CITY OF CLEVELAND, OHIO

DEPARTMENT OF PUBLIC UTILITIES
DIVISION OF WATER

REPORT ON AUDITS OF FINANCIAL STATEMENTS
For the years ended December 31, 2002 and 2001

CITY OF CLEVELAND, OHIO

DEPARTMENT OF PUBLIC UTILITIES
DIVISION OF WATER

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Auditor of State
Betty Montgomery

INDEPENDENT ACCOUNTANTS' REPORT

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

To the Honorable Jane L. Campbell, Mayor, Members of Council, and the Audit Committee:

We have audited the accompanying financial statements of the Division of Water, Department of Public Utilities, City of Cleveland, Ohio, as of and for the years ended December 31, 2002 and December 31, 2001, as listed in the table of contents. These financial statements are the responsibility of the Division of Water's management. Our responsibility is to express an opinion 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 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 audits provide a reasonable basis for our opinion.

As discussed in Note A, the financial statements present only the Division of Water and do not purport to, and do not, present fairly the financial position of the City of Cleveland as of December 31, 2002 and December 31, 2001, and the 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 financial position of the Division of Water as of December 31, 2002 and December 31, 2001, and the changes in financial position and cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

Betty Montgomery

Betty Montgomery
Auditor of State

June 26, 2003

Lausche Building / 615 Superior Ave., NW / Twelfth Floor / Cleveland, OH 44113-1801
Telephone: (216) 787-3665 (800) 626-2297 Fax: (216) 787-3361
www.auditor.state.oh.us

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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 fiscal year ended December 31, 2002. Please read this information in conjunction with the Division’s financial statements and footnotes that begin on page 10.

The Division of Water 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 of Cleveland, but also 70 suburban municipalities in Cuyahoga, Medina, Summit and Geauga counties. The Division is an emergency standby provider for systems in 3 other counties. The present service area covers over 640 square miles and serves over 1.5 million people. In 2002, the aggregate metered consumption of water in the City constituted 34 percent of the total metered consumption in the service area, while consumption in the direct service communities and master meter communities constituted 55 percent and 11 percent, respectively.

FINANCIAL HIGHLIGHTS

- The assets of the Division exceeded its liabilities at December 31, 2002 by $773,866,000 (net assets). Of this amount, $277,896,000 (unrestricted net assets) may be used to meet the Division’s ongoing obligations to customers and creditors.

- The Division’s total net assets increased by $57,088,000 during 2002**.** The increase was predominately due to an increase in revenues from the sale of water and associated services.

- During 2002, the Division made expenditures for capital improvements totaling $110,160,000. The principal capital expenditures during the year were for the Morgan Plant Renovation, Baldwin Plant Renovation, Nottingham Plant Renovation, Water Main Rehabilitation, and Plant Enhancement Program Design.

- The Division’s total debt increased by $186,783,000 (27 percent) during the current fiscal year. The key factor in this increase was the issuance of 2 new series of bonds in 2002, Series K and Series L.

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 of Cleveland’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.

OVERVIEW OF THE FINANCIAL STATEMENTS (Continued)

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 10 - 15 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 16 - 29 of this report.

CONDENSED BALANCE SHEET INFORMATION

Provided below is condensed balance sheet information for the Division as of December 31, 2002 and 2001:

	2002	2001	Increase/ (Decrease)
		(In thousands)	
Assets:			
Capital assets	$ 967,187	$ 886,567	$ 80,620
Restricted assets	404,240	253,727	150,513
Unamortized bond issuance costs	7,512	5,964	1,548
Current assets	312,230	285,983	26,247
Total assets	1,691,169	1,432,241	258,928
Net Assets and Liabilities:			
Net assets:			
Invested in capital assets, net of related debt	394,542	349,275	45,267
Restricted for debt service	101,428	110,112	(8,684)
Unrestricted	277,896	257,391	20,505
Total net assets	773,866	716,778	57,088
Liabilities:			
Long-term obligations	841,374	653,209	188,165
Payable from restricted assets	13,318	5,303	8,015
Current liabilities	62,611	56,951	5,660
Total liabilities	917,303	715,463	201,840
Total net assets and liabilities	$ 1,691,169	$ 1,432,241	$ 258,928

CONDENSED BALANCE SHEET INFORMATION (Continued)

Assets: Capital assets increased due to the continuing renovation program. Restricted assets increased due to the issuance of bond Series K and L

Capital assets: The Division's investment in capital assets, as of December 31, 2002, amounted to $967,187,000 (net of accumulated depreciation). The total increase in the Division's investment in capital assets for the current fiscal year was 9 percent. A summary of the activity in the Division's capital assets during the year ended December 31, 2002 is as follows:

	Balance January 1, 2002	Additions	Reductions	Balance December 31, 2002
		(In thousands)		
Land	$ 5,271	$	$	$ 5,271
Land improvements	12,676	1,440		14,116
Utility plant	813,195	53,885	(218)	866,862
Buildings, structures and improvements	174,729	3,463		178,192
Furniture, fixtures and equipment	65,516	13,603		79,119
Construction in progress	128,005	105,279	(67,510)	165,774
Total	1,199,392	177,670	(67,728)	1,309,334
Less: Accumulated depreciation	(312,825)	(30,400)	1,078	(342,147)
Capital assets, net	$ 886,567	$ 147,270	$ (66,650)	$ 967,187

Major events during the current fiscal year affecting the Division's capital assets included the following:

- Construction on Morgan, Baldwin and Nottingham renovations.
- Purchase of vehicles and equipment.
- Water main rehabilitation.

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:

Payables from restricted assets: Payables from restricted assets increased due to an increase in construction in the continuing system renovation program.

Current liabilities: This increase was due mainly to an increase in the current portion of the scheduled payment of bonds.

CONDENSED BALANCE SHEET INFORMATION (Continued)

Long-term debt: At the end of the current fiscal year, the Division had total debt outstanding of $885,921,000. All bonds and notes are backed by the revenues generated by the Division.

The activity in the Division's debt obligations outstanding during the year ended December 31, 2002 is summarized below (excluding unamortized discounts, premiums and losses on debt refundings):

	Balance January 1, 2002	Debt Issued	Debt Refunded	Debt Retired	Balance December 31, 2002
			(In thousands)		
Water Revenue Bonds:					
Series A, 1977	$ 12,905	$	$	$ (12,905)	$
Series D, 1986	15,350		(15,350)		
Series G, 1993	187,440			(6,330)	181,110
Series H, 1996	81,105			(9,030)	72,075
Series I, 1998	303,765			(1,900)	301,865
Series J, 2001	92,595				92,595
Series K, 2002		138,050			138,050
Series L, 2002		90,000			90,000
Ohio Water Development Authority Loan	5,978	4,621		(373)	10,226
Total	$ 699,138	$ 232,671	$ (15,350)	$ (30,538)	$ 885,921

The bond ratings for the Division's outstanding revenue bonds are as follows and remain unchanged since 2001.

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 2002, 2001, and 2000 was 186%, 213%, and 196%, respectively.

Additional information on the Division's long-term debt can be found in Note B on pages 19 - 24.

Net Assets: Net assets serves as a useful indicator of a government's financial position. In the case of the Division, assets exceed liabilities by $773,866,000 at the close of the most recent fiscal year.

CONDENSED BALANCE SHEET INFORMATION (Continued)

By far, the largest portion of the Division's net assets (51 percent) 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 (13 percent) represents resources classified as restricted assets since their use is limited by the bond indentures. The remaining balance of unrestricted net assets, $277,896,000 or (36 percent), 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 2002 and 2001 increased its net assets by $57,088,000 and $63,031,000, respectively. Key elements of these are summarized below:

	2002	2001	Increase/ (Decrease)
		(In thousands)	
Operating revenues	$ 215,688	$ 212,724	$ 2,964
Operating expenses	149,275	146,523	2,752
Operating income	66,413	66,201	212
Non-operating revenue (expense):			
Investment income	10,706	17,103	(6,397)
Interest expense	(20,233)	(19,776)	(457)
Amortization of bond issuance costs and discount	163	(770)	933
Workers' compensation refund	39	2,100	(2,061)
(Loss) on disposal of capital assets		(1,827)	1,827
Total non-operating revenue (expense), net	(9,325)	(3,170)	(6,155)
Increase in net assets	57,088	63,031	(5,943)
Net assets, beginning of year	716,778	653,747	63,031
Net assets, end of year	$ 773,866	$ 716,778	$ 57,088

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

Investment income decreased due to lower interest rates in 2002.

Operating income increased over 2002 due to the January 1, 2002 rate increase of approximately 3.4 percent.

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

A rate increase of approximately 3.4% in 2003, 2004 and 2005 will increase revenue to match expected expenditures.

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, 2002 and 2001

	(In thousands) 2002	2001
ASSETS		
CAPITAL ASSETS		
Land	$ 5,271	$ 5,271
Land improvements	14,116	12,676
Utility plant	866,862	813,195
Buildings, structures and improvements	178,192	174,729
Furniture, fixtures and equipment	79,119	65,516
	1,143,560	1,071,387
Less: Accumulated depreciation	(342,147)	(312,825)
	801,413	758,562
Construction in progress	165,774	128,005
CAPITAL ASSETS, NET	967,187	886,567
RESTRICTED ASSETS		
Cash and cash equivalents	388,662	239,945
Investments	10,999	12,899
Accrued interest receivable	673	883
OWDA loans receivable	3,906	
TOTAL RESTRICTED ASSETS	404,240	253,727
UNAMORTIZED BOND ISSUANCE COSTS	7,512	5,964
CURRENT ASSETS		
Cash and cash equivalents	91,806	111,148
Investments	160,256	118,510
Receivables:		
Accounts receivable - net of allowance for doubtful accounts of $7,258,000 in 2002 and $7,741,000 in 2001	23,602	20,430
Unbilled revenue	25,214	22,750
Due from other City of Cleveland departments, divisions or funds	4,732	5,113
Accrued interest receivable	1,249	1,502
Materials and supplies - at average cost, net of allowance for obsolescence of $600,000 in 2002 and 2001	4,880	5,343
Prepaid expenses	491	1,187
TOTAL CURRENT ASSETS	312,230	285,983
TOTAL ASSETS	$ 1,691,169	$ 1,432,241

(Continued)

CITY OF CLEVELAND, OHIO

DEPARTMENT OF PUBLIC UTILITIES
DIVISION OF WATER
BALANCE SHEETS
December 31, 2002 and 2001

	(In thousands) 2002	2001
NET ASSETS AND LIABILITIES		
NET ASSETS		
Invested in capital assets, net of related debt	$ 394,542	$ 349,275
Restricted for debt service	101,428	110,112
Unrestricted	277,896	257,391
TOTAL NET ASSETS	773,866	716,778
LIABILITIES		
LONG-TERM OBLIGATIONS-excluding amounts due within one year:		
Revenue bonds	829,312	645,366
OWDA loan	9,839	5,738
Accrued wages and benefits	2,223	2,105
TOTAL LONG-TERM OBLIGATIONS	841,374	653,209
PAYABLE FROM RESTRICTED ASSETS	13,318	5,303
CURRENT LIABILITIES		
Current portion of long-term debt, due within one year	24,377	17,500
Accounts payable	3,208	5,323
Due to other City of Cleveland departments, divisions or funds	5,001	5,534
Accrued interest	17,848	17,018
Current portion of accrued wages and benefits	8,619	8,515
Other accrued expenses	393	430
Customer deposits and other liabilities	3,165	2,631
TOTAL CURRENT LIABILITIES	62,611	56,951
TOTAL LIABILITIES	917,303	715,463
TOTAL NET ASSETS AND LIABILITIES	$ 1,691,169	$ 1,432,241

See notes to financial statements.

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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, 2002 and 2001

	(In thousands) 2002	2001
OPERATING REVENUES		
Charges for services	$ 215,688	$ 212,724
TOTAL OPERATING REVENUES	215,688	212,724
OPERATING EXPENSES		
Operations	91,259	93,299
Maintenance	28,477	23,542
Depreciation	29,539	29,682
TOTAL OPERATING EXPENSES	149,275	146,523
OPERATING INCOME	66,413	66,201
NON-OPERATING REVENUE (EXPENSE)		
Investment income	10,706	17,103
Interest expense	(20,233)	(19,776)
Amortization of bond issuance costs, premiums, and discounts	163	(770)
Workers' compensation refund	39	2,100
Loss on disposal of capital assets		(1,827)
TOTAL NON-OPERATING REVENUE (EXPENSE), NET	(9,325)	(3,170)
INCREASE IN NET ASSETS	57,088	63,031
NET ASSETS, beginning of year	716,778	653,747
NET ASSETS, end of year	$ 773,866	$ 716,778

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, 2002 and 2001

	(In thousands) 2002	2001
CASH FLOWS FROM OPERATING ACTIVITIES		
Cash received from customers	$ 212,910	$ 212,022
Cash payments to suppliers for goods or services	(60,023)	(55,677)
Cash payments to employees for services	(63,559)	(61,748)
Receipt of customer deposits, net	534	55
NET CASH PROVIDED BY OPERATING ACTIVITIES	89,862	94,652
CASH FLOWS FROM NONCAPITAL FINANCING ACTIVITIES		
Grants	473	
Workers compensation refund	95	2,100
NET CASH PROVIDED BY NONCAPITAL FINANCING ACTIVITIES	568	2,100
CASH FLOWS FROM CAPITAL AND RELATED FINANCING ACTIVITIES		
Acquisition and construction of capital assets	(87,449)	(56,958)
Proceeds of OWDA loan	457	6,208
Principal paid on long-term debt	(30,491)	(20,835)
Interest paid on long-term debt	(34,885)	(38,201)
Cash paid to escrow agent for refunding	(17,307)	(97,680)
Proceeds of new and refunding bonds	234,717	97,711
NET CASH PROVIDED BY (USED FOR) CAPITAL AND RELATED FINANCING ACTIVITIES	65,042	(109,755)
CASH FLOWS FROM INVESTING ACTIVITIES		
Purchase of investment securities	(206,780)	(184,343)
Proceeds from sale and maturity of investment securities	167,944	279,322
Interest received on investments	12,739	29,280
NET CASH PROVIDED BY (USED FOR) INVESTING ACTIVITIES	(26,097)	124,259
NET INCREASE IN CASH AND CASH EQUIVALENTS	129,375	111,256
CASH AND CASH EQUIVALENTS, beginning of year	351,093	239,837
CASH AND CASH EQUIVALENTS, end of year	$ 480,468	$ 351,093

(Continued)

CITY OF CLEVELAND, OHIO

DEPARTMENT OF PUBLIC UTILITIES
DIVISION OF WATER
STATEMENTS OF CASH FLOWS
For the Years Ended December 31, 2002 and 2001

	2002	2001
	(In thousands)	
RECONCILIATION OF OPERATING INCOME TO NET CASH PROVIDED BY OPERATING ACTIVITIES		
OPERATING INCOME	$ 66,413	$ 66,201
Adjustments to reconcile operating income to net cash provided by operating activities:		
Depreciation	29,539	29,682
Changes in assets and liabilities:		
Accounts receivable, net	(3,172)	(4,654)
Unbilled revenue	(2,464)	(151)
Due from other City of Cleveland departments, divisions or funds	381	562
Materials and supplies, net	463	(640)
Prepaid expenses	695	(963)
Accounts payable	(2,179)	2,402
Due to other City of Cleveland departments, divisions or funds	(533)	4,474
Accrued wages and benefits	222	(2,446)
Other accrued expenses	(37)	130
Customer deposits and other liabilities	534	55
TOTAL ADJUSTMENTS	23,449	28,451
NET CASH PROVIDED BY OPERATING ACTIVITIES	$ 89,862	$ 94,652

See notes to financial statements.

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

NOTES TO FINANCIAL STATEMENTS
For the Years Ended December 31, 2002 and 2001

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, 2002, the Division changed its financial reporting by implementing the provisions of Statement No. 34 of the Governmental Accounting Standards Board (GASB), Ma*nagement's Discussion and Analysis – for State and Local Governments,* GASB Statement No. 37, *Basic Financial Statements – and Management's Discussion and Analysis – for State and Local Governments: Omnibus,* and GASB Statement No. 38, *Certain Financial Statement Note Disclosures*. These "Reporting Model" statements affect the way the Division prepares and presents financial information. As a result of the implementation of these new GASB statements, the amount previously reported as the Division's equity is now reported as the Division's net assets in the accompanying balance sheets, and the net assets are divided into three categories as follows:

- Amount invested in capital assets, net of related debt.
- 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.

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.

NOTES TO FINANCIAL STATEMENTS (Continued)
For the Years Ended December 31, 2002 and 2001

NOTE A - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

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 2002 and 2001. STAROhio is an investment pool managed by the State Treasurers 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, 2002 and 2001.

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.

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 fixed 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 and equipment 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	6 to 100 years
Land improvements	38 to 100 years
Buildings, structures and improvements	20 to 60 years
Furniture, fixtures and equipment	5 to 50 years

NOTE A - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

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 2002 and 2001, total interest costs incurred amounted $38,007,000 and $38,299,000, respectively, of which $15,199,000 and $10,669,000, respectively, was capitalized, net of interest income of $2,575,000 in 2002 and $7,854,000 in 2001.

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 unless written approval for carryover of vacation time is obtained. Sick days not taken may be accumulated until retirement. An employee is paid one-third of accumulated sick leave upon retirement, calculated at current wage rates, with the balance being forfeited.

NOTES TO FINANCIAL STATEMENTS (Continued)
For the Years Ended December 31, 2002 and 2001

NOTE B - LONG-TERM DEBT

Long-term debt outstanding at December 31, 2002 and 2001 is as follows:

	Interest Rate	Original Issuance	2002	2001
			(In thousands)	
Water Revenue Bonds:				
Series A, 1977, due through 2008	6.13%	$ 80,000	$	$ 12,905
Series D, 1986, due through 2015	5.00%-7.00%	119,065		15,350
Series G, 1993, due through 2021	4.60%-5.50%	228,170	181,110	187,440
Series H, 1996, due through 2026	4.20%-5.75%	204,885	72,075	81,105
Series I, 1998, due through 2026	4.00%-5.25%	305,650	301,865	303,765
Series J, 2001, due through 2016	4.00%-5.375%	92,595	92,595	92,595
Series K, 2002, due through 2033	3.50%-5.250%	138,050	138,050	
Series L, 2002, due through 2033	4.00%-Variable	90,000	90,000	
Ohio Water Development Authority Loan payable annually through 2024	3.20%-4.14%		10,226	5,978
		$ 1,258,415	885,921	699,138
Less:				
Unamortized discount and premium			9,085	2,121
Unamortized loss on debt refunding			(31,478)	(32,655)
Current portion			(24,377)	(17,500)
Total Long-Term Debt			$ 839,151	$ 651,104

NOTE B - LONG-TERM DEBT (Continued)

Summary: Changes in long-term obligations for the year ended December 31, 2002 are as follows:

	Balance January 1, 2002	Increase	Decrease	Balance December 31, 2002	Due Within One Year
			(In thousands)		
Water Revenue Bonds:					
Series A, 1977, due through 2008	$ 12,905	$	$ (12,905)	$	$
Series D, 1986, due through 2015	15,350		(15,350)		
Series G, 1993, due through 2021	187,440		(6,330)	181,110	8,800
Series H, 1996, due through 2026	81,105		(9,030)	72,075	3,105
Series I, 1998, due through 2026	303,765		(1,900)	301,865	2,175
Series J, 2001, due through 2016	92,595			92,595	9,910
Series K, 2002, due through 2033		138,050		138,050	
Series L, 2002, due through 2033		90,000		90,000	
Ohio Water Development Authority Loan payable annually through 2024	5,978	4,621	(373)	10,226	387
Total revenue bonds/loans	699,138	232,671	(45,888)	885,921	24,377
Accrued wages and benefits	10,620	222		10,842	8,619
Total	$ 709,758	$ 232,893	$ (45,888)	$ 896,763	$ 32,996

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)	
2003	$ 24,377	$ 40,105	$ 64,482
2004	25,746	43,130	68,876
2005	27,340	41,942	69,282
2006	29,551	40,431	69,982
2007	35,362	38,755	74,117
2008-2012	204,974	163,836	368,810
2013-2017	197,274	109,742	307,016
2018-2022	151,551	63,841	215,392
2023-2027	118,435	29,678	148,113
2028-2032	65,800	9,053	74,853
2033	13,380	270	13,650
Total	$ 893,790	$ 580,783	$ 1,474,573

The above schedule of minimum principal and interest payments on long-term debt includes the amortization on three 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 three 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, 2002, the amount financed on these three loan projects, less the principal payments made to date, totaled $18,095,000 and was reflected in the debt service payment schedule. However, the total on the actual loan balances received by the City was $10,226,000 as reflected on the schedules of long-term debt outstanding and changes in long-term debt obligations as of December 31, 2002. The difference of $7,869,000 will be received or accrued in future years(s).

NOTE B - LONG-TERM DEBT (Continued)

In prior years, the Division defeased certain Mortgage 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. 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, 2002 and 2001 is as follows:

Bond Issue	**2002**	**2001**
	(In thousands)	
Series F, 1992	$ -	$ 263,010
Series H, 1996	102,340	104,950
Series G, 1993	-	2,040
Series D, 1986	15,350	-

In 1996, the City authorized the adoption of the eighth supplemental indenture to amend and restate the existing indenture, subject to the receipt of the 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. On the 25th day of each month, 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, 2002 and 2001, the Division had $172,731,000 and $184,337,000 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.

Effective October 4, 2001, the Division of Water issued $92,595,000 of Waterworks Refunding Revenue Bonds, Series J 2001. The proceeds were used to currently refund certain outstanding Series F, Series G and Series H Revenue Bonds and to pay costs of issuance. Proceeds of $96,566,000 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 in the aggregate principal amount of $91,965,000 are considered to be defeased and the liability for these bonds has been removed from long-term debt. The City completed the refunding to reduce its total debt service payments over the next fifteen years by $7,231,000 and to obtain an economic gain (difference between the present values of the old and new debt service payment) of $7,193,000.

On November 21, 2002, the Division of Water issued $138,050,000 of Water Revenue Bonds, Series K, 2002 and $90,000,000 Water Revenue Bonds, Series L, 2002. The proceeds of the Series K Bonds will be used to currently refund all of the $15,350,000 outstanding Waterworks Improvement First Mortgage Refunding Revenue Bonds, Series D, 1986, to pay costs of improvement to the Waterworks System and to pay costs of issuance of the Series K Bonds. Net proceeds of $15,733,750 were placed in an escrow account, which was used to pay principal and interest on the refunded bonds on January 1, 2003. As a result, the refunded bonds are considered to be defeased and the liability for these bonds have been removed from long-term debt. The City completed the refunding of the Series D Bonds to reduce its total debt service payments by $1.38 million over the next 14 years and to obtain an economic gain (difference between the present values of the old and new debt service payments) of approximately $881,000. The Series L Bonds were issued to pay costs of improvements to the Waterworks System and to pay costs of issuance of the Series L Bonds. Series L Bonds were issued as variable rate bonds in a weekly mode with a liquidity facility provided by WestLB, AG, acting through its New York branch.

NOTE B - LONG-TERM DEBT (Continued)

Ohio Water Development Authority (OWDA) Loans: These loans are payable from net revenues derived from the waterworks and water pollution control systems. These obligations do not have a lien on revenues of the Divisions. The Division received an increase in OWDA loans in the amount of $4,621,000 during 2002.

NOTE C - DEPOSITS AND INVESTMENTS

Deposits: The carrying amount of the Division's deposits at December 31, 2002 and 2001 totaled $76,059,000 and $15,556,000, respectively, and the Division's bank balances were $77,741,000 and $16,830,000, respectively.

Based on the criteria described in GASB Statement No.3, *Deposits with Financial Institutions, Investments (including Repurchase Agreements), and Reverse Repurchase Agreements*, $63,174,000 and $1,997,000 of the bank balances at December 31, 2002 and 2001, respectively, were insured or collateralized with securities held by the City or by its agent in the City's name, and $13,509,000 and $10,958,000, respectively, was invested in Bank Investment Contracts secured by repurchase agreements of government securities held as collateral by the City's trustee in the name of the trustee. The remaining balances of $1,058,000 and $3,875,000 at December 31, 2002 and 2001, respectively, were uncollateralized as defined by the GASB because they were secured by a collateral pool held at the Federal Reserve Bank in the name of the respective depository bank, which pledges a pool of collateral against all public deposits it holds, as permitted under Ohio law.

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:

NOTE C - DEPOSITS AND INVESTMENTS (Continued)

Category 1: Includes insured or registered, or securities held by the City or its agent in the City's name.

Category 2: Includes uninsured and unregistered, with securities held by the counterparty's trust department or agent in the City's name.

Category 3: Includes uninsured and unregistered, with securities held by the counterparty, or it's trust department or agent but not in the City's name.

The categorized investments shown in the following table include those which are 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	Risk Category	2002 Fair Value	2002 Cost	2001 Fair Value	2001 Cost
		(In thousands)			
U.S. Agency Obligations	1	$ 171,256	$ 169,413	$ 136,703	$ 135,870
U.S. Government Bonds	2			12,899	12,899
STAROhio	n/a	20,422	20,422	100,576	100,576
Investment in Mutual Funds	n/a	136,987	136,987	86,255	86,255
Guaranteed Investment Contract	n/a	246,999	246,999	130,513	130,513
Total Investments		575,664	573,821	466,946	466,113
Total Deposits		76,059	76,059	15,556	15,556
Total Deposits and Investments		$ 651,723	$ 649,880	$ 482,502	$ 481,669

STAROhio investments, guaranteed investment contracts, and investments in mutual funds are not classified by risk categories because they are not evidenced by securities that exist in physical or book entry form.

NOTES TO FINANCIAL STATEMENTS (Continued)
For the Years Ended December 31, 2002 and 2001

NOTE D – CAPITAL ASSETS

Capital Asset Activity: Capital asset activity for the year ended December 31, 2002 was as follows:

	Balance January 1, 2002	Additions	Reductions	Balance December 31, 2002
		(In thousands)		
Capital assets, not being depreciated:				
Land	$ 5,271	$	$	$ 5,271
Construction in progress	128,005	105,279	(67,510)	165,774
Total capital assets, not being depreciated	133,276	105,279	(67,510)	171,045
Capital assets, being depreciated:				
Land improvements	12,676	1,440		14,116
Utility plant	813,195	53,885	(218)	866,862
Buildings, structures and improvements	174,729	3,463		178,192
Furniture, fixtures and equipment	65,516	13,603		79,119
Total capital assets, being depreciated	1,066,116	72,391	(218)	1,138,289
Less: Accumulated depreciation	(312,825)	(30,400)	1,078	(342,147)
Total capital assets being depreciated, net	753,291	41,991	860	796,142
Capital assets, net	$ 886,567	$ 147,270	$ (66,650)	$ 967,187

Commitments: The Division has outstanding commitments at December 31, 2002 for approximately $150,870,000 of future capital expenditures. 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, other than non-administrative full-time police officers and firefighters, participate in the Ohio Public Employees Retirement System (OPERS), a cost-sharing multiple-employer public employee retirement system administered by the Ohio Public Employees Retirement Board (the "Board"). OPERS provides basic retirement and disability benefits, annual cost of living adjustments, and death benefits to plan members and beneficiaries. Benefits are established by Chapter 145 of the Ohio Revised Code. OPERS issues a stand-alone financial report, which may be obtained by writing to the Ohio Public Employees Retirement System, 277 East Town Street, Columbus, Ohio 43215-4642.

Plan members are required to contribute 8.5 percent of their annual covered salary to fund pension obligations. The 2002 and 2001 employer pension contribution rate for the Division was 13.55 percent of covered payroll. Contributions are authorized by State statute. The contribution rates are determined actuarially. The Division's required contributions to OPERS for the years ended December 31, 2002, 2001, and 2000 were $6,568,000, $6,071,000, and $6,104,000, respectively. The required payments due in 2002, 2001, and 2000 have been made.

NOTE F - OTHER POST EMPLOYMENT BENEFITS

The Ohio Public Employees Retirement System (OPERS) provides postretirement health care coverage to age and service retirees with ten or more years of qualifying Ohio service credit. Health care coverage for disability recipients and primary survivor recipients is available. The health care coverage provided by the retirement system is considered an Other Post Employment Benefit 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 based on authority granted by State statute. The 2002 and 2001 employer contribution rate was 13.55 percent of covered payroll; 5.0 percent in 2002 and 4.30 percent in 2001 was the portion that was used to fund health care.

Benefits are advance-funded using the entry age normal actuarial cost method. Significant actuarial assumptions, based on OPERS's latest actuarial review performed as of December 31, 2001, include a rate of return on investments of 8 percent, an annual increase in active employee total payroll of 4 percent compounded annually (assuming no-change in the number of active employees) and an additional increase in total payroll of between .50 percent and 6.30 percent based on additional annual pay increases. Health care premiums were assumed to increase 4 percent annually.

All investments are carried at market. For actuarial valuation purposes, a smoothed market approach is used. Assets are adjusted to reflect 25 percent of unrealized market appreciation or depreciation on investment assets. The number of active contributing participants was 402,041 at December 31, 2001. The Division's actual contributions for 2002, which were used to fund postretirement benefits were $2,424,000. The actual contribution and the actuarially required contribution amounts are the same. OPERS's net assets available for payment of benefits at December 31, 2001, (the latest information available) were $11.6 billion. The actuarially accrued liability and the unfunded actuarial accrued liability were $16.4 billion and $4.8 billion, respectively.

In December 2001, the Board adopted the Health Care "Choices" Plan in its continuing effort to respond to the rise in the cost of Health Care. The Choices Plan will be offered to all persons newly hired under OPERS after January 1, 2003, with no prior service credit accumulated toward health care coverage. Choices, as the name suggests, will incorporate a cafeteria approach, offering a more broad range of health care options. The Plan uses a graded scale from ten to thirty years to calculate a monthly health care benefit. This is in contrast to the ten-year "cliff" eligibility standard for the present Plan.

The benefit recipient will be free to select the option that best meets their needs. Recipients will fund health care costs in excess of their monthly health care benefit. The Plan will also offer a spending account feature, enabling the benefit recipient to apply their allowance toward specific medical expenses, much like a Medical Spending Account.

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 2002.

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 program to provide workers' compensation benefits to its employees.

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.

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 $2,239,000 and $2,269,000 in 2002 and 2001, respectively. The Division also provides miscellaneous services to other departments and divisions of the City. Revenue realized from such services was approximately $1,026,000 and $2,138,000 in 2002 and 2001, respectively.

NOTE H - RELATED PARTY TRANSACTIONS (Continued)

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:

	2002	2001
	(In thousands)	
Electricity purchases	$ 13,200	$ 8,953
Street construction and maintenance	793	1,522
City administration	1,100	1,600
Motor vehicle maintenance	1,926	2,274
Telephone exchange	677	384
Utilities administration and fiscal control	2,086	1,735
Data processing	68	300

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 $3,582,000 and $3,477,000 for the years ended December 31, 2002 and 2001, respectively.

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