2005 totaled $51,986,000 and $31,935,000, respectively, and the Division's bank balances were $49,031,000 and $31,687,000, respectively. The differences represent normal reconciling items.

Based on the criteria described in GASB Statement No.3, *Deposits with Financial Institutions, Investments (including Repurchase Agreements), and Reverse Repurchase Agreements*, $49,031,000 and $21,729,000 of the bank balances at December 31, 2006 and 2005, respectively, were insured or collateralized with securities held by the City or by its agent in the City's name. The remaining balances of $0 and $9,958,000, respectively, were invested in Bank Investment Contract(s) that were secured by repurchase agreements of government securities held as collateral by the City's trustee in the name of the trustee.

Investments: The City's investment policies are governed by state statutes and City ordinances which authorize the City to invest in obligations of the U.S. Treasury, agencies and instrumentalities; bonds and other State obligations; certificates of deposit; U.S. Government Money Market Mutual Funds; STAROhio; guaranteed investment contracts and repurchase transactions. Such repurchase transactions must be purchased from financial institutions or registered broker/dealers and are not to exceed a period of one year and confirmation of securities pledged must be obtained.

Under City policy, investments are limited to repurchase agreements, U.S. Government securities, certificates of deposit, investments in certain money market mutual funds, and STAROhio. Generally, investments are recorded in segregated accounts by way of book entry through the bank's commercial or trust department and are kept at the Federal Reserve Bank in the depository institution's separate custodial account for the City, apart from the assets of the depository institution. Ohio statute prohibits the use of Reverse Repurchase Agreements.

Investment securities are exposed to various risks such as interest rate, market and credit. Market values of securities fluctuate based on the magnitude of changing market conditions; significant changes in market conditions could materially affect portfolio value.

GASB Statement No. 3, *Deposits with Financial Institutions, Investments (Including Repurchase Agreements) and Reverse Repurchase Agreements*, requires the City to categorize its investments into one of three credit risk categories:

Credit Risk: The Division's investments as of December 31, 2006 and 2005 include U.S. Agencies, Victory Federal Money Market Funds, Allegiant Government Money Market Funds, STAROhio, mutual funds and guaranteed investment contracts. The Division maintains the highest ratings for their investments. Investments in FHLMC, FNMA, FFCB and FHLB agency securities are rated AAA by Standard & Poor's. Investments in the Victory Money Market Fund, Allegiant Government Money Market Fund and STAROhio carry a rating of AAAm, which is the highest money market fund rating given by Standard & Poor's. Ohio law requires that STAROhio maintain the highest rating provided by at least one nationally recognized standard rating service. The Division has no investment policy that would further limit its investment choices.

NOTE C – DEPOSITS AND INVESTMENTS (Continued)

Concentration of Credit Risk: The Division places a limitation on the amount it may invest in any one issuer to help minimize the concentration of credit risk. The Division had the following investments at December 31, 2006 and 2005, which include those classified as cash and cash equivalents in the balance sheet in accordance with the provisions of GASB Statement No. 9 since they have a maturity of three months or less:

Type of Investment	2006 Fair Value	2006 Cost	2005 Fair Value	2005 Cost	Investment Maturities: Less than One Year	1 - 5 Years	5 Years or More
	(In thousands)						
U.S. Agency Obligations	$127,052	$127,640	$172,610	$175,258	$ 85,195	$ 41,857	$
STAROhio	11,115	11,115	3,676	3,676	11,115		
Investment in Mutual Funds	125,278	125,278	125,240	125,240	125,278		
Guaranteed Investment Contracts	139,238	139,238	163,948	163,948		102,388	36,850
Total Investments	402,683	403,271	465,474	468,122	221,588	144,245	36,850
Total Deposits	51,986	51,986	31,935	31,935	51,986		
Total Deposits and Investments	$454,669	$455,257	$497,409	$500,057	$ 273,574	$ 144,245	$ 36,850

Concentration of Credit Risk: The Division places no limit on the amount it may invest in any one issuer. As of December 31, 2006, the investments in U.S. Agency Obligations, STAROhio and guaranteed investment contracts are approximately 32%, 31% and 35%, respectively, of the Division's total investments. As of December 31, 2005, the investments in U.S. Agency Obligations, STAROhio and guaranteed investment contracts are approximately 37%, 27% and 35%, respectively, of the Division's total investments.

NOTE D – CAPITAL ASSETS

Capital Asset Activity: Capital asset activity for the year ended December 31, 2006 was as follows:

	Balance January 1, 2006	Additions	Deletions	Balance December 31, 2006
		(In thousands)		
Capital assets, not being depreciated:				
Land	$ 5,463	$	$	$ 5,463
Construction in progress	282,472	104,290	(70,870)	315,892
Total capital assets, not being depreciated	287,935	104,290	(70,870)	321,355
Capital assets, being depreciated:				
Land improvements	16,406	567		16,973
Utility plant	1,001,469	58,861	(4,138)	1,056,192
Buildings, structures and improvements	205,354	107	(941)	204,520
Furniture, fixtures, equipment and vehicles	118,785	13,267	(772)	131,280
Total capital assets, being depreciated	1,342,014	72,802	(5,851)	1,408,965
Less: Accumulated depreciation	(436,498)	(37,581)	4,750	(469,329)
Total capital assets being depreciated, net	905,516	35,221	(1,101)	939,636
Capital assets, net	$ 1,193,451	$ 139,511	$ (71,971)	$ 1,260,991

Capital Asset Activity: Capital asset activity for the year ended December 31, 2005 was as follows:

	Balance January 1, 2005	Additions	Deletions	Balance December 31, 2005
		(In thousands)		
Capital assets, not being depreciated:				
Land	$ 5,463	$	$	$ 5,463
Construction in progress	200,583	112,459	(30,570)	282,472
Total capital assets, not being depreciated	206,046	112,459	(30,570)	287,935
Capital assets, being depreciated:				
Land improvements	16,406			16,406
Utility plant	977,332	25,360	(1,223)	1,001,469
Buildings, structures and improvements	205,307	47		205,354
Furniture, fixtures, equipment and vehicles	109,826	10,741	(1,782)	118,785
Total capital assets, being depreciated	1,308,871	36,148	(3,005)	1,342,014
Less: Accumulated depreciation	(403,062)	(36,259)	2,823	(436,498)
Total capital assets being depreciated, net	905,809	(111)	(182)	905,516
Capital assets, net	$ 1,111,855	$ 112,348	$ (30,752)	$ 1,193,451

NOTE D – CAPITAL ASSETS (Continued)

Commitments: The Division has outstanding commitments at December 31, 2006 and 2005 of approximately \$249,489,000 and \$282,470,000, respectively, for future capital expenditures, respectively. It is anticipated that these commitments will be financed from the Division's cash balances; however, at the discretion of the Division, additional long-term debt may be issued in the future to finance a portion of the costs.

NOTE E – EMPLOYEES RETIREMENT PLAN

All full-time employees participate in the Ohio Public Employees Retirement System (OPERS). OPERS administers three separate pension plans as described below:

1) The Traditional Pension Plan (TP) – a cost-sharing, multiple-employer defined benefit pension plan.
2) The Member-Directed Plan (MD) – a defined contribution plan in which the member invests both member and employer contributions (employer contributions vest over five years at 20% per year). Under the Member-Directed Plan members accumulate retirement assets equal to the value of member and (vested) employer contributions plus any investment earnings.
3) The Combined Plan (CO) – a cost-sharing, multiple-employer defined benefit pension plan. Under the Combined Plan, employer contributions are invested by OPERS to provide a formula retirement benefit similar in nature to the Traditional Pension Plan benefit. Member contributions, the investment of which is self-directed by the members, accumulate retirement assets in a manner similar to the Member-Directed Plan.

OPERS provides retirement, disability, survivor and death benefits and annual cost-of-living adjustments to members of the Traditional Pension and Combined Plans. Members of the Member-Directed Plan do not qualify for ancillary benefits. Authority to establish and amend benefits is provided by state statute per Chapter 145 of the Ohio Revised Code. OPERS issues a stand-alone financial report. Interested parties may obtain a copy by making a written request to OPERS, 277 East Town Street, Columbus, Ohio 43215-4642 or by calling (614) 222-5601 or 1-800-222-7377.

The Ohio Revised Code provides statutory authority for member and employer contributions. Member and employer contribution rates were consistent across all three plans (TP, MD and CO). Member contribution rates were 9.0% in 2006 and 8.5% in 2005 and 2004 and employer contribution rates were 13.70% of covered payroll in 2006 and 13.55% of covered payroll in 2005 and 2004. The Division's required employer contributions to OPERS for the pension portion of all the plans for the years ending December 31, 2006, 2005 and 2004 were approximately \$4,929,000, \$5,095,000 and \$5,100,000 each year, respectively. The required payments due in 2006, 2005 and 2004 have been made.

NOTE F – OTHER POST-EMPLOYMENT BENEFITS

Ohio Public Employees Retirement System: Ohio Public Employees Retirement System (OPERS) administers three separate pension plans: The Traditional Pension Plan (TP) – a cost-sharing, multiple-employer defined benefit pension plan; the Member-Directed Plan (MD) – a defined contribution plan; and the Combined Plan (CO) – a cost-sharing, multiple-employer defined benefit pension plan that has elements of both a defined benefit and defined contribution plan. OPERS provides retirement, disability and survivor benefits as well as postretirement health care coverage to qualifying members of both the Traditional Pension and the Combined Plans. Members of the Member-Directed Plan do not qualify for ancillary benefits, including postemployment health care coverage. In order to qualify for postretirement health care coverage, age and service retirees under the Traditional Pension and Combined Plans must have 10 or more years of qualifying Ohio service credit. Health care coverage for disability benefit recipients and qualified survivor benefit recipients is available. The health care coverage provided by OPERS is considered to be an Other Postemployment Benefit (OPEB) as described in GASB Statement No. 12.

A portion of each employer's contribution to OPERS is set aside for the funding of postretirement health care. The Ohio Revised Code provides statutory authority for employer contributions. The Division's contribution rate was 13.70% of covered payroll in 2006 and 13.55% of covered payroll in 2005 and 2004, and 4.50% was used to fund health care for the year in 2006 and 4.00% was used to fund health care for the year in 2005 and 2004. The Ohio Revised Code provides the statutory authority requiring public employers to fund postretirement health care through their contributions to OPERS. The assumptions and calculations below were based on OPERS' latest actuarial review performed as of December 31, 2005. The individual entry age actuarial cost method of valuation is used in determining the present value of OPEB. The difference between assumed and actual experience (actuarial gains and losses) becomes part of the unfunded actuarial accrued liability. All investments are carried at market value. For actuarial valuation purposes, a smoothed market approach is used. Under this approach, assets are adjusted to reflect 25% of unrealized market appreciation or depreciation on investment assets annually, not to exceed a 12% corridor. The investment assumption rate for 2005 was 6.50%. An annual increase of 4.00%, compounded annually, is the base portion of the individual pay increase assumption. This assumes no change in the number of active employees. Additionally, annual pay increases, over and above the 4.00% base increase, were assumed to range from 0.50% to 6.30%.

Health care costs were assumed to increase at the projected wage inflation rate plus an additional factor ranging from .50% to 6% for the next 9 years. In subsequent years (10 and beyond) health care costs were assumed to increase at 4% (the projected wage inflation rate). OPEBs are advance-funded on an actuarially determined basis. The Traditional Pension and Combined Plans had 369,214 active contributing participants as of December 31, 2006. The number of active contributing participants for both plans used in December 31, 2005, actuarial valuation was 358,804. The employer contribution rate of 13.70 % is the actuarially determined contribution requirements for OPERS. The Division's actual contributions for 2006 which were to fund postemployment benefits were approximately $2,411,000. $11.1 billion represents the actuarial value of OPERS' net assets available for OPEB at December 31, 2005. Based on the actuarial cost method used, the actuarial valuation as of December 31, 2005, reported the actuarial accrued liability and the unfunded actuarial accrued liability for OPEB at $31.3 billion and $20.2 billion, respectively.

NOTE F – OTHER POST-EMPLOYMENT BENEFITS (Continued)

The Health Care Preservation Plan (HCPP) adopted by the OPERS Retirement Board on September 9, 2004, will be effective January 1, 2007. OPERS took additional actions to improve the solvency of the Health Care Fund in 2005 by creating a separate investment pool for health care assets. Member and employer contribution rates increased as of January 1, 2006, and January 1, 2007, which will allow additional funds to be allocated to the health care plan.

NOTE G – CONTINGENT LIABILITIES AND RISK MANAGEMENT

Contingent Liabilities: Various claims are pending against the City involving the Division for personal injuries, property damage and other matters. The City is responsible for the suits. The City's management is of the opinion that ultimate settlement of such claims will not result in a material adverse effect on the Division's financial position, results of operations or cash flows.

Risk Management: The Division is exposed to various risks of loss related to torts; thefts of, damage to and destruction of assets; errors and omissions; injuries to employees; and natural disasters. The Division is generally self-insured. No material losses, including incurred but not reported losses, occurred in 2006 or 2005.

The City provides the choice of four separate health insurance plans for its employees. These plans are provided by two different insurers through commercial insurance. Operating funds are charged a monthly rate per employee, by type of coverage. The City participates in the State of Ohio workers' compensation retrospective rating program.

In accordance with GASB Statement No. 10, claims liabilities are reported when it is probable that a loss has occurred and the amount of the loss can be reasonably estimated. Liabilities include an amount for claims that have been incurred but not reported. The result of the process to estimate the claims liability is not an exact amount as it depends on many complex factors, such as inflation, changes in legal doctrines, and damage awards. Accordingly, claims are re-evaluated periodically to consider the effects of inflation, recent claim settlement trends (including frequency and amount of pay-outs), and other economic and social factors.

The estimate of the claims liability also includes amounts for incremental claim adjustment expenses related to specific claims and other claim adjustment expenses, regardless of whether allocated to specific claims. Estimated recoveries, for example from salvage or subrogation, are another component of the claims liability estimate. Claims liability for the Division is immaterial.

NOTE H – RELATED PARTY TRANSACTIONS

Revenues and Accounts Receivable: The Division provides water services to the City of Cleveland, including its various departments and divisions. Standard consumption rates are charged, except for the Division of Fire, public buildings and certain other facilities owned by the City of Cleveland, which by ordinance are provided free water services.

NOTE H – RELATED PARTY TRANSACTIONS (Continued)

The Division performs billing and collection services for the Division of Water Pollution Control for a fee. This fee is based on the number of billings made on behalf of that division during the year at the same rates as charged to other users of the billing system. Revenue realized from the Division of Water Pollution Control for such services was approximately $2,257,000 and $2,320,000 in 2006 and 2005, respectively. The Division also provides miscellaneous services to other departments and divisions of the City. Revenue realized from such services was approximately $2,387,000 and $4,383,000 in 2006 and 2005, respectively.

Operating Expenses: The Division is provided various intra-city services. Charges are based on actual use or on a reasonable pro rata basis. The more significant costs for the years ended December 31 were as follows:

	2006	2005
	(In thousands)	
Electricity purchases	$ 11,835	$ 12,011
City administration	4,032	1,743
Motor Vehicle Maintenance	2,279	2,301
Telephone exchange	928	804
Utilities Administration and Utilities Fiscal Control	2,980	2,708

NOTE I – CUYAHOGA COUNTY REAL PROPERTY TAXES

The Division is required by ordinance to keep records of the estimated property taxes which would be payable to Cuyahoga County were it subject to such taxes. The estimated property taxes for the Division, based on book value of real estate at the current tax rates, would have been approximately $4,962,000 and $4,619,000 for the years ended December 31, 2006 and 2005, respectively.

NOTE J – SUBSEQUENT EVENTS

On February 5, 2007, legislation was passed by City Council authorizing the issuance of not to exceed $185,000,000 of Water Revenue Bonds. The proceeds of these bonds will be used to pay for improvements to the Waterworks System. Effective June 28, 2007, the City issued $143,570,000 Water Revenue Bonds, Series O, 2007.

Mary Taylor, CPA
Auditor of State

CITY OF CLEVELAND – DIVISION OF WATER

CUYAHOGA COUNTY

CLERK'S CERTIFICATION

This is a true and correct copy of the report which is required to be filed in the Office of the Auditor of State pursuant to Section 117.26, Revised Code, and which is filed in Columbus, Ohio.

Susan Babbitt

CLERK OF THE BUREAU

CERTIFIED
AUGUST 2, 2007

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