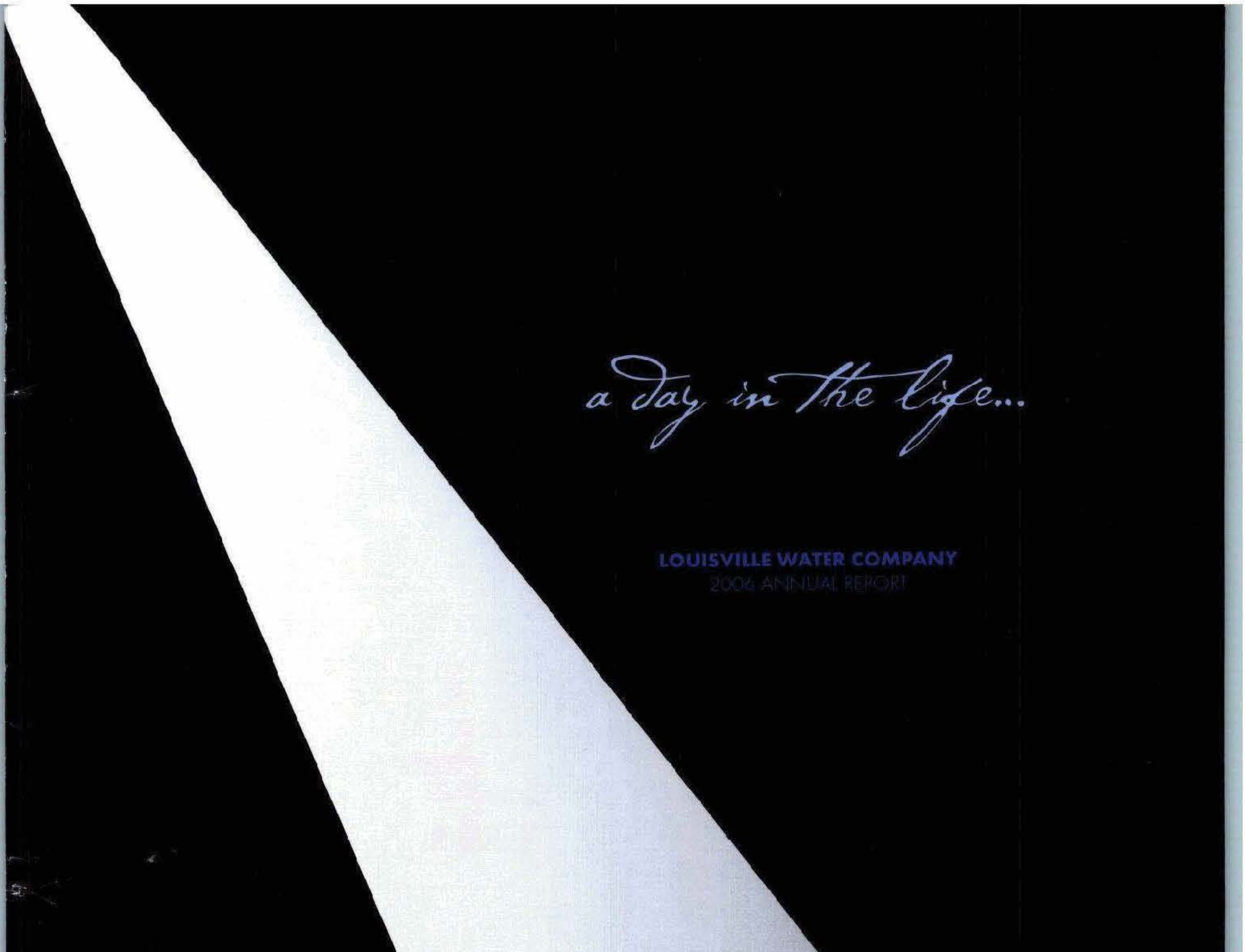
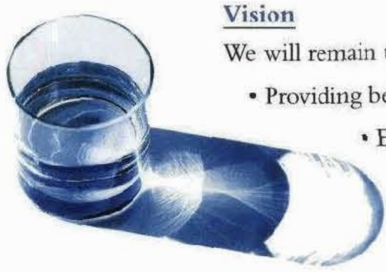


a day in the life...

LOUISVILLE WATER COMPANY
2006 ANNUAL REPORT

LWC 0005



Vision

We will remain the water supplier of choice throughout the region by:

- Providing best-of-class quality, customer service and value
- Expanding the geographic areas we serve
- Creating new lines of business building on existing competencies

Purpose

To provide safe, high quality water and related business services earning customer trust and confidence.

2006 Annual Report Contents

Our company met all major business objectives in 2006 except one: total water sales. The reason: Total precipitation in the Louisville area was the seventh-highest in history. This reduced the need for irrigation, and the amount of water we sold was the lowest since 1993.

As a result, revenue was below expectations, and we had to take measures to reduce costs. Vacant positions were not filled, and our employees stepped in to help fill the gaps.

The weather has been the biggest unknown—and the biggest variable—in our operations for several years. Three of the past four years have been unusually wet. But 2005 was unusually dry, which produced high sales and record revenue. Total water sold declined by three billion gallons from 2005 to 2006.

Weather also brought a benefit in 2006. Mild temperatures during the winter reduced the number of cold-weather water main breaks and leaks throughout our system during the year to nearly 33 percent below average.

Residential water sales vary widely with the weather, but have shown an overall decline for the past 15 years or more. A major reason is the federal regulations that require fixtures and appliances to use less water; and these regulations are expected to become stricter in the future. The other major reason is the slow decline in the number of persons per household, confirmed by census figures.

We took these factors under consideration in preparing a new strategic plan for 2007-2021. Our major focus will continue to be enhancing water quality, maintaining high levels of customer satisfaction, and providing value in our services. Other goals include expanding our service area, expanding our range of services, supporting community-wide economic development, and creating and designing a new work force to meet future demands. Another major emphasis will be on growth in total income and revenue, which will provide growth in dividends paid to our owner, Louisville Metro.

Enhancing water quality is one of our most important goals. Advancements in scientific measurement techniques and knowledge of the effects of impurities in water have resulted in stricter regulations for water quality. Treatment beyond traditional methods—called advanced treatment—will be necessary. We have been preparing for the future by setting our own stricter water quality goals and developing ways to meet them.

The major development has been riverbank filtration, which uses the filtering ability of the earth to clean the water from the Ohio River. For the past six years, our first filtration well at the B. E. Payne plant has been providing about one-eighth of the total water we sell. It consistently provides water that is free from nearly all pollutants in the river.

In 2006, we completed arrangements for expanding this source by building four more such wells at the plant. They should be completed and in service by the end of 2009.

At our Zorn Avenue pumping station and Crescent Hill treatment plant, we are experimenting with several alternatives for advanced treatment. Two test wells are being built to determine if the aquifer there is suitable for riverbank filtration. Two year-long tests are also being conducted to determine the effectiveness of ozone disinfection and biological filtration of the water from the river.

Advanced treatment is one of the major reasons our costs are increasing. The growing cost of the state's County Employees Retirement System, which covers our employees, is another factor; it has been increasing at an average of about 20 percent a year for several years. And the cost of health care has been outpacing inflation for many years.

To meet future costs, our new strategic plan forecasts rate increases that will be two percentage points higher than the consumer price index for the foreseeable future. We believe this will be necessary to enhance water quality, maintain high levels of customer satisfaction, and provide true value in our services.

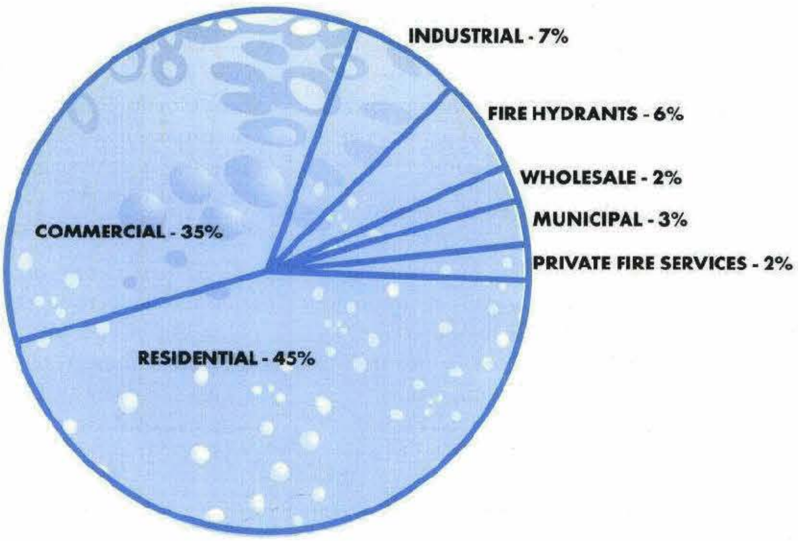
John L. Huber

Operations

	2006	2005	2004	2003	2002
Water Delivered to Mains	44,590	47,733	46,276	46,340	47,405
Total Consumption*	36,979	40,052	38,243	38,044	40,204
Unmetered Water	6,810	6,838	7,086	7,423	7,201
Average Daily Delivery	122	131	127	127	130
Average Daily Water Usage	101	110	105	104	110
Average Daily Pumpage	122	131	127	127	130
Maximum Daily Pumpage	206	205	161	174	178
Other Measures:					
Percent of Water Unmetered	15.5%	15%	15%	6%	15%
Average Residential Monthly Water Bill**	$17.25	$16.43	$15.43	***14.73(15.87)	$14.13

**Excludes temporary service consumption*
***Based upon median usage of 6,000 gallons per month*
****Figures corrected from 2003 annual report figures, which are shown in parentheses*

Water Revenues

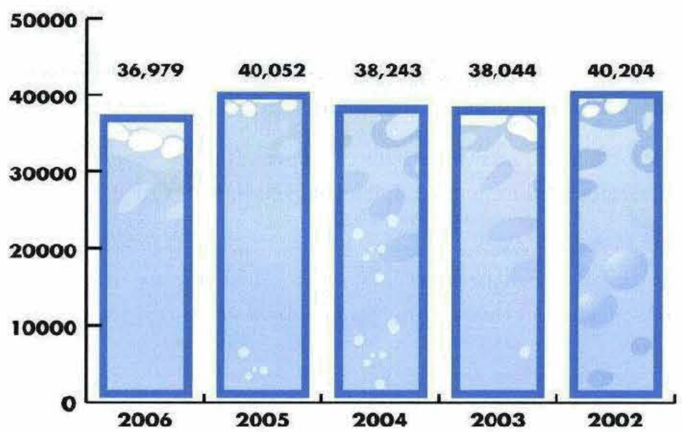


Historical Review

	2006	2005	2004	2003	2002
Operating Revenues	$114,092,112	$115,230,255	$103,462,053	$97,687,143	$98,172,031
Total Operating Expenses	80,028,845	76,376,589	70,024,119	68,980,817	65,742,954
Net Non-Operating Expenses	(3,373,310)	(4,131,917)	(4,868,918)	(4,125,792)	(4,596,329)
Net Income Before Distributions, Contributions and Extraordinary Items	30,689,957	34,721,750	28,569,016	24,580,534	27,832,748
Extraordinary Items	–	–	–	–	–
Distributed Property	–	–	–	–	(879,564)
Dividends Paid and Payable	(14,058,863)	(16,178,050)	(14,552,137)	(12,318,831)	(12,379,623)
Contributions	19,299,646	15,797,959	16,430,901	13,249,414	16,646,769
Increase in Net Assets	35,930,740	34,341,659	30,447,780	25,511,117	31,220,330
Net Assets, Beginning of Year	605,540,756	571,199,097	540,751,317	515,240,200	484,019,870
Net Assets, End of Year	641,471,496	605,540,756	571,199,097	540,751,317	515,240,200
Other					
Investment in System	$61,655,812	$ 61,700,410	$ 52,414,164	60,413,810(42,340,839)*	62,703,948(61,760,384)*
Debt Service Coverage	2.74	3.48	3.03	2.79	3.33
Return on Total Assets	3.53%	4.66%	3.95%	3.53%	4.13%

*Figures corrected from 2003 annual report figures, which are shown in parentheses

Total Water Consumption



INTRODUCTION

An eight-ounce glass of water–3,840 drops–makes a long journey from the cloud to the consumer and can take many detours along the way. Water from the tap in Louisville starts as precipitation over more than 90,000 square miles of land in parts of seven states. Most of the water travels down the Ohio River. Some arrives in the aquifer, the underground water that flows through the earth along and below the riverbed. For more than a century, Louisville Water Company drew all of its water from the Ohio River. Now, an increasing percentage is being drawn from the aquifer.

Louisville Water Company provides water to about 810,000 people in Louisville Metro and parts of Oldham and Bullitt counties. In 2006, the company delivered an average of more than 122 million gallons per day through more than 3,900 miles of water main.

Water is drawn from the Ohio River at two points: the raw water pump station at Zorn Avenue and River Road, and the B. E. Payne pump station northeast of Harrods Creek. Water is also drawn from the river through a riverbank filtration well at the Payne plant.

The water is treated at two locations: the Crescent Hill plant, which has a capacity of 180 million gallons per day, and the Payne plant, which has a capacity of 60 million gallons per day. Both plants treat the water using processes that include coagulation, softening, corrosion stabilization, disinfection, filtration, fluoridation and final disinfection. Storage capacity for treated water totals more than 90 million gallons, in reservoirs, elevated tanks and standpipes.

Mains range up to 60 inches in diameter. Booster pump stations, pressure-reducing stations and water storage facilities are used to maintain the appropriate pressure throughout the system.

To ensure the highest quality, the company operates a laboratory certified by the state of Kentucky under U. S. Environmental Protection Agency standards, performing more than 120,000 water quality tests every year.

In addition to water sold to its retail customers, the company wholesales water to West Shelby Water District, North Shelby Water Company, North Nelson Water District, Taylorsville and Mount Washington.

ASSURING WATER QUALITY

On its way to Louisville, our glass of water has had the opportunity to pick up many impurities. Water first enters the treatment system at the B. E. Payne plant, along the Ohio River northeast of Harrods Creek in northern Jefferson County. There are two sources: the river itself, and the aquifer along the Kentucky side of the river. The rest of the water enters the system at the historic pumping station at the end of Zorn Avenue. This has been the major source of Louisville's water since 1860.

The often muddy look of Ohio River water prompted Louisville Water Company to become a pioneer in water treatment methods more than a century ago. As science and technology have advanced through the years, knowledge of the effects of contaminants in the water has increased tremendously. The company has kept ahead of the times, studying and adopting new ways to purify the water. Company standards are stricter than federal and state regulations require. Finished water has met all the government standards for many years and, in 2006, met the company's stricter goals for the fifth year in a row.

When unusual problems occur, such as an oil spill upstream or a growth of algae that cause the water to taste and smell bad, powdered activated carbon is added to absorb the problem substances. In 2006, carbon was added to the treatment process in May to remove herbicides washed into the river by heavy rains; in August, it was added again to remove taste and odor from large algae blooms in the river. The additional treatment alleviated potential customer concerns about taste and odor.

Since 1999, the company has been using a new source of water that will provide a more efficient way to meet increasingly strict standards in the future. A large riverbank filtration well was constructed at the B. E. Payne plant to draw water from the river through the aquifer.

The water from this well is almost as clean as the water currently leaving the plant. It has also been free of oil spilled in the river, and of the taste and odor from algae. For six years, it has provided about half the water processed at the B. E. Payne plant—or about one-eighth of the total amount of water sold.

Keeping the plants efficient and up-to-date is a continuing process. In 2006, a coagulation basin at the Crescent Hill plant was rehabilitated at a cost of more than \$3.7 million. The original slate roofs on the historic chemical and north/south filter buildings were replaced at a cost of nearly \$4.2 million. Other renovation and improvement projects at the plant totaled more than \$800,000.

At the B. E. Payne plant, a \$13.5 million process to rehabilitate major basins and systems was begun; the work should be completed in 2008.

EXPANDING AND MAINTAINING THE SYSTEM

Our glass of water leaves the filter plant clear and pure—meeting all government standards for drinking water, and meeting our stricter standards as well. It also meets or exceeds all the government standards for bottled water—for a fraction of the cost—making it an outstanding bargain for drinking. Next, it is delivered to more than 293,000 homes and businesses.

It takes more than 3,900 miles of water main to serve our customers. The system is constantly growing to serve new customers, and the older parts of the system are being renovated to meet the needs of the future.

In Jefferson County, 32.3 miles of new mains were built in 2006, at a cost of more than \$6.4 million. The mains will serve 3,746 potential new customers in new developments.

In Bullitt County, two extension programs were at work. The Bullitt County Water Improvement Program installed 12.9 miles of new mains, at costing more than \$3.7 million, to serve 173 present residences. An additional 5.6 miles of main were built, for nearly \$1 million, to serve 421 potential new customers in new developments. And 3.2 miles of mains were replaced, costing more than \$1.6 million.

In Oldham County, 9.9 miles of mains were built to serve new developments, at a cost of more than \$1.9 million. About 536 potential new customers will be served.

A 15-year program to replace or rehabilitate 500 miles of old cast-iron mains in Louisville had met most of its goals by the end of 2006, and will be completed on schedule in 2007. The program was aimed at pipes that had become increasingly troublesome, with relatively high rates of breaks and leaks, or were having flow constriction and periodic discolored water from iron rust tubercles in the pipes. During 2006, about 11.3 miles of these mains were replaced and 6.7 miles were rehabilitated, at a cost of more than \$6.3 million. The total cost over the 15 years is expected to be \$132 million—\$18 million less than the original estimate. It has reduced the company's system-wide water main failure rate by nearly 30 percent—slightly more than its goal.

In addition, the company replaced 775 lead service lines in 2006, continuing its progress toward replacing all such lines.

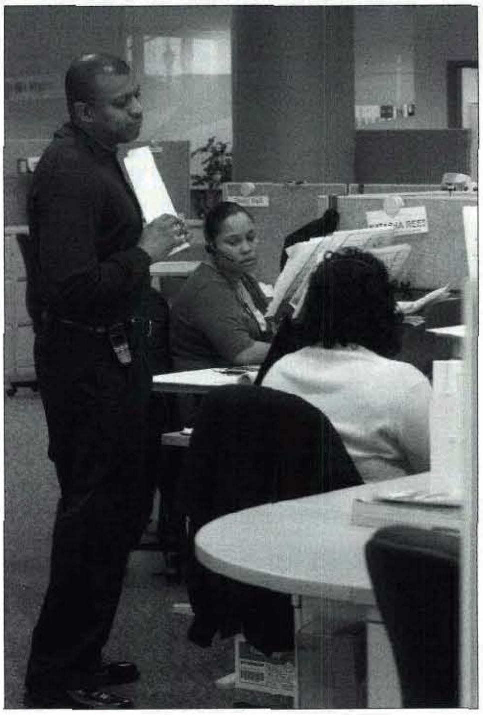
SERVING THE CUSTOMERS

After a long and eventful journey, our glass of water arrives at the customer's faucet. In the comfort of a home, it could provide a refreshing drink or a warm bath, or be used to prepare a family meal. Businesses and industries use it for firefighting, manufacturing, heating and cooling.

The three major categories of customers served by Louisville Water Company are residential, commercial and industrial. Usage in all three categories declined in 2006, mainly because the wet weather (Louisville's seventh-wettest year on record) reduced the amount of water used for irrigation.

The residential category is the largest, with more than 244,000 customer accounts. This number increased by about one percent in 2006, but residential water usage declined by more than 10 percent.

Reduced lawn-and-garden watering accounted for most of this, but there are other factors, as well: a slow but steady decline in the number of people per household, and an increase in the use of water-conserving fixtures and appliances. Average residential household water consumption in Louisville has decreased by more than 12 percent since 1990.



The commercial category is the second-largest, at more than 23,000 customers. The number increased by 2.7 percent in 2006, but usage declined by 4.7 percent.

The third-largest category is industrial. The number of these customers declined by 2.4 percent in 2006—continuing a long-time trend of a shrinking industrial base in the Louisville area. Water usage was down 9.2 percent.

Overall, the amount of water sold in 2006 was 7.7 percent below 2005 sales, despite an increase in the number of customers.

PLANNING FOR THE FUTURE

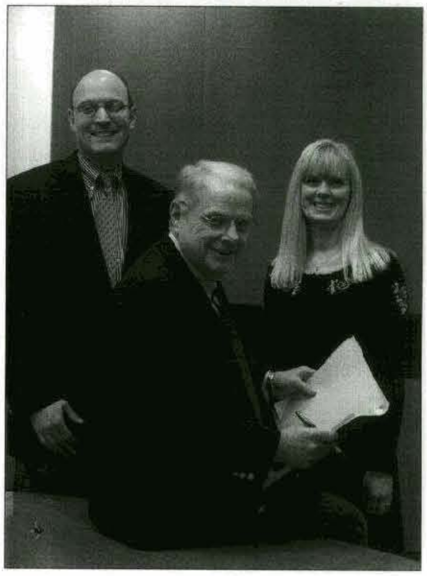
Our glass of water has fulfilled its purpose and continues on its way–flowing downstream to serve other communities, soaking into the ground to the aquifer, or simply evaporating and becoming an element of the weather. Some day, part of it will return to Louisville.

A variety of trends will influence Louisville Water Company's plans for the future:

- Stricter drinking water standards to respond to new scientific developments. New treatment methods have been in development for some time.
- Stricter security standards, to meet the challenges of terrorism.
- Continuing growth in the Louisville area; changes in the patterns of development and the changing economy.

Our treatment system already exceeds the EPA's 2012 standards for disinfection by-products. But our traditional treatment methods just meet the 2012 standards for removal of particles from water, with little margin for error.

The stricter standards for particle removal are designed to help ensure that microscopic parasites, specifically cryptosporidium and giardia, are kept out of the finished water.

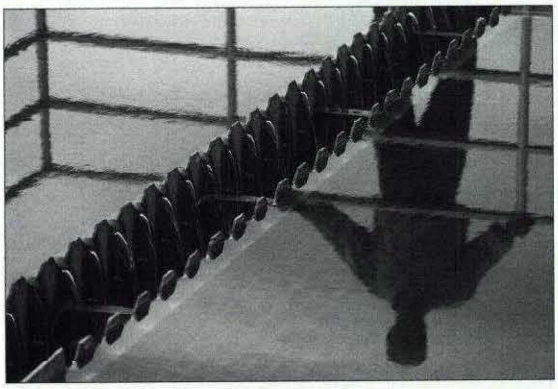


The well at the B. E. Payne plant has shown it can easily meet the new particle standards with room to spare. In late 2006, we awarded a contract, signed by President John Huber, to build four new wells at the plant, to be completed by the end of 2009. The new wells will have horizontal collectors similar to the present well. But instead of having a pump house at each well, there will be only one pump house. A 7,700-foot tunnel in the bedrock below the wells will connect them. Each well will be capped at ground level.

This system was adopted after an earlier design—for 31 vertical wells connected by a tunnel—turned out to be too costly. The lowest bid for construction of the earlier design was more than 50 percent higher than engineering estimates. The new design will be less costly, totaling just over $43.4 million.

The four new wells plus the present well will provide more water than the Payne plant's current capacity, eliminating the need to draw water directly from the river. But different methods may be required at the Crescent Hill plant, which provides three-fourths of the system's water.

In late 2006, the company began a program to test two ways to improve the treatment methods at the Crescent Hill plant: riverbank filtration wells (different from the wells at the Payne plant), or



a combination of ozone disinfection and biological filtration.

Test wells will be operated for a year at two locations: near the pumping station at Zorn Avenue, and near River Road and Glenview Avenue, where the aquifer is narrow. The test wells, plus smaller monitor wells around them, will determine the quantity and quality of the water available.

Ozone disinfection is a promising alternative for eliminating taste, odor and the threat from microscopic parasites. Biological filtration uses colonies of biological organisms on filtration media to eat harmful organic matter in the water. The two methods will be evaluated in year-long tests on water drawn from the river at Zorn Avenue.

The total budget for this testing program is nearly $3.2 million.

Security has been a major concern since the terrorist attacks on New York and Washington, D.C. in September 2001. Security measures at our facilities have increased substantially since then. One remaining concern is the delivery of liquid chlorine in 90-ton tank cars for our disinfection process at Crescent Hill.

The plan is to build a new facility to make a mild liquid chlorine bleach solution from salt and water. The original proposal was to build it on an open field on our property north of the Crescent Hill reservoirs. Neighbors objected, however, saying it would eliminate their traditional use of the field as park land.

The company organized a community advisory group to study the problem and possible solutions. After several months of study, the group recommended that the facility be built on company land south of Frankfort Avenue, instead of north of the reservoir. The company's board agreed and allocated $12.2 million for the project. Preliminary design work should be complete during the first half of 2007, and construction will take another two to three years. In announcing the decision, the company also emphasized to the community that the field may be needed for additional treatment facilities in the future.

Challenges and solutions for the future are described in detail in the 2007-2021 Strategic Plan, completed in 2006. The timeframe is nearly three times as long as the previous five-year strategic plans, and the board played an expanded role in developing the plan.

The key issues addressed include water quality and water quality regulations; rebuilding or refurbishing existing plants and mains; sustaining and enhancing high levels of customer satisfaction; finding ways for the company to grow and increase its revenue; recruiting and retaining skilled and talented employees; and financing the improvements needed.

FINANCING OUR OPERATIONS

Our customers consumed nearly 592 billion glasses of water in 2006. Filtering it, purifying it, and delivering it took the efforts of 437 people, working with a system valued at more than $746 million. Operating expenses in 2006 totaled more than $80 million. The costs of providing this water are paid with the income from water sales.

Water utility costs have been increasing more than inflation for years. Many factors have contributed, including: stricter government standards for water which require new and more expensive treatment methods; repair, replacement and rehabilitation of aging facilities; new facilities to accommodate growth; and inflation. The costs of employee benefits have been rising faster than inflation. Health insurance costs are constantly rising, and our required contributions to the state's County Employees Retirement System (a defined benefit plan which covers our employees) have risen about 20 percent for several years in a row—with more large increases forecast in the future.

To cover these costs, the company increased retail rates an average of 5 percent on January 1, 2006, and increased wholesale rates (charged to other water companies) 4.3 percent in May.

Despite the rate increases, the income from water sales actually declined in 2006. The amount of water sold was the lowest since 1993.

Lower-than-expected sales began in January and continued for most of the year. Only June and July brought sales that were more than expected, but their volume wasn't enough to offset the lower sales in earlier months.

To meet the decline in sales, the company reduced costs wherever possible—including not hiring replacements for employees who left. And because of the long-term trends, the forecasts for water usage in 2007 were reduced when the new budget was prepared.

A dip in water sales, however, doesn't reduce the demand for funds needed for improvements and expansion. The 2007-2021 Strategic Plan predicts that water rates will have to increase by two percentage points more than inflation to continue to provide quality water for a growing and changing community. In late 2006, the board approved a retail rate increase averaging 6.5 percent in 2007.

SERVING OUR COMMUNITY

More than two million empty Pure Tap bottles have been given away since 1996, and roughly half a million of the smaller filled bottles are distributed each year. Filling the bottle costs about one twenty-fifth of a cent.

The Pure Tap program, which completed its 10th year in 2006, has been an outstanding success. The program is a reminder that pure, good-tasting drinking water can be had at reasonable cost—and that Louisville Water Company is a good corporate citizen with programs that benefit the public. Many of these programs involve an emphasis on health.

The Smile! Kentucky program provides free dental screenings for elementary school pupils and free dental treatment for those who qualify. The program is a partnership of the company, the Louisville Dental Society and the University of Louisville School of Dentistry, and receives support from other organizations. In November, more than 6,000 children at 33 schools in six counties received free screenings, and 667 qualified for free treatment in early 2007 (twice as many as those who received free treatment in early 2006.)

Another program, Tap Into Fitness, was implemented to improve the overall health and fitness level of students at six elementary schools in Jefferson County. Part of the program focuses on the importance of water in fitness and health.

The Clean Hands Up program is designed to teach children the value of washing their hands to prevent the spread of communicable disease. Health-and science-related experiments are also presented to area students.

The labor/management partnership between the company and AFSCME Local 1683 has received national attention for its success. In 2006, it won the University of Louisville's Labor-Management Award for the second time; the first time was in 1998. The partnership has produced important results for the company, its employees and the community.

The company's dedication to diversity also brought recognition in 2006. The Kentuckiana Minority Business Council named the company its Corporation of the Year and again bestowed its Million Dollar Spend award to Louisville Water Company. Each award recognizes the company's goods and services procurements with local women-and minority-owned businesses.

Maintaining the company's historic structures has been a commitment to the community for many years. Louisville Water Company's historic architectural legacy has helped brand the company and has been recognized with many awards. During 2006, a major renovation of the landmark water tower at Zorn Avenue and the Ohio River was being planned. Construction was scheduled to start in 2007, at a total cost of more than $590,000.

Management's Discussion and Analysis

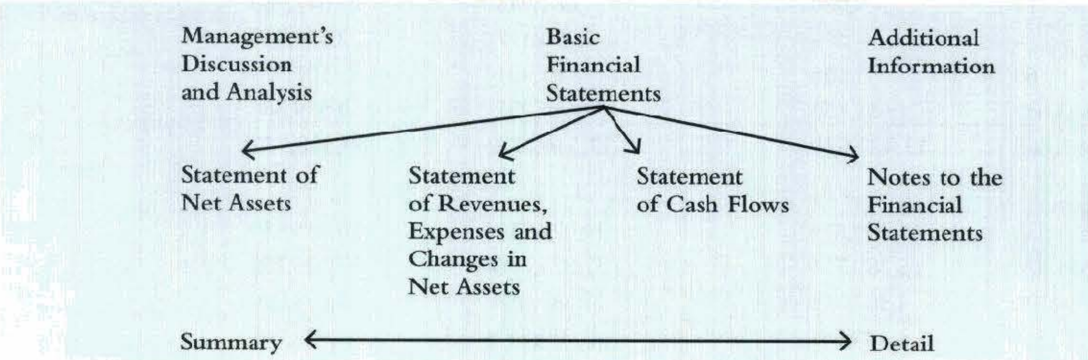
The following discussion and analysis of Louisville Water Company's financial performance provides an overview of the Company's financial activities for the fiscal year ended December 31, 2006 as compared with the prior year. Please read it in conjunction with the President's Message at the front of this report and the Company's financial statements which follow this section.

Overview of the Financial Statements

This annual financial report consists of three parts: Management's Discussion and Analysis, Financial Statements, and Additional Information. The Financial Statements also include notes that explain in more detail some of the information in the financial statements. The statements are followed by a section of Additional Information that further explains and supports the information in the Financial Statements. The Financial Statements of the Company report information about the Company using accounting methods similar to those used by private sector water utility companies, except for the reporting of contributions in aid of construction, equity capital and retained earnings. For financial reporting purposes, the Company is considered a Special-purpose Government Engaged Only in Business-type Activities. These statements offer short and long term financial information about its activities. Figure 1 shows how the required parts of the annual financial report are arranged and relate to one another.

Figure 1

Required Components of Louisville Water Company's Annual Financial Report



The Statement of Net Assets includes all of the Company's assets and liabilities and provides information about the nature and amounts of investments in resources (assets) and the obligations to Company creditors (liabilities). It also provides the basis for evaluating the capital structure of the Company and assessing the liquidity and financial flexibility of the Company.

All of the current year's revenues and expenses are accounted for in the Statement of Revenues, Expenses and Changes in Net Assets. This statement measures the success of the Company's operations in meeting financial objectives over the past year and can be used to determine whether the Company has successfully recovered all of its costs through its water rates and other charges, has earned a profit, and has maintained credit-worthiness.

The final required financial statement is the Statement of Cash Flows. The primary purpose of this statement is to provide information about the Company's cash receipts, cash payments, and net changes in cash resulting from operations, investing, and financing activities and provides information on the sources and uses of cash and the changes in cash balances during the year.

Financial Highlights

- Total Assets increased by $118,986,554 or 15.8%, from $751,284,149 in 2005 to $870,270,703 in 2006, due to proceeds from the issuance of the Series 2006 Bonds in the amount of $83,845,000 and due to increases in Utility Plant that were financed from cash generated from operations, contributions in aid of construction, and draws from the Construction Fund.
- Operating Revenues decreased by $1,138,144 or 1.0%, from $115,230,256 to $114,092,112, due to decreased water sales to residential, commercial and industrial customers and despite a 5.0% increase in water rates effective January 1, 2006. Water sales in 2006 of 37 billion gallons were at the lowest level since 1993.
- Operating Expenses increased by $3,652,256 or 4.8%, from $76,376,589 to $80,028,845, due to increases in Operation and Maintenance Expenses, Depreciation and Amortization Expenses, and Water Service Provided in Lieu of Taxes.
- Net Non-Operating Expenses decreased by $758,607 or 18.4% from $4,131,917 to $3,373,310. Interest earned on investments of the proceeds from the Series 2006 Bond Issue more than offset the interest paid on the Series 2006 Bonds.
- Net Income before dividends and contributions decreased by $4,031,793 or 11.6%, from $34,721,750 to $30,689,957, due to decreases in sale of water revenue and increases in operating expenses which were only partially offset by the decrease in net non-operating expenses.
- Dividends Paid and Payable decreased by $2,119,187 or 13.1%, from $16,178,050 to $14,058,863.

Statement of Net Assets

Total Assets increased by $118,986,554 or 15.8% in 2006 (see Figure 2). The largest portion of Net Assets is Utility Plant, which increased by $40,896,416 in 2006 through capital improvements. The capital improvements were funded by cash generated from operations, draws from the Construction Fund, and by Contributions in Aid of Construction from developers, customers and governmental agencies. Other Property and Investments increased by $71,078,646 due to reimbursement of Depreciation Fund and Infrastructure Replacement Reserve funds that had been previously requisitioned with proceeds from the Series 2006 Bond Issue and due to deposit of the remainder of the bond proceeds into the Construction Fund. There were no deposits made to the Infrastructure Replacement Reserve from operating revenues during 2006. Long-term Liabilities increased by $79,465,750 due to the issuance of the Series 2006 Bonds in the amount of $83,845,000 and offset by principal payments in the amount of $2,210,000 on the Series 2000 Bonds and $4,000,000 on the Series 2001 Bonds made during the year. Long-term debt is discussed in more detail in the section titled Debt Administration.

Figure 2

Condensed Statement of Net Assets

	2006	2005	Difference	Percent
Current Assets	$ 33,130,979	$ 26,119,487	$ 7,011,492	26.8%
Non-Current Assets	91,037,144	19,958,498	71,078,646	356.1%
Utility Plant	746,102,580	705,206,164	40,896,416	5.8%
Total Assets	870,270,703	751,284,149	118,986,554	15.8%
Current Liabilities	34,881,080	31,291,016	3,590,064	11.5%
Long Term Liabilities	193,918,127	114,452,377	79,465,750	69.4%
Total Net Assets	$ 641,471,496	$ 605,540,756	$ 35,930,740	5.9%

Statement of Revenues, Expenses and Changes in Net Assets

Operating Revenues decreased by $1,138,144 or 1.0% in 2006 (see Figure 3). Water sales decreased by three billion gallons or 7.7% in 2006. This is equivalent to approximately more than twenty-eight days of billable consumption. The decrease in operating revenues from lower water sales to residential, commercial, and wholesale customers more than offset a 5.0% increase in water rates effective January 1, 2006.

Operating Expenses increased by $3,652,256 or 4.8% in 2006. The key components of operating expenses are: Operation and Maintenance Expenses, Depreciation and Amortization Expenses, Taxes and Water Service Provided in Lieu of Taxes, and Loss on Disposition of Assets. Operations and Maintenance Expenses increased by $1,070,068 due to higher labor and labor related overhead costs, contractual services, power, and warehouse costs. Depreciation Expense increased by $1,833,269 due to increased investments in utility plant. Amortization Expense increased by $628,064 due to amortization of research costs for preliminary engineering for Crescent Hill Filter Plant advanced treatment technology options and other non-plant assets. Taxes and Water Service in Lieu of Taxes increased by $470,898 due to increased rates on municipal water usage and increased fire hydrant charges. Loss on Disposition of Assets decreased by $350,043, primarily due to a gain on the sale of surplus property.

Net Non-Operating Expenses (non-operating expenses less non-operating income) decreased by $758,607 or 18.4% in 2006 due to the interest earned on investment of the proceeds from the Series 2006 Bond Issue more than offsetting the interest paid on the Series 2006 Bonds.

Net Income before Distributions and Contributions decreased by $4,031,793 or 11.6% in 2006 due to decreases in sale of water revenue and increases in operating expenses which were only partially offset by the decrease in net non-operating expenses. The formula for computing the dividend is established as a covenant in the Series 1992 Bond Resolution (the Master Bond Resolution). The dividend is calculated as sixty percent of net income after deducting bond principal payments and certain other items. Dividends Paid and Payable decreased by $2,119,187 or 13.1%, from $16,178,050 to $14,058,863.

Contributions in Aid of Construction are composed of: pipeline contributions from developers for water main extensions and from governmental agencies for water main relocations; service installation fees from customers; apportionment warrant fees and tapping fees from customers to extend water service to unserved area; and system development charges from customers for growth-related expansion. The level of capital contributions varies from year-to-year and is affected by economic cycles. These types of projects are fully funded or nearly-fully funded by outside entities in advance of construction. Contributions in Aid of Construction increased by $3,501,687, primarily due to reimbursement for three large transmission main relocation projects associated with road widening work.

Figure 3

Condensed Statement of Revenues, Expenses and Changes in Net Assets

	2006	2005	Difference	Percent
Operating Revenue	$114,092,112	$115,230,256	$(1,138,144)	(1.0%)
Operating Expenses	80,028,845	76,376,589	3,652,256	4.8%
Net Operating Revenue	34,063,267	38,853,667	(4,790,400)	(12.3%)
Net Non-Operating Expenses	3,373,310	4,131,917	(758,607)	(18.4%)
Net Income Before Distributions and Contributions	30,689,957	34,721,750	(4,031,793)	(11.6%)
Dividends Paid and Payable	(14,058,863)	(16,178,050)	(2,119,187)	(13.1%)
Contributions in Aid of Construction	19,299,646	15,797,959	3,501,687	22.2%
Increase in Net Assets	35,930,740	34,341,659	1,589,081	4.6%
Net Assets, Beginning of Year	605,540,756	571,199,097	34,341,659	6.0%
Net Assets, End of Year	$641,471,496	$605,540,756	$35,930,740	5.9%

Statement of Cash Flows

Cash and Temporary Investments at the end of 2006 were $3,950,142 or 143.6% higher than at the end of 2005 (see Figure 4). Cash from Operating Activities decreased by $7,332,394 due to decreased amounts received from customers and increased amounts paid to employees and suppliers. Cash from Capital and Related Financing Activities increased by $91,985,017 due to the issuance of the Series 2006 Bonds, increased capital contributions in aid of construction, and decreased unamortized debt discount. Cash from Investing Activities decreased by $77,197,198 due to reimbursement of Depreciation Fund and Infrastructure Replacement Reserve funds that had been previously requisitioned with proceeds from the Series 2006 Bond Issue and due to deposit of the remainder of the bond proceeds into the Construction Fund.

Figure 4

Condensed Statement of Cash Flows

	2006	2005	Difference	Percent
Cash from Operating Activities	$ 54,189,143	$ 61,521,537	$(7,332,394)	(11.9%)
Cash from Capital and Related Financing Activities	15,106,416	(76,878,601)	91,985,017	119.6%
Cash from Investing Activities	(65,345,417)	11,851,781	(77,197,198)	(651.4%)
Change in Cash and Temporary Investments	3,950,142	(3,505,283)	7,455,425	212.7%
Cash and Temporary Investments, Beginning of Year	2,750,313	6,255,596	(3,505,283)	(56.0%)
Cash and Temporary Investments, End of Year	$ 6,700,455	$ 2,750,313	$ 3,950,142	143.6%

In addition to the amounts held in Cash and Temporary Investments, Louisville Water Company also holds funds for capital improvements in reserves totaling $73,589,379 under Other Property and Investments on the Statement of Net Assets. The total amount of funds available for operations and capital improvements increased by $67,778,005 in 2006, from $12,511,829 to $80,289,834, as Louisville Water Company replenished its fund balances following the long-term borrowing.

Capital Assets

The Company uses a five-year Capital Improvements Program (CIP) that is updated annually. Development of the CIP is based on the Company's current Facilities Plan and recommendations from the annual inspection of facilities. The CIP also identifies anticipated capital expenditures for a total of 10 years. The Company's current Facilities Plan covers the years from 2002 through 2021. The Company expects to invest $396,625,467 improvements during 2007-2011. The key capital projects for 2007 are: construction of riverbank filtration facilities, renewal of buried infrastructure, renovation of water treatment plant facilities, improvements to storage and boosted pressure systems, investments in information technology architectures, and transmission and distribution system improvements.

Debt Administration

Louisville Water Company issued the Series 2006 Bonds with a principal amount of $83,845,000 and a closing date of July 12, 2006. The bonds sold with a net original issue premium of $2,405,959 and carry interest rates of 4.00% to 5.00% and yields of 3.70% to 4.61%. The true interest cost for the issue was 4.61%. The Debt Service Reserve Fund was increased to equal one-half of the maximum aggregate bond service in the current or future bond fiscal year. A requisition to reimburse the Operating Fund, Depreciation Fund and Infrastructure Replacement Reserve Fund for previous capital expenditures was processed for $43,549,285 and the remaining funds were invested in allowable investments to optimize liquidity and yield until requisitioned for capital project expenditures.

At December 31, 2006, the Company had $71,800,000 principal outstanding for the Series 2000 Bonds; and $39,750,000 principal outstanding for the Series 2001 Bonds; and $83,845,000 principal outstanding for the Series 2006 Bonds; for a total of $195,395,000. The aggregate net debt service for 2006 increased due to the partial year interest payment for the Series 2006 Bonds. As shown in Figure 5, the debt service coverage of 2.74 times in 2006 is favorable to the statutory and bond resolution limits of 1.3 times. The Series 2000 Bonds are insured, callable beginning in 2010, and carry a Aaa rating from Moody's Investors Service and a AAA rating from Standard & Poor's Corporation. The Series 2001 Bonds are not insured, but are also callable beginning in 2010, and carry a Aa1 rating from Moody's and a AA+ rating from Standard & Poor's. The Series 2006 Bonds have a combination of insured and uninsured maturities, are callable beginning in 2016, and carry ratings of Aaa/Aa1 from Moody's and ratings of AAA/AA+ from Standard & Poor's.

Figure 5

Debt Service Coverage

	2006	2005	Difference	Percent
Income Available for Debt Service	$38,203,163	$41,615,539	$(3,412,376)	(8.2%)
Current Aggregate Net Debt Service	$13,967,930	$11,961,809	$ 2,006,121	16.8%
Coverage Times	2.74	3.48	(0.74)	(21.26%)

The Company's debt rating was upgraded from AA to AA+ by Standard & Poor's in 2006 and is among the very highest in the United States for water utility revenue bonds.

Economic Factors and Next Year's Budgets and Rates

Management believes that the 2007 Budget adequately addresses all revenue requirements. Water rates will be increased for retail water service by 6.5% for water service on and after January 1, 2007. Water rates will also be increased by 4.9% for wholesale water service effective May 1, 2007. The rate change for three wholesale customers is also subject to approval by the Kentucky Public Service Commission.

Management believes that the most challenging economic issues facing Louisville Water Company in 2007 will be the continued decrease in water consumption per account due to conservation and the continued increase in pension contribution rates and medical insurance expenses. Management plans to pursue strategies to assure steady top-line revenue growth and profitability through: increasing water sales within the boundaries of existing infrastructure; pursuing traditional growth opportunities for wholesale and retail service; pursuing non-traditional growth opportunities through mergers, acquisitions, joint ventures and management contracts; and pursuing new or expanded related business opportunities that capitalize on our existing competencies, expertise and strengths.

Computation of Stockholder's Equity

Stockholder's equity for Louisville Water Company is no longer published in the audited financial statements following adoption of GASB 34 in 2002. Using the Common Stock, Retained Earnings, and Total Equity Capital reported in the 2001 audited financial statements and using Income before Distributions and Contributions less Dividends Paid and Payable from audited financial statements for subsequent years, Figure 6 below describes management's computation of stockholder's equity for the years ending December 31, 2005 and 2006.

Figure 6

Computation of Stockholder's Equity

	2006	2005	Difference	Percent
Total Equity Capital, Beginning of Year	$345,990,260	$327,446,560	$18,543,700	5.7%
Plus Income before Distributions and Contributions	30,689,957	34,721,750	(4,031,793)	(11.6%)
Less Dividends Paid and Payable	14,058,863	16,178,050	(2,119,187)	(13.1%)
Total Equity Capital, End of Year	362,621,354	345,990,260	16,631,094	4.8%
Less Cumulative Deposits to Infrastructure Replacement Reserve	36,103,333	36,103,333	0	0.0%
Stockholders Equity Eligible for Return Computation	$326,518,021	$309,886,927	$16,631,094	5.4%

The net income for 2006 available for the return on equity computation was $29,881,379 based on Income before Distributions and Contributions of $30,689,957 less interest earned on the Construction Fund of $808,578. The return on equity earned by Louisville Water Company in 2006 was 9.15% which compares unfavorably to the return on equity target for 2006 of 9.48% and the return on equity earned for 2005 of 10.60%.

Comparative Analysis of Financial Results

To optimize long-term financial viability, Louisville Water Company management plans for and monitors five groups of financial metrics: liquidity, capitalization, coverage, profitability and dividend payout. Figure 7 below describes management's computation of certain financial ratios within each of these groups of metrics.

Figure 7

Comparative Analysis of Financial Results

Liquidity	Access Readily Available Assets to Meet Near-Term Obligations	2007 Budget	2006	2005	Target
Days of Funded Operations	(Cash + Unrestricted Fund Reserves)/ (O&M Expense/365)	581.05	418.82	96.07	> 200
Days of Cash Funded Operations	Cash / (O&M Expense/365)	60	50	21.16	> 60
Capitalization	**Reliance on Debt Financing for Capital Investments**	**2007 Budget**	**2006**	**2005**	**Target**
Long Term Debt to Net Utility Plant	Long Term Debt/Net Utility Plant	23.85%	26.21%	16.74%	<35%
Debt to Capitalization	Long Term Debt/(Long Term Debt+ Unrestricted Stock Equity	34.31%	37.46%	27.58%	
Coverage	**Capacity to Make Debt Service Payments**	**2007 Budget**	**2006**	**2005**	**Target**
Debt Service Coverage	EBIT/Debt Service EBIT/Maximum Aggregate Debt Service	Current 2.68 Max Year 2.41	Current 2.74 Max Year 2.09	Current 3.48 Max Year 3.42	Target >2.0 Minimum >1.3
Debt Service Safety Margin	(O&M Expense+Debt Service)/ (Operating Revenue+ Non-Operating Revenue)	46.87%	46.88%	48.93%	>30%
EBITDA/Interest Expense	EBITDA / Interest Expense	7.65	8.45	11.18	>5.0

Profitability	Profitability of the Company	2007 Budget	2006	2005	Target
Return on Equity	(Net Income-IRR-Construction Interest)/ Stockholder Equity Eligible for Return	9.66%	9.15%	10.60%	2005 >9.22% 2006 >9.48% 2007 >9.74%
Return on Assets	(Net Income-IRR-Construction Interest)/ Total Assets	3.70%	3.43%	4.37%	
Return on Net Utility Plan	(Net Income-IRR-Construction Interest)/ Net Utility Plant	4.21%	4.0%	4.66%	
Net Profit Margin	(Net Income-IRR-Construction Interest)/ Operating Revenue	26.55%	26.19%	28.52%	
Operating Margin	EBITDA / Operating Revenue	57.88%	57.48%	58.83%	

Dividend Payout	Measurement of Distribution of 2007 Budget Profit as a Dividend	2006	2005	Target
Dividend Payout	Dividends Declared/ (Net Income-IRR-Construction Interest)	47.39%	47.05%	49.23%
Total Transfers	(Water in Lieu of Taxes+Dividends)/ Operating Revenue	21.00%	21.00%	22.23%
Dividend Yield	Dividends Declared/ Stockholder Equity Eligible for Return	4.58%	4.31%	5.22%

Contacting the Company's Financial Management

This financial report is designed to provide our citizens, ratepayers, customers, creditors and stockholder with a general overview of the Company's finances and to show the Company's accountability for the money it receives. If you have questions about this report or need additional financial information, contact the Treasurer's Office at Louisville Water Company, 550 South Third Street, Louisville, KY, 40202.

Independent Auditors' Report

Board of Water Works
Louisville Water Company
Louisville, Kentucky

We have audited the accompanying statements of net assets of Louisville Water Company as of December 31, 2006 and 2005, and related statements of revenues, expenses and changes in net assets and cash flows for the year then ended. These financial statements are the responsibility of Louisville Water Company'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 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 opinions.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Louisville Water Company as of December 31, 2006 and 2005, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

The Management's Discussion and Analysis and other required supplementary information on pages 14 through 20 and 39 through 43 are not a required part of the basic financial statements but are supplementary information required by accounting principles generally accepted in the United States of America. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit the information and express no opinion on it.

Our audit was conducted for the purpose of forming an opinion on the financial statements that collectively comprise Louisville Water Company's basic financial statements. The supplemental schedules are presented for purposes of additional analysis and are not a required part of the basic financial statements. The supplemental schedules have been subjected to the auditing procedures applied in the audit of the basic financial statements and, in our opinion, are fairly stated in all material respects in relation to the basic financial statements taken as a whole.

Strothman & Company PSC

Strothman & Company PSC
Louisville, Kentucky
February 28, 2006

	December 31 2006	December 31 2005
Assets		
Current Assets		
Cash and temporary investments	$ 6,700,455	$ 2,750,313
Accounts receivable	15,521,441	14,790,155
Contracts receivable, current portion	244,485	213,983
Materials and supplies	6,890,745	6,576,023
Bond service account - Series 2000	747,550	534,082
Bond service account - Series 2001	1,021,444	513,511
Bond service account - Series 2006	419,893	-
Other current assets	1,444,303	709,225
Accrued interest receivable	140,663	32,195
Total Current Assets	33,130,979	26,119,487
Utility Plant, net of accumulated depreciation	746,102,580	705,206,164
Non-current Assets		
Non-utility property	170,583	171,084
Contracts receivable	2,496,510	2,646,981
Reserves	81,281,267	14,461,517
Retirement plan past Service costs, net	924,739	1,138,140
Unamortized debt discount and expense	1,734,317	1,368,829
Preliminary engineering charges	152,919	170,106
Prepaid regulatory assets	4,276,809	1,841
Total Non-current Assets	91,037,144	19,958,498
Total Assets	$ 870,270,703	$ 751,284,149

Continued

	December 31 2006	December 31 2005
Liabilities and Net Assets		
Current Liabilities		
Accounts payable	$ 5,444,321	$ 3,088,551
Sewer collections (contra)	10,134,652	9,251,667
Customer deposits	6,915,958	6,263,606
Tax collections payable	638,204	451,171
Accrued interest payable	1,186,232	724,437
Dividend payable	-	302,351
Contracts payable, retainage percentage	797,925	1,514,477
Accrued payroll	310,177	315,571
Accrued vacation and sick leave	894,544	1,683,048
Insurance reserve	1,399,067	1,213,637
Bonds and notes payable, current portion	7,160,000	6,482,500
Total Current Liabilities	34,881,080	31,291,016
Long-Term Liabilities		
Customer advances for construction	2,955,109	2,444,307
Unamortized debt premium	2,563,018	458,070
Bond payable, less current portion	188,400,000	111,550,000
Total Long-Term Liabilities	193,918,127	114,452,377
Total Liabilities	228,799,207	145,743,393
Net Assets		
Unrestricted	7,458,762	2,857,982
Invested in capital assets, net of related debt	550,542,580	587,173,664
Restricted, expendable	83,470,154	15,509,110
Total Net Assets	641,471,496	605,540,756
Total Liabilities and Net Assets	$ 870,270,703	$ 751,284,149

See Notes to Financial Statements

	Years Ended December 31 2006	2005
Revenues		
Operating revenues	$ 114,092,112	$ 115,230,256
Operating Expenses		
Operation and maintenance expenses	48,512,042	47,441,974
Depreciation	20,242,541	18,409,272
Amortization	548,955	(79,109)
Taxes and water service provided in lieu of taxes	9,906,087	9,435,189
Loss from sale and salvage of retired assets	819,220	1,169,263
Total Operating Expenses	80,028,845	76,376,589
Net Operating Revenue	34,063,267	38,853,667
Non-Operating Income (Expense)		
Interest income	3,061,129	690,549
Interest expense	(6,693,988)	(4,855,929)
Other expense	259,549	33,463
Net Non-Operating Expense	(3,373,310)	(4,131,917)
Income Before Distributions and Contributions	30,689,957	34,721,750
Distributions and Contributions		
Dividends paid and payable	(14,058,863)	(16,178,050)
Contributions in aid of construction	19,299,646	15,797,959
Total Distributions and Contributions	5,240,783	(380,091)
Increase in Net Assets	35,930,740	34,341,659
Net Assets, beginning of year	605,540,756	571,199,097
Net Assets, end of year	$ 641,471,496	$ 605,540,756

See Notes to Financial Statements

	Years Ended December 31 2006	2005
Cash Flows from Operating Activities		
Cash received from customers	$104,509,825	$107,478,375
Cash paid to suppliers and others	(28,309,297)	(24,576,818)
Cash paid to employees for services	(22,011,385)	(21,380,020)
Net Cash Provided by Operating Activities	54,189,143	61,521,537
Cash Flows from Capital and Related Financing Activities		
Acquisition and construction of utility plant	(61,655,812)	(61,700,410)
Proceeds from 2006 Series Bonds	83,845,000	-
Contributions in aid of construction	19,299,646	15,797,959
Customer advances for construction	510,802	(2,033,129)
Refunds of customer advances for construction	-	(23,271)
Preliminary engineering charges	17,187	92,692
Principal paid	(6,317,500)	(6,180,888)
Interest paid	(6,232,194)	(5,038,089)
Dividends paid	(14,361,214)	(17,728,956)
Non-utility property reduction	501	(64,509)
Net Cash Provided by (Used In) Capital and Related Financing Activities	15,106,416	(76,878,601)
Cash Flows from Investing Activities		
Reserved funds	(66,819,750)	10,710,487
Restricted funds	(1,141,294)	(47,347)
Contracts	119,969	256,093
Contracts, retainage percentage	(716,552)	208,536
Interest received	2,952,661	690,549
Other non-operating expense	259,549	33,463
Net Cash Provided by (Used In) Investing Activities	(65,345,417)	11,851,781
Net Change in Cash and Temporary Investments	3,950,142	(3,505,283)
Cash and Temporary Investments, Beginning of Year	2,750,313	6,255,596
Cash and Temporary Investments, End of Year	$ 6,700,455	$ 2,750,313

Continued

Reconciliation of Net Operating Revenue to Net Cash Provided By Operating Activities	Years Ended December 31 2006	2005
Net operating revenue	$ 34,063,267	$ 38,853,667
Adjustments to reconcile net operating revenue to net cash provided by operating activities		
Depreciation	21,130,680	19,385,049
Amortization	548,955	(79,109)
Amortization of retirement plan past service costs	213,401	213,401
Loss from sale and salvage of retired assets	819,220	1,169,263
Increase (decrease) in cash due to changes in current assets and liabilities		
Accounts receivable	(731,286)	(291,651)
Materials and supplies	(314,722)	(773,972)
Other current assets	(735,077)	(75,678)
Other deferred charges	(4,274,968)	17,302
Accounts payable	2,355,770	821,217
Accounts payable, sewer collections	882,985	210,127
Customer deposits	652,352	1,947,587
Tax collections payable	187,033	194,882
Accrued vacation and sick leave	(788,503)	(211,390)
Accrued payroll	(5,394)	(185,952)
Insurance reserve	185,430	326,794
Net Cash Provided By Operating Activities	$ 54,189,143	$ 61,521,537

See Notes to Financial Statements

December 31, 2006 and 2005

NOTE 1 - SIGNIFICANT ACCOUNTING POLICIES

Description of the Business: Louisville Water Company (the "Company") is a provider of water and related services to residential, commercial, industrial, fire and wholesale consumers in Jefferson, Bullitt and Oldham Counties. The Company is wholly owned by Louisville Jefferson County Metro Government ("Metro Government") and therefore follows Governmental Accounting Standards.

Basis of Presentation: The accompanying financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America as prescribed by the Governmental Accounting Standards Board ("GASB"). The financial statements include the accounts of Louisville Water Company and have been prepared on the accrual basis of accounting. Under the accrual basis of accounting, revenues are recognized when earned and expenses are recorded when an obligation has been incurred. The Company reports as a Business Type Activity ("BTA"). BTAs are those activities that are financed in whole or in part by fees charged to external parties for goods and services.

The Company classifies resources for accounting and reporting purposes into the following net asset categories:

- *Invested in capital assets, net of related debt:*
  Capital assets, net of accumulated depreciation and outstanding principal balances of debt attributable to the acquisition, construction or improvement of those assets.
- *Restricted:*
  Nonexpendable - Net assets subjected to externally imposed stipulations that they be maintained permanently by the Company.

  Expendable - Net assets whose use by the Company is subject to externally imposed stipulations that can be fulfilled by actions of the Company pursuant to those stipulations or that expire by the passage of time.
- *Unrestricted:*
  Net assets whose use by the Company is not subject to externally imposed stipulations. Unrestricted net assets may be designated for specific purposes by action of management or the Board of Water Works or may otherwise be limited by contractual agreements with outside parties.

Method of Accounting: The Company's accounting policies conform to accounting principles generally accepted in the United States of America for water utilities. Although the Company is not subject to regulation, the accounts are maintained in accordance with the uniform system of accounts prescribed by the National Association of Regulatory Utility Commissioners, except with respect to the treatment of gains and losses from the retirement or disposition of utility plant. The Company recognizes gain or loss, including cost of removal, upon the retirement or disposition of utility plant rather than the transfer of cost to accumulated depreciation, as provided by the National Association of Regulatory Utility Commissioners.

Prepaid Regulatory Assets: The Company adopted Financial Accounting Standard No. 71 *"Accounting for the Effects of Certain Types of Regulation"* effective January 2006 and is currently amortizing development costs of $3,186,000 over five years beginning in 2006 and abandoned plant assets of $3,593,782 over eight years beginning in 2008.

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

Utility Plant: Utility plant is stated at cost of acquisition or construction, including certain indirect costs. The Company applies the straight-line method of depreciation to the estimated useful lives of the various classes of depreciable property. The estimated useful lives of some significant asset categories are as follows:

Buildings	50 to 100 years
Pipelines	65 to 100 years
Fire hydrants	50 years
Services	40 years
Meters	15 years
Equipment	5 to 10 years
Trucks and autos	5 years

Depreciation expense for 2006 was $21,130,680 of which $888,139 was allocated to other operating expenses. Depreciation expense for 2005 was $19,385,049 of which $975,777 was allocated to other operating expenses.

Capitalized Interest: The Company follows the practice of capitalizing interest during construction on capital projects. Interest in the amount of $979,016 and $1,228,611 was capitalized during 2006 and 2005, respectively.

Revenue: Revenue is recognized in the period in which billings are rendered to consumers. The Company does not accrue revenue for water delivered but not billed.

Allowance for Doubtful Accounts: The allowance for doubtful accounts is established based on historical collection experience and a review of the current status of existing receivables.

Materials and Supplies: Materials and supplies inventories are stated at the average cost.

Statements of Cash Flows: For purposes of the statements of cash flows, the Company considers all highly liquid investments purchased with a maturity of three months or less to be temporary investments.

Accrued Vacation and Sick Leave: Employees' vested and accumulated vacation and sick leave are recorded as liabilities in the financial statements. Accrued vacation and sick leave was $894,544 at December 31, 2006, and $1,683,048 at December 31, 2005.

Customer Deposits: In 2005, the Company implemented a security deposit policy for all customers applying for residential, commercial or industrial water service who: (i) have not had an account with Louisville Water Company for three consecutive years; or (ii) have had a previous account in bad debt or bankruptcy status; or (iii) have had a service disconnected due to non-payment within the last three years of service. The Company refunds the security deposit when: (i) a customer closes the account; or (ii) the customer has paid their bill in a timely manner for three consecutive years. Total security deposits at December 31, 2006 and 2005 were $1,468,045 and $777,795, respectively. Customer deposits are included as current liabilities on the statement of net assets.

Customer Advances for Construction: The Company requires customers to make a deposit for the cost of construction of pipelines and special services. Advances are refundable, within certain time limits up to 20 years, under the terms of the various contracts.

The customer advance accounts reflect the liability for probable refunds of these construction advances. Once the refund period has expired, any balance is transferred to net assets as a contribution in aid of construction.

Investment Securities: Investments are reported at fair value with gains and losses included in the statements of revenues and expenses. Gains or losses on dispositions are determined using the specific identification method.

Union Employees: The Company has numerous employees who are covered by a collective bargaining agreement. At December 31, 2006, approximately 47% of the Company's employees were covered by a collective bargaining agreement. The existing agreement expired January 31, 2006 and was renegotiated for five years, expiring January 31, 2011, and ratified on January 31, 2006.

Taxes: The Company, by virtue of its ownership by Metro Government, is exempt from taxation by federal, state and local taxing authorities. However, the Company is liable for certain other taxes and provides water and fire services in lieu of taxes to Metro Government. Tax expense, which includes water and fire services in lieu of taxes for December 31, 2006 and 2005, was $9,906,087 and $9,435,189, respectively.

Amortization: Amortization of bond discounts, expenses and premiums are amortized over the life of the bonds.

Reclassification: Certain reclassifications have been made to the 2005 financial statements to conform to the 2006 presentation. There was no change to net assets or to the change in net assets.

NOTE 2 - ACCOUNTS RECEIVABLE

Accounts receivable include:

	Year ended December 31 2006	2005
Water	$ 5,523,373	$ 5,202,338
Sewer (contra)	9,467,859	8,577,357
Other	912,439	1,702,916
Allowance for uncollectable accounts	(382,230)	(692,456)
	$ 15,521,441	$ 14,790,155

NOTE 3 – 2006 BOND ISSUE RESOLUTION FUNDS

Bond Reserve Account: The Master Bond Resolution requires that a bond reserve account be established at one-half of the highest future annual maximum aggregate net bond service of $18,089,390 to be paid in 2011. The fund is to be used to pay maturing bonds and interest in the event funds in the Bond Service Account are not sufficient. Otherwise, funds may not be withdrawn until the bond issue is paid in full. However, the income earned on investments may be transferred to the Bond Service Account. The 2006 reserve is invested in mutual funds and a certificate of deposit and is stated at fair value.

Depreciation Fund: The Series 2006 Bond Resolution authorizing the Bond Issue of 2006 requires the Company to maintain the depreciation fund in the same manner as required for the 2001 series (refunding 1992) bond issue (see Note 4).

Bond Service Account: Except to the extent that the interest and principal are to be paid from other available sources, the Company is required to deposit monthly, into the Trustee's Bond Service Account, one-sixth of the amount of the next succeeding interest payment on the 2006 Bonds outstanding and one-twelfth of the next maturing principal of those bonds. The account is invested in a government obligation mutual fund and is stated at fair value.

NOTE 4 - 2001 BOND ISSUE RESOLUTION FUNDS

Bond Reserve Account: The Master Bond Resolution requires that a bond reserve account be established at one-half of the highest future annual maximum aggregate net bond service of $18,089,390 to be paid in 2011. The fund is to be used to pay maturing bonds and interest in the event funds in the Bond Service Account are not sufficient. Otherwise, funds may not be withdrawn until the bond issue is paid in full. However, the income earned on investments may be transferred to the Bond Service Account. The 2001 reserve is invested in U. S. Treasury Bonds and is stated at fair value.

Depreciation Fund: The Master Bond Resolution requires the Company to make monthly deposits of an amount equal to one-twelfth of an amount not less than the annual depreciation charges into a depreciation fund. The balance includes interest income earned and the gain on sale of property and is available to fund capital improvements to the water system. The fund is invested in a sweep account. This fund and the funding requirements are also included in the 2000 and 2006 bond issues (see Note 3 and 5).

Infrastructure Replacement Reserve Fund: The Master Bond Resolution was revised to provide for the creation and funding in 1993 of the Infrastructure Replacement Reserve Fund to support the infrastructure main replacement and rehabilitation projects. Budgeted funding was $480,000 and $875,000 for 2006 and 2005, respectively. The total actual deposits were $1,858,333 in 2005 and there were no deposits to the fund in 2006 other than reimbursement for capital projects funded by the Company from the 2006 bond issue. The balance at December 31, 2006 is stated at fair value and represents the remaining funds and interest earned on monies invested in a sweep account.

U. S. Treasury State and Local Government Fund: The Series 2 Note Reserve was established in the amount of $1,440,400 pursuant to the Master Bond Resolution. The note was paid in August 1993 and the reserve amount was transferred to the Company and was deposited in the U.S. Treasury State and Local Government Fund. The excess funds from the 2001 Bond Refunding were deposited in this fund. The fund is invested in U.S. Treasury bonds and is stated at fair value.

Bond Service Account: Except to the extent that the interest and principal are to be paid from other available sources, the Company is required to deposit monthly, into the Trustee's Bond Service Account, one-sixth of the amount of the next succeeding interest payment on the 2001 Bonds outstanding and one-twelfth of the next maturing principal of those bonds. The account is invested in a government obligation mutual fund and is stated at fair value.

NOTE 5 – 2000 BOND ISSUE RESOLUTION FUNDS

Bond Reserve Account: The resolution authorizing the Bond Issue of 2000 requires that a bond reserve account be established at one-half of the highest future annual maximum aggregate net bond service. As an alternative, the Resolution provides for deposit of an insurance policy, surety bond or other comparable security into the Reserve Account in an amount sufficient to meet the bond reserve requirement. The Company maintains an insurance policy to meet this requirement. The policy is to be used to pay maturing bonds and interest in the event funds in the Bond Service Account are not sufficient.

Depreciation Fund: The Series 2000 Bond Resolution authorizing the Bond Issue of 2000 requires the Company to maintain the depreciation fund in the same manner as required for the 2001 series (refunding 1992) bond issue (see Note 4).

Bond Service Account: Per the Series 2000 Bond Resolution, except to the extent that the interest and principal are to be paid from other available sources, the Company is required to deposit monthly, into the Trustee's Bond Service Account, one-sixth of the amount of the next succeeding interest payment on the 2000 Bonds outstanding and (beginning with the 12th month preceding the first maturity of any bonds) one-twelfth of the next maturing principal of those bonds. The account is invested in a government obligation mutual fund and is stated at fair value.

Operation Fund: Per the Series 2000 Bond Resolution, each month the Company shall, after making required payments to the Bond Service Account, the Bond Reserve Account, and the Depreciation Fund, withdraw from the Revenue Fund and deposit with a Depository in the name of the Company to the credit of the Operation Fund the balance remaining in the Revenue Fund. The fund is included in cash and temporary investments.

Rebate Fund: The Rebate Fund is created by the Series 2000 Bond Resolution. Monies credited to the Rebate Fund shall be free from the lien of the Resolution. Payments shall be made by the Board and the Company within 15 days following each five-year computation period for the calculation of excess rebateable arbitrage under the Code. The Board and the Company have covenanted to rebate excess earnings to the United States in accordance with law. There were no deposits required to be made to this fund during 2006 or 2005.

NOTE 6 - EXTENSION OF WATER SERVICE IN JEFFERSON COUNTY

In 2004, the Company completed the implementation of a plan to extend water service to unserved residences in Jefferson County. The cost of the planned extension of water service was approximately $60 million and was funded by a combination of customer, government and Company funds, summarized as follows:

Apportionment Warrant Reserve: Monies from the County and from new customers in the extension area are deposited in the Apportionment Warrant Reserve account. New customers in the extension area must pay an "apportionment warrant" fee. To supplement these customer monies, Metro Government made commitments to fund a total of $6 million of the cost of the water service extension project through 2003. Disbursements from this account can only be used to pay for the cost of construction of water main extensions in the designated area. The account was closed in 2006.

System Development Charge Reserve: A System Development Charge Reserve has been established to finance growth-related expansion in the apportionment warrant extension area and is assessed for new service connections other than initial connections. The collections are deposited to the System Development Charge Reserve account and disbursements from this account can only be used to pay for growth-related expansion. Disbursements exceeded collections in 2005 and this account was closed in 2006.

Company Monies: The Company budgeted a total of $17 million of Company funds to pay for the transmission component, or "backbone grid," of the extension program.

NOTE 7 - RESERVES

Reserve Funds include the following:

	Year ended December 31 2006	2005
Bond Related Reserves		
Bond reserve account	$ 6,032,590	$ 3,059,858
Depreciation fund	34,825,830	7,419,053
Infrastructure replacement reserve fund	14,138,347	1,057,898
U.S. Treasury state and local government fund	1,640,143	1,640,143
Construction Fund	24,610,149	-
Cost of Issuance	19,155	-
Total Bond Related Reserves	81,266,214	13,176,952
Other Reserves		
Apportionment warrant reserve	-	1,260,330
System development charge reserve	-	22,703
Bullitt County water reserve	15,053	89
Shepherdsville water reserve	-	1,443
Total Other Reserves	15,053	1,284,565
	$ 81,281,267	$ 14,461,517

NOTE 8 - CASH AND INVESTMENTS

The Company has adopted the provisions of GASB Statement No. 40, *Deposits and Investment Risk Disclosures*. This statement adds certain additional disclosures about cash and investments, including common areas of investment risk.

The Company's investment policy specifies that the primary objectives, in priority order, of investment activities is safety, liquidity and yield. In addition, funds are to be invested in conformity with Federal, state and other legal requirements, including bond resolutions.

At December 31, 2006 and 2005, the Company had cash and temporary investments of $6,703,685 and $2,778,829, respectively. Of these amounts, $200,000 was covered by insurance provided by the Federal Deposit Insurance Company ("FDIC"). The remaining balance was uninsured and uncollateralized.

The Company had investments as follows:

	Year ended December 31 2006	2005
U.S. Treasury Bonds, 8.22%, due November 15, 2013	$ 4,700,000	$ 4,700,001
Mutual Funds	17,071,923	1,047,593
Commercial Paper	9,750,000	-
Certificate of Deposit	2,969,000	-
Sweep Accounts	48,976,000	9,737,000
	$ 83,466,923	$ 15,484,594

Custodial Credit Risk–Deposits: Custodial credit risk is the risk that in the event of a bank failure, the Company's deposits may not be returned to it. The Company does not have a formal deposit policy for custodial credit risk; however, accounts are set up with overnight sweep accounts so that cash is invested in short term, liquid investments daily to minimize the amount of cash not covered by insurance provided by the FDIC.

Custodial Credit Risk–Investments: For an investment, custodial credit risk is the risk that, in the event of the failure of the counterparty, the Company will not be able to recover the value of its investments or collateral securities that are in the possession of an outside party. The Company's investments are held in the name of the Company by a trustee.

Concentration of Credit Risk: The Company has no restrictions on the amount it may invest in any one issuer.

Interest Rate Risk: The Company does not have a formal policy limiting maturities of its investments. Investments are made based on the prevailing market conditions and anticipated cash needs at the time of the transaction.

Credit Risk: The Company has historically only purchased investment grade securities. The Standard & Poor's rating for the U.S. Treasury Bonds and commercial paper listed above is AAA.

NOTE 9 – UTILITY PLANT, NET

The following is a schedule of utility plant for the year ended December 31, 2006:

	Beginning Balance	Additions	Reductions	Ending Balance
Capital assets not being depreciated:				
Land	$ 7,340,275	$ -	$ (160,652)	$ 7,179,623
Construction in progress	54,874,025	74,427,744	(78,329,733)	50,972,036
Total capital assets not being depreciated	62,214,300	74,427,744	(78,490,385)	58,151,659
Other capital assets:				
Buildings	80,778,414	4,120,859	(3,037,507)	81,861,766
Machinery and equipment	43,768,073	4,294,467	(1,672,799)	46,389,741
Infrastructure	766,653,547	65,329,570	(11,600,579)	820,382,538
Total other capital assets at historical cost	891,200,034	73,744,896	(16,310,885)	948,634,045
Less accumulated depreciation for:				
Buildings	(29,628,993)	(1,751,701)	1,876,165	(29,504,529)
Machinery and equipment	(25,268,849)	(4,172,900)	1,653,279	(27,788,470)
Infrastructure	(193,310,328)	(15,254,529)	5,174,732	(203,390,125)
Total accumulated depreciation	(248,208,170)	(21,179,130)	8,704,176	(260,683,124)
Other Capital Assets, Net	642,991,864	52,565,766	(7,606,709)	687,950,921
Capital Assets, Net	$ 705,206,164	$126,993,510	$(86,097,094)	$ 746,102,580

The following is a schedule of utility plant for the year ended December 31, 2005:

	Beginning Balance	Additions	Reductions	Ending Balance
Capital Assets Not Being Depreciated:				
Land	$ 6,122,892	$ 1,217,383	-	$ 7,340,275
Construction in progress	63,769,042	68,526,575	(77,421,592)	54,874,025
Total capital assets not being depreciated	69,891,934	69,743,958	(77,421,592)	62,214,300
Other Capital Assets:				
Buildings	71,909,507	8,971,991	(103,084)	80,778,414
Machinery and equipment	36,793,808	8,004,558	(1,030,293)	43,768,073
Infrastructure	716,880,073	54,154,695	(4,381,221)	766,653,547
Total other capital assets at historical cost	825,583,388	71,131,244	(5,514,598)	891,200,034
Less accumulated depreciation for:				
Buildings	(27,999,628)	(1,681,948)	52,583	(29,628,993)
Machinery and equipment	(22,860,210)	(3,399,140)	990,501	(25,268,849)
Infrastructure	(180,664,836)	(13,719,838)	1,074,346	(193,310,328)
Total accumulated depreciation	(231,524,674)	(18,800,926)	2,117,430	(248,208,170)
Other Capital Assets, Net	594,058,714	52,330,318	(3,397,168)	642,991,864
Capital Assets, Net	$ 663,950,648	$ 122,074,276	$ (80,818,760)	$ 705,206,164

NOTE 10 – LONG-TERM LIABILITIES

Long-term liabilities at December 31, 2006 are summarized as follows:

	Beginning Balance	Additions	Reductions	Ending Balance	Current Portion	Noncurrent Portion
Bonds Payable	$118,032,500	$83,845,000	$ (6,317,500)	$195,560,000	$7,160,000	$188,400,000
Unamortized Debt Premium	458,070	2,200,539	(95,590)	2,563,019	-	2,563,019
Customer Advances for Construction	2,444,307	510,801	-	2,955,108	-	2,955,108
Total Long-Term Liabilities	$120,934,877	$86,556,340	$(6,413,090)	$201,078,127	$7,160,000	$193,918,127

Long-term liabilities at December 31, 2005 are summarized as follows:

	Beginning Balance	Additions	Reductions	Ending Balance	Current Portion	Noncurrent Portion
Bonds Payable	$124,213,388	$ -	$(6,180,888)	$118,032,500	$6,482,500	$111,550,000
Unamortized Debt Premium	509,651	-	(51,581)	458,070	-	458,070
Customer Advances for Construction	4,500,707	1,415,257	(3,471,657)	2,444,307	-	2,444,307
Total Long-Term Liabilities	$129,223,746	$ 1,415,257	$(9,704,126)	$120,934,877	$6,482,500	$114,452,377

Bonds and notes payable at December 31, 2006 and 2005 consist of the following:

	2006	2005
Water System Revenue Bonds, 2000 tax exempt, interest rates ranging from 5.0% to 5.5% with maturities from 2003 through 2025	$ 71,800,000	$ 74,010,000
Water System Revenue Bonds, 2001 tax exempt, interest rates ranging from 4.0% to 4.7% with maturities from 2001 through 2014	39,750,000	43,750,000
Water System Revenue Bonds, 2006 tax exempt, interest rates ranging from 4.0% to 5.0% with maturities from 2007 through 2031	83,845,000	-
Other Debt	165,000	272,500
Total Debt	195,560,000	118,032,500
Less Current Portion	7,160,000	6,482,500
	$ 188,400,000	$ 111,550,000

All bonds are subject to optional redemption provisions.

The Water System Revenue Bond resolutions contain a rate covenant requiring that the schedule of rates and charges, and the rules and regulations for water services will not be revised so as to result in a decrease of revenues. Also, future adjustments to water rates and charges are required as necessary so that annual net revenues will not be less than 1.30% of the total annual bond debt service requirements for the then outstanding bonds.

NOTE 14 - CONTINGENT LIABILITIES

The Company retains certain insurable risks up to a fixed maximum per claim exposure. Liability claims are retained up to $1,000,000 per occurrence, with insurance coverage for any judgment or settlement of up to $35,000,000 above that amount. Workers' compensation is self-funded up to $350,000 per claim prior to October 1, 2004 and $450,000 beginning October 1, 2004, with an aggregate limit of 90% of the premium that would be developed by applying the rate times the payroll. A reserve of $1,399,067 and $1,213,637 was established at December 31, 2006 and 2005, respectively, to provide for liability and worker's compensation claims incurred.

The Company is involved in litigation, which has arisen out of operations in the ordinary course of business. While it is not possible to forecast the outcome of this litigation, it is the opinion of the Company's management, based on evaluations by outside counsel, that it will not have a material adverse effect on the financial statements of the Company.

SCHEDULE OF INVESTMENTS
LOUISVILLE WATER COMPANY

December 31, 2006

		Maturity	Par	Fair Mkt Value
Bond Reserve Account - Series 2001				
U.S. Treasury Bonds	8.22%	11/15/13	$ 3,059,858	$ 3,059,858
Bond Reserve Account - Series 2006				
First American Funds	4.90%	10/16/07	3,730	3,730
US Bank Certificate of Deposit	5.23%	7/23/07	2,969,000	2,969,000
Depreciation Fund				
Sweep Account	5.51%		34,824,000	34,824,000
Infrastructure Replacement				
Sweep Account	5.51%		14,137,000	14,137,000
U.S. Treasury State and Local Government Fund				
U.S. Treasury Bonds	8.22%		1,640,143	1,640,143
Bullitt County Water Reserve				
Sweep Account	5.47%		15,000	15,000
Bond Service Account - Series 2000				
First American Funds	4.89%	10/16/07	747,550	747,550
Bond Service Account - Series 2001				
First American Funds	4.89%	10/16/07	1,021,445	1,021,445
Bond Service Account - Series 2006				
First American Funds	4.89%	10/16/07	419,893	419,893
Construction Fund				
First American Funds	4.89%	10/16/07	14,860,149	14,860,149
US Bancorp Commercial Paper	5.00%	03/01/07	9,750,000	9,750,000
Cost of Issuance Fund				
First American Funds	4.89%	10/16/07	19,155	19,155
			$83,466,923	$83,466,923

See Independent Auditor's Report

SUMMARIZED SCHEDULE OF BOND ISSUES
LOUISVILLE WATER COMPANY

December 31, 2006

2006 SERIES BOND ISSUE

The Water Revenue Bonds were issued by the Board of Water Works and are payable only from revenue of the Company.

Master resolution date	July 14, 1992
Third supplemental resolution date	May 25, 2006
Original amount	$83,845,000
Interest rate	4.00% to 5.00%
Bonds payable	November 15
Interest payable	May 15 and November 15
Call provisions in whole or in part	100% after November 15, 2016

Sinking Fund installments for 2030 and 2031 maturity bonds: 2006 Issue

November 15, 2030		November 15, 2031	
Year	Amount	Year	Amount
2030	$ 5,225,000	2031	$ 5,470,000
	$ 5,225,000		$ 5,470,000

2001 SERIES BOND ISSUE

The Water Revenue Bonds were issued by the Board of Water Works and are payable only from revenue of the Company.

Master resolution date	July 14, 1992
Second supplemental resolution date	February 13, 2001
Original amount	$60,300,000
Interest rate	4.00% to 4.70%
Bonds payable	November 15
Interest payable	May 15 and November 15
Call provisions in whole or in part	100% after November 15, 2010

Continued

SUMMARIZED SCHEDULE OF BOND ISSUES
LOUISVILLE WATER COMPANY

December 31, 2005

2000 SERIES BOND ISSUE

The Water Revenue Bonds were issued by the Board of Water Works and are payable only from revenue of the Company.

Master resolution date	July 14, 1992
Supplemental resolution date	August 8, 2000
Original amount	$78,500,000
Interest rate	5.00% to 5.50%
Bonds payable	November 15
Interest payable	May 15 and November 15
Call provisions	100% after November 15, 2010

Sinking Fund installments for 2022 and 2024 maturity bonds:

November 15, 2022		November 15, 2024	
Year	Amount	Year	Amount
2021	$ 4,710,000	2023	$ 5,260,000
2022	4,975,000	2024	5,555,000
	$ 9,685,000		$ 10,815,000

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SCHEDULE OF OUTSTANDING BOND INDEBTEDNESS AND ANNUAL DEBT SERVICE REQUIREMENTS

December 31, 2006

	2006 Bonds		
Year Ending December 31	Principal Installments	Interest	Aggregate Bond Service
2007	$ 500,000	$ 3,974,856	$ 4,474,856
2008	1,725,000	3,954,856	5,679,856
2009	2,180,000	3,885,856	6,065,856
2010	2,465,000	3,798,656	6,263,656
2011	2,370,000	3,700,056	6,070,056
2012	2,460,000	3,605,256	6,065,256
2013	2,555,000	3,506,856	6,061,856
2014	2,655,000	3,404,656	6,059,656
2015	2,760,000	3,298,456	6,058,456
2016	2,870,000	3,160,456	6,030,456
2017	2,985,000	3,016,956	6,001,956
2018	3,110,000	2,867,706	5,977,706
2019	3,240,000	2,731,644	5,971,644
2020	3,375,000	2,585,844	5,960,844
2021	3,520,000	2,429,750	5,949,750
2022	3,675,000	2,253,750	5,928,750
2023	3,835,000	2,070,000	5,905,000
2024	4,000,000	1,878,250	5,878,250
2025	4,180,000	1,678,250	5,858,250
2026	4,365,000	1,469,250	5,834,250
2027	4,565,000	1,251,000	5,816,000
2028	4,770,000	1,022,750	5,792,750
2029	4,990,000	784,250	5,774,250
2030	5,225,000	534,750	5,759,750
2031	5,470,000	273,500	5,743,500
	$ 83,845,000	$ 63,137,610	$ 146,982,610

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	2001 Bonds		
Year Ending December 31	Principal Installments	Interest	Aggregate Bond Service
2007	$ 4,185,000	$ 1,789,978	$ 5,974,978
2008	4,380,000	1,612,115	5,992,115
2009	4,590,000	1,415,015	6,005,015
2010	4,820,000	1,208,465	6,028,465
2011	5,055,000	991,565	6,046,565
2012	5,305,000	764,090	6,069,090
2013	5,570,000	525,365	6,095,365
2014	5,845,000	274,715	6,119,715
	$ 39,750,000	$ 8,581,308	$ 48,331,308

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SCHEDULE OF OUTSTANDING BOND INDEBTEDNESS AND ANNUAL DEBT SERVICE REQUIREMENTS

December 31, 2006

Year Ending December 31	2000 Bonds Principal Installments	Interest	Aggregate Bond Service
2007	$ 2,310,000	$ 3,725,019	$ 6,035,019
2008	2,420,000	3,609,519	6,029,519
2009	2,540,000	3,488,519	6,028,519
2010	2,660,000	3,361,519	6,021,519
2011	2,790,000	3,228,519	6,018,519
2012	2,930,000	3,089,019	6,019,019
2013	3,075,000	2,942,519	6,017,519
2014	3,235,000	2,788,769	6,023,769
2015	3,405,000	2,627,019	6,032,019
2016	3,590,000	2,452,512	6,042,512
2017	3,790,000	2,264,037	6,054,037
2018	4,000,000	2,065,062	6,065,062
2019	4,225,000	1,855,062	6,080,062
2020	4,460,000	1,633,250	6,093,250
2021	4,710,000	1,399,100	6,109,100
2022	4,975,000	1,151,825	6,126,825
2023	5,260,000	890,637	6,150,637
2024	5,555,000	614,487	6,169,487
2025	5,870,000	322,850	6,192,850
	$ 71,800,000	$ 43,509,243	$ 115,309,243

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SCHEDULES OF OPERATION AND MAINTENANCE EXPENSES AND TAXES

Years ended December 31, 2006 and 2005

	2006	2005
Operation and Maintenance Expenses		
Pumping	$ 5,191,650	$ 5,029,576
Water treatment	6,878,006	6,027,511
Transmission and distribution	12,066,154	11,367,218
Customer accounts expenses	7,148,485	6,883,294
Administrative and general expenses	16,571,526	17,791,010
Operation expenses under applied	656,221	343,365
Total Operation and Maintenance Expenses	$ 48,512,042	$ 47,441,974
Taxes		
Water and fire services in lieu of taxes	$ 9,857,822	$ 9,415,500
Social security taxes	1,937,219	1,940,162
State unemployment taxes	48,265	19,689
Payroll taxes allocated	(1,937,219)	(1,940,162)
Total Taxes	$ 9,906,087	$ 9,435,189

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Board Members

Jerry Abramson
Mayor, Louisville Metro
(ex officio)

Stewart E. Conner
Board Chairman
Managing Partner
Wyatt, Tarrant & Combs

Margaret Leavell Harris
Retired Executive
BellSouth Telecommunications

Gerald Martin
Vice President and
Managing Member
River Hill Capital, LLC

Wendy C. Welsh
Board Vice Chairman
Senior Vice President,
Information Technology
E.ON U.S.

Marita Willis
Assistant Vice President
PNC Bank

Dr. Joseph B. Wise, III
Business Manager,
Secretary/Treasurer
Greater Louisville Building
and Construction Trades Council

Executive Leadership Team

Front row: Barbara Dickens, Vice President, General Counsel and Secretary - John Huber, President and Chief Executive Officer - Susan Lehmann, Vice President, Human Resources and Organizational Effectiveness

Back row: Robert K. Miller, Vice President and Treasurer, Business Resourcing - Karla Olson Teasley, Vice President, Serving Customers and Business Development - Gregory C. Heitzman, Senior Vice President of Operations and Chief Engineer - Billy Meeks, President, AFSCME Local 1683

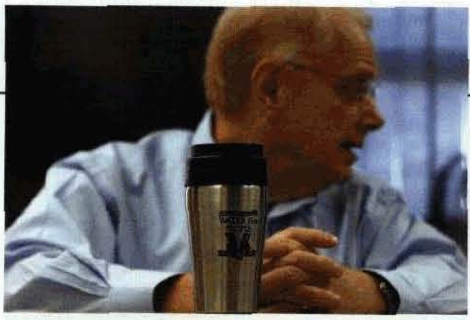
Edwin Chestnut, Jr., Assistant to the President, Director of Business Performance Management

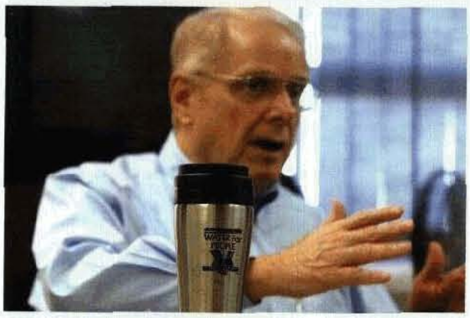
Board of Water Works

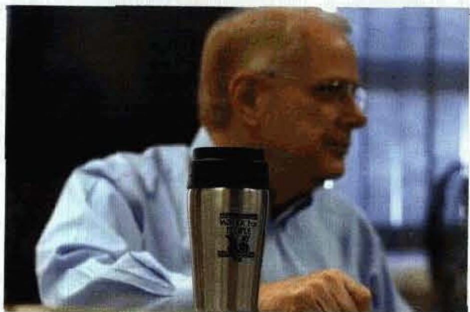
The Board of Water Works is composed of seven members:

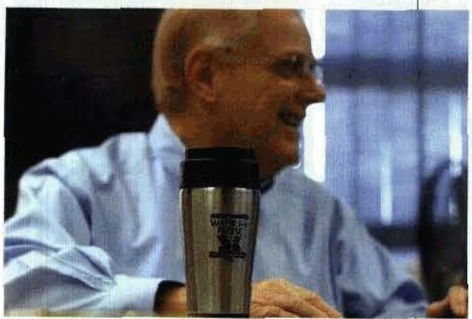
- The Louisville Metro Mayor appoints all members.
- The membership is bi-partisan, with no more than 50 percent from the same political party.
- All new board members serve staggered four-year terms.
- The Louisville Metro Mayor serves as ex officio.

The Board meets the second Tuesday of each month at 12:30 pm at 550 South Third Street. Each April, the Board appoints officers of the company.









As I complete a career that includes more than 16 years as President and CEO of Louisville Water Company, and over 40 years in the water business, I want to express my gratitude to the talented and dedicated people who have supported me. I owe a debt of gratitude to my mentors and teachers, including the members of Louisville Water Company's Board of Directors. I've been privileged to work with and learn from skilled, effective leaders. Working alongside the dedicated and gifted employees of Louisville Water Company, in the spirit of service to our customers and community, has been gratifying.

My biggest thanks and gratitude go to my wife, Cindy. Her encouragement, participation and support underlie the success I've achieved and the community and water industry honors and awards I've received.

It's been a privilege for us to be a part of the water industry.

It's been an honor for us to be a part of Louisville Water Company.

John L. Huber

LOUISVILLE, KENTUCKY
OFFICE OF THE MAYOR

JERRY E. ABRAMSON
MAYOR

March 7, 2007

Mr. John Huber
President
Louisville Water Company
550 S. Third St.
Louisville, KY 40202

Dear John,

On behalf of our community's citizens, thank you for your commitment to the Louisville Water Company and to three decades of volunteerism here and around the world.

Your 30 years with the Louisville Water Company and especially your 16 years as its president have been marked by accomplishments and innovations. From the clean and affordable water service we all enjoy every day to the Louisville Water Company's integral role in philanthropy and community involvement, our entire community has benefited from your leadership.

In Louisville, you have shown your dedication to higher education by working with the University of Louisville Board of Overseers and Speed School, as well as Spalding University's Board of Trustees. As board chair for the Louisville Science Center, you helped complete a major capital campaign for new exhibits and earn the center valuable national recognition. On a global scale, your leadership as board president of Water for People has had a powerful impact on lives all over the world.

John, you are leaving a legacy that will hold the Louisville Water Company in good stead for many years to come and our community is honored to salute you.

Sincerely,

Jerry E. Abramson
Mayor

ect

LOUISVILLE METRO HALL 527 WEST JEFFERSON STREET LOUISVILLE, KENTUCKY 40202 502.574.2003

Louisville Water Company

550 South Third Street
Louisville, Kentucky 40202
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www.louisvillewater.com

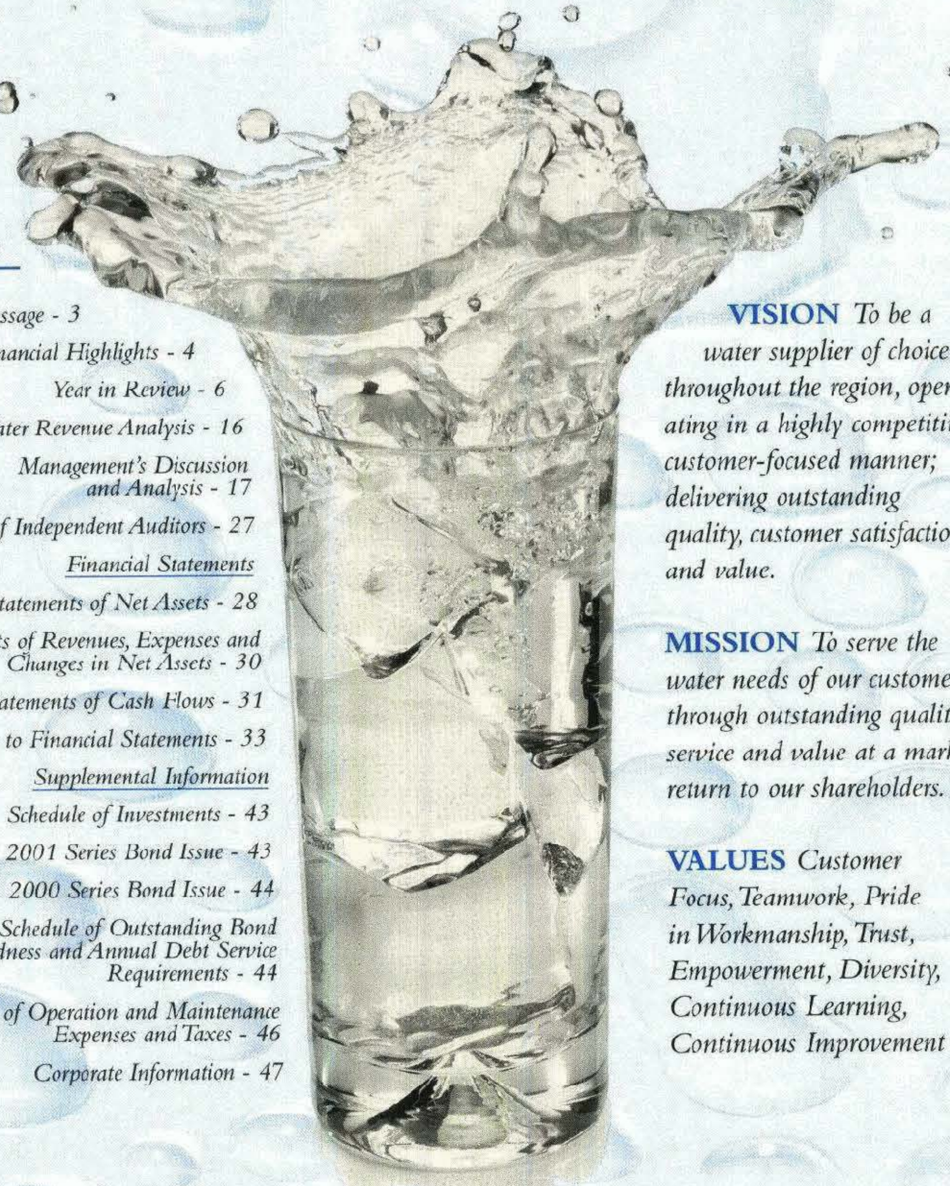
LOUISVILLE WATER COMPANY

24/7 Water

2005 ANNUAL REPORT

LWC 0049

CONTENTS



VISION *To be a water supplier of choice throughout the region, operating in a highly competitive, customer-focused manner; delivering outstanding quality, customer satisfaction and value.*

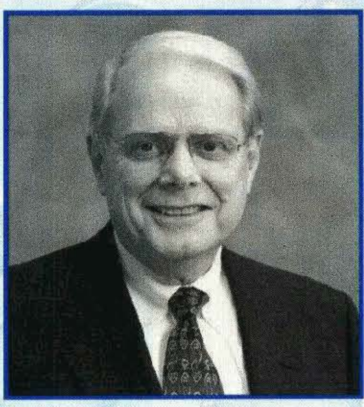
MISSION *To serve the water needs of our customers through outstanding quality, service and value at a market return to our shareholders.*

VALUES *Customer Focus, Teamwork, Pride in Workmanship, Trust, Empowerment, Diversity, Continuous Learning, Continuous Improvement*

:

LWC 0050

PRESIDENT'S MESSAGE



Providing a safe, continuous supply of high quality water has been our goal for more than a century, and we performed very well in 2005. After two years of very wet weather, most of the 2005 growing season was dry, increasing the amount of water used for residential irrigation. Water production in May set a new record for the month; water production in June topped 200 million gallons in one day for the first time in our history.

The dry weather, plus our growing customer base, produced record revenues in 2005, which in turn allowed us to pay a record dividend.

For the fourth year in a row, delivered water quality exceeded our own standards, which are higher than government regulations require. Our continuing improvements in this area mean we already meet or exceed most of the new federal water quality regulations going into effect in 2012; plans are well under way to assure we exceed all of them by that date.

Our talented water quality and treatment staff again demonstrated exceptional skill in January, when a major spill dumped several hundred thousand gallons of oil into an Ohio River tributary upstream from our intakes. We began intensive testing immediately and devised special measures in our treatment processes to remove the oil. As a result, no detectable amounts of oil were ever found in our finished water, and we were able to provide all the water our community needed.

The spill helped prove the value of our riverbank filtration well, the forerunner of planned major improvements. The B. E. Payne plant well uses natural filtering processes to cleanse Ohio River water as it flows through the aquifer. Throughout the spill and afterward, there were no detectable signs of oil in the water from the well. No additional treatment was needed.

Plans to expand the number of wells at the Payne plant were set back early in the year, when bids for constructing a new well field exceeded our estimates by more than 50 percent. Special engineering studies identified several major areas where costs could be reduced, and we plan to advertise for bids on the redesigned project in 2006.

The Crescent Hill treatment plant will require changes to meet new water quality standards. A steering committee of board members and senior staff engaged technical experts to identify and evaluate different ways to meet the new standards. By the end of the year, two alternatives were identified for preliminary engineering studies. One alternative includes riverbank filtration wells, and the other includes ozone and biologically activated filters for water drawn directly from the river.

A major renovation and expansion project was completed at the 30-year-old Payne plant during the year. The project renovated filters and electrical gear and raised the plant's capacity by 15 million gallons per day to a total of 60 million. Improvements also included backup electrical generating equipment capable of operating the plant at 30 million gallons per day. This project was completed at a cost 12 percent less than budgeted.

Our board and staff continued to work on corporate governance in 2005, establishing new policies and procedures designed to assure our actions remain fully transparent and in compliance with best practices.

In December, I announced my plans to retire in August 2007, to allow the board to begin the process of choosing my successor. Several initiatives over the past few years have been designed to help with this transition in leadership.

I have been blessed to have spent nearly 40 years in the water industry and at Louisville Water Company; it has been an immensely challenging and rewarding experience. I look forward to helping prepare the company for its next generation of leadership.

John L. Huber

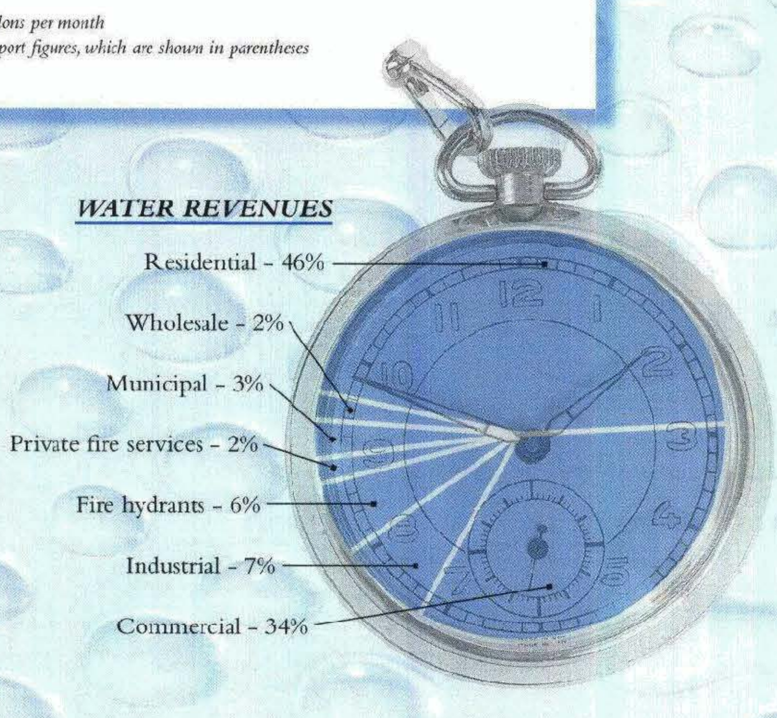
24/7 WATER - FINANCIAL HIGHLIGHTS

OPERATION HIGHLIGHTS

	2005	2004	2003	2002	2001
Water Delivered to Mains	47,733	46,276	46,340	47,405	46,313
Total Consumption*	40,052	38,243	38,044	40,204	39,378
Unmetered Water	6,838	7,086	7,423	7,201	6,934
Average Daily Delivery	131	127	127	130	127
Average Daily Water Usage	110	105	104	110	108
Average Daily Pumpage	131	127	127	130	127
Maximum Daily Pumpage	205	161	174	178	175
Other Measures:					
Percent of Water Unmetered	15%	15%	16%	15%	15%
Average Residential Monthly Water Bill**	$16.43	$15.43	***$14.73(15.87)	$14.13	$13.50

**Excludes temporary service consumption*
***Based upon median usage of 6,000 gallons per month*
****Figures corrected from 2003 annual report figures, which are shown in parentheses*

WATER REVENUES

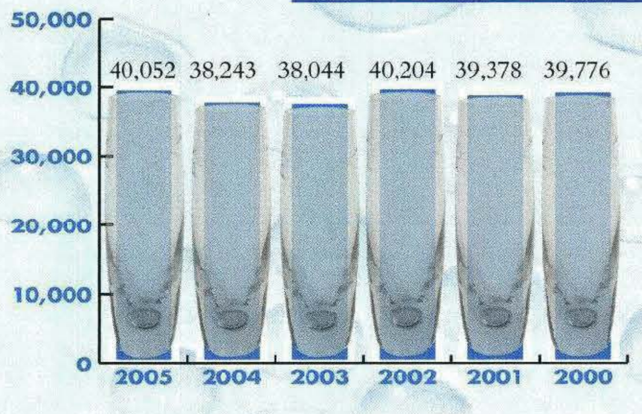


HISTORICAL REVIEW HIGHLIGHTS

	2005	2004	2003	2002	2001
Operating Revenues	$115,230,256	$103,462,053	$97,687,143	$98,172,031	$92,769,157
Total Operating Expenses	76,376,589	70,024,120	68,980,817	65,742,954	62,814,427
Net Non-operating Expenses	(4,131,917)	(4,868,917)	(4,125,792)	(4,596,329)	(1,429,411)
Net Income Before Distributions, Contributions and Extraordinary Items	34,721,750	28,569,016	24,580,534	27,832,748	28,525,319
Extraordinary Items	-	-	-	-	(2,253,356)
Distributed Property	-	-	-	(879,564)	-
Dividends Paid and Payable	(16,178,050)	(14,552,137)	(12,318,831)	(12,379,623)	(13,076,344)
Contributions	15,797,959	16,430,901	13,249,414	16,646,769	14,527,045
Increase in Net Assets	34,341,659	30,447,780	25,511,117	31,220,330	27,722,664
Net Assets, Beginning of Year	571,199,097	540,751,317	515,240,200	484,019,870	456,297,208
Net Assets, End of Year	605,540,756	571,199,097	540,751,317	515,240,200	484,019,872
Other					
Investment in System	$ 61,700,408	$ 52,414,164	60,413,819(42,340,839)*	62,703,948(61,760,384)*	$48,515,271
Debt Service Coverage	3.38	2.93	2.79	3.33	4.35
Return on Total Assets	4.66%	3.95%	3.53%	4.13%	4.06%

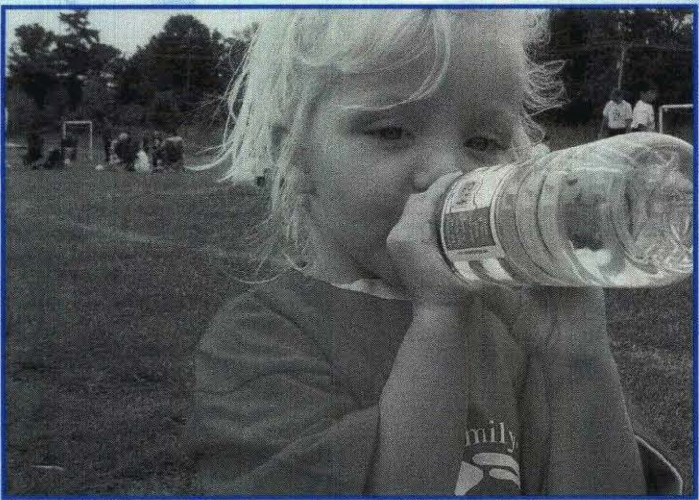
Figures corrected from 2003 annual report figures, which are shown in parentheses

TOTAL WATER CONSUMPTION



Figures in million gallons

INTRODUCTION



One of our young customers enjoying Pure Tap on the run.

Providing high quality water—24 hours a day, seven days a week, throughout the year without interruption—is Louisville Water Company's reason for being. All of the company's efforts are aimed toward continuing to meet this goal, by providing for the community's growth and for continuous service in the face of natural and man-made problems.

The company provides water to about 810,000 people in Louisville Metro and parts of Oldham and Bullitt counties. In 2005, the company delivered an average of nearly 131 million gallons per day through nearly 3,600 miles of water main.

Water is drawn from the Ohio River at three points: the raw water pump station at Zorn Avenue and River Road, and the B. E. Payne pump station northeast of Harrods Creek. Water is also drawn from the river through a riverbank infiltration well at the Payne plant.

The water is treated at two locations: the Crescent Hill plant, which has a capacity of 180 million gallons per day, and the Payne plant, which has a capacity of 60 million gallons per day. Both plants treat the water using processes that include coagulation, softening, corrosion stabilization, disinfection, filtration, fluoridation, and final disinfection. Storage capacity for treated water totals over 90 million gallons in reservoirs, elevated tanks and standpipes.

Mains range up to 60 inches in diameter. Booster pump stations, pressure-reducing stations and water storage facilities are used to maintain the appropriate pressure throughout the system.

To ensure the highest quality, the company operates a laboratory certified by the state of Kentucky under U. S. Environmental Protection Agency standards, performing more than 120,000 water quality tests every year.

In addition to water sold to our retail customers, the company wholesales water to West Shelby Water District, North Shelby Water Company, North Nelson Water District, Taylorsville, Mount Washington and Lebanon Junction.

A VERY GOOD YEAR

Water production broke several records in 2005, as a dry growing season followed the area's wettest year in history in 2004. Rainfall from February through July was below average, and water usage increased as the growing season progressed.

While several other water utilities in Kentucky and Indiana had to restrict water use during the dry weather, our company continued to provide all the water our customers needed. In May, water production averaged 157.7 million gallons per day—a new record for the month. Then on June 24, water production topped 200 million gallons per day for the first time, reaching 201.5 million. This easily surpassed the previous record of 198 million gallons per day, set during the height of the drought of 1999. June 25 set another record:

In late January, a 22-inch oil pipeline ruptured near Carrollton, Ky., dumping more than 260,000 gallons of crude oil into the Kentucky River.

204.5 million gallons. Total production for the year was the fourth largest in our history.

Our water sales for the year also set a record: more than $115 million. Dividends paid and payable totaled a record of more than $16 million.

Our effort to supply quality water around the clock was not without its challenges. The largest came in late January, when a 22-inch oil pipeline ruptured near Carrollton, Ky., dumping more than 260,000 gallons of crude oil into the Kentucky River. While efforts to contain the spill began quickly, some oil escaped and was washed down the Kentucky River into the Ohio River. Our staff began preparations immediately to deal with the oil, taking samples from the Ohio River at Carrollton, Westport and Goshen to determine what would be needed for treatment. Less than 48 hours after the spill, traces of oil were detected at our intakes, and additional treatment began.

Five days after the spill, the booms designed to contain the oil failed, and a large quantity was discharged into the Ohio River. Environmental officials reported that oil covered the surface of the river from bank to bank. Our president declared an operational emergency, and our company's emergency response team was activated.

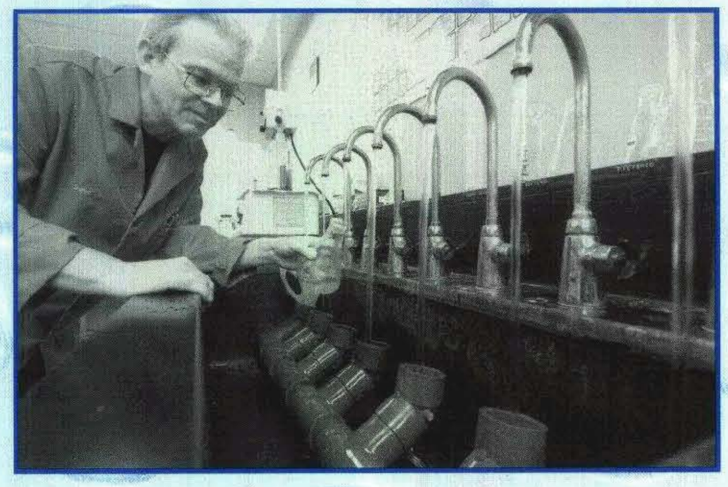
To remove the oil, powdered activated carbon was added to the water from the river at our Zorn Avenue pumping station and at our Crescent Hill treatment plant. The effort continued until mid-February, when the oil on the river had passed downstream of Louisville. (During the spill, our B. E. Payne plant stopped withdrawing water from the river and relied on the riverbank filtration well, which never showed signs of the oil.)

The spill was one of the largest on the Ohio River in at least 25 years. Throughout the emergency, there were no detectable amounts of the oil in our finished water. Our cost of treatment to remove the oil was more than $387,000, which was to be paid by the pipeline company.

The dry weather brought another problem which is not uncommon along the Ohio River: the water becomes clearer than normal, which allows more sunlight to penetrate it and causes more algae to grow. The algae, in turn, produce substances that can make the water taste, and smell, like algae. The problem began in May 2005 and continued off and on through mid-October. Powdered activated carbon was added to the treatment process to remove the algae taste and odor; the total cost for this treatment for the year was more than $190,000.

WATER QUALITY

When it comes to providing safe water 24/7, quality and reliability are paramount. For years, Louisville Water Company's standards for water quality have been higher than federal and state regulations require. In 2005, for the fourth year in a row, we met or exceeded all of our own standards for water quality.



For the fourth year in a row, we met or exceeded all regulatory standards for water quality.

Our standards have kept us ahead of the trends as science discovers more about the possible contents of water and their effects on human health. In December 2005, the U.S. Environmental Protection Agency promulgated new drinking water regulations that will require utilities serving populations of more than 100,000 to meet stricter standards by 2012. Thanks to our efforts over the years, our company already meets the new standards for disinfection byproducts. And riverbank filtration wells will help our B. E. Payne plant to meet the new regulations for particles, including cryptosporidium and giardia parasites.

The riverbank filtration well at the Payne plant, which finished its sixth year of operation in 2005, has shown the value of this system. Basically, it uses the natural filtration of the soil and sand strata along the Ohio River to remove contaminants from our source of water. Over the years, the quality of the water from the well has approached the quality of water taken from the river after being processed by our treatment plants. During and after the January 2005 oil spill, the water from the well showed no traces of contamination from the oil. In summer, the water from the well is also free of the byproducts of algae growth that cause taste and odor problems with water from the river.

Experience with this well demonstrated the value of this approach for meeting stricter water quality standards and, in 2003, our board approved design of a new system of wells to provide nearly all the water at the B. E. Payne plant. As proposed in 2004, the system included a 12-foot-diameter tunnel in the bedrock along the river, supplied by 31 vertical wells in the aquifer above the rock. Competitive bids for construction were received in March 2005; the lowest was more than \$17 million more than the engineering estimate of \$31 million.

The bids were rejected and we began a special value engineering effort to identify the costlier items and find ways to deal with them.

One problem was the classification of the bedrock as "gaseous," based on reports of natural gas in some of the bedrock south of the tunnel. A series of 28 new test bores in late 2005, taken about every 250 feet along the route of the tunnel, showed no gas—and no fractures in the rock.

Another problem was the cost of accurately drilling vertical wells to meet the tunnel. A new design includes fewer and larger vertical shafts with horizontal collector wells extending from them into the aquifer. This design is similar to the basic idea of the demonstration well, with an important difference: the shafts will be capped at ground level, and the pump station will be built at the end of the tunnel.

Other changes are expected to bring the construction cost of the project down to the originally planned \$31 million, adjusted for inflation and special construction conditions at the time of bidding. The new design should be ready to advertise for bids the summer of 2006, with construction starting sometime in 2007.

While riverbank filtration can be a great way to provide clean drinking water, it may not be the best way in all instances. The characteristics of the aquifer, the bedrock and potential for contamination from human activity can have a great effect on its efficiency. Because of this, the cost and usefulness of a series of wells running northeast along the river from our historic Zorn Avenue Ohio River intake to supply the Crescent Hill treatment plant is uncertain.

Early in 2005, our board set up a Steering Group on Alternative Treatment Technology for the Crescent Hill treatment plant. Made up of board members, company officials and a representative of Louisville Metro government, it met with our consulting engineers five times during the year. Nine preliminary treatment options were considered, then narrowed down to five that were reviewed in depth. Three options were chosen for further study.

Continuing development in the area we serve brought us more than 3,600 new retail customers in 2005.

In November, the board approved $2.5 million for preliminary engineering studies to test two of the options: riverbank filtration (wells) and an Ohio River intake with treatment by ozone and biologically active filters. While no timetable for a final decision was set, the new system should meet EPA's 2012 deadline.

The continuing need for improvements to meet water quality goals and to provide adequate service for a growing community will increase expenses in the future. To meet this need, the board in December approved a 5 percent across-the-board increase in water rates for 2006. One percent of this amount is reserved for developing advanced treatment technology for our Crescent Hill plant, to enable it to meet future, more stringent, water quality regulations.

(The increase did not apply to customers in the recently acquired Goshen, Kentucky Turnpike and Shepherdsville systems, where rates are already higher than our regular rates. The rate differential is used to make improvements in those systems; when this is accomplished, rates will be equalized.)

EXPANSION

Continuing development in the area we serve brought us more than 3,600 new retail customers in 2005. We experienced increases in all customer categories except industrial, which remained the same as in 2004.

The major areas of growth are to the eastern and southern parts of our service area, and several projects were under way and completed to meet the growing demand.

Capacity at our B. E. Payne plant was expanded by 15 million gallons per day, to a total of 60 million gallons per day.

Foremost was the completion of the project to expand the capacity of our B. E. Payne plant by 15 million gallons per day, to a total of 60 million gallons per day. The expansion, originally budgeted at $20.5 million, actually cost $18.2 million—12 percent under budget.

The new facilities include higher capacity filters, a new backwash system, additional pumps, new electrical switch gear and a diesel-powered backup power supply capable of operating the plant at 30 million gallons per day.

The plant operated at its full 60 million gallons per day capacity during the company's record production peak in June, and the backup power supply operated at full capacity during a test exercise in August.

Other capacity improvements included new or enlarged water mains. The largest was the relocation of a major main to make way for an expansion at Louisville International Airport. The 60-inch main through the airport property was relocated with a new 60-inch main at a cost of $5.6 million; the airport authority shared in the funding of this relocation to accommodate the west runway extension.

In 2005, developers installed most of the new water lines built to serve customers in our service area.

In Jefferson County, 41.1 miles of new main were built at a cost of more than $7.3 million. They will serve 3,855 new customers.

In Bullitt County, 8.4 miles of main were built at a cost of nearly $2 million. They will serve 399 new customers.

And in Oldham County, 3.8 miles of main were built at a cost of more than $600,000. They will serve 249 new customers.

In Bullitt and Oldham counties, we continued to make improvements to systems acquired in the past few years. These improvements are financed by the higher rates historically paid by the customers in those areas. Their rates will be adjusted to Louisville Water Company rates when the improvements are paid for. (Because they are already paying more than our standard rates, they were not subject to our rate increases in 2004, 2005 and 2006.)

As part of our Bullitt County Extension Program, we spent $3.5 million to build 14.7 miles of water mains into unserved areas, providing service to 235 customers. We also renovated or replaced 4.6 miles of existing mains at a cost of $1.7 million. Twenty-six new fire hydrants were installed, qualifying the Zoneton Fire District for an upgraded fire insurance rating and lowering insurance premiums in the area.

We also added one new wholesale customer during the year. Lebanon Junction water system approved a contract to use Louisville Water Company as a backup to provide water in emergencies.

MAINTAINING OUR SYSTEM

Supplying water 24/7 requires an efficient, smoothly functioning system. This poses challenges when parts of the system are a century old or more.

One ongoing problem is breaks in our water mains. Stress from cold weather is one common cause; in December 2005, we repaired 168 of them—52 more than the average for recent Decembers.

On the evening of November 2, a major break at the downtown intersection of Broadway and Second Street flooded the streets.

Occasionally, the breaks can be quite disruptive. On the evening of November 2, a major break in a 30-inch water main at the downtown intersection of Broadway and Second Street flooded the streets and caused traffic congestion for more than a week. Our crews worked around the clock to make repairs, which were complicated by natural gas lines, underground electric and fiber-optic cable lines and a large brick sewer line. Our cost for the repair totaled more than $98,000.

A 12-inch break on Baxter Avenue near Breckenridge Street the evening of March 30 damaged several properties and closed the street to traffic. The break was repaired and service was restored early the next morning. Our cost for this repair was $38,000, not including damage claims.

A regular program to repair or replace aging facilities is one of the ways we try to reduce these challenges. Since 1992, we have been renovating or replacing the 500 miles of unlined cast iron water mains that were installed before 1935. In 2005, about 5.1 miles of main were replaced at a cost of $5.3 million. The entire 500 miles of work should be completed by the end of 2007. In the meantime, other mains are becoming troublesome and will require replacement or rehabilitation. Preliminary discussions of a new rehabilitation program are already under way to address the next generation of aging infrastructure installed from 1935 to 1970.

Another legacy of the past is the lead pipe service lines that connect the water mains with water meters in older parts of our system. In an ongoing program, we replaced 710 of them in 2005. Approximately 19,700 lead service lines remain in service. We expect to replace all of them by 2015.

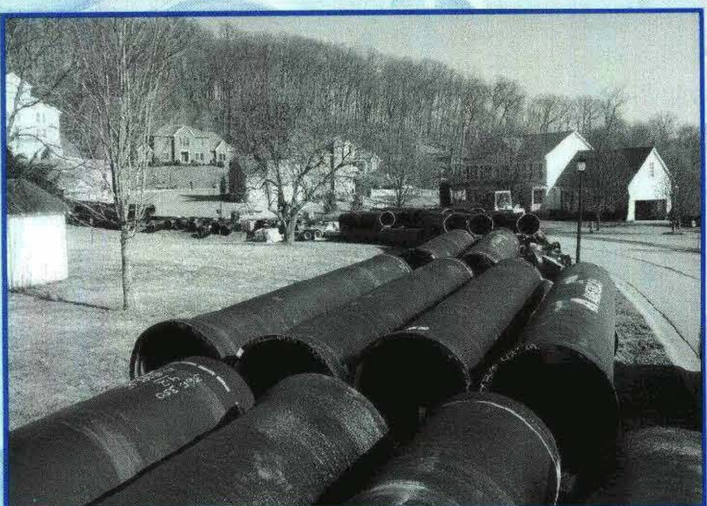
In an effort to slow the deterioration of our cast-iron mains, we launched a pilot program in 2005 to install sacrificial anodes to reduce corrosion. A sacrificial anode is made of magnesium, a metal that will corrode faster than cast iron. The anodes are buried alongside the water main and attached to it.

The anodes are expected to help preserve water mains in areas where there are stray electrical currents and soil types that promote corrosion. They were installed in 2005 in two areas in western Louisville and one in Jeffersontown.

Another new program is designed to reduce the percentage of water that we list as "unmetered"—the difference between the amount of water we pump into the system, and the amount of water metered. Part of this water, but not all, is lost in main breaks. A special team was formed to deal with the problem; one of its main findings was that a certain type of water meter, as it aged, was not registering all the water passing through.

Since 1992, we have been renovating or replacing the 500 miles of unlined cast iron water mains that were installed before 1935.

Normally, meters are expected to remain accurate for approximately 20 years. We had a regular program to replace them but it was discontinued in anticipation of a new automated meter reading system. However, automated meter reading feasibility appears to be farther in the future than originally anticipated, so the replacement program was reinstated. More than 14,000 were exchanged during 2005. Other meters are being tested, both at our plants and at our customers' connections. In two years, the program, plus the reduction in the number of main breaks because of our rehabilitation and replacement program, has reduced the amount of unmetered water.



Our Crescent Hill treatment plant facilities underwent extensive repairs and renovations in 2005.

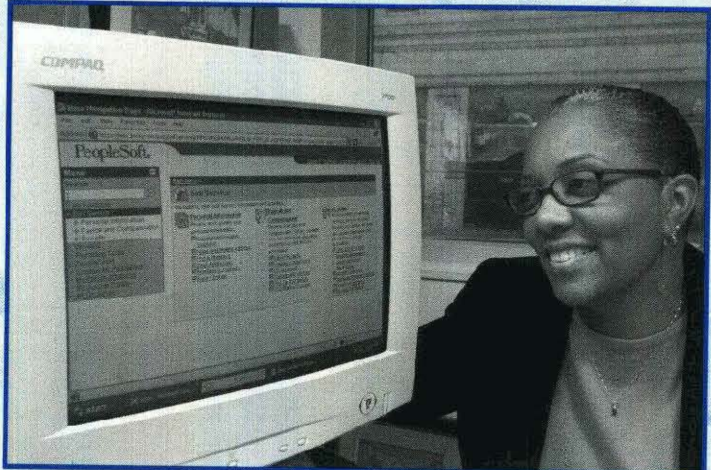
The slate roofs on our historic chemical and filter buildings had been scheduled for replacement beginning in 2005, at a cost of more than $3.6 million. But an inspection early in the year revealed an unexpected problem at the filter building. During the ice, sleet and snow storm of December 2004, a buildup of ice had slid off the higher chemical building roof, crashing into the filter building roof and causing significant damage. The estimated cost increased to more than $3.8 million.

Repairs to the iron, steel and wood of the roof structure and the masonry of the building are part of the project; work began in the fall of 2005 and should be completed in two years. Slate will be used once again, in the hope that the roof will last for another century.

Another major project at Crescent Hill was the $3.8 million renovation of the south coagulation complex, which removes particles from the water. The work began in April 2004 and is expected to be completed in March 2006.

While ongoing repairs, replacements and renovations have kept the Crescent Hill plant operating efficiently, emergencies still happen. On August 11, while demand for water was heavy because of dry weather, a 36-inch backwash supply line at the Crescent Hill plant failed spectacularly, shooting a plume of water 30 feet in the air and flooding the parking lot. The water was shut off quickly, but the failure kept the filters from being backwashed, which flushes away the particles they remove from the water so they can function efficiently.

Our crews went into emergency operation, adjusting the filtering process and uncovering the problem pipe for repair. The repair was accomplished in 26 hours, without affecting the quality of the water provided to our customers.



TECHNOLOGY AT WORK

Over the past several years, we have replaced nearly all of our old computer systems with best-of-breed systems that are much more user-friendly and scalable. The most recent is the Human Resources Management System that went into operation in mid-December 2005.

The Human Resources Management System allows employees to enroll online in their health benefit plans.

Planning for the new system began in 2004, as specifications were drawn up. Implementation began in May 2005.

Some of the advantages of the new system include:

- It interacts with our financial, payroll and timekeeping systems. Data is entered only once. Under the old arrangement, the same data had to be entered separately in up to four different systems.
- It is expandable. One of the old systems was running out of room for new entries, and there was no way to expand it to add capacity.
- It maintains a record of past changes. Under the old system, a change would replace the old data, and there was no record in the system of past changes.
- It can handle much more information, such as state and federal training requirements, union contractual issues, safety requirements, Department of Labor statistics, certifications and licenses, and other items.
- For the first time, employees can view their information by computer, either at the office or on their home computers.
- And, for the first time, employees can make corrections or changes in some of the information in their files, such as changes of address, income tax withholding, and beneficiaries. In early 2006, the system was used to allow employees to enroll online in their health benefit plans, for the first time without paper forms.

CORPORATE GOVERNANCE

The Board of Water Works adopted a new set of corporate governance policies and procedures in 2005 to assure continued public confidence in the financial integrity and operations of Louisville Water Company.

The action represented the company's efforts to adopt best management practices from the federal Sarbanes-Oxley Act of 2002. While the Act does not apply to Louisville Water Company, its requirements are recognized as the best governance practices for today's corporations. As part of the company's efforts to meet these standards, the board voted in 2004 to separate the offices of the president of the company from the chairman of its board. The board now elects its own chairman and vice chairman.

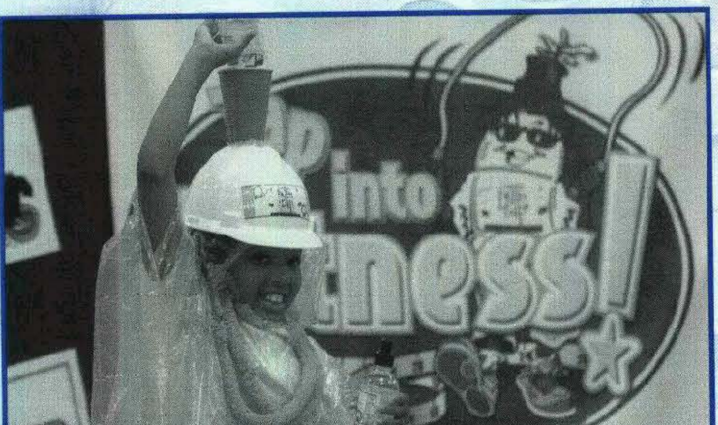
The guiding principles of the new corporate governance policy are:

- Transparency of financial conditions and operations.
- Transparency of transactions with interested parties, with no improper benefits at the expense of the organization.
- Access to sound counsel unaffected by conflict of interest.

The detailed policies and procedures were the result of work by the company's staff based on publications from not-for-profit university and hospital industry groups. The individual sections include detailed standards including: the independence of external auditors; the responsibilities of the board's audit committee and company officers; senior financial officers' code of ethics; accountability for corporate fraud or criminal actions; and certification by the treasurer of the financial reports.

A new program, "Tap Into Fitness," was tested at two local elementary schools in 2004-2005.

The new policies are also consistent with guidance from standards recommended by the Committee of Sponsoring Organizations of the Treadway Commission.



COMMUNITY ACTIVITIES

While providing safe water 24/7 is our major goal, we are committed to helping improve our community's health in other ways, as well.

In 2005, we visited 1,054 classrooms with our educational programs, reaching 44,622 children. And more than 200 teachers attended our summer workshops.

"Smile Kentucky!" is co-sponsored by the University of Louisville School of Dentistry and the Kentucky Dental Association and began its fourth year of dental education, screening and free treatment for school children in the area. In the 2005 school year, 31 schools in Jefferson, Bullitt, Shelby and Nelson counties took part. About 15,000 children saw the educational programs, 7,000 received free dental screening and about 400 were scheduled for free dental treatment in February 2006. In 2005, the program won the Kentucky-Tennessee American Water Works Association Award for communication and public service and gained grants and other help from Alcoa, Colgate and the American Dental Association Foundation.

A new program, "Tap Into Fitness," was tested at two local elementary schools in 2004-2005. It teaches the importance of fitness and nutrition, and illustrates how advertising affects health choices. Developed in partnership with the Heuser Clinic, the program concentrates on fifth graders. Research showed that about 80 percent of the children who participated showed improved physical fitness afterward. The program was expanded to five schools for the 2005-2006 school year.

Our Customer Advisory Council continued to meet in 2005, providing valuable suggestions concerning our operations and programs. Members are volunteers who represent different segments of

the community and different types of customers. Topics covered during the year included water main breaks and our response; the wells project at the B. E. Payne plant; improvements and renovations at the Crescent Hill reservoir; our customer satisfaction surveys and index; and customer communications regarding drought conditions.

LWC receives EPA's Partnership for Safe Drinking Water Five-Year Director's Award. The national award was given to water utilities that surpassed federal drinking water standards for five consecutive years.

When Hurricane Katrina struck the Gulf Coast, we provided more than 10,000 bottles of our Pure Tap water for rescue teams hurrying to the area. We also offered to send maintenance and repair crews and technical personnel if needed; however, there were no requests for their services.

AWARDS

Our company, employees and programs won awards during 2005 recognizing achievements in several areas.

In the realm of water quality, we received the national Partnership for Safe Water's Five-Year Director's Award for continuing to provide drinking water that surpasses federal quality standards. Both the B. E. Payne and Crescent Hill treatment plants were recognized for their accomplishments. The partnership was developed by the United States Environmental Protection Agency and other water organizations working to provide high-quality drinking water.

"Smile Kentucky" earned the American Water Works Association Kentucky-Tennessee regional award for communication/public service. The program was also awarded grants from Alcoa, Colgate and the American Dental Association Foundation.

Our Local 1683 of the American Federation of State, County and Municipal Employees won the union's Council 62 Award: "In acknowledgement of the contributions made towards training and empowering labor/management skills of the rank-and-file members and management both locally and nationally." The ongoing partnership between the union and the company has won international attention for its effectiveness.

Our "Water Works" documentary video won first place in the documentary profile category at the national Hometown Video Festival in June. It also received the Philo Award for outstanding journalism by a government access television station in the four-state region composed of Kentucky, Indiana, Michigan and Ohio.

The American Council of Engineering Companies of Kentucky gave Louisville Water Company and consultants GRW Engineers its Engineering Excellence Award for development of our automated mapping and facilities management geographic information system.

And our team won the overall 2005 American Public Works Association Roadeo competition for utilities and other public agencies in Jefferson County.

SALE OF WATER REVENUE ANALYSIS

	Number of Customers through December 31,		Consumption - YTD (1000 Gallons)		Revenue - YTD		Revenue (1000 Gallons)	
	2005	2004	2005	2004	2005	2004	2005	2004
GENERAL PRESSURE SERVICES								
Residential	151,627	151,421	9,723,943	9,457,082	28,967,036.90	26,450,814.79	2.979	2.797
Commercial	16,948	16,861	11,216,865	10,976,437	26,328,522.74	24,081,024.87	2.347	2.194
Industrial	321	321	4,361,847	4,506,099	7,691,392.52	7,440,323.30	1.763	1.651
Fire Services & Fire Hydrants	3,118	3,067	33,164	40,045	1,274,109.17	1,185,466.02		
Public Fire Hydrants	12,133	11,956	-	-	4,005,654.05	3,704,605.32		
Municipal	579	541	1,288,835	1,149,253	2,740,895.45	2,413,563.21	2. 127	2.100
Wholesale *	-	-	-	36,768	-	38,210.00		1.039
Total GP Services	**184,726**	**184,167**	**26,624,654**	**26,165,684**	**71,007,690. 83**	**65,314,007.01**	**2. 489**	**2.325**
ELEVATED PRESSURE SERVICES								
Residential	90,311	87,472	7,365,931	6,578,838	21,998,593.54	18,726,249.65	2.987	2.846
Commercial	5,663	5,518	4,163,849	3,766,378	11,006,729.82	9,449,575.11	2.643	2.509
Industrial	8	8	225,469	252,565	407,337.28	431,863.95	1. 807	1.710
Fire Services & Fire Hydrants	1,504	1,450	9,980	11,097	647,980.08	600,051.64		
Public Fire Hydrants	7,798	7,515	-	-	2,540,977.83	2,290,550.00		
Municipal	33	3	128	102	127,972.76	59,101.14	999.787	579.423
Wholesale *	5	5	1,662,453	1,468,758	2,579,386.01	2,165,468.52	1.552	1.474
Total Elevated Services	**105,322**	**101,971**	**13,427,810**	**12,077,738**	**39,308,977.32**	**33,722,860.01**	**2.682**	**2.550**
TOTALS								
Residential	241,938	238,893	17,089,874	16,035,920	50,965,630.44	45,177,064.44	2.982	2.817
Commercial	22,611	22,379	15,380,714	14,742,815	37,335,252.56	33,530,599.98	2.427	2.274
Industrial	329	329	4,587,316	4,758,664	8,098,729.80	7,872,187.25	1.765	1.654
Fire Services & Fire Hydrants	4,622	4,517	43,144	51,142	1,922,169.25	1,785,517.66		
Public Fire Hydrants	19,931	19,471	-	-	6,546,631.88	5,995,155.32		
Municipal	612	544	1,288,963	1,149,355	2,868,868.21	2,472,664.35	2.226	2.151
Wholesale	5	5	1,662,453	1,505,526	2,579,386.01	2,203,678.02	1.552	1.464
GRAND TOTALS	**290,048**	**286,138**	**40,052,464**	**38,243,422**	**110,316,668.15**	**99,036,867.02**	**2.546**	**2.389**

All categories, excluding Wholesale, are services active in the last 30 days.
** Effective 4-28-04, North Nelson Wholesale Customer reclassified as EPS, as opposed to GPS*

FINANCIAL STATEMENTS & SUPPLEMENTAL INFORMATION
MANAGEMENT'S DISCUSSION AND ANALYSIS

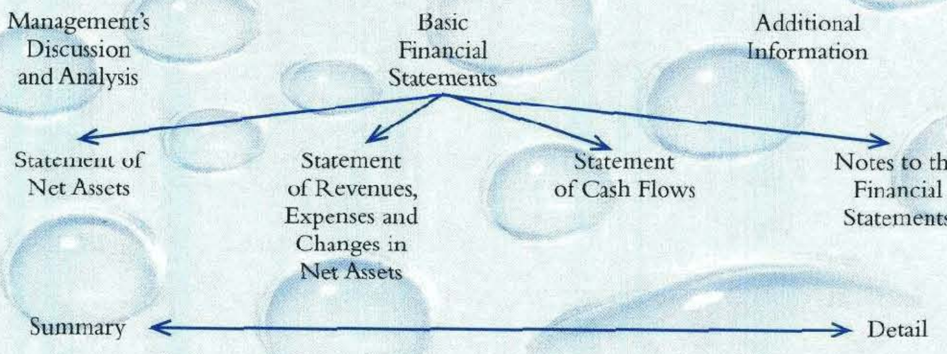
The following management's discussion and analysis of Louisville Water Company's ("LWC") financial performance provides an overview of the Company's financial activities for the fiscal year ended December 31, 2005 as compared with the prior year. Please read it in conjunction with the Company's financial statements which follow this section.

OVERVIEW OF THE FINANCIAL STATEMENTS

This annual financial report consists of three parts: Management's Discussion and Analysis, Financial Statements, and Supplemental Data. The Financial Statements also include notes that explain in more detail some of the information in the financial statements. The statements are followed by a section of Supplemental Data that further explains and supports the information in the Financial Statements. The Financial Statements of the Company report information about the Company using accounting methods similar to those used by private sector water utility companies, except for the reporting of contributions in aid of construction, equity capital and retained earnings. For financial reporting purposes, the Company is considered a Special-purpose Government Engaged Only in Business-type Activities. These statements offer short-and long-term financial information about its activities. Figure A-1 shows how the required parts of the annual financial report are arranged and relate to one another.

FIGURE A-1

Required Components of Louisville Water Company's Annual Financial Report



The Statement of Net Assets includes all of the Company's assets and liabilities and provides information about the nature and amounts of investments in resources (assets) and the obligations to Company creditors (liabilities). It also provides the basis for evaluating the capital structure of the Company and assessing the liquidity and financial flexibility of the Company.

All of the current year's revenues and expenses are accounted for in the Statement of Revenues, Expenses and Changes in Net Assets. This statement measures the success of the Company's operations in meeting financial objectives over the past year and can be used to determine whether the Company has successfully recovered all of its costs through its water rates and other charges, has earned a profit, and has maintained credit worthiness.

The final required financial statement is the Statement of Cash Flows. The primary purpose of this statement is to provide information about the Company's cash receipts, cash payments, and net changes in cash resulting from operations, investing, and financing activities and provides information on the sources and uses of cash and the changes in cash balances during the year.

FINANCIAL HIGHLIGHTS

- Total Assets increased by $27,683,106 or 3.8%, from $723,142,973 in 2004 to $750,826,079 in 2005, due to increases in Utility Plant that were financed from cash generated from operations, contributions in aid of construction, and draws from the Depreciation Fund and the System Development Charge Fund.

- Operating Revenues increased by $11,768,203 or 11.4%, from $103,462,053 to $115,230,256, due to increased water sales to residential, commercial and wholesale customers and increased sale of water revenues from a 6.5% increase in water rates effective January 1, 2005.
- Operating Expenses increased by $6,352,469 or 9.1%, from $70,024,120 to $76,376,589, due to increases in Operation and Maintenance Expenses, Depreciation Expense, and Water Service Provided in Lieu of Taxes.
- Net Non-Operating Expenses decreased by $737,000 or 15.1% from $4,868,917 to $4,131,917. Decreases in interest earned on investments and the amount of bond interest expense allocated to capital projects were offset by decreases in interest paid on the Series 2000 and Series 2001 Bonds and the non-recurrence of Early Retirement Incentive Program costs incurred in 2004.
- Net Income before dividends increased by $6,152,734 or 21.5%, from $28,569,016 to $34,721,750, due to increases in sale of water which were greater than increases in operating expenses.
- Dividends Paid and Payable increased by $1,625,913 or 11.2%, from $14,552,137 to $16,178,050.

STATEMENT OF NET ASSETS

Total Net Assets increased by $34,341,659 or 6.0% in 2005 (see Figure A-2). The largest portion of Net Assets is Utility Plant, which increased by $41,255,516 in 2005 through capital improvements. The capital improvements were funded by cash generated from operations, draws from the Depreciation Fund and the System Development Charge Fund, and by Contributions in Aid of Construction from developers, customers and governmental agencies. Non-Current Assets decreased by $11,262,043 due to the draws from the Depreciation Fund and the System Development Charge Fund. There were deposits made to the Infrastructure Replacement Reserve in the amount of $1,858,333 during 2005 following two years with no deposits to that reserve. Long-term Liabilities decreased by $8,243,129 due to principal payments on the Series 2000 and 2001 Bonds made during the year and the continued buyout of a portion of the refunding contracts payable to developers. Long-term debt is discussed in more detail in the section titled *Debt Administration*.

FIGURE A-2

Condensed Statement of Net Assets

	2005	2004	Difference	Percent
Current Assets	$ 26,115,893	$ 28,426,260	$ (2,310,367)	(8.1%)
Non-Current Assets	19,504,022	30,766,065	(11,262,043)	(36.6%)
Utility Plant	705,206,164	663,950,648	41,255,516	6.2%
Total Assets	750,826,079	723,142,973	27,683,106	3.8%
Current Liabilities	31,291,016	29,706,440	1,584,576	5.3%
Long-Term Liabilities	113,994,307	122,237,436	(8,243,129)	(6.7%)
Total Net Assets	$ 605,540,756	$ 571,199,097	$ 34,341,659	6.0%

STATEMENT OF REVENUES, EXPENSES AND CHANGES IN NET ASSETS

Operating Revenues increased by $11,768,203 or 11.4% in 2005 (see Figure A-3). Water sales increased by 1,809 million gallons in 2005. This is equivalent to approximately more than 17 days of billable consumption. The increase in operating revenues is due to a 6.5% rate increase effective January 1, 2005 and additional water sales to residential, commercial, and wholesale customers.

Operating Expenses increased by $6,352,469. The key components of operating expenses are: Operation and Maintenance Expenses, Depreciation Expense, and Water Service Provided in Lieu of Taxes. Operations and Maintenance Expenses increased by $3,839,405 due to higher labor and labor-related overhead costs, contractual services, chemicals, power, and transportation costs. Depreciation Expense increased by $1,584,211 due to increased investments in utility plant. Taxes and Water Service in Lieu of Taxes increased by $936,873 due to increased municipal water usage and increased fire hydrant charges.

Net Non-Operating Expenses (non-operating expenses less non-operating income) decreased by $737,000 due to decreases in interest earned on investments and the amount of bond interest expense allocated to capital projects, which were offset by decreases in interest paid on the Series 2000 and Series 2001 Bonds and the non-recurrence of Early Retirement Incentive Program costs incurred in 2004.

Net Income before Distributions and Contributions increased by $6,152,734 due to Operating Revenue increasing faster than Operating Expenses. The formula for computing the dividend is established as a covenant in the Series

1992 Bond Resolution (the Master Bond Resolution). The dividend is calculated as 60% of net income after deducting bond principal payments and certain other items. Dividends Paid and Payable increased by $1,625,913 or 11.2%, from $14,552,137 to $16,178,050.

Contributions in Aid of Construction are composed of: pipeline contributions from developers for water main extensions and from governmental agencies for water main relocations; service installation fees from customers; apportionment warrant fees and tapping fees from customers to extend water service to unserved areas; and system development charges from customers for growth-related expansion. The level of capital contributions varies from year to year and is affected by economic cycles. These types of projects are fully funded or nearly fully funded by outside entities in advance of construction. Contributions in Aid of Construction decreased by $632,942 due to fewer Apportionment Warrants issued following completion of the Jefferson County Water Extension Program in 2004.

FIGURE A-3

Condensed Statement of Revenues, Expenses and Changes in Net Assets

	2005	2004	Difference	Percent
Operating Revenue	$ 115,230,256	$ 103,462,053	$ 11,768,203	11.4%
Operating Expenses	76,376,589	70,024,120	6,352,469	9.1%
Net Operating Revenue	38,853,667	33,437,933	5,415,734	16.2%
Net Non-Operating Expenses	4,131,917	4,868,917	(737,000)	(15.1%)
Net Income Before Distributions and Contributions	34,721,750	28,569,016	6,152,734	21.5%
Dividends Paid and Payable	(16,178,050)	(14,552,137)	1,625,913	11.2%
Contributions in Aid of Construction	15,797,959	16,430,901	(632,942)	(3.9%)
Increase in Net Assets	34,341,659	30,447,780	3,893,879	12.8%
Net Assets, Beginning of Year	571,199,097	540,751,317	30,447,780	5.6%
Net Assets, End of Year	$ 605,540,756	$ 571,199,097	$ 34,341,659	6.0%

STATEMENT OF CASH FLOWS

Cash and Temporary Investments at the end of 2005 were $3,505,283 or 56.0% lower than at the end of 2004 (see Figure A-4). Cash from Operating Activities increased by $9,020,557 due to increased amounts received from customers. Cash from Capital and Related Financing Activities decreased by $16,364,087 due to increased acquisition and construction of utility plant and increased dividends paid. Cash from Investing Activities increased by $1,462,824 due to decreased non-operating expenses.

FIGURE A-4

Condensed Statement of Cash Flows

	2005	2004	Difference	Percent
Cash from Operating Activities	$ 61,523,378	$ 52,502,821	$ 9,020,557	17.2%
Cash from Capital and Related Financing Activities	(76,880,441)	(60,516,354)	(16,364,087)	27.0%
Cash from Investing Activities	11,851,780	10,388,956	1,462,824	14.1%
Change in Cash and Temporary Investments	(3,505,283)	2,375,423	(5,880,706)	(247.6%)
Cash and Temporary Investments, Beginning of Year	6,255,596	3,880,173	2,375,423	61.2%
Cash and Temporary Investments, End of Year	$ 2,750,313	$ 6,255,596	($ 3,505,283)	(56.0%)

In addition to the amounts held in Cash and Temporary Investments, LWC also holds funds for capital improvements in reserves totaling $9,761,516 under Other Property and Investments on the Statement of Net Assets. The total amount of funds available for operations and capital improvements decreased by $14,215,769 in 2005, from $26,727,598 to $12,511,829, as LWC spent down the fund balances in advance of the next long-term borrowing.

CAPITAL ASSETS

The Company uses a five-year Capital Improvements Program (CIP) that is updated annually. Development of the CIP is based on the Company's current Facilities Plan and recommendations from the annual inspection of facilities. The CIP also identifies anticipated capital expenditures for a total of 20 years. The Company's current Facilities Plan covers the years from 2002 through 2021. The Company expects to invest $406,976,953 in capital improvements during 2006-2010. The key capital projects for 2006 are: construction of riverbank filtration facilities, renewal of buried infrastructure, renovation of water treatment plant facilities, improvements to storage and boosted pressure systems, investments in information technology architectures, and transmission and distribution system improvements.

DEBT ADMINISTRATION

At December 31, 2005, the Company had $74,010,000 principal outstanding for the Series 2000 Bonds and $43,750,000 principal outstanding for the Series 2001 Bonds, for a total of $117,760,000. The aggregate net debt service for 2005 increased due to the ramping up of bond principal payments for the Series 2000 Bonds. As shown in Figure A-5, the debt service coverage of 3.38 times in 2005 is favorable to the statutory and bond resolution limits of 1.3 times. The Series 2000 Bonds are insured, callable beginning in 2010, and carry a Aaa rating from Moody's and a AAA rating from Standard & Poor's. The Series 2001 Bonds are not insured, but are also callable beginning in 2010, and carry a Aa1 rating from Moody's and a AA rating from Standard & Poor's. The Company's debt rating is among the very highest in the United States for water utility revenue bonds.

Debt service funding for a new money borrowing of $40,000,000 in 2006 is included in the 2006 Annual Budget. Management has not yet determined the timing and structure of that borrowing but anticipates that it will occur prior to mid-2006 and may include a variable interest rate component. The Board of Water Works has selected Public Financial Management to serve as financial advisor for the contemplated borrowing. Management will also evaluate opportunities for advance refunding the existing bonds at the time of the new money borrowing.

FIGURE A-5

Debt Service Coverage

	2005	2004	Difference	Percent
Income Available for Debt Service	40,446,290	$33,329,216	$7,117,074	21.4%
Current Aggregate Net Debt Service	11,961,809	$11,368,396	$593,413	5.2%
Coverage Times	3.38	2.93	0.45	15.4%

ARBITRAGE REBATE LIABILITY

An arbitrage rebate calculation for the Series 2000 Bonds was performed by the PFM Group for the Installment Computation Period from September 7, 2000 through September 7, 2005. During that period, LWC earned $51,995.34 in positive arbitrage; however, no rebate payment is due because the proceeds allocable to the Project Fund and the Capitalized Interest Fund met the requirements of the two-year spending exception to arbitrage rebate.

A preliminary arbitrage rebate calculation for the Series 2001 Bonds was also performed by the PFM Group in 2005. This was accomplished in advance of the required rebate computation date in 2006 due to the complexity of the financings that preceded the Series 2001 Bonds and to allow for accrual of any arbitrage rebate liability. Based on the computation by the PFM Group, the amount of the arbitrage earnings from March 2001 through December 2005 that must be rebated to the U.S. Treasury was computed as $608,250 and was accrued on the 2005 financial statements. Staff is also accruing approximately $12,000 each month for additional arbitrage earnings in 2006.

NEW ACCOUNTING STANDARD

The Company adopted Statement No.71 of the Financial Accounting Standards Board (FAS 71) for the fiscal year ending December 31, 2005. This statement provides guidance in preparing financial statements of most regulated public utilities. The type of regulation covered by this statement permits rates to be set at levels intended to recover the estimated costs of providing regulated services or products. For a number of reasons, revenues intended to cover some costs are provided either before or after the costs are incurred. If regulation provides assurance that incurred costs will be recovered in the future, this statement requires companies to capitalize those costs. If current recovery is provided for costs that are expected to be incurred in the future, this statement requires companies to recognize those current receipts as liabilities. LWC's rates for regulated services and products are subject to approval by its governing board, the Board of Water Works, which is empowered by statute to establish rates that bind customers. The regulated rates are designed to recover the specific costs of providing regulated services and products.

In view of the demand for the regulated services and products and the level of competition, direct and indirect, it is reasonable to assume that rates set at levels that will recover LWC's costs can be charged to and collected from customers. This criterion considers anticipated changes in levels of demand or competition during the recovery period of the costs. The Board of Water Works authorized the capitalization of research costs for preliminary engineering for Crescent Hill Filter Plant Advanced Treatment Technology Options in the amount of $2,500,000 as a regulatory asset that would otherwise be charged to expense, based on: (a) it is probable that future revenue in an amount at least equal to the capitalized costs will result from inclusion of that cost in allowable costs for rate-making purposes and (b) based on available evidence, the future revenue will be provided to permit recovery of the previously incurred cost rather than to provide for expected levels of similar future costs.

These costs will be amortized over five years and recovered through rates in equal amounts over that same period beginning in 2006. The primary effect of this statement will be to better match the expense of this research with the period in which water rates will recover this expense.

RISK MITIGATION/RATE STABILIZATION RESERVE EVALUATED

Management considered the establishment of a risk mitigation/rate stabilization reserve in 2005 to allow for greater flexibility in financing business risks while optimizing the stability of water rate changes and dividend payments. Staff evaluated several funding sources for creating this reserve. At that time, it appeared the most expeditious method would be from existing cash reserves. However, after reviewing this matter with Bond Counsel, it was determined that the reserve could be established without adverse impact on bondholders only through deferred dividend payments. Also, the creation of the reserve would require a complex change to the dividend covenant in the Master Bond Resolution that would have the unintended effect of making the dividend calculation less transparent. Management has determined that further consideration of establishing this reserve will be deferred pending a review of bond covenants during a new money or refunding bond issue.

RIVERBANK FILTRATION TUNNEL PROJECT DEFERRED

LWC opened bids for the Riverbank Filtration Tunnel and Pump Station Project at the B. E. Payne Water Treatment Plant in March 2005. The low bid of $48.4 million exceeded the estimate of $31.0 million by $17.4 million. Management conducted a value engineering exercise with the project engineering firm to consider design modifications or scope alterations that would allow the project to be constructed within budget while meeting the functional objective of delivering a 45-million-gallons-per-day supply using the riverbank filtration method. The major areas of discrepancy between the estimate and bid amounts include: the gas tunnel classification, construction cost escalation, tunnel shaft construction, limited construction hours, and limited competition for the project. The recommended scope following the value engineering work was to construct a 6,000-linear-foot hard-rock tunnel and three horizontal collector wells with the construction shaft utilized and interconnected to the existing low-lift pump station. The project budget was increased from $37.3 million to $40.8 million and is scheduled to be re-bid in August 2006.

As a result of the decision to defer award of the construction contract, the borrowing that was planned for 2005 was also deferred. The 2005 Budget contained net interest expense of $983,333, based on interest expense of $1,333,333 for a planned borrowing of $40,000,000 at five percent interest on May 1, 2005 offset by $350,000 of interest income on the investment of bond proceeds. The Board of Water Works approved a recommendation that the funds included in the 2005 water rates for net interest expense be instead deposited to the Infrastructure Replacement Reserve. This increased the deposit to this reserve in 2005 from an original budget level of $875,000 to $1,858,333.

ECONOMIC FACTORS AND NEXT YEAR'S BUDGETS AND RATES

Management commissioned an in-depth analysis of historical water trends following lower water sales in 2003 and 2004 in order to update the water sales forecast contained in the long-range financial plan. Monthly data was compiled for the 30-year period from January 1975 through December 2004 for all customer classes. The overall per customer trend for total usage/total customers over the 30-year period is clearly downwards for the combined customer classes. Although the analysis did not specifically address causes for the decline in usage, management attributes the decline primarily to the introduction of low-flow fixtures and other conservation devices, the dramatic decline in industrial sales over the period and reduction in average size of household.

The rate of reduction in sales per customer for all customer classes has declined approximately 20% over the 30-year period. The rate of decline for industrial customers is more significant, at approximately 45% for the period. The residential customer class showed a more moderate decrease of 7% over the period. Conversely, commercial and wholesale sales have increased at 9% and 20% respectively in the last 30 years. The analysis also modeled the forecast for consumption over the next 20-year period based on the historic trends for consumption per customer and for growth in the number of customer accounts. This analysis shows that total consumption over the next 20 years is projected to be essentially flat and is dependent upon an increase in the number of customers to offset the decrease in usage per customer. Staff has also evaluated several different growth scenarios over the 20-year period to project total consumption if the current growth in customers slows to one-half of the projected rate and if there is no growth in the number of customers. These scenarios emphasize that total consumption would decrease over the next 20 years if the net change in number of customers slows below the predicted amounts.

Declining sales per customer is a national trend. Most water utilities benchmarked by staff report similar long-term trends in declining sales when they have conducted similar data analysis. Some water utilities in areas of the country where water resources are limited and rates for service are high have actively promoted reduced consumption per customer through water conservation programs and periodic water use restrictions. The impact of nationally mandated low-flow fixtures in new housing is having similar effects on water sales per customer across the country. The reduction in residents per household is also a national trend. Likewise, the significant drop Louisville has experienced in industrial sales from manufacturing industries is consistent with a significant downward trend nationally over the past 30 years.

If no action is taken to offset the trend in declining sales per customer, total consumption over the next 20 years is projected to be flat. And, if the number of customers does not increase by the predicted amounts, then total consumption is expected to decrease. A flat or decreasing sales trend has significant implications for short-and long-term financial planning. This includes impacts on the LWC's capacity to fund: continuing increases in the cost of operations and maintenance expenses; existing and future capital investment requirements; expected net income and dividends paid to the owner; and increases in customer expectations for service.

This will require a balancing of providing adequate financial resources to deliver high customer satisfaction while keeping rate increases within an acceptable level. At this point, rate increases contemplated in our current 10-year financial plan exceed the forecast change in the Consumer Price Index by more than one percent. This is without considering the impact of a flat or decreasing sales trend. A further risk is the decrease in customer satisfaction if customers experience significant rate increases to compensate for declining sales or reductions in the level of water quality or service they receive.

Utilities sometimes consider expanding into ventures beyond their primary business that build upon their strengths. These ventures can take two primary forms:

- Horizontal integration – The acquisition of additional business activities at the same level of the value chain, achieved by internal expansion (organic growth) or external expansion (mergers and acquisitions). This is pursued to achieve economies of scale to enhance profit margins.
- Vertical integration – The degree to which a firm owns its upstream suppliers and its downstream buyers. Expansion of activities downstream is forward integration. Expansion upstream is backward integration. This is pursued to improve coordination and capture new profits.

Horizontal integration of water utilities typically remains as a regulated enterprise, where the amount of profit is limited to the amount deemed fair by the governmental regulator. Vertical integration provides opportunities for non-regulated activities, with profits limited only by what the market will bear.

LWC has successfully pursued horizontal integration since 1991 under the frameworks described in the Jefferson County Extension Program, Bullitt County Extension Program, and the Regionalization Policy. As a result, the geographic area for retail service has approximately doubled in that time. The Company has also provided billing and collection services for a fee to wastewater utilities serving our customer base. The Company has previously evaluated but not pursued vertical integration opportunities such as laboratory services and bottled water. Research has shown several examples of successes and failures by other large investor-owned water utilities.

A team of LWC managers was chartered in early 2005 to identify and evaluate new frontiers of revenue opportunities through the concept of "Strategy Innovation." This requires a complete evaluation of the Company's business model and a willingness to make changes to accommodate new revenue opportunities. A fundamental assumption of strategy innovation is that by thoroughly evaluating new markets and aligning with corporate competencies, there are "frontiers" of new revenue opportunities that can be successfully entered. A project timeline has been developed for a deliverable in 2006. This will allow the results of the strategic innovation process to flow seamlessly into the next update of the Strategic Plan.

Management believes that the 2006 Budget adequately addresses all revenue requirements. Water rates will be increased for retail water service by 5.0% for water service on and after January 1, 2006. Water rates will also be increased for wholesale water service effective May 1, 2006. The rate change for three wholesale customers are also subject to approval by the Kentucky Public Service Commission.

STRATEGIC PLANNING AND ENTERPRISE RISK MANAGEMENT

LWC considers one of the roles of management as putting assets at risk in order to achieve business objectives while the role of risk management is to minimize the variance between business objectives and actual results. Risk can be defined as occurrences which may adversely affect our ability to achieve our objectives and successfully execute our strategies. LWC has developed an Enterprise Risk Management Program to identify, assess, and manage risks and ensure adequate business risk controls are in place. Business risk controls are the processes, plans, structures and systems put into place to mitigate risks. As part of the 2004-2008 Strategic Plan, management has identified these key constituents, objectives and risks:

Constituents	Objectives	Risks
Customers	Meet and exceed customer needs and expectations, including providing appropriate information on product quality and services.	Winter emergency; major loss of information technology architectures; loss or severe damage to communications systems; adverse media reports about LWC and/or industry; publicized threat or potential act of terrorism; and destruction of or major damage to corporate headquarters.
Water Quality	Assure safe water supply, meet water quality regulations and customer expectations for distribution water quality.	Continued use of liquid chlorine and ammonia as disinfectants; destruction of or major damage to a critical LWC production facility; major Contamination of Ohio River; health-related issues in finished water; and disruption of chemical supplies.
Stockholder	Recognize and support the stockholder's interests.	Uninsured property or liability loss; LWC cost structure outpaces revenues; acquisition of regional utilities by competitors; inadequate due diligence for merger or acquisition; and MSD Consent Decree adversely impacts LWC finances and operations.
Employees	Provide an environment which values quality of work life, continuous learning, employee contribution, and well being.	LWC healthcare costs continue to escalate; workplace violence; escalating cost of benefits other than healthcare; market competition for technical positions; deterioration of union relationship; and adverse changes in LWC work culture.
Elected Officials	Maintain effective communications and relationships with elected officials and their staffs.	
Regulatory Agencies	Sustain effective partnerships with public health, water quality, and regulatory agencies to better serve our customers.	Failure to monitor regulated activities; and increased stringency of contamination regulations.
Community	Actively support employee and corporate participation in establishing and supporting community goals.	
Suppliers	Build supplier and contractor partnerships to support our ability to meet and enhance standards and service goals and link suppliers and contractors to our diversity strategies.	

Management intends to continue to develop the Enterprise Risk Management program proportional in scale and complexity to the size and nature of our business, integrated and transparent, and using a common set of measures. The Company enterprise risk management approach is consistent with the model promulgated by the Committee of Sponsoring Organizations (COSO) of the Treadway Commission. The Treadway Commission is a voluntary, private sector group jointly sponsored by five major professional accounting and financial associations, and the COSO model places its greatest emphasis on the evaluation of internal control effectiveness and upon risk-based auditing.

FUTURE AFFORDABILITY OF WATER AND SEWER BILLS

The 2006-2015 Long Range Financial Plan contemplates annual water rate increases of 5% during 2006-2010. In addition, Metropolitan Sewer District anticipates annual sewer rate increases of 6.5% to 14.5% as a result of a consent decree filed with U.S. District Court on April 25, 2005. As a result, the combined water and sewer bi-monthly bill could exceed $100 and may become unaffordable for some low-income customers.

Affordability is the ability of customers to pay for utility services billed to them. The affordability threshold is the percentage of income that a household can afford to pay to a utility through user charges. Factors affecting affordability for a community include the median household income, poverty levels, and minimum Social Security and Supplemental Security Income benefits. The affordability threshold is typically set by policy makers at 2% for water service plus 2% for wastewater service. Inability to pay for service results in a combination of lower revenues and higher expenses for the utility due to late payments, service disconnections, and uncollectible accounts.

The median Louisville residential bi-monthly water and sewer bill in 2005 is $72.48 for 12,000 gallons ($32.86 for water and $39.62 for sewer). These bill amounts are above the current 2% threshold for minimum Social Security benefits, but below the 2% poverty threshold for a three-person household, and well below the 2% threshold for an average household in Jefferson County. If the poverty threshold remains at the current level and water and sewer rates increase at projected levels, then the combined water and sewer bill is forecast to exceed the affordability threshold for poverty-level customers by 2009.

LWC does not have an affordability program comparable to cities with higher water rates and/or larger portions of the population living below the poverty level. Affordability programs in those cities typically consist of a combination of rate design and targeted assistance programs. Reduced bill delinquencies and related service costs are often cited as the primary benefits sought by utilities when implementing an affordability program. The most typical drawbacks to affordability programs are the cost of administration, the difficulty in sustaining the program over a long period, and the perceived unfairness of one class of customers being subsidized by the other classes. Staff is currently evaluating alternatives related to monthly billing and automated meter reading. And, since affordability problems will likely occur first for bills with summer irrigation water usage, staff is considering options for equalized or level billing.

CORPORATE GOVERNANCE POLICY AND PROCEDURES

The Board of Water Works is committed to effective governance and holds management to the highest standards of accountability. To assure continued public confidence in the financial integrity and operations of LWC, the Board of Water Works expects management to adhere to these guiding principles: transparency of financial conditions and operations; transparency of transactions with interested parties with no improper benefits at the expense of the organization; and access to sound counsel unaffected by conflict of interest.

In addition, the Board of Water Works has adopted—for itself and the Audit Committee, for management, and for the external auditors—consistent governance practices identified in the Sarbanes-Oxley Act of 2002, including:

> External Auditor Independence - The external auditors are prohibited from providing nonaudit services to LWC unless extenuating circumstances exist and the Audit Committee approves the work in advance. Also, the external auditors must report to the audit committee: all critical accounting policies and practices used by the client that have been discussed with management; all alternative treatments of financial information, ramifications of such use, and the treatment preferred by the public accounting firm; and other material written communication between the public accounting firm and management, such as the management letter or schedule of unadjusted differences.
>
> Corporate Responsibility - Each member of the Audit Committee shall be a member of the Board of Water Works and shall otherwise be independent. The Audit Committee shall have authority and funding to engage

independent counsel or other advisors, as necessary to carry out its duties. Senior Financial Officers are prohibited from taking any action to fraudulently influence, coerce, manipulate, or mislead an auditor engaged in the performance of an audit for the purpose of rendering the financial statements materially misleading.

Enhanced Financial Disclosures - Personal loans to any director or executive officer of the Company by the Company are prohibited.

Corporate and Criminal Fraud Accountability - The Internal Auditor will maintain records of all complaints covered by whistleblower procedures, tracking their receipt, investigation and resolution and shall prepare a periodic report to the Audit Committee until the matter identified in the complaint has been resolved to the satisfaction of the Audit Committee. The Company will not discharge, demote, suspend, threaten, harass or in any manner discriminate against any employee in the terms and conditions of his/her employment based upon the lawful action of any such employee with respect to good faith reporting of a matter covered by whistleblower procedures.

Certification - The Treasurer will include the following certification in each month's financial report provided to the Board of Water Works: *"In connection with the accompanying monthly financial report of Louisville Water Company, I hereby certify that, to my knowledge, the information contained in the report fairly presents, in all material respects, the financial condition and results of the Company."*

Staff is also evaluating recommendations contained in *Guidance for Smaller Public Companies Reporting on Internal Control over Financial Reporting* from the Committee of Sponsoring Organizations of the Treadway Commission for additional improvements to our governance practices.

RETURN ON EQUITY TARGET AND RESULTS

The equity capital invested by Metro Louisville in LWC accomplishes these purposes: to maintain control of the entity responsible for providing safe water for public health and fire protection to the community; to ensure commitment to outstanding quality, service, and value as perceived by its customers; to earn a market return on the financial stake it has in the Company; to grow the value of the Company as a going concern; and to coordinate infrastructure investments in support of community goals. Louisville and Jefferson County Metro Government has, through its direct investment in LWC, placed financial capital at risk in order to fund the infrastructure investments necessary to serve the water needs of the citizens and businesses of Louisville and adjacent communities. A target return is established in the annual budget as the "cost of equity capital" to be recovered through the water rates. The Board of Water Works has the sole authority to establish the annual budget and retail water rates through KRS 96.260.

The Board of Water Works role is one of accurately identifying and effectively balancing the interests of its constituencies. When approving the return contained in the budget and water rates, the Board is acting equally and concurrently as: the representative of Metro Government's interest in a financial return on behalf of the Mayor and Metro Council; the regulator of water rates on behalf of the citizens of Metro Louisville; and the protector of bondholder interests as identified in the Master Bond Resolution on behalf of the Bond Trustee.

The target return-on-equity is based on a return-on-equity methodology adopted by the Board to standardize the earnings component in the annual budget and water rates. The target return percentage is computed as the simple average of returns on equity allowed by state public service commissions for investor-owned utilities with common equity of more than $100 million. The target return percentage is then multiplied by Metro Louisville's equity stake in LWC to establish a target return for the year.

The primary disadvantage of the current methodology is that stockholder's equity for LWC is no longer published in the audited financial statements following adoption of GASB 34 in 2002. Also, revenues deposited into the Infrastructure Replacement Reserve are not included in the stockholder's equity for the purpose of computing the return. Using the Common Stock, Retained Earnings and Total Equity Capital reported in 2001 audited financial statements and using Income Before Distributions and Contributions less Dividends Paid and Payable from audited financial statements for subsequent years, Figure A-6 below describes management's computation of stockholder's equity for the year ended December 31, 2005.

FIGURE A-6

Computation of Stockholder's Equity

Common Stock, par value $100 per share, 12,751 shares outstanding	$ 1,275,100
Retained Earnings December 31, 2001	285,319,317
Less Cummulative Deposits to Infrastructure Replacement Reserve 2001 and prior	(31,725,000)
Total Equity Capital December 31, 2001	$ 254,869,417
Plus Income Before Distributions and Contributions 2002	27,832,748
Less Distributed Property 2002	(879,564)
Less Dividends Paid and Payable 2002	(12,379,623)
Less 2002 Deposits to Infrastructure Replacement Reserve	(2,520,000)
Total Equity Capital December 31, 2002	$ 266,922,978
Plus Income Before Distributions and Contributions 2003	24,580,534
Less Dividends Paid and Payable 2003	(12,318,831)
Total Equity Capital December 31, 2003	$ 279,184,681
Plus Income Before Distributions and Contributions 2004	28,569,016
Less Dividends Paid and Payable 2004	(14,552,137)
Total Equity Capital December 31, 2004	$ 293,201,560
Plus Income Before Distributions and Contributions 2005	34,721,750
Less Dividends Paid and Payable 2005	(16,178,050)
Less 2005 Deposits to Infrastructure Replacement Reserve	(1,858,333)
Stockholder's Equity Eligible for Return Computation December 31, 2005	$ 309,886,927

The net income for 2005 available for the return-on-equity computation was $32,863,417 based on Net Income Before Distributions and Contributions of $34,721,750 less deposits to the Infrastructure Replacement Reserve of $1,858,333. The return-on-equity earned by LWC in 2005 was 10.61%, which compares favorably to the return-on-equity target for 2005 of 9.22%.

CONTACTING THE COMPANY'S FINANCIAL MANAGEMENT

This financial report is designed to provide our citizens, ratepayers, customers, creditors and stockholder with a general overview of the Company's finances and to show the Company's accountability for the money it receives. If you have questions about this report or need additional financial information, contact the Treasurer's Office at LWC, 550 South Third Street, Louisville, KY, 40202.

INDEPENDENT AUDITORS' REPORT

Board of Water Works
Louisville Water Company
Louisville, Kentucky

We have audited the accompanying statement of net assets of the Louisville Water Company as of December 31, 2005, and related statements of revenues, expenses and changes in net assets and cash flows for the year then ended. These financial statements are the responsibility of the Louisville Water Company's management. Our responsibility is to express opinions on these financial statements based on our audit. The financial statements of Louisville Water Company as of December 31, 2004 were audited by other auditors whose report dated February 11, 2005, expressed an unqualified opinion on those statements.

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

In our opinion, the 2005 financial statements referred to above present fairly, in all material respects, the financial position of the Louisville Water Company as of December 31, 2005, and the results of its operations and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

The Management's Discussion and Analysis on pages 17 through 26 is not a required part of the basic financial statements but is supplementary information required by accounting principles generally accepted in the United States of America. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit the information and express no opinion on it.

Our audit was conducted for the purpose of forming an opinion on the basic financial statements of the Louisville Water Company taken as a whole. The supplemental data contained on pages 43 through 46 is presented for purposes of additional analysis and is not a required part of the basic financial statements. The supplemental data has been subjected to the auditing procedures applied in the audit of the basic financial statements and, in our opinion, is fairly stated in all material respects in relation to the basic financial statements taken as a whole.

Strothman & Company PSC

Louisville, Kentucky
February 17, 2006

STATEMENTS OF NET ASSETS

December 31, 2005 and 2004

	2005	2004
Assets		
Current Assets		
Cash and temporary investments	$ 2,750,313	$ 6,255,596
Accounts receivable	14,790,155	14,498,504
Contracts receivable	213,983	204,121
Materials and supplies	6,572,429	5,802,051
Bond service account - Series 2000	534,082	510,837
Bond service account - Series 2001	513,511	489,409
Prepaid expenses	709,225	633,547
Accrued interest receivable	32,195	32,195
Total Current Assets	26,115,893	28,426,260
Utility Plant, net of accumulated depreciation	705,206,164	663,950,648
Noncurrent Assets		
Non-utility property	171,084	106,576
Contracts receivable, less current portion	2,646,981	2,912,935
Reserves	14,461,517	25,172,003
Retirement plan past service costs, net	1,138,140	1,351,541
Unamortized debt discount and expense	910,759	941,070
Preliminary engineering charges	171,947	262,798
Other deferred charges	3,594	19,142
Total Noncurrent Assets	19,504,022	30,766,065
Total Assets	**$ 750,826,079**	**$ 723,142,973**

December 31, 2005 and 2004

	2005	2004
Liabilities and Net Assets		
Current Liabilities		
Accounts payable	$ 3,088,551	$ 2,267,335
Sewer collections (contra)	9,251,667	9,041,539
Customer advances, currently refundable	-	23,271
Customer deposits	6,263,606	4,316,018
Tax collections payable	451,171	256,289
Accrued interest payable	724,437	906,598
Dividend payable	302,351	1,853,257
Contracts payable, retainage percentage	1,514,477	1,305,942
Accrued payroll	315,571	501,523
Accrued vacation and sick leave	1,683,048	1,894,438
Insurance reserve	1,213,637	886,842
Bonds and notes payable, current portion	6,482,500	6,453,388
Total Current Liabilities	31,291,016	29,706,440
Long-Term Liabilities		
Customer advances for construction	2,444,307	4,477,436
Bond payable, less current portion	111,550,000	117,760,000
Total Long-Term Liabilities	113,994,307	122,237,436
Total Liabilities	**145,285,323**	**151,943,876**
Net Assets		
Unrestricted	2,857,982	5,289,588
Invested in capital assets, net of related debt	587,173,664	539,737,260
Restricted, expendable	15,509,110	26,172,249
Total Net Assets	605,540,756	571,199,097
Total Liabilities and Net Assets	**$ 750,826,079**	**$ 723,142,973**

See Notes to Financial Statements

STATEMENTS OF REVENUES AND EXPENSES AND CHANGES IN NET ASSETS

Years Ended December 31

	2005	2004
Revenues		
Operating revenues	$ 115,230,256	$ 103,462,053
Operating Expenses		
Operation and maintenance expenses	47,441,974	43,602,569
Depreciation and amortization	18,330,163	16,821,561
Taxes and water service provided in lieu of taxes	9,435,189	8,498,316
Loss from sale and salvage of retired assets	1,169,263	1,101,674
Total Operating Expenses	76,376,589	70,024,120
Net Operating Revenue	38,853,667	33,437,933
Non-Operating Income (Expense)		
Interest income	690,549	1,024,396
Interest expense	(4,855,929)	(4,769,422)
Other income (expense)	33,463	(1,123,891)
Net Non-Operating Expenses	(4,131,917)	(4,868,917)
Income Before Distributions and Contributions	34,721,750	28,569,016
Distributions and Contributions		
Dividends paid and payable	(16,178,050)	(14,552,137)
Contributions in aid of construction	15,797,959	16,430,901
Total Distributions and Contributions	(380,091)	1,878,764
Increase in Net Assets	34,341,659	30,447,780
Net Assets, beginning of year	571,199,097	540,751,317
Net Assets, end of year	$ 605,540,756	$ 571,199,097

See Notes to Financial Statements

STATEMENTS OF CASH FLOWS

Years Ended December 31

	2005	2004
Cash Flows from Operating Activities		
Cash received from customers	$ 107,478,375	$ 94,614,677
Cash paid to suppliers and others	(24,574,977)	(21,932,456)
Cash paid to employees for services	(21,380,020)	(20,179,400)
Net Cash Provided By Operating Activities	61,523,378	52,502,821
Cash Flows from Capital and Related Financing Activities		
Acquisition and construction of utility plant	(61,700,408)	(52,414,164)
Contributions in aid of construction	15,797,959	16,430,901
Customer advances for construction	(2,033,129)	1,624,399
Refunds of customer advances for construction	(23,271)	(3,772,181)
Preliminary engineering charges	90,850	711,298
Principal paid	(6,180,888)	(5,608,101)
Interest paid	(5,038,089)	(4,787,631)
Dividends paid	(17,728,956)	(12,698,880)
Non-utility property reduction	(64,509)	(1,995)
Net Cash Used In Capital and Related Financing Activities	(76,880,441)	(60,516,354)
Cash Flows from Investing Activities		
Reserved funds	10,710,487	9,365,771
Restricted funds	(47,347)	453,628
Contracts	256,093	261,376
Contracts, retainage percentage	208,536	371,423
Interest received	690,549	1,060,649
Other non-operating income (expense)	33,462	(1,123,891)
Net Cash Provided by Investing Activities	11,851,780	10,388,956
Net Change in Cash and Temporary Investments	(3,505,283)	2,375,423
Cash and Temporary Investments, Beginning of Year	6,255,596	3,880,173
Cash and Temporary Investments, End of Year	$ 2,750,313	$ 6,255,596

Continued

STATEMENTS OF CASH FLOWS—CONTINUED

Years Ended December 31

	2005	2004
Reconciliation of Net Operating Revenue to Net Cash Provided By Operating Activities		
Net operating revenue	$ 38,853,667	$ 33,437,933
Adjustments to reconcile net operating revenue to net cash provided by operating activities		
Depreciation and amortization	19,305,940	18,072,837
Amortization of retirement plan past service costs	213,401	213,402
Loss from sale and salvage of retired assets	1,169,263	1,101,674
Increase (decrease) in cash due to changes in current assets and liabilities		
Accounts receivable	(291,651)	(3,226,060)
Materials and supplies	(770,379)	(753,508)
Prepaid expenses	(75,678)	37,058
Other deferred charges	15,549	62,276
Accounts payable	821,217	1,147,135
Accounts payable, sewer collections	210,127	1,694,920
Customer deposits	1,947,587	895,979
Tax collections payable	194,882	10,327
Accrued vacation and sick leave	(211,390)	(479,235)
Accrued payroll	(185,952)	225,585
Insurance reserve	326,795	62,498
Net Cash Provided By Operating Activities	$ 61,523,378	$ 52,502,821

See Notes to Financial Statements

NOTES TO FINANCIAL STATEMENTS

December 31, 2005 and 2004

NOTE 1 - SIGNIFICANT ACCOUNTING POLICIES

Description of the Business: The Louisville Water Company ("The Company") is a provider of water and related services to residential, commercial, industrial, fire and wholesale consumers in Jefferson, Bullitt and Oldham Counties. The Company is wholly owned by the Louisville Jefferson County Metro Government ("Metro Government") and therefore follows *Government Accounting Standards.*

Basis of Presentation: The accompanying financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America as prescribed by the Governmental Accounting Standards Board ("GASB"). The financial statements include the accounts of Louisville Water Company and have been prepared on the accrual basis of accounting. Under the accrual basis of accounting, revenues are recognized when earned and expenses are recorded when an obligation has been incurred. The Company reports as a Business Type Activity ("BTA"). BTAs are those activities that are financed in whole or in part by fees charged to external parties for goods and services.

The Company classifies resources for accounting and reporting purposes into the following net asset categories:

- *Invested in capital assets, net of related debt:* Capital assets, net of accumulated depreciation and outstanding principal balances of debt attributable to the acquisition, construction or improvement of those assets.
- *Restricted:*

  Nonexpendable- Net assets subjected to externally imposed stipulations that they be maintained permanently by the Company.

  Expendable- Net assets whose use by the Company is subject to externally imposed stipulations that can be fulfilled by actions of the Company pursuant to those stipulations or that expire by the passage of time.
- *Unrestricted:* Net assets whose use by the Company is not subject to externally imposed stipulations. Unrestricted net assets may be designated for specific purposes by action of management or the Board of Water Works or may otherwise be limited by contractual agreements with outside parties.

Method of Accounting: The Company's accounting policies conform to accounting principles generally accepted in the United States of America for water utilities. Although the Company is not subject to regulation, the accounts are maintained in accordance with the uniform system of accounts prescribed by the National Association of Regulatory Utility Commissioners, except with respect to the treatment of gains and losses from the retirement or disposition of utility plant. The Company recognizes gain or loss, including cost of removal, upon the retirement or disposition of utility plant rather than the transfer of cost to accumulated depreciation, as provided by the National Association of Regulatory Utility Commissioners.

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

Utility Plant: Utility plant is stated at cost of acquisition or construction, including certain indirect costs. The Company applies the straight-line method of depreciation to the estimated useful lives of the various classes of depreciable property. The estimated useful lives of significant asset categories are as follows:

Buildings	50 to 100 years
Pipelines	65 to 100 years
Fire hydrants	50 years
Services	40 years
Meters	15 years
Equipment	5 to 10 years
Trucks and autos	5 years

Depreciation expense for 2005 was $19,385,049 of which $975,777 was allocated to other operating expenses. Depreciation expense for 2004 was $18,076,337 of which $1,251,276 was allocated to other operating expenses.

Capitalized Interest: The Company follows the practice of capitalizing interest during construction on capital projects. Interest in the amount of $1,228,611 and $1,578,120 was capitalized during 2005 and 2004, respectively.

Revenue: Revenue is recognized in the period in which billings are rendered to consumers. The Company does not accrue revenue for water delivered but not billed.

Allowance for Doubtful Accounts: The allowance for doubtful accounts is established based on historical collection experience and a review of the current status of existing receivables.

Materials and Supplies: Materials and supplies inventories are stated at the lower of average cost or market.

Statements of Cash Flows: For purposes of the statements of cash flows, the Company considers all highly liquid investments purchased with a maturity of three months or less to be temporary investments.

Accrued Vacation and Sick Leave: Employees' vested and accumulated vacation and sick leave are recorded as liabilities in the financial statements. Accrued vacation and sick leave was $1,683,048 at December 31, 2005, and $1,894,438 at December 31, 2004.

Customer Deposits: In 2005, the Company implemented a security deposit policy for all customers applying for residential, commercial or industrial water service who: (i) have not had an account with the Louisville Water Company for three consecutive years; (ii) have had a previous account in bad debt or bankruptcy status; or (iii) have had a service disconnected due to non-payment within the last three years of service. The Company refunds the security deposit when: (i) a customer closes the account; or (ii) the customer has paid their bill in a timely manner for three consecutive years. Total security deposits at December 31, 2005 and 2004 were $777,795 and $99,495, respectively. Customer deposits are included as current liabilities on the statement of net assets.

Customer Advances for Construction: The Company requires customers to make a deposit for the cost of construction of pipelines and special services. Advances are refundable, within certain time limits up to twenty years, under the terms of the various contracts. The customer advance accounts reflect the liability for probable refunds of these construction advances. Once the refund period has expired, any balance is transferred to net assets as a contribution in aid of construction.

Investment Securities: Investments are reported at fair value with gains and losses included in the statements of revenues, expenses and changes in net assets. Gains or losses on dispositions are determined using the specific identification method.

Union Employees: The Company has numerous employees who are covered by a collective bargaining agreement. At December 31, 2005, approximately 48% of the Company's employees were covered by a collective bargaining agreement. The existing agreement expired January 31, 2006 and was renegotiated for 5 years, expiring January 31, 2011, and ratified on January 31, 2006.

Taxes: The Company, by virtue of its ownership by the Metro Government, is exempt from taxation by federal, state and local taxing authorities. However, the Company is liable for certain other taxes and provides water and fire services in lieu of taxes to Metro Government. Tax expense, which includes water and fire services in lieu of taxes for

December 31, 2005 and 2004, was $9,435,189 and $8,498,316, respectively.

Reclassification: The 2004 statement of net assets has been reclassified to conform to the 2005 presentation. Such reclassifications have no effect on the total assets, total liabilities, or net assets.

NOTE 2- ACCOUNTS RECEIVABLE

Accounts receivable include:

Accounts Receivable

Year Ended December 31

	2005	2004
Water	$ 5,202,338	$ 4,942,935
Sewer (contra)	8,577,357	8,362,353
Other	1,702,916	1,906,271
Allowance for uncollectible accounts	(692,456)	(713,055)
	$ 14,790,155	$ 14,498,504

NOTE 3 - 2001 BOND ISSUE RESOLUTION FUNDS

Bond Reserve Account: The Master Bond Resolution requires that a bond reserve account be established at one-half of the highest future annual maximum aggregate net bond service of $6,119,715 to be paid in 2014. The fund is to be used to pay maturing bonds and interest in the event funds in the Bond Service Account are not sufficient. Otherwise, funds may not be withdrawn until the bond issue is paid in full. However, the income earned on investments may be transferred to the Bond Service Account. The reserve is invested in U. S. Treasury Bonds and is stated at fair value.

Depreciation Fund: The Master Bond Resolution requires the Company to make monthly deposits of an amount equal to one-twelfth of an amount not less than the annual depreciation charges into a depreciation fund. The balance includes interest income earned and the gain on sale of property and is available to fund capital improvements to the water system. The fund is invested in a sweep account. This fund and the funding requirements are also included in the 2000 bond issue (see Note 4).

Infrastructure Replacement Reserve Fund: The Master Bond Resolution was revised to provide for the creation and funding in 1993 of the Infrastructure Replacement Reserve Fund to support the infrastructure main replacement and rehabilitation projects. Budgeted funding was $875,000 and $2,600,000 for 2005 and 2004, respectively. The total actual deposits were $1,858,333 in 2005 and there were no deposits to the fund in 2004. The balance at December 31, 2005 is stated at fair value and represents the remaining funds and interest earned on monies invested in a sweep account.

U. S. Treasury State and Local Government Fund: The Series 2 Note Reserve was established in the amount of $1,440,400 pursuant to the Master Bond Resolution. The note was paid in August 1993 and the reserve amount was transferred to the Company and was deposited in the U.S. Treasury State and Local Government Fund. The excess funds from the 2001 Bond Refunding were deposited in this fund. The fund is invested in U.S. Treasury bonds and is stated at fair value.

Bond Service Account: Except to the extent that the interest and principal are to be paid from other available sources, the Company is required to deposit monthly, into the Trustee's Bond Service Account, one-sixth of the amount of the next succeeding interest payment on the 2001 Bonds outstanding and one-twelfth of the next maturing principal of those bonds. The account is invested in a government obligation mutual fund and is stated at fair value.

NOTE 4 - 2000 BOND ISSUE RESOLUTION FUNDS

Bond Reserve Account: The resolution authorizing the Bond Issue of 2000 requires that a bond reserve account be established at one-half of the highest future annual maximum aggregate net bond service. As an alternative, the Resolution provides for deposit of an insurance policy, surety bond or other comparable security into the Reserve Account in an amount sufficient to meet the bond reserve requirement. The Company maintains an insurance policy to meet this requirement. The policy is to be used to pay maturing bonds and interest in the event funds in the Bond Service Account are not sufficient.

Depreciation Fund: The Series 2000 Bond Resolution authorizing the Bond Issue of 2000 requires the Company to maintain the depreciation fund in the same manner as required for the 2001 series (refunding 1992) bond issue (see Note 3).

Bond Service Account: Per the Series 2000 Bond Resolution, except to the extent that the interest and principal are to be paid from other available sources, the Company is required to deposit monthly, into the Trustee's Bond Service Account, one-sixth of the amount of the next succeeding interest payment on the 2000 Bonds outstanding and (beginning with the twelfth month preceding the first maturity of any bonds) one-twelfth of the next maturing principal of those bonds. The account is invested in a government obligation mutual fund and is stated at fair value.

Operation Fund: Per the Series 2000 Bond Resolution, each month the Company shall, after making required payments to the Bond Service Account, the Bond Reserve Account, and the Depreciation Fund, withdraw from the Revenue Fund and deposit with a Depository in the name of the Company to the credit of the Operation Fund the balance remaining in the Revenue Fund. The fund is included in cash and temporary investments.

Rebate Fund: The Rebate Fund is created by the Series 2000 Bond Resolution. Monies credited to the Rebate Fund shall be free from the lien of the Resolution. Payments shall be made by the Company within 15 days following each five-year computation period for the calculation of excess rebateable arbitrage under the Internal Revenue Code. The Company has covenanted to rebate excess earnings to the United States in accordance with law. There were no deposits required to be made to this fund during 2004 or 2005.

NOTE 5 - EXTENSION OF WATER SERVICE IN JEFFERSON COUNTY

In 2004, the Company completed the implementation of a plan to extend water service to unserved residences in Jefferson County. The cost of the planned extension of water service was approximately $60 million and was funded by a combination of customer, government, and Company funds, summarized as follows:

Apportionment Warrant Reserve: Monies from Metro Government and from new customers in the extension area are deposited in the Apportionment Warrant Reserve account. New customers in the extension area must pay an "apportionment warrant" fee. To supplement these customer monies, Metro Government made commitments to fund a total of $6 million of the cost of the water service extension project through 2003. Disbursements from this account can only be used to pay for the cost of construction of water main extensions in the designated area. The account is invested in a sweep account, which is stated at fair value.

System Development Charge Reserve: A System Development Charge Reserve has been established to finance growth-related expansion in the apportionment warrant extension area and is assessed for new service connections other than initial connections. The collections are deposited to the System Development Charge Reserve account and disbursements from this account can only be used to pay for growth-related expansion. The account is invested in a sweep account, which is stated at fair value.

Company Monies: A total of $17 million of Company funds was budgeted to pay for the transmission component, or "backbone grid," of the extension program.

NOTE 6 - RESERVES

Reserve Funds include the following:

	Year Ended December 31	
	2005	**2004**
Bond related reserves		
Bond reserve account	$ 3,059,858	$ 3,059,858
Depreciation fund	7,419,053	15,077,190
Infrastructure replacement reserve fund	1,057,898	219,970
U.S. Treasury state and local government fund	1,640,143	1,640,143
Total Bond related reserves	13,176,952	19,997,161
Other		
Apportionment warrant reserve	1,260,330	1,224,710
System development charge reserve	22,703	2,929,254
Bullitt County water reserve	89	856,513
Shepherdsville water reserve	1,443	164,365
Total Other reserves	1,284,565	5,174,842
	$ 14,461,517	$ 25,172,003

NOTE 7 - CASH AND INVESTMENTS

The Company has adopted the provisions of GASB Statement No. 40, *Deposits and Investment Risk Disclosures*. This statement adds certain additional disclosures about cash and investments, including common areas of investment risk.

The Company's investment policy specifies that the primary objectives, in priority order, of investment activities is safety, liquidity and yield. In addition, funds are to be invested in conformity with Federal, state and other legal requirements, including bond resolutions.

At December 31, 2005 and 2004, the Company had cash and temporary investments of $12,511,829 and $26,727,598, respectively. Of these amounts, $300,000 and $100,000, respectively, was covered by insurance provided by the Federal Deposit Insurance Company ("FDIC"). The remaining balance was uninsured and uncollateralized, and was invested primarily in repurchase agreements supported by U. S. government obligations.

At December 31, 2005 and 2004, the Company had investments as follows:

	2005	**2004**
U.S. Tresaury Bonds, 8.22%, due November 15, 2013	$ 4,700,001	$ 4,700,001
Federal Home Loan Bank Note, 1.85%, due May 20, 2005		6,041,440
Mutual funds	1,047,593	1,000,246
	$ 5,747,594	$11,741,687

Custodial Credit Risk - Deposits: Custodial credit risk is the risk that in the event of a bank failure, the Company's deposits may not be returned to it. The Company does not have a formal deposit policy for custodial credit risk; however, accounts are set up with overnight sweep accounts so that cash is invested in short term, liquid investments daily to minimize the amount of cash not covered by insurance provided by the FDIC.

Custodial Credit Risk – Investments: For an investment, custodial credit risk is the risk that, in the event of the failure of the counterparty, the Company will not be able to recover the value of its investments or collateral securities that are in the possession of an outside party. The Company's investments are held in the name of the Company by a trustee.

Concentration of Credit Risk: The Company has no restrictions on the amount it may invest in any one issuer.

Interest Rate Risk: The Company does not have a formal policy limiting maturities of its investments. Investments are made based on the prevailing market conditions and anticipated cash needs at the time of the transaction.

Credit Risk: The Company has historically only purchased investment grade securities. The Standard & Poor's rating for the U.S. Treasury Bonds listed above is AAA.

NOTE 8 - UTILITY PLANT, NET

The following is a schedule of utility plant for the year ended December 31, 2005:

	Beginning Balance	Additions	Reductions	Ending Balance
Capital assets not being depreciated:				
Land	$ 6,122,892	$ 1,217,383		$ 7,340,275
Construction in progress	63,769,042	68,526,575	$ (77,421,592)	54,874,025
Total capital assets not being depreciated	69,891,934	69,743,958	(77,421,592)	62,214,300
Other capital assets:				
Buildings	71,909,507	8,971,991	(103,084)	80,778,414
Machinery and equipment	36,793,808	8,004,558	(1,030,293)	43,768,073
Infrastructure	716,880,073	54,154,695	(4,381,221)	766,653,547
Total other capital assets at historical cost	825,583,388	71,131,244	(5,514,598)	891,200,034
Less accumulated depreciation for:				
Buildings	(27,999,628)	(1,681,948)	52,583	(29,628,993)
Machinery and equipment	(22,860,210)	(3,399,140)	990,501	(25,268,849)
Infrastructure	(180,664,836)	(13,719,838)	1,074,346	(193,310,328)
Total accumulated depreciation	(231,524,674)	(18,800,926)	2,117,430	(248,208,170)
Other Capital Assets, Net	594,058,714	52,330,318	(3,397,168)	642,991,864
Capital Assets, Net	$ 663,950,648	$ 122,074,276	$ (80,818,760)	$ 705,206,164

The following is a schedule of utility plant for the year ended december 31, 2004:

	Beginning Balance	Additions	Reductions	Ending Balance
Capital assets not being depreciated:				
Land	$ 5,808,420	$ 314,472		$ 6,122,892
Construction in progress	63,854,050	61,574,140	$ (61,659,148)	63,769,042
Total capital assets not being depreciated	69,662,470	61,888,612	(61,659,148)	69,891,934
Other capital assets:				
Buildings	69,546,266	2,450,641	(87,400)	71,909,507
Machinery and equipment	32,262,790	5,651,940	(1,120,922)	36,793,808
Infrastructure	674,493,889	45,859,897	(3,473,713)	716,880,073
Total other capital assets at historical cost	776,302,945	53,962,478	(4,682,035)	825,583,388
Less accumulated depreciation for:				
Buildings	(26,557,268)	(1,463,738)	21,378	(27,999,628)
Machinery and equipment	(20,491,307)	(3,356,181)	987,278	(22,860,210)
Infrastructure	(168,236,156)	(13,252,417)	823,737	(180,664,836)
Total accumulated depreciation	(215,284,731)	(18,072,336)	1,832,393	(231,524,674)
Capital Assets, Net	$ 630,680,684	$ 97,778,754	$ (64,508,790)	$ 663,950,648

NOTE 9 - LONG-TERM LIABILITIES

Long-term liabilities at December 31, 2005, are summarized as follows:

	Beginning Balance	Additions	Reductions	Ending Balance	Current Portion	Noncurrent Portion
Bonds payable	$ 124,213,388	$0	$ 6,180,888	$ 118,032,500	$ 6,482,500	$ 111,550,000
Customer advances for construction	4,500,707	1,415,257	3,471,657	2,444,307		2,444,307
Total Long-Term Liabilities	$ 128,714,095	$ 1,415,257	$ 9,652,545	$ 120,476,807	$ 6,482,500	$ 113,994,307

Long-term liabilities at December 31, 2004, are summarized as follows:

	Beginning Balance	Additions	Reductions	Ending Balance	Current Portion	Noncurren Portion
Bonds payable	$ 129,821,489	$0	$ 5,608,101	$124,213,388	$ 6,453,388	$117,760,000
Customer advances for construction	6,648,489	1,624,399	3,772,181	4,500,707	23,271	4,477,436
Total Long-Term Liabilities	$ 136,469,978	$ 1,624,399	$ 9,380,282	$ 128,714,095	$ 6,476,659	$122,237,436

Bonds and notes payable at December 31, 2005 and 2004 consist of the following:

	2005	2004
Water System Revenue Bonds, 2000 tax exempt, interest rates ranging from 5.0% to 5.5% with maturities from 2003 through 2025	$ 74,010,000	$ 76,085,000
Water System Revenue Bonds, 2001 tax exempt, interest rates ranging from 4.0% to 4.7% with maturities from 2001 through 2014	43,750,000	47,575,000
Other Debt	272,500	553,388
	118,032,500	124,213,388
Less current portion	6,482,500	6,453,388
	$ 111,550,000	$ 117,760,000

All bonds are subject to optional redemption provisions.

The Water System Revenue Bond resolutions contain certain covenants that require, among other things, that the schedule of rates and charges, and the rules and regulations for water services will not be revised so as to result in a decrease of revenues. Also, future adjustments to water rates and charges are required as necessary so that annual net revenues will not be less than 1.30% of the total annual bond debt service requirements for the then outstanding bonds.

Maturities of long-term debt are as follows:

Year	Principal	Interest	Total
2006	$6,210,000	$5,795,497	$12,005,497
2007	6,495,000	5,514,997	12,009,997
2008	6,800,000	5,221,634	12,021,634
2009	7,130,000	4,903,534	12,033,534
2010	7,480,000	4,569,984	12,049,984
2011-2015	37,210,000	17,231,579	54,441,579
2016-2020	20,065,000	10,269,923	30,334,923
2021-2025	26,370,000	4,378,900	30,748,900
	$117,760,000	$57,886,048	$175,646,048

NOTE 10 - DIVIDENDS

The Company is required by bond resolution to pay a dividend to Metro Government, the sole stockholder. The dividend is calculated in accordance with the provisions of the resolution and paid quarterly based on budgeted income. The required annual dividend is sixty percent of the Company's income before distributions and contributions with certain adjustments and exclusions. The dividend computed under these provisions was $16,178,050 for 2005 and $14,093,410 for 2004. A settlement based on actual income is made the following year.

NOTE 11 - DEFERRED COMPENSATION PLANS

The Company offers its employees a deferred compensation plan created in accordance with Internal Revenue Code Section 457. The plan permits participating employees to defer a portion of their salary until future years. An employee may contribute up to a maximum of 25 percent of his or her adjusted gross compensation or $14,000, whichever is less, to the plan. The deferred compensation is not available to employees until termination, retirement, death or unforeseen emergency. Plan assets and liabilities are not recorded by the Company. The Company contributes $0.25 for every $1.00 of an employee's contribution up to $1,500 ($375 maximum Company contribution) to the plan. The amount contributed to the plan by the Company and charged to expense was approximately $53,400 and $83,000 for the years ended December 31, 2005 and 2004, respectively.

The Company has a defined contribution plan covering substantially all employees of the Company. An eligible employee can contribute up to an annual maximum of 25 percent of his or her adjusted gross compensation or $14,000, whichever is less, to the plan. The Company contributes $0.25 for every $1.00 of an employee's contribution ($375 maximum Company contribution) to the plan. The amount contributed to the plan by the Company and charged to expense was approximately $34,200 and $31,000 for the years ended December 31, 2005 and 2004, respectively.

NOTE 12 - PENSION PLAN

All full-time employees of the Company participate in the County Employee Retirement System ("CERS") which is a cost-sharing multiple-employer defined benefit retirement plan administered by Kentucky Retirement Systems, an agency of the Commonwealth of Kentucky.

Normal retirement is at age 65 with at least 48 months of service. This entitles an employee to a basic benefit of 2.2% of final compensation multiplied by years of service. Final compensation is the employee's average salary for the highest five plan years. A reduced early retirement benefit is available from ages 55 to 64 with 60 months of service, at least 12 of which are current, or at any age after 25 years of service. CERS also provides death, disability, optional joint and survivorship, and certain health care benefits. Eligibility and benefits are established by state statute.

Eligible employees are required by state statute to contribute 5% of their salary to the Plan. The Company is required by the same statute to contribute the remaining amounts necessary to pay benefits when due. The Company's actuarially determined contribution rate was 7.34% effective July 1, 2003, 8.48% effective July 1, 2004 and 10.98% effective July 1, 2005. For 2005 and 2004, participating employees contributed 5% of creditable compensation to CERS totaling $1,324,453 and $1,353,898, respectively. Employer contribution rates are intended to fund the normal cost on a current basis plus an amount equal to the amortization of unfunded past service costs over thirty years. The Company contributed $2,888,640, $2,354,391, and $2,092,949 for 2005, 2004, and 2003 respectively. The Company's total payroll was $26,972,013 and $27,181,871 for 2005 and 2004, respectively. CERS covered payroll was $26,575,004 and $26,984,394 for 2005 and 2004, respectively.

Vesting in a retirement benefit begins immediately upon entry into the System. The participant has a fully vested interest after the completion of sixty months of service, 12 of which are current service.

The "pension benefit obligation" is a standardized disclosure measure of the present value of pension benefits, adjusted for the effects of projected salary increases and step-rate benefits, estimated to be payable in the future as a result of employee service to date. The measure, which is the actuarial present value of credited projected benefits, is intended to help users assess the CERS's funding status on a going-concern basis, assess progress made in accumulating sufficient assets to pay benefits when due, and make comparisons among the Public Employee Retirement Systems and employers. The CERS does not make separate measurements of assets and pension benefit obligations for individual employers.

The following table provides information on the CERS as a whole, determined through the most recent actuarial valuations:

	June 30 2005	2004
Net assets available for benefits	$ 6,511,561,710	$ 6,645,463,572
Pension benefit obligation	7,180,774,025	6,577,289,608
Net assets in excess of (less than) pension benefit obligation	$ (669,212,315)	$ 68,173,964

Ten year historical trend information showing the CERS's progress in accumulating sufficient assets to pay benefits when due is presented in the Kentucky Retirement Systems' June 30, 2005 annual financial report (which is a matter of public record).

In addition to the assets transferred from its previous plan, the Company became obligated to CERS for $4,273,873 for remaining unfunded past service costs. The remaining liability for unfunded past service costs plus accrued interest was paid with proceeds from the 1992 Series 2 Note Payable. The related past service cost asset is being amortized over twenty years on the straight-line method.

NOTE 13 - CONTINGENT LIABILITIES

The Company retains certain insurable risks up to a fixed maximum per claim exposure. Liability claims are retained up to $1,000,000 per occurrence, with insurance coverage for any judgment or settlement of up to $35,000,000 above that amount. Workers' compensation is self-funded up to $350,000 per claim prior to October 1, 2004 and $450,000 beginning October 1, 2004, with an aggregate limit of 90% of the premium that would be developed by applying the rate times the payroll. A reserve of $1,213,637 and $886,842 was established at December 31, 2005 and 2004, respectively, to provide for liability and worker's compensation claims incurred.

The Company is involved in litigation, which has arisen out of operations in the ordinary course of business. While it is not possible to forecast the outcome of this litigation, it is the opinion of the Company's management, based on evaluations by outside counsel, that it will not have a material adverse effect on the financial statements of the Company.

NOTE 14 - EARLY RETIREMENT PROGRAM

In December of 2003, the Company offered early retirement to 39 employees with greater than 20 years of continuous service. Severance paid in 2004 totaled $949,266. This expense is included in other non-operating expense on the statements of revenues, expenses and changes in net assets. A total of 30 employees accepted early retirement.

NOTE 15 - SUBSEQUENT EVENTS

In the first quarter of 2006, the Company will prepare for a significant borrowing in 2006 to fund the long-term capital project plan.

LOUISVILLE WATER COMPANY SCHEDULE OF INVESTMENTS

December 31, 2005

		Maturity	Par	Fair Value
Bond Reserve Account U. S. Treasury Bonds	8.22%	11/15/13	$ 3,059,858	$ 3,059,858
Depreciation Fund Sweep Account	4.51%		7,419,053	7,419,053
Infrastructure Replacement Sweep Account	4.51%		1,057,898	1,057,898
Apportionment Warrant Reserve Sweep Account	4.51%		1,260,330	1,260,330
System Development Charge Reserve Sweep Account	4.51%		22,703	22,703
U. S. Treasury State and Local Government Fund				
U. S. Treasury Bonds	8.22%		1,640,143	1,640,143
Bond Service Account – Series 2000 First American Funds	3.81%		534,082	534,082
Bond Service Account – Series 2001 First American Funds	3.81%		513,511	513,511
Bullitt County Water Reserve Sweep Account	4.51%		89	89
Shepherdsville Water Reserve Sweep Account	4.51%		1,443	1,443
			$ 15,509,110	$ 15,509,110

See Independent Auditors' Report

LOUISVILLE WATER COMPANY 2001 SERIES BOND ISSUE

December 31, 2005

The Water Revenue Bonds were issued by the Board of Water Works and are payable only from revenue of the Company.

Master resolution date	July 14, 1992
Secondary resolution date	February 13, 2001
Original amount	$60,300,000
Interest rate	4.00% to 4.70%
Bonds payable	November 15
Interest payable	May 15 and November 15
Call provisions in whole or in part	100% after November 15, 2010

See Independent Auditors' Report

LOUISVILLE WATER COMPANY 2000 SERIES BOND ISSUE

December 31, 2005

The Water Revenue Bonds were issued by the Board of Water Works and are payable only from revenue of the Company.

Resolution date	September 1, 2000
Original amount	$78,500,000
Interest rate	5.00% to 5.50%
Bonds payable	November 15
Interest payable	May 15 and November 15
Call provisions	100% after November 15, 2010

See Independent Auditors' Report

Sinking Fund installments for 2022 and 2024 maturity bonds:

November 15, 2022		November 15, 2024	
Year	Amount	Year	Amount
2021	$ 4,710,000	2023	$ 5,260,000
2022	4,975,000	2024	5,555,000
	$ 9,685,000		$ 10,815,000

See Independent Auditors' Report

SCHEDULE OF OUTSTANDING BOND INDEBTEDNESS AND ANNUAL DEBT SERVICE REQUIREMENTS

December 31, 2005

	2001 Bonds		Aggregate
Year Ending December 31	Principal Installments	Interest	Bond Service
2006	$ 4,000,000	$ 1,959,978	$ 5,959,978
2007	4,185,000	1,789,978	5,974,978
2008	4,380,000	1,612,115	5,992,115
2009	4,590,000	1,415,015	6,005,015
2010	4,820,000	1,208,465	6,028,465
2011	5,055,000	991,565	6,046,565
2012	5,305,000	764,090	6,069,090
2013	5,570,000	525,365	6,095,365
2014	5,845,000	274,715	6,119,715
	$ 43,750,000	$ 10,541,286	$ 54,291,286

See Independent Auditors' Report

SCHEDULE OF OUTSTANDING BOND INDEBTEDNESS AND ANNUAL DEBT SERVICE REQUIREMENTS

December 31, 2005

	2000 Bonds		Aggregate
Year Ending December 31	Principal Installments	Interest	Bond Service
2006	$ 2,210,000	$ 3,835,519	$ 6,045,519
2007	2,310,000	3,725,019	6,035,019
2008	2,420,000	3,609,519	6,029,519
2009	2,540,000	3,488,519	6,028,519
2010	2,660,000	3,361,519	6,021,519
2011	2,790,000	3,228,519	6,018,519
2012	2,930,000	3,089,019	6,019,019
2013	3,075,000	2,942,519	6,017,519
2014	3,235,000	2,788,769	6,023,769
2015	3,405,000	2,627,019	6,032,019
2016	3,590,000	2,452,512	6,042,512
2017	3,790,000	2,264,037	6,054,037
2018	4,000,000	2,065,062	6,065,062
2019	4,225,000	1,855,062	6,080,062
2020	4,460,000	1,633,250	6,093,250
2021	4,710,000	1,399,100	6,109,100
2022	4,975,000	1,151,825	6,126,825
2023	5,260,000	890,637	6,150,637
2024	5,555,000	614,487	6,169,487
2025	5,870,000	322,850	6,192,850
	$ 74,010,000	$ 47,344,762	$ 121,354,762

See independent Auditors' Report

SCHEDULES OF OPERATION AND MAINTENANCE EXPENSES AND TAXES

Years ended December 31, 2005 and 2004

	2005	2004
Operation and Maintenance Expenses		
Pumping	$ 5,029,576	$ 4,935,538
Water treatment	6,027,511	5,462,392
Transmission and distribution	11,367,218	9,588,064
Customer accounts expenses	6,883,294	6,521,681
Administrative and general expenses	17,791,010	16,450,227
Operation expenses under applied	343,365	644,667
Total Operation and Maintenance Expenses	$ 47,441,974	$ 43,602,569
Taxes		
Water and fire services in lieu of taxes	$9,415,500	$ 8,471,902
Social security taxes	1,940,162	1,926,686
State unemployment taxes	19,689	26,414
Payroll taxes allocated	(1,940,162)	(1,926,686)
Total Taxes	$ 9,435,189	$ 8,498,316

See Independent Auditors' Report

CORPORATE INFORMATION

BOARD MEMBERS

Jerry Abramson
Mayor, Louisville Metro
(ex officio)

Stewart E. Conner
Board Chairman
Managing Partner
Wyatt, Tarrant & Combs

Margaret Leavell Harris
Retired Executive
BellSouth Telecommunications

Gerald Martin
Vice President and
Managing Member
River Hill Capital, LLC

Wendy C. Welsh
Board Vice Chairman
Senior Vice President,
Information Technology
E. ON U.S. Services Inc.

Marita Willis
Assistant Vice President
PNC Bank

Dr. Joseph B. Wise, III
Business Manager,
Secretary/Treasurer
Greater Louisville Building
and Construction Trades Council

BOARD OF WATER WORKS

The Board of Water Works is composed of seven members:

- The Louisville Metro Mayor appoints all members
- The membership is bi-partisan, with no more than 50% from the same political party
- All new board members serve staggered four-year terms
- The Louisville Metro Mayor serves as ex officio

The Board meets the second Tuesday of each month at 12:30 pm at 550 South Third Street. Each April they appoint officers of the company.

EXECUTIVE LEADERSHIP TEAM

Front row: Billy Meeks, President, AFSCME Local 1683
Edwin Chestnut, Jr., Assistant to the President, Director of Business Performance Management
John Huber, President and Chief Executive Officer
Susan Lehmann, Vice President, Human Resources and Organizational Effectiveness
Barbara Dickens, Vice President, General Counsel and Secretary
Back row: Gregory C. Heitzman, Vice President, Chief Engineer
Robert K. Miller, Vice President and Treasurer, Business Resourcing
Karla Olson Teasley, Vice President, Serving Customers and Business Development

IN MEMORY OF OWEN HAMMONS

We were saddened to learn in December of the death of Owen C. Hammons, who served on our board from 1988 until he retired in 2003. A civic leader as well as a long-time official with the United Auto Workers union, he helped inspire our award-winning labor/management partnership.

LWC 0095

LOUISVILLE WATER COMPANY

550 S. Third Street
Louisville, KY 40202
Phone 502.569.3600
www.louisvillewater.com

LOUISVILLE WATER COMPANY
2004 ANNUAL REPORT

What's the message in the bottle?

Contents

QUALITY

Quality

Louisville Water Company's "Message in a Bottle" is, quite simply, quality. Water is essential, key to good health and is the building block for our community. From the moment you awake to the moment you go to sleep, your day revolves around water.

Louisville Water Company provides water to about 810,000 people in Louisville Metro and parts of Oldham and Bullitt counties. In 2004 the company delivered an average of nearly 126 million gallons per day through nearly 3,600 miles of water main.

Water is drawn from the Ohio River at two points: the raw water pump station at Zorn Avenue and River Road, and the B. E. Payne pump station northeast of Harrods Creek. Water is also drawn from a riverbank filtration well at the Payne plant.

The water is treated at two locations: the Crescent Hill plant, which has a capacity of 180 million gallons per day, and the Payne plant, which has a capacity of 45 million gallons per day. Both plants treat the water using processes that include coagulation, softening, corrosion stabilization, disinfection, filtration, fluoridation, and final disinfection.

Storage capacity for treated water totals over 90 million gallons in reservoirs, elevated tanks, and standpipes.

Mains range up to 60 inches in diameter. Booster pump stations, pressure-reducing stations and water storage facilities are used to maintain the appropriate pressure throughout the system.

To ensure the highest quality, the company operates a laboratory certified by the state of Kentucky under U.S. Environmental Protection Agency standards, performing more than 120,000 water quality tests every year.

In addition to water sold to its retail customers, the company wholesales water to West Shelby Water District, North Shelby Water Company, North Nelson Water District, Taylorsville, and Mount Washington.

Operations Highlights

Operations Highlights

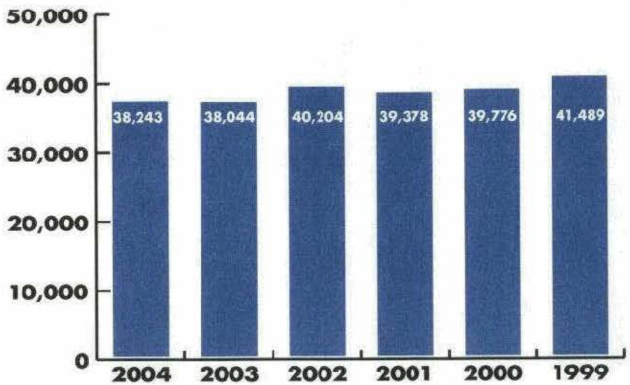
	2004	2003	2002	2001	2000	1999
Water Delivered to Mains	46,276	46,340	47,405	46,313	46,414	49,092
Total Consumption*	38,243	38,044	40,204	39,378	39,776	41,489
Unaccounted for Water	7,086	7,423	7,201	6,934	6,639	7,103
Average Daily Delivery	127	127	130	127	127	134
Average Daily Water Usage	105	104	110	108	109	115
Average Daily Pumpage	127	127	130	127	***127(1300)	138
Maximum Daily Pumpage	161	174	178	175	***188(190)	198
Other Measures:						
Percent of Water Unaccounted for	15%	16%	15%	15%	14%	14%
Average Residential Monthly Water Bill**	$15.43	****14.73(15.87)	$14.13	$13.50	$12.99	$12.62

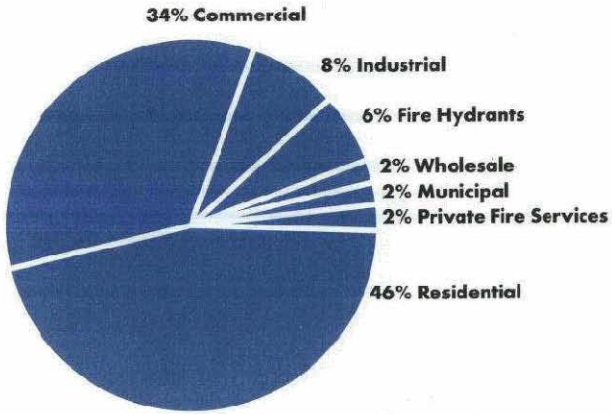
*Excludes temporary service consumption

**Based upon median usage of 6,000 gallons per month

***Figures corrected from 2000 annual report shown in parentheses

****Figures corrected from 2003 annual report shown in parentheses





2004 Water Revenue Highlights

Total Water Consumption Highlights

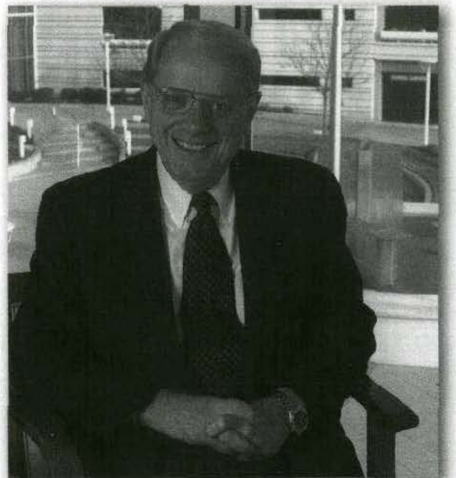
Historical Review Highlights

	2004	2003	2002	2001	2000
Operating Revenues	$ 103,462,053	$ 97,687,143	$ 98,172,031	$ 92,769,157	$88,255,340
Total Operating Expenses	70,024,119	68,980,817	65,742,954	62,814,427	57,117,953
Net Non-operating Expenses	(4,868,918)	(4,125,792)	(4,596,329)	(1,429,411)	(2,019,886)
Net Income Before Distributions, Contributions and Extraordinary Items	28,569,016	24,580,534	27,832,748	28,525,319	29,117,501
Extraordinary Items	-	-	-	(2,253,356)	-
Distributed Property	-	-	(879,564)	-	-
Dividends Paid and Payable	(14,552,137)	(12,318,831)	(12,379,623)	(13,076,344)	(12,876,681)
Contributions	16,430,901	13,249,414	16,646,769	14,527,045	27,779,233
Increase in Net Assets	30,447,780	25,511,117	31,220,330	27,722,664	44,020,053
Net Assets, Beginning of Year	540,751,317	515,240,200	484,019,870	456,297,208	412,277,155
Net Assets, End of Year	571,199,097	540,751,317	515,240,200	484,019,872	456,297,208
Other					
Investment in System	$ 52,414,164	$ 60,413,819 (42,340,839)*	$ 62,703,948 (61,760,384)*	$ 48,515,271	$63,161,056
Debt Service Coverage	2.93	2.79	3.33	4.35	4.83
Return on Total Assets	3.95%	3.53%	4.13%	4.06%	4.68%

*Figures corrected from 2003 annual report shown in parentheses

President's Message

Our "Message in the Bottle" to all our customers and colleagues: Despite our challenges, we continue to maintain and improve the outstanding quality of our water.



For two years in a row, our company has faced and met difficult challenges caused by water sales that did not measure up to our expectations.

One cause was the weather. After an unusually wet year in 2003, Louisville experienced its highest rainfall on record in 2004. This reduced the amount of water our customers used for irrigation during the growing season.

The second cause was one that had been building slowly for some time. Average residential water usage for purposes other than irrigation reached a peak, and actually began to decline. Two factors caused this: a smaller number of people per household, and the effect of water-saving appliances and plumbing fixtures mandated by the federal government in the 1990s.

Another trend also affected commercial use: higher apartment vacancy rates. Low interest rates provide opportunity for expanded home ownership, causing a drop in occupancy in rental housing. Most apartment buildings and complexes are commercial customers.

At the same time, development in our area was continuing. In Louisville Metro, population was moving to the east and southeast, requiring us to build new facilities to provide service.

Faced with sales below expectations in 2003, we took several measures to reduce expenses. And as sales continued to lag in 2004, we made adjustments to our operations to reduce expenses further. Early retirements of 30 of our experienced employees helped reduce our work force; 14 more positions were cut by attrition and not filling

VISION *To be a water supplier of choice throughout the region, operating in a highly competitive, customer-focused manner; delivering outstanding quality, customer satisfaction and value.*

LWC 0102

MISSION *To serve the water needs of our customers through outstanding quality, service and value at a market return to our shareholders.*

VALUES *Customer Focus, Teamwork, Pride in Workmanship, Trust, Empowerment, Diversity, Continuous Learning, Continuous Improvement*

vacancies. Other measures included reducing capital spending and selling excess fleet vehicles. Our very dedicated and competent employees have responded beautifully in making these measures work. Together, our efforts helped us to meet our dividend goals for the year.

At the same time, we continued our efforts to renovate the aging parts of our system. Our 12-year-old campaign to renovate or replace all our cast-iron water mains installed before 1935 was on schedule and should be completed by the end of 2006. We also completed an eight-year renovation of our historic Crescent Hill reservoirs and re-opened their walkways to the public.

Work to expand the capacity of our B. E. Payne plant to 60 million gallons per day reached the 85 percent completion point and will be completed in 2005. The plant is the major source of water for the rapidly developing area in the eastern and southeastern parts of our area.

We also revised our governance structure this year to comply with the latest best practices. For the first time in many years, the offices of board chairman and president/CEO have been separated. In November, our board elected Stewart Conner chairman and Wendy Welsh vice chair. Both have significant experience in corporate governance and as directors. The company will be well served by their leadership.

Phillip Bond retired from the board during the year after serving since 1992. He served as the long-time chair of the audit committee; his professionalism and business acumen were especially valued by his board colleagues and by the company. He was always keenly interested in how the company's decisions would impact low-income customers. Margaret Harris was appointed to take his place.

For the third year in a row, we met or exceeded all of our own standards for water quality–standards that are stricter than government regulations require. Our "Pure Tap" bottle–filled with water from the tap–is as good or better than any bottled water on the shelf.

John L. Huber

John Huber, LWC President

WATER QUALITY

Clean, safe water is our top priority at Louisville Water Company, and the quality of the water we provided reached a new high in 2004.

For the third year in a row, we met or exceeded our own internal standards for water quality—standards which are stricter than federal and state regulations. And we are continuing to take steps to improve our water quality further, anticipating stricter government regulations in the future.

As part of this effort, we operate a sophisticated laboratory to monitor the quality of our intake water, as well as the quality of the water we provide to the community. Our laboratory is one of the few nationwide approved by the Environmental Protection Agency to test for cryptosporidium in water—and the only laboratory approved for this purpose in Kentucky.

This laboratory is an integral part of our effort to develop and test new ways to provide the highest quality water.

As part of this effort, our riverbank filtration demonstration well at the B. E. Payne plant finished its fifth year of operation in 2004.

Riverbank filtration uses the natural filtering qualities of the aquifer along the Ohio River to clean the water, instead of using pretreatment systems to clean water pumped directly from the river. Tests with the demonstration well have shown that the water it provides is as clear as the water leaving our filters. All it requires is softening, to adjust its mineral content, and disinfection, and we polish it off with filtration.

For two weeks in March, the demonstration well supplied all of the water processed at the B. E. Payne plant and confirmed, once again, its reliability, capacity, and the quality of the water it provides.

In 2005, we plan construction of a different kind of well field that will eventually provide all of the water treated at the B. E. Payne plant. The field will consist of 31 vertical wells and an 8,600-foot long conduit to carry the water to a single pump house. Currently this conduit is designed as a 12-foot diameter tunnel.

A few years ago LWC created the Pure Tap campaign to promote the health benefits, convenience and value of tap water. The bottles shown in photos throughout this report are some of the millions that have been given out over the years to customers for personal use and community events.

The project is expected to be completed in 2008, at a cost of about $38 million.

Our historic Crescent Hill treatment plant is also in line for major improvements. Our 2002-2021 facilities plan calls for spending more than $100 million for advanced treatment there. Studies are under way to determine which of several technologies would be best for the site; a ground water source using riverbank filtration is one of the major options.

Every filter, pipe, valve, hydrant, and meter vault appears in a computerized mapping system.

TECHNOLOGY AT WORK

Advances in information technology are helping us manage our growing system more efficiently. Two major areas were the focus of attention in 2004.

First, we completed a five-year program to put all of our pipeline transmission and distribution network on an automated mapping and facility management (AM/FM) system.

In simple terms, this means that every pipe, valve, hydrant, meter vault and other components of LWC's infrastructure, appear in a computerized mapping system—along with information about its size, age, composition, etc.

The new system also allows increased benefits from the Louisville/Jefferson County Information Consortium (LOJIC), providing references to information about streets, roads, drainage systems, sewer lines, buildings, easements, and other landscape features that can affect our facilities.

The AM/FM/Geographic Information System (GIS), also has links to our customer information and financial systems. Information is available by computer to all employees to help them with their work.

Second, we began using a mobile dispatch system which uses wireless technology to transmit customers' service requests to the laptop computers of our field technicians. The central records are updated from the field when the work has been accomplished. The results: quicker response to customer requests and more efficient record-keeping.

We continued our pilot program in automated meter reading. This system uses small radio transmitters on water meters to transmit their readings to a hand-held or vehicle-mounted receiver.

More than 7,300 meters in Goshen, Shepherdsville and Bullitt County are part of this program. So far, automated meter reading has reduced the percentage of missed readings that result in estimated bills and the time it takes to read the meters.

The system will continue to be evaluated in 2005 to judge its overall efficiency and impact on operations.

EXPANSION AND DEVELOPMENT

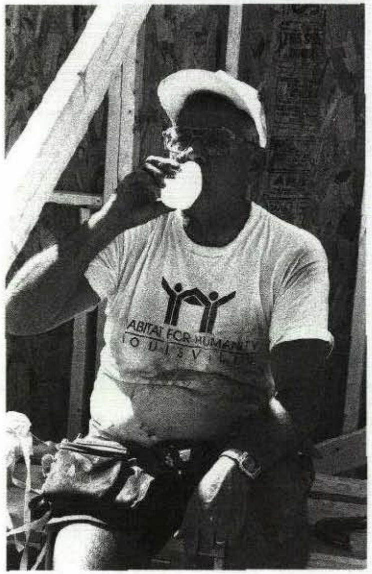
While our average customer may be using slightly less water, our community and service area continue to grow. A total of 3,209 customers was added in our retail service area in 2004.

A total of 3,209 customers was added in our retail service area in 2004.

During the year, we accepted 49.1 miles of new water mains built by developers in Jefferson, Oldham and Bullitt counties. These new lines have the potential to serve 4,566 new customers.

In Louisville Metro, the shift of population growth to the east and southeast requires significant expansion measures to meet the demand. During the year, we put the finishing touches on a project that started in 1990 to provide water service throughout Jefferson County. Nearly all the major construction was complete; only two small projects remained to be built. We built 2.25 miles of new water mains, serving 50 new customers.

Also in Jefferson County, we completed 85 percent of our $20.5 million program to increase the capacity, improve reliability and improve water quality at our B. E. Payne plant, which supplies most of the eastern part of the county plus customers in adjoining counties. The project is scheduled to be completed in 2005, increasing the plant's capacity from 45 million gallons per day to 60 million gallons per day, and increasing the reliability of the plant. New electric power feeds and backup emergency generators are part of this work.



Outside Jefferson County, we continued to make improvements in systems acquired during the past few years. These improvements are financed by the higher rates historically paid by the customers served. Their rates will be adjusted to Louisville Water Company rates when the improvements are paid for. (Because they are already paying more than our standard rates, they were not subject to the rate increases in January 2004 and January 2005.)

Major accomplishments in these service areas during 2004 included:

- $3.86 million spent in the former Kentucky Turnpike systems in Bullitt County, as part of a 10-year program of improvements. More than 10.2 miles of new pipe were installed, and 163 customers were added.
- $1.59 million spent on improvements in Goshen. Nearly 2.4 miles of new pipe were installed as grid ties, relocations or replacement of undersized mains. In addition, Goshen Utilities, which was operating as a wholly-owned subsidiary, was merged into Louisville Water Company at midnight Dec. 31, 2004, increasing efficiency in operations and reporting.
- $370,000 spent on improvements in Shepherdsville.
- $360,000 spent on improvements in Oldham County outside Goshen. About 2.6 miles of new pipe were installed as replacements for mains that had a high number of breaks annually.

MAINTAINING OUR SYSTEM

Careful stewardship is the key to maintaining reliable operation in a system that has parts more than a century old. Regular maintenance and rehabilitation are a very important part of our effort to continue to provide high quality water.

In 1993, we began a 15-year program to replace or rehabilitate 500 miles of unlined cast iron water mains that were installed before 1935. Many of the older mains were still sound and could be rehabilitated by lining them with corrosion-resistant materials, saving the cost and inconvenience of replacing them. The rest of the old lines were becoming troublesome and had to be replaced.

In 2004, we spent $6 million on the program: 9 miles were rehabilitated, and another 5 miles were replaced. All of the scheduled rehabilitation had been completed by the end of the year; the remaining lines older than 1935 will be replaced by the end of 2006.

In addition, we are replacing old lead-pipe services that connect our mains with water meters in older sections of our system. In 2004, we replaced about 1,800 of them; the program will continue until all are replaced.

Our Crescent Hill reservoirs were reopened to the public in the summer of 2004, after more than eight years of work to repair underground leaks. The reservoirs, more than 125 years old, began leaking badly in the mid-1990s; the weathered limestone bedrock posed problems that were difficult to solve.

Louisville Water Company's earnings for 2004 were more than $28.5 million, a strong achievement following two years of declining demand for water.

The scenic walkway around the reservoir has been a popular place for walking and jogging for many years. They now feature advanced security measures and are open to the public only during daylight hours.

FINANCIAL PERFORMANCE

Louisville Water Company's earnings for 2004 were more than $28.5 million, a strong achievement following two years of declining demand for water.

The immediate problem was the weather. Wet summer weather reduces water sales, because less water is used for irrigation. 2003 had been wetter than normal, prompting the company to take measures to reduce expenses; most of these measures took effect in 2004. Then 2004 became the wettest year on record in Louisville, with a rainfall total that was 47 percent more than normal.

Oddly, the wet weather took a vacation as fall approached. September 2004 was the driest on record, and a 39-day dry spell that began in early September was the longest on record. Water sales rebounded somewhat, but most of the irrigation season had already passed. And once the dry spell ended, the wet weather returned: October was the wettest on record.

Sharp swings in weather in recent years, however, masked a trend that was unexpected: an actual decline in average residential and commercial water use.

This trend became more apparent by early 2004, when residential and commercial water sales continued to fall below forecasts. A statistical expert at the University of Louisville was hired to do an extensive analysis of water usage. The result: the "flattening" of water demand that had been observed, and expected to continue, was turning into a slow decline. The projections used for preparing the company's budget would have to be revised.

Three major influences appeared to be at work:

- The effects of the federal water conservation measures of the 1990s, which require nearly all household water-using appliance and plumbing fixtures to be designed to use less water than in the past;
- The declining average number of persons per household, confirmed by census data; and
- Lower apartment occupancy rates, also confirmed by census data. (Most apartment houses and complexes are commercial customers.)

The residential trend has been confirmed by figures for residential consumption. In 2003 and 2004, for the first time in more than 25 years, average annual residential consumption fell below 70,000 gallons—more than 3,000 gallons below the lowest previous average annual residential consumption.

Measures were taken in late 2003 and early 2004 to reduce expenses by about \$2 million in 2004. By the spring of 2004, it became apparent that further measures were necessary. As part of a reduction in work force, 30 experienced employees retired in early 2004. An early retirement incentive program incurred a one-time cost of \$950,000 in 2004. Overall, however, the work force was reduced by 44 through attrition, early retirement and not filling vacancies; the savings for 2004 totaled nearly \$1.3 million.

Other cost-cutting measures were taken, including reducing expenses for non-labor-related operations and maintenance, reducing depreciation expenses through reduced capital spending, and selling surplus fleet vehicles.

These measures and others, aided by higher water sales during the record dry spell in September and October, helped the company exceed its revised earnings target for the year—and declare a larger dividend than expected for the year.

A 6.5 percent rate increase effective January 1, 2005, will help the company continue its water quality and expansion programs, continue renovating older installations, and meet its revenue and dividend goals for 2005.

MANAGEMENT CHANGES

Acting on a study of best management practices with guidance from the federal Sarbanes-Oxley Act, the Board of Water Works decided in 2004 to separate the offices of board chair and president/CEO of the company.

Our company does not come under the Sarbanes-Oxley Act, which covers stockholder-owned companies governed by the Securities and Exchange Commission and other regulators. One of the act's key recommendations is to ensure independence of boards of directors in their role of overseeing management.

Our award-winning educational programs for children reached more than 31,000 youngsters in 1,100 different sessions in 2004. And 150 teachers attended our "in-service" workshops.

For many years, the president of Louisville Water Company has also acted as chairman of the board. Under this year's changes, the board elects its own chairman and—for the first time—a vice chairman.

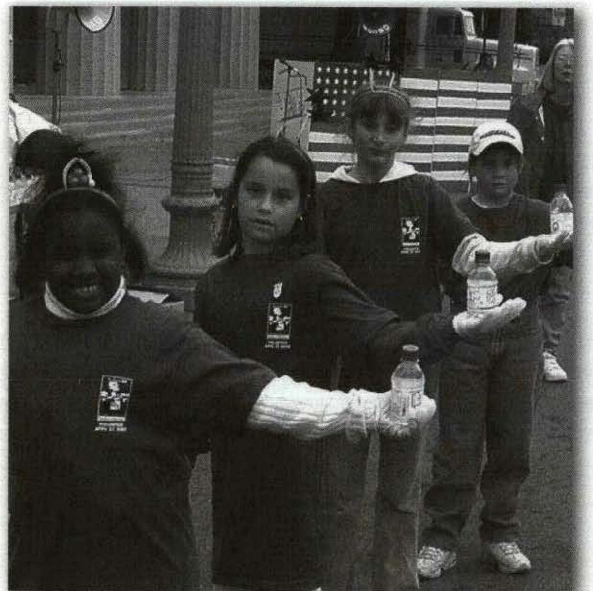
In November, the board elected Stewart Conner chairman and Wendy Welsh vice chair. John Huber remains president/CEO.

Also during the year, Phillip Bond retired from the board after serving since 1992. Margaret Harris was appointed to take Mr. Bond's place.

COMMUNITY ACTIVITIES

Louisville Water Company was founded more than 150 years ago to improve the health of the community by providing safe water. The health and welfare of our community are still among our major concerns.

Our award-winning educational programs for children reached more than 31,000 youngsters in 1,100 different sessions in 2004. And 150 teachers attended our "in-service" workshops.



We also cooperate with the Kentucky Dental Association and the University of Louisville School of Dentistry in the "Smile Kentucky!" program, which provided education and screening for more than 15,000 children at 31 schools in Jefferson, Bullitt, Henry, Spencer and Nelson counties. Free dental treatment will be provided to 300 of these children in 2005. The three-year-old program won the American Dental Association's Community Partnership Award in 2004.

About 500 Girl Scouts took part in our Belle of Louisville "Adventures in Water" cruise, each winning a patch for their participation.

The Beautification League of Louisville gave us two awards for landscaping in 2004: for our corporate office downtown, and for our Crescent Hill plant on Frankfort Avenue.

Our commitment to historic preservation brought First Lady Laura Bush to our historic Water Tower in April. She designated Louisville and 30 other Kentucky cities and towns as the nation's newest "Preserve America" communities for their efforts to preserve the nation's heritage while ensuring opportunities for the future.

The University of Louisville Center for Infrastructure Research, in which we are a partner, received a $500,000 federal grant in 2004 to study the problems of aging water and wastewater infrastructure.

President John Huber received the Water For People's Kenneth J. Miller Founder's Award in recognition of outstanding volunteer service to the organization. Water for People was founded in 1991 by the American Water Works Association to help the most impoverished people worldwide to improve their quality of life by supporting sustainable drinking water, sanitation and hygiene projects.

LWC FINANCIAL SECTION FOR DECEMBER 31, 2004 AND 2003

SALE OF WATER REVENUE ANALYSIS

	Number of Customers		Consumption - YTD (1,000 Gallons) through Dec 31,		Revenue - YTD		Revenue (1,000 Gallons)	
	2004	2003	2004	2003	2004	2003	2004	2003
GENERAL PRESSURE SERVICES								
Residential	151,421	151,483	9,457,082	9,556,240	26,450,814.79	25,532,284.81	2.79693	2.67179
Commercial	16,861	16,857	10,976,437	11,197,613	24,081,024.87	23,484,138.45	2.19388	2.09725
Industrial	321	331	4,506,099	4,633,789	7,440,323.30	7,339,314.37	1.65117	1.58387
Fire Services & Fire Hydrants	3,067	3,022	40,045	36,228	1,185,466.02	1,088,551.21	-	-
Public Fire Hydrants	11,956	11,741	-	-	3,704,605.32	3,484,178.75	-	-
Municipal	541	524	1,149,253	1,266,808	2,413,563.21	2,326,148.42	2.10011	1.83623
Wholesale *	-	2	36,768	61,750	38,209.50	105,694	1.03921	1.71164
Total GP Services	184,167	183,960	26,165,684	26,752,428	65,314,007.01	63,360,309.66	2.32450	2.21981
ELEVATED PRESSURE SERVICES								
Residential	87,472	84,423	6,578,838	6,099,354	18,726,249.65	16,591,673.39	2.84644	2.72023
Commercial	5,518	5,395	3,766,378	3,587,029	9,449,575.11	8,462,701.82	2.50893	2.35925
Industrial	8	10	252,565	241,662	431,863.95	396,410.34	1.70991	1.64035
Fire Services & Fire Hydrants	1,450	1,405	11,097	9,220	600,051.64	552,782.38	-	-
Public Fire Hydrants	7,515	7,141	-	-	2,290,550.00	2,075,578.46	-	-
Municipal	3	3	102	18,749	59,101.14	60,729.75	579.42294	3.23909
Wholesale *	5	3	1,468,758	1,335,655	2,165,468.52	1,824,427.11	1.47435	1.36594

Total Elevated Services	101,971	98,380	12,077,738	11,291,669	33,722,860.01	29,964,303.25	2.55029	2.42151
TOTALS								
Residential	238,893	235,906	16,035,920	15,655,594	45,177,064.44	42,123,958.20	2.81724	2.69066
Commercial	22,379	22,252	14,742,815	14,784,642	33,530,599.98	31,946,840.27	2.27437	2.16081
Industrial	329	341	4,758,664	4,875,451	7,872,187.25	7,735,724.71	1.65429	1.58667
Fire Services & Fire Hydrants	4,517	4,427	51,142	45,448	1,785,517.66	1,641,333.59	-	-
Public Fire Hydrants	19,471	18,882	-	-	5,995,155.32	5,559,757.21	-	-
Municipal	544	527	1,149,355	1,285,557	2,472,664.35	2,386,878.17	2.15135	1.85669
Wholesale *	5	5	1,505,526	1,397,405	2,203,678.02	1,930,120.76	1.46373	1.38122
GRAND TOTALS	286,138	282,340	38,243,422	38,044,097	99,036,867.02	93,324,612.91	2.38939	2.26649

**** Effective 4-28-04, North Nelson Wholesale Customer reclassified as Elevated Pressure Services (EPS), as opposed to General Pressure Services (GPS).***

MANAGEMENT'S DISCUSSION AND ANALYSIS

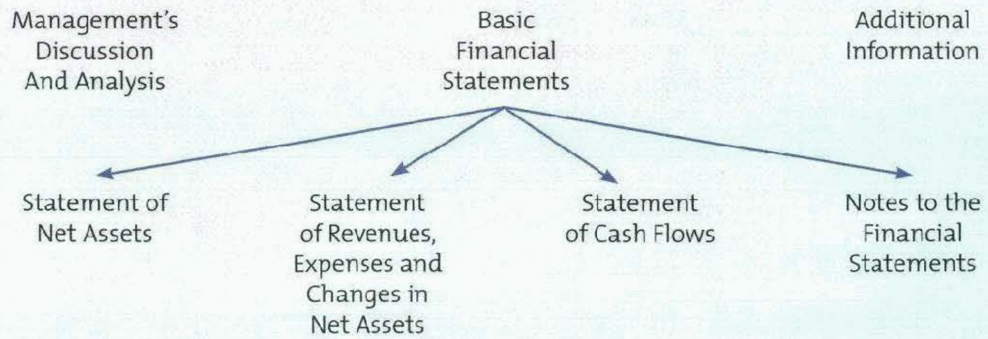
The following discussion and analysis of the Louisville Water Company's ("the Company") financial performance provides an overview of the Company's financial activities for the fiscal year ended December 31, 2004 as compared with the prior year. Please read it in conjunction with the President's Message at the front of this report and the Company's financial statements, which follow this section.

Overview of the Financial Statements

This annual financial report consists of three parts: Management's Discussion and Analysis, Financial Statements, and Additional Information. The Financial Statements also include notes that explain in more detail some of the information in the financial statements. The statements are followed by a section of Additional Information that further explains and supports the information in the Financial Statements. The Financial Statements of the Company report information about the Company using accounting methods similar to those used by private sector water utility companies, except for the reporting of contributions in aid of construction, equity capital and retained earnings. For financial reporting purposes, the Company is considered a Special-purpose Government Engaged Only in Business-type Activities. These statements offer short and long term financial information about its activities. Figure A-1 shows how the required parts of the annual financial report are arranged and relate to one another.

Figure A-1

Required Components of Louisville Water Company's Annual Financial Report



Summary ⟷ Detail

The Statement of Net Assets includes all of the Company's assets and liabilities and provides information about the nature and amounts of investments in resources (assets) and the obligations to Company creditors (liabilities). It also provides the basis for evaluating the capital structure of the Company and assessing the liquidity and financial flexibility of the Company.

All of the current year's revenues and expenses are accounted for in the Statement of Revenues, Expenses and Changes in Net Assets. This statement measures the success of the Company's operations over the past year and can be used to determine whether the Company has successfully recovered all of its costs through its water rates and other charges, has earned a profit, and has maintained credit worthiness.

The final required financial statement is the Statement of Cash Flows. The primary purpose of this statement is to provide information about the Company's cash receipts, cash payments, and net changes in cash resulting from operations, investing, and financing activities and provides information on the sources and uses of cash and the changes in cash balances during the year.

Financial Highlights

- Total Assets increased by $28,455,577, or 4.1%, from $694,687,396 in 2003 to $723,142,973 in 2004, due to increases in Utility Plant that were financed from cash generated from operations, contributions in aid of construction, and draws from the Depreciation Fund.
- Operating Revenues increased by $5,774,910, or 5.9%, from $97,687,143 to $103,462,053, due to increased sale of water revenues from residential, commercial and industrial accounts following a 4.9% increase in water rates effective January 1, 2004.
- Operating Expenses increased by $1,043,303, or 1.5%, from $68,980,817 to $70,024,120, due to increases in Depreciation Expense and Water Service Provided in Lieu of Taxes.
- Net Non-Operating Expenses increased by $743,125, or 18.0%, from $4,125,792 to $4,868,917. The costs of an Early Retirement Incentive Program were partially offset by an increase in the amount of interest on bonds allocated to capital projects work-in-progress instead of to interest expense.

- Net Income before distributions and contributions increased by $3,988,482, or 16.2%, from $24,580,534 to $28,569,016 due to increases in sale of water revenues which were greater than increases in operating expenses.
- Dividends Paid and Payable increased by $2,233,306, or 18.1%, from $12,318,831 to $14,552,137.

Statement of Net Assets

Total Net Assets increased by $30,447,780 or 5.6% in 2004 (see Figure A-2). The largest portion of Net Assets is Utility Plant, which increased by $33,269,964 in 2004 through capital improvements. The capital improvements were funded by cash generated from operations, draws from the Depreciation Fund, and by Contributions in Aid of Construction from developers, customers and governmental agencies. Non-Current Assets decreased by $10,690,678 due to the draws from the Depreciation Fund. There were no deposits made to the Infrastructure Replacement Reserve during 2004. Long-term Liabilities decreased by $8,047,782 due to principal payments on the Series 2000 and 2001 Bonds made during the year and buyout of a portion of the refunding contracts payable to developers. Long-term debt is discussed in more detail in the section titled Debt Administration.

Figure A-2

Condensed Statement of Net Assets

	2004	2003	Difference	Percent
Current Assets	$ 28,426,260	$ 22,549,969	$ 5,876,291	26.1%
Non-Current Assets	30,766,065	41,456,743	(10,690,678)	(25.8%)
Utility Plant	663,950,648	630,680,684	33,269,964	5.3%
Total Assets	723,142,973	694,687,396	28,455,577	4.1%
Current Liabilities	29,706,440	23,650,861	6,055,579	25.6%
Long Term Liabilities	122,237,436	130,285,218	(8,047,782)	(6.2%)
Total Net Assets	$ 571,199,097	$ 540,751,317	$ 30,447,780	5.6%

Statement of Revenues, Expenses and Changes in Net Assets

Operating Revenues increased by $5,774,910, or 5.9%, in 2004 (see Figure A-3). Water sales increased by 209.3 million gallons in 2004. This is equivalent to approximately two days of billable consumption. The increase in operating revenues is due to a 4.9% rate increase effective January 1, 2004 and additional water sales to residential, commercial and industrial accounts.

Operating Expenses increased by $1,043,303. The key components of operating expenses are: Operation and Maintenance Expenses, Depreciation Expense, and Water Service Provided in Lieu of Taxes. Operations and Maintenance Expenses decreased by $473,501 due to cost reduction initiatives which included a reduction in workforce accomplished through an early retirement incentive program. Depreciation Expense increased by $1,289,594. Net Non-Operating Expenses (non-operating expenses less non-operating income) increased by $743,125 due to the costs of the early retirement incentive program.

Net Income before Distributions and Contributions increased by $3,988,482 due to Operating Revenue increasing faster than Operating Expenses. The formula for computing the dividend is established as a covenant in the Series 1992 Bond Resolution (the Master Bond Resolution). The dividend is calculated as sixty percent of net income after deducting bond principal payments and certain other items. Dividends Paid and Payable increased by $2,233,306, or 18.1%, from $12,318,831 to $14,552,137.

Contributions in Aid of Construction are composed of: pipeline contributions from developers for water main extensions and from governmental agencies for water main relocations; service installation fees from customers; apportionment warrant fees and tapping fees from customers to extend water service into unserved residences; and system development charges from customers for growth-related expansion. The level of capital contributions varies from year-to-year and is affected by economic cycles. These types of projects are fully funded or nearly-fully funded by outside entities in advance of construction. Contributions in Aid of Construction increased by $3,181,487 due to increased activity by property developers.

Figure A-3

Condensed Statement of Revenues, Expenses and Changes in Net Assets

	2004	2003	Difference	Percent
Operating Revenue	$103,462,053	$ 97,687,143	$ 5,774,910	5.9%
Operating Expenses	(70,024,120)	(68,980,817)	1,043,303	1.5%
Net Operating Revenue	33,437,933	28,706,326	4,731,607	16.5%
Net Non-Operating Expenses	4,868,917	4,125,792	743,125	18.0%
Net Income Before Distributions and Contributions	28,569,016	24,580,534	3,988,482	16.2%
Dividends Paid and Payable	(14,552,137)	(12,318,831)	2,233,306	18.1%
Contributions in Aid of Construction	16,430,901	13,249,414	3,181,487	24.0%
Increase in Net Assets	30,447,780	25,511,117	4,936,663	19.4%
Net Assets, Beginning of Year	540,751,317	515,240,200	25,511,117	5.0%
Net Assets, End of Year	$ 571,199,097	$ 540,751,317	$ 30,447,780	5.6%

Statement of Cash Flows

Cash and Temporary Investments at the end of 2004 were $2,375,423, or 61.2%, higher than at the end of 2003 (see Figure A-4). Cash from Operating Activities increased by $3,676,335 due to increased amounts received from customers. Cash from Capital and Related Financing Activities increased by $8,775,927 due to decreased acquisition and construction of utility plant. Cash from Investing Activities decreased by $7,329,868 due to reduced reinvestment of securities in order to fund the investments in utility plant.

Figure A-4

Condensed Statement of Cash Flows

	2004	2003	Difference	Percent
Cash from Operating Activities	$ 52,502,821	$ 48,826,486	$ 3,676,335	7.5%
Cash from Capital and Related Financing Activities	(60,516,354)	(69,292,281)	8,775,927	(12.7)%

Cash from Investing Activities	10,388,956	17,718,824	(7,329,868)	(41.4)%
Change in Cash and Temporary Investments	2,375,423	(2,746,971)	5,122,394	186.5%
Cash and Temporary Investments, Beginning of Year	3,880,173	6,627,144	(2,746,971)	(41.5)%
Cash and Temporary Investments, End of Year	6,255,596	$ 3,880,173	$ 2,375,423	61.2%

Capital Assets

The Company uses a five-year Capital Improvements Program (CIP) that is updated annually. Development of the CIP is based on the Company's current facilities plan and recommendations from the annual inspection of facilities. The CIP also identifies anticipated capital expenditures for a total of 20 years. The Company's current facilities plan covers the years from 2002 through 2021. The Company expects to invest $342,126,558 in capital improvements during 2005-2009. The key capital projects for 2005 are: construction of riverbank filtration facilities, renewal of buried infrastructure, renovation of water treatment plant facilities, improvements to storage and boosted pressure systems, investments in information technology architectures, and transmission and distribution system improvements.

Debt Administration

At December 31, 2004, the Company had $76,085,000 principal outstanding for the Series 2000 Bonds and $47,575,000 principal outstanding for the Series 2001 Bonds, for a total of $123,660,000. The aggregate net debt service for 2004 increased due to the ramping up of bond principal payments for the Series 2000 Bonds. As shown in Figure A-5, the debt service coverage of 2.93 times in 2004 is favorable to the statutory and bond resolution limits of 1.3 times. The Series 2000 Bonds are insured, callable beginning in 2010, and carry an Aaa rating from Moody's and an AAA rating from Standard & Poor's. The Series 2001 Bonds are not insured, but are also callable beginning in 2010, and carry an Aa1 rating from Moody's and an AA rating from Standard & Poor's. The Company's debt rating is among the very highest in the United States for water utility revenue bonds.

Debt service funding for a new money borrowing of $40,000,000 during the second quarter of 2005 is included in the 2005 Annual Budget. Management has not yet determined the recommended structure of that borrowing but anticipates that it will include a variable interest rate component. The Board of Water Works has selected Public Financial Management to update its long-range financial plan and serve as Financial Advisor for the contemplated borrowing. Management will also evaluate opportunities for advance refunding of the existing bonds at the time of the new money borrowing.

Figure A-5

Debt Service Coverage

	2004	2003	Difference	Percent
Income Available for Debt Service	$33,329,216	$30,588,609	$2,740,607	9.0%
Current Aggregate Net Debt Service	$11,368,396	$ 10,971,434	$ 396,962	3.6%
Coverage Times	2.93	2.79	0.14	5.0%

Economic Factors and Next Year's Budgets and Rates

Following lower water sales in 2003 and 2004 versus budget, management developed the 2005 Annual Budget based on sales of 37.5 billion gallons, which is 1.2 billion gallons below the amount budgeted for the previous two years. Water rates will be increased for retail water service by 6.5% for water service on and after January 1, 2005. Approximately 3.2% of the rate increase was attributable to the lower planned water sales. Management believes that the 2005 Budget adequately addresses all revenue requirements.

Water rates will be increased for wholesale water service by 4.7% effective May 1, 2005. Wholesale water rates were increased in 2004 for the first time since 1994. The wholesale customers whose rates are regulated by the Kentucky Public Service Commission submitted letters at that time stating that they did not object to the increase. Management intends to request similar statements from those wholesale customers again in 2005.

Management is working with the University of Louisville to continue analysis of historical water trends and update the long-range water sales forecast using economic data from the Kentucky Data Center and weather data from the Kentucky Agricultural Weather Center. Management intends to incorporate this sales forecast into the long-range financial plan.

Management is considering the establishment of a risk mitigation / rate stabilization reserve in 2005 to allow for greater flexibility in financing business risks while optimizing the stability of water rate changes and dividend payments. This reserve could be funded from one or more methods: a rate component specifically established to build the reserve over time; additional income provided during unusually high water sales years; or existing cash reserves. This reserve is not required by the Master Bond Resolution.

Contacting the Company's Financial Management

This financial report is designed to provide our citizens, ratepayers, customers, creditors and stockholder with a general overview of the Company's finances and to show the Company's accountability for the money it receives. If you have questions about this report or need additional financial information, contact the Treasurer's Office at Louisville Water Company, 550 South Third Street, Louisville, KY, 40202.

REPORT OF INDEPENDENT AUDITORS

Board of Water Works
Louisville Water Company
Louisville, Kentucky

We have audited the accompanying consolidated statements of net assets of the Louisville Water Company as of December 31, 2004 and 2003, and the related statements of revenues, expenses and changes in net assets and cash flows for the years then ended. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated 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 audit to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the consolidated 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.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of the Louisville Water Company as of December 31, 2004 and 2003, and the results of its operations and its cash flows for the years then ended, in conformity with accounting principles generally accepted in the United States of America.

Our audit was performed for the purpose of forming an opinion on the basic consolidated financial statements of the Louisville Water Company taken as a whole. The data contained on pages 28 through 31 is presented for purposes of additional analysis and is not a required part of the basic consolidated financials statements. Such information has been subjected to the auditing procedures applied in the audit of the basic consolidated financial statements and, in our opinion, is fairly stated, in all material respects, in relation to the basic consolidated financial statements taken as a whole.

The Management's Discussion and Analysis (MD&A) on pages 10 through 13 is not a required part of the consolidated financial statements but is supplementary information required by the Governmental Accounting

Standards Board. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit the information and express no opinion on it.

Crowe Chizek and Company LLC

Crowe Chizek and Company LLC

Louisville, Kentucky
February 11, 2005

CONSOLIDATED STATEMENTS OF NET ASSETS

December 31, 2004 and 2003

	2004	2003
ASSETS		
Current assets		
Cash and temporary investments	$ 6,255,596	$ 3,880,173
Accounts receivable, net of allowance:		
Water	4,942,935	3,792,198
Sewer (contra)	8,362,354	6,573,132
Other	1,193,215	907,114
Contracts receivable, current portion	204,121	155,882
Materials and supplies	5,802,051	5,048,543
Bond Service Account - Series 2000	510,837	458,514
Bond Service Account - Series 2001	489,409	483,571
KTWD Debt Discharge Fund	-	511,789
Prepaid expenses	633,547	670,605
Accrued interest receivable	32,195	68,448
Total current assets	28,426,260	22,549,969
Noncurrent assets		
Non-utility property	106,576	104,581
Contracts receivable	2,912,935	3,222,550
Bond Reserve Account	3,059,858	3,059,858
Depreciation Fund	15,077,190	25,162,372
Infrastructure Replacement Reserve Fund	219,970	216,010
Apportionment Warrant Reserve	1,224,710	906,367
System Development Charge Reserve	2,929,254	2,871,629

U.S. Treasury State and Local Government Fund	1,640,143	1,640,143
Bullitt County Water Reserve	856,513	509,670
Shepherdsville Water Reserve	164,365	171,725
Retirement plan past service costs, net	1,351,541	1,564,943
Unamortized debt discount and expense	941,070	971,381
Preliminary engineering charges	262,798	974,096
Other deferred charges	19,142	81,418
Utility plant, net	663,950,648	630,680,684
Total noncurrent assets	694,716,713	672,137,427
Total assets	$ 723,142,973	$ 694,687,396

CONSOLIDATED STATEMENTS OF NET ASSETS

December 31, 2004 and 2003

	2004	2003
LIABILITIES		
Current liabilities		
Accounts payable	$ 2,267,335	$ 1,120,200
Sewer collections (contra)	9,041,539	7,346,619
Customer advances, currently refundable	23,271	23,271
Customer deposits	4,316,018	3,420,039
Tax collections payable	256,289	245,962
Bonds and notes payable, current portion	6,453,388	6,161,489
Accrued interest payable	906,598	924,807
Dividend payable	1,853,257	-
Contracts payable, retainage percentage	1,305,942	934,519
Accrued payroll	501,523	275,938
Accrued vacation and sick leave	1,894,438	2,373,673
Insurance reserve	886,842	824,344
Total current liabilities	29,706,440	23,650,861
Long-term liabilities		
Customer advances for construction	4,477,436	6,625,218
Bonds payable, less current portion	117,760,000	123,660,000
Total long-term liabilities	122,237,436	130,285,218
Total liabilities	151,943,876	153,936,079

NET ASSETS		
Invested in capital assets, net of related debt	539,737,260	500,859,195
Restricted, expendable	26,172,249	35,991,648
Unrestricted	5,289,588	3,900,474
Total net assets	$ 571,199,097	$ 540,751,317

CONSOLIDATED STATEMENTS OF REVENUES, EXPENSES AND CHANGES IN NET ASSETS

Years ended December 31, 2004 and 2003

	2004	2003
Operating revenues	$103,462,053	$ 97,687,143
Operating expenses		
Operation and maintenance expenses	43,602,569	44,076,070
Depreciation	16,825,061	15,535,467
Amortization	(3,500)	(39,283)
Taxes and water service provided in lieu of taxes	8,498,316	7,984,209
Loss from sale and salvage of retired assets	1,101,674	1,424,354
Total operating expenses	70,024,120	68,980,817
Net operating revenue	33,437,933	28,706,326
Non-operating income (expense)		
Interest income	1,024,396	1,231,207
Other expense	(1,123,891)	(154,798)
Interest expense	(4,769,422)	(5,202,201)
Net non-operating expense	(4,868,917)	(4,125,792)
Income before distributions and contributions	28,569,016	24,580,534
Dividends paid and payable	(14,552,137)	(12,318,831)
Contributions in aid of construction	16,430,901	13,249,414

Increase in net assets	30,447,780	25,511,117
Net assets, beginning of year	540,751,317	515,240,200
Net assets, end of year	$ 571,199,097	$ 540,751,317

CONSOLIDATED STATEMENTS OF CASH FLOWS

Years ended December 31, 2004 and 2003

	2004	2003
Cash flows from operating activities		
Cash received from customers	$ 94,614,677	$ 91,151,561
Cash paid to suppliers and others	(21,932,456)	(20,967,592)
Cash paid to employees for services	(20,179,400)	(21,357,483)
Net cash from operating activities	52,502,821	48,826,486
Cash flows from capital and related financing activities		
Acquisition and construction of utility plant	(52,414,164)	(60,413,810)
Contributions in aid of construction	16,430,901	13,249,414
Customer advances for construction	1,624,399	413,061
Refunds of customer advances for construction	(3,772,181)	(184,075)
Preliminary engineering charges	711,298	172,139
Principal paid	(5,608,101)	(4,637,779)
Interest paid	(4,787,631)	(5,215,054)
Dividends paid	(12,698,880)	(12,676,717)
Non-utility property reduction	(1,995)	540
Net cash from capital and related financing activities	(60,516,354)	(69,292,281)
Cash flows from investing activities		
Reserved funds	9,365,771	15,872,289
Restricted funds	453,628	973,556
Contracts	261,376	608,611

Contracts, retainage percentage	371,423	(820,748)
Interest received	1,060,649	1,239,914
Other non-operating expense	(1,123,891)	(154,798)
Net cash from investing activities	10,388,956	17,718,824
Net change in cash and temporary investments	2,375,423	(2,746,971)
Cash and temporary investments, beginning of year	3,880,173	6,627,144
Cash and temporary investments, end of year	$ 6,255,596	$ 3,880,173

CONSOLIDATED STATEMENTS OF CASH FLOWS

Years ended December 31, 2004 and 2003

	2004	2003
Reconciliation of net operating revenue to net cash from operating activities		
Net operating revenue	$ 33,437,933	$ 28,706,326
Adjustments to reconcile net operating revenue to net cash from operating activities:		
Depreciation	18,076,337	16,718,211
Amortization	(3,500)	(39,283)
Amortization of retirement plan past service costs	213,402	213,401
Loss from sale and salvage of retired assets	1,101,674	1,424,354
(Increase) decrease in cash due to changes in assets and liabilities		
Accounts receivable	(3,226,060)	1,289,692
Materials and supplies	(753,508)	(768,433)
Prepaid expenses	37,058	(13,724)
Other deferred charges	62,276	109,485
Accounts payable	1,147,135	(550,323)
Accounts payable, sewer collections	1,694,920	1,081,579
Customer deposits	895,979	1,079,865
Tax collections payable	10,327	11,282
Accrued vacation and sick leave	(479,235)	(119,113)
Accrued payroll	225,585	275,938

Insurance reserve	62,498	(592,771)
Total adjustments	19,064,888	20,120,160
Net cash from operating activities	$ 52,502,821	$ 48,826,486

NOTE 1 - SIGNIFICANT ACCOUNTING POLICIES

Description of the Business: The Louisville Water Company ("Company") is a provider of water and related services to residential, commercial, industrial, fire and wholesale consumers in Jefferson, Bullitt and Oldham Counties. The Company is wholly owned by the City of Louisville and therefore follows Governmental Accounting Standards.

Basis of Presentation: The accompanying consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America as prescribed by the Governmental Accounting Standards Board (GASB). The consolidated financial statements include the accounts of Louisville Water Company and Goshen Utilities and have been prepared on the accrual basis of accounting. Under the accrual basis of accounting, revenues are recognized when earned and expenses are recorded when an obligation has been incurred. The Company reports as a Business Type Activity (BTA). BTAs are those activities that are financed in whole or in part by fees charged to external parties for goods and services.

The Company classifies resources for accounting and reporting purposes into the following net asset categories:

- *Invested in capital assets, net of related debt:* Capital assets, net of accumulated depreciation and outstanding principal balances of debt attributable to the acquisition, construction or improvement of those assets.
- *Restricted:*

  Nonexpendable- Net assets subjected to externally imposed stipulations that they be maintained permanently by the Company.

  Expendable- Net assets whose use by the Company is subject to externally imposed stipulations that can be fulfilled by actions of the Company pursuant to those stipulations or that expire by the passage of time.
- *Unrestricted:* Net assets whose use by the Company is not subject to externally imposed stipulations. Unrestricted net assets may be designated for specific purposes by action of management or the Board of Water Works or may otherwise be limited by contractual agreements with outside parties.

Method of Accounting: The Company's accounting policies conform to accounting principles generally accepted in the United States of America for water utilities. Although the Company is not subject to regulation, the accounts are maintained in accordance with the uniform system of accounts prescribed by the National Association of Regulatory Utility Commissioners, except with respect to the treatment of gains and losses from the retirement or disposition of fixed assets. The Company recognizes gain or loss, including cost of removal, upon the retirement or

LWC 0134

disposition of fixed assets rather than the transfer of cost to accumulated depreciation, as provided by the National Association of Regulatory Utility Commissioners.

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

Utility Plant: Utility plant is stated at cost of acquisition or construction, including certain indirect costs. The Company applies the straight-line method of depreciation to the estimated useful lives of the various classes of depreciable property. The estimated useful lives of some significant asset categories are as follows:

Buildings	50 to 100 years
Pipelines	65 to 100 years
Fire hydrants	50 years
Services	40 years
Meters	15 years
Equipment	5 to 10 years
Trucks and autos	5 years

Depreciation expense for 2004 was $18,076,337 of which $1,251,276 was allocated to other operating expenses. Depreciation expense for 2003 was $16,718,211 of which $1,182,744 was allocated to other operating expenses.

Capitalized Interest: The Company follows the practice of capitalizing interest during construction on the capital projects paid with the proceeds of bond issues. Interest in the amount of $1,578,120 and $1,358,720 was capitalized during 2004 and 2003, respectively.

Revenue: Revenue is recognized in the period in which billings are rendered to consumers. The Company does not accrue revenue for water delivered but not billed.

Allowance for Doubtful Accounts: The allowance for doubtful accounts is established based on historical collection experience and a review of the current status of existing receivables.

Materials and Supplies: Materials and supplies inventories are stated at the lower of average cost or market.

Statements of Cash Flows: For purposes of the statements of cash flows, the Company considers all highly liquid investments purchased with a maturity of three months or less to be temporary investments.

Accrued Vacation and Sick Leave: Employees' vested and accumulated vacation and sick leave are recorded as liabilities in the consolidated financial statements. Accrued vacation and sick leave was $1,894,438 at December 31, 2004, and $2,373,673 at December 31, 2003.

Customer Deposits: In 2002, the Company acquired Goshen Utilities, which required a security deposit for new customer accounts. The Company retained the policy for the Goshen customers and pays 6% interest on all deposits held for one year. Total security deposits at December 31, 2004 and 2003 were $99,495 and $102,631, respectively. Customer deposits are included as current liabilities on the statement of net assets.

Customer Advances for Construction: The Company requires customers to make a deposit for the cost of construction of pipelines and special services. Advances are refundable, within certain time limits up to twenty years, under the terms of the various contracts.

The customer advance accounts reflect the liability for probable refunds of these construction advances. The amount estimated to be payable within the next fiscal year is shown as a current liability. Once the refund period has expired, any balance is transferred to net assets as a contribution in aid of construction.

Investment Securities: Investments are reported at fair value with gains and losses included in the statements of revenues, expenses and changes in net assets. Gains or losses on dispositions are determined using the specific identification method.

Union Employees: The Company has numerous employees who are covered by a collective bargaining agreement. At December 31, 2004, approximately 48% of the Company's employees were covered by a collective bargaining agreement. The existing agreement was renegotiated in 2001 and expires on January 31, 2006.

Taxes: The Company, by virtue of its ownership by the City of Louisville, is exempt from taxation by federal, state and local taxing authorities. However, the Company is liable for certain other taxes and provides water and fire services in lieu of taxes to the City of Louisville. Tax expense, which includes water and fire services in lieu of taxes for December 31, 2004 and 2003, was $8,498,316 and $7,984,209, respectively.

Reclassification: Certain reclassifications have been made to the 2003 consolidated financial statements to conform to the classifications used in 2004.

NOTE 2 - 2001 BOND ISSUE RESOLUTION FUNDS

Bond Reserve Account: The Master Bond Resolution requires that a bond reserve account be established at one-half of the highest future annual maximum aggregate net bond service of $6,119,715 to be paid in 2014. The fund is to be used to pay maturing bonds and interest in the event funds in the Bond Service Account are not sufficient. Otherwise, funds may not be withdrawn until the bond issue is paid in full. However, the income earned on investments may be transferred to the Bond Service Account. The reserve is invested in U. S. Treasury Bonds and is shown at fair value.

Depreciation Fund: The Master Bond Resolution requires the Company to make monthly deposits of an amount equal to one-twelfth of an amount not less than the annual depreciation charges into a depreciation fund. The balance includes interest income earned and the gain on sale of property and is available to fund capital improvements to the water system. The fund is invested in a money market account, fixed income obligations, and a sweep account, which are stated at fair value. This fund and the funding requirements are also included in the 2000 bond issue (see Note 3).

Infrastructure Replacement Reserve Fund: The Master Bond Resolution was revised to provide for the creation and funding in 1993 of the Infrastructure Replacement Reserve Fund to support the infrastructure main replacement and rehabilitation projects. Budgeted funding was $2,600,000 and $2,825,000 for 2004 and 2003, respectively. There were no deposits to the fund in 2003 or 2004. The balance at December 31 is stated at fair value and represents the remaining funds and interest earned on monies invested in a sweep account.

U. S. Treasury State and Local Government Fund: The Series 2 Note Reserve was established in the amount of $1,440,400 pursuant to the Master Bond Resolution. The note was paid in August 1993 and the reserve amount was transferred to the Company and was deposited in the U.S. Treasury State and Local Government Fund. The excess funds from the 2001 Bond Refunding were deposited in this fund. The fund is invested in U.S. Treasury bonds and is shown at fair value.

Bond Service Account: Except to the extent that the interest and principal are to be paid from other available sources, the Company is required to deposit monthly, into the Trustee's Bond Service Account, one-sixth of the amount of the next succeeding interest payment on the 2001 Bonds outstanding and one-twelfth of the next maturing principal of those bonds. The account is invested in a money market fund and commercial paper, which are stated at fair value.

NOTE 3 – 2000 BOND ISSUE RESOLUTION FUNDS

Bond Reserve Account: The resolution authorizing the Bond Issue of 2000 requires that a bond reserve account be established at one-half of the highest future annual maximum aggregate net bond service. As an alternative, the Resolution provides for deposit of an insurance policy, surety bond or other comparable security into the Reserve Account in an amount sufficient to meet the bond reserve requirement. The Company maintains an insurance policy to meet this requirement. The policy is to be used to pay maturing bonds and interest in the event funds in the Bond Service Account are not sufficient.

Depreciation Fund: The Series 2000 Bond Resolution authorizing the Bond Issue of 2000 requires the Company to maintain the depreciation fund in the same manner as required for the 2001 series (refunding 1992) bond issue (see Note 2).

Bond Service Account: Per the Series 2000 Bond Resolution, except to the extent that the interest and principal are to be paid from other available sources, the Company is required to deposit monthly, into the Trustee's Bond Service Account, one-sixth of the amount of the next succeeding interest payment on the 2000 Bonds outstanding and (beginning with the twelfth month preceding the first maturity of any bonds) one-twelfth of the next maturing principal of those bonds. The account is invested primarily in U. S. Treasury Notes and commercial paper, which are stated at fair value.

Operation Fund: Per the Series 2000 Bond Resolution, each month the Company shall, after making required payments to the Bond Service Account, the Bond Reserve Account, and the Depreciation Fund, withdraw from the Revenue Fund and deposit with a Depository in the name of the Company to the credit of the Operation Fund the balance remaining in the Revenue Fund. The fund is included in cash and temporary investments.

Rebate Fund: The Rebate Fund is created by the Series 2000 Bond Resolution. Monies credited to the Rebate Fund shall be free from the lien of the Resolution. Payments shall be made by the Board and the Company within 15 days following each five-year computation period for the calculation of excess rebateable arbitrage under the Code. The

Board and the Company have covenanted to rebate excess earnings to the United States in accordance with law. There were no deposits required to be made to this fund during 2003 or 2004.

NOTE 4 - EXTENSION OF WATER SERVICE IN JEFFERSON COUNTY

In 2004, the Company completed the implementation of a plan to extend water service to unserved residences in Jefferson County. The cost of the planned extension of water service was approximately $60 million and was funded by a combination of customer, government, and Company funds, summarized as follows:

Apportionment Warrant Reserve: Monies from the County and from new customers in the extension area are deposited in the Apportionment Warrant Reserve account. New customers in the extension area must pay an "apportionment warrant" fee. To supplement these customer monies, Jefferson County made commitments to fund a total of $6 million of the cost of the water service extension project through 2003. Disbursements from this account can only be used to pay for the cost of construction of water main extensions in the designated area. The account is invested in a sweep account, which is stated at fair value.

System Development Charge Reserve: A System Development Charge Reserve has been established to finance growth-related expansion in the apportionment warrant extension area and is assessed for new service connections other than initial connections. The collections are deposited to the System Development Charge Reserve account and disbursements from this account can only be used to pay for growth-related expansion. The account is invested in a sweep account, which is stated at fair value.

Company Monies: The Company has budgeted a total of $17 million of Company funds to pay for the transmission component, or "backbone grid", of the extension program.

NOTE 5 - CASH AND INVESTMENTS

At December 31, 2004 and 2003, the carrying value of the Company's cash and temporary investments was $6,255,596 and $3,880,173, respectively. The bank balance, including temporary investments, was $7,758,724 and $3,462,651, respectively, which were collateralized by U.S. Government Agency securities.

The Company's investments, including certificates of deposit, as of December 31, 2004 and 2003, are classified as to credit risk by the three categories described below:

Category 1:

Insured or registered, with securities held by the Company or its agent in the Company's name.

Category 2:

Uninsured or unregistered, with securities held by the counterparty's trust department or agent in the Company's name.

Category 3:

Uninsured and unregistered, with securities held by the counterparty, or by its trust department or agency, but not in the Company's name.

All of the Company's investments are classified as Category 1 at December 31, 2004 and 2003.

The differences between cost and fair value are not material. The fair value of investment securities at December 31, 2004 and 2003 are as follows:

	2004	2003
U.S. Government obligations	$ 10,741,441	$ 20,700,001
Certificates of deposit	100,000	100,000
Money market investments	2,035,508	8,394,112
Repurchase agreements	13,295,300	6,797,535
	$ 26,172,249	$ 35,991,648

At December 31, 2004 and 2003, no investment securities were pledged.

NOTE 6 – UTILITY PLANT, NET

The following is a schedule of utility plant for the year ended December 31, 2004:

	Beginning Balance	Additions	Reductions	Ending Balance
Capital assets not being depreciated:				
Land	$ 5,808,420	$ 314,472	$ -	$ 6,122,892
Construction in progress	63,854,050	61,574,140	(61,659,148)	63,769,042
Total capital assets not being depreciated	69,662,470	61,888,612	(61,659,148)	69,891,934
Other capital assets:				
Buildings	69,546,266	2,450,641	(87,400)	71,909,507
Machinery and equipment	32,262,790	5,651,940	(1,120,922)	36,793,808
Infrastructure	674,493,889	45,859,897	(3,473,713)	716,880,073
Total other capital assets at historical cost	776,302,945	53,962,478	(4,682,035)	825,583,388
Less accumulated depreciation for:				
Buildings	(26,557,268)	(1,463,738)	21,378	(27,999,628)
Machinery and equipment	(20,491,307)	(3,356,181)	987,278	(22,860,210)
Infrastructure	(168,236,156)	(13,252,417)	823,737	(180,664,836)
Total accumulated depreciation	(215,284,731)	(18,072,336)	1,832,393	(231,524,674)
Other capital assets, net	561,018,214	35,890,142	(2,849,642)	594,058,714
Capital assets, net	$ 630,680,684	$ 97,778,754	$ (64,508,790)	$ 663,950,648

The following is a schedule of utility plant for the year ended December 31, 2003:

	Beginning Balance	Additions	Reductions	Ending Balance
Capital assets not being depreciated:				
Land	$ 5,689,588	$ 268,926	$ (150,094)	$ 5,808,420
Construction in progress	47,291,394	61,136,458	(44,573,802)	63,854,050
Total capital assets not being depreciated	52,980,982	61,405,384	(44,723,896)	69,662,470
Other capital assets:				
Buildings	68,544,116	2,181,810	(1,179,660)	69,546,266
Machinery and equipment	32,058,079	1,944,045	(1,739,334)	32,262,790
Infrastructure	644,297,412	41,643,260	(11,446,783)	674,493,889
Total other capital assets at historical cost	744,899,607	45,769,115	(14,365,777)	776,302,945
Less accumulated depreciation for:				
Buildings	(26,259,446)	(1,409,119)	1,111,297	(26,557,268)
Machinery and equipment	(19,084,116)	(3,091,861)	1,684,670	(20,491,307)
Infrastructure	(164,197,182)	(12,217,231)	8,178,257	(168,236,156)
Total accumulated depreciation	(209,540,744)	(16,718,211)	10,974,224	(215,284,731)
Other capital assets, net	535,358,863	29,050,904	(3,391,553)	561,018,214
Capital assets, net	$ 588,339,845	$ 90,456,288	$ (48,115,449)	$ 630,680,684

NOTE 7 – LONG-TERM LIABILITIES

Long-term liabilities at December 31, 2004, are summarized as follows:

	Beginning Balance	Additions	Reductions	Ending Balance	Current Portion	Noncurrent Portion
Bonds payable	$129,821,489	$ -	$ 5,608,101	$124,213,388	$6,453,388	$ 117,760,000
Customer advances for construction	6,648,489	1,624,399	3,772,181	4,500,707	23,271	4,477,436
Total long-term liabilities	$136,469,978	$1,624,399	$ 9,380,282	$128,714,095	$ 6,476,659	$122,237,436

Long-term liabilities at December 31, 2003, are summarized as follows:

	Beginning Balance	Additions	Reductions	Ending Balance	Current Portion	Noncurrent Portion
Bonds payable	$134,459,268	$ -	$ 4,637,779	$129,821,489	$ 6,161,489	$123,660,000
Customer advances for construction	6,419,503	413,061	184,075	6,648,489	23,271	6,625,218
Total long-term liabilities	$140,878,771	$ 413,061	$ 4,821,854	$136,469,978	$ 6,184,760	$130,285,218

Bonds and notes payable at December 31, 2004 and 2003 consist of the following:

	2004	2003
Water System Revenue Bonds, 2000 tax exempt, interest rates ranging from 5.0% to 5.5% with maturities from 2003 through 2025	$ 76,085,000	$ 77,510,000
Water System Revenue Bonds, 2001 tax exempt, interest rates of 4.0% to 4.7% with maturities from 2001 through 2014	47,575,000	51,230,000
Kentucky Infrastructure Authority Assistance Agreement, interest rates ranging from 4.25% to 5.75% with final maturity in 2008	307,500 (A)	390,003 (A)
Kentucky Infrastructure Authority Deferred Loan, interest rate of 7.0% with maturity in 2008	$ 175,888 (A)	$ 175,888 (A)
Kentucky Infrastructure Authority Note, interest rates ranging from 4.25% to 5.75% with principal and interest paid semi-annually from 2001 through 2008	70,000 (A)	86,598 (A)
GMAC Bonds acquired from Shepherdsville system acquisition, interest rate of 3.875% with principal and interest paid semi-annually; paid off in 2004	-	155,000 (A)
GMAC Bonds acquired from Shepherdsville system acquisition, interest rate of 5.0% with principal and interest paid semi-annually; paid off in 2004	-	274,000 (A)
	124,213,388	129,821,489
Less current portion	6,453,388	6,161,489
	$ 117,760,000	$ 123,660,000

All bonds are subject to optional redemption provisions.

LWC 0144

The Water System Revenue Bond resolutions contain a rate covenant requiring that the schedule of rates and charges, and the rules and regulations for water services will not be revised so as to result in a decrease of revenues. Future adjustments to water rates and charges are required as necessary so that annual net revenues will not be less than 1.30% of the total annual bond debt service requirements for the then outstanding bonds.

(A) Funds are being held in escrow to pay off this debt so it is classified as current.

Maturities of long-term debt are as follows:

Year	Principal	Interest	Total
2005	$ 6,453,388	$ 6,061,809	$ 12,515,197
2006	6,210,000	5,795,497	12,005,497
2007	6,495,000	5,514,997	12,009,997
2008	6,800,000	5,221,634	12,021,634
2009	7,130,000	4,903,534	12,033,534
2010-2014	41,285,000	19,174,545	60,459,545
2015-2019	19,010,000	11,263,692	30,273,692
2020-2024	24,960,000	5,689,299	30,649,299
2025	5,870,000	322,850	6,192,850
	$ 124,213,388	$ 63,947,857	$ 188,161,245

NOTE 8 - DIVIDENDS

The Company is required by bond resolution to pay a dividend to the City of Louisville, the sole stockholder. The dividend is calculated in accordance with the provisions of the resolution and paid quarterly based on budgeted income. The required annual dividend is sixty percent of the Company's income before distributions and contributions with certain adjustments and exclusions. The dividend computed under these provisions was $14,093,410 for 2004 and $11,251,319 for 2003. A settlement based on actual income is made after year-end.

NOTE 9 - DEFERRED COMPENSATION PLANS

The Company offers its employees a deferred compensation plan created in accordance with Internal Revenue Code Section 457. The plan permits participating employees to defer a portion of their salary until future years. An employee may contribute up to a maximum of 25 percent of his or her adjusted gross compensation or $13,000; whichever is less, to the plan. The deferred compensation is not available to employees until termination, retirement, death or unforeseen emergency. Plan assets and liabilities are not recorded by the Company. The Company contributes $0.25 for every $1.00 of an employee's contribution up to $1,500 ($375 maximum Company contribution) to the plan. The amount contributed to the plan by the Company and charged to expense was approximately $83,000 and $86,000 for the years ended December 31, 2004 and 2003, respectively.

The Company has a defined contribution plan covering substantially all employees of the Company. An eligible employee can contribute up to an annual maximum of 25 percent of his or her adjusted gross compensation or $13,000; whichever is less, to the plan. The Company contributes $0.25 for every $1.00 of an employee's contribution ($375 maximum Company contribution) to the plan. The amount contributed to the plan by the Company and charged to expense was approximately $31,000 and $23,000 for the years ended December 31, 2004 and 2003, respectively.

NOTE 10 - PENSION PLAN

All full-time employees of the Company participate in the County Employee Retirement System (CERS) which is a cost-sharing multiple-employer defined benefit retirement plan administered by Kentucky Retirement Systems, an agency of the Commonwealth of Kentucky.

Normal retirement is at age 65 with at least 48 months of service. This entitles an employee to a basic benefit of 2.2% of final compensation multiplied by years of service. Final compensation is the employee's average salary for the highest five plan years. A reduced early retirement benefit is available from ages 55 to 64 with 60 months of service, at least 12 of which are current, or at any age after 25 years of service. CERS also provides death, disability, optional joint and survivorship, and certain health care benefits. Eligibility and benefits are established by state statute.

Eligible employees are required by state statute to contribute 5% of their salary to the Plan. The Company is required by the same statute to contribute the remaining amounts necessary to pay benefits when due. The

Company's actuarially determined contribution rate was 6.34% effective July 1, 2002 through June 2003, 7.34% effective July 1, 2003 and 8.48% effective July 1, 2004. For 2004 and 2003, participating employees contributed 5% of creditable compensation to CERS totaling $1,353,898 and $1,391,160, respectively. Employer contribution rates are intended to fund the normal cost on a current basis plus an amount equal to the amortization of unfunded past service costs over thirty years. The Company contributed $2,354,391 and $2,092,949 for 2004 and 2003, respectively. The Company's total payroll was $27,181,871 and $28,133,934 for 2004 and 2003, respectively. CERS covered payroll was $26,984,394 and $27,811,890 for 2004 and 2003, respectively.

Vesting in a retirement benefit begins immediately upon entry into the System. The participant has a fully vested interest after the completion of sixty months of service, 12 of which are current service.

The "*pension benefit obligation*" is a standardized disclosure measure of the present value of pension benefits, adjusted for the effects of projected salary increases and step-rate benefits, estimated to be payable in the future as a result of employee service to date. The measure, which is the actuarial present value of credited projected benefits, is intended to help users assess the CERS's funding status on a going-concern basis, assess progress made in accumulating sufficient assets to pay benefits when due, and make comparisons among the Public Employee Retirement Systems and employers. The CERS does not make separate measurements of assets and pension benefit obligations for individual employers.

The following table provides information on the CERS as a whole, determined through the most recent actuarial valuations:

	June 30	
	2004	2003
Net assets available for benefits	$ 6,645,463,572	$ 6,753,584,903
Pension benefit obligation	6,577,289,608	5,917,226,584
Net assets in excess of pension benefit obligation	$ 68,173,964	$ 836,358,319

Ten year historical trend information showing the CERS's progress in accumulating sufficient assets to pay benefits when due is presented in the Kentucky Retirement Systems' June 30, 2004, annual financial report (which is a matter of public record).

In addition to the assets transferred from its previous plan, the Company became obligated to CERS for $4,273,873 for remaining unfunded past service costs. The remaining liability for unfunded past service costs plus accrued interest was paid with proceeds from the 1992 Series 2 Note Payable. The related past service cost asset is being amortized over twenty years on the straight-line method.

NOTE 11 - CONTINGENT LIABILITIES

The Company retains certain insurable risks up to a fixed maximum per claim exposure. Effective October 1, 2003, liability claims are retained up to $1,000,000 per occurrence, with insurance coverage for any judgment or settlement of up to $35,000,000 above that amount. The retained amount for claims prior to October 1, 2003 was $500,000 per occurrence. Workers' compensation is self-funded up to $350,000 per claim prior to October 1, 2004 and $450,000 beginning October 1, 2004, with an aggregate limit of 90% of the premium that would be developed by applying the rate times the payroll. A reserve of $886,842 and $824,344 was established at December 31, 2004 and 2003, respectively, to provide for aggregate claims incurred.

The Company is involved in litigation, which has arisen out of operations in the ordinary course of business. While it is not possible to forecast the outcome of this litigation, it is the opinion of the Company's management that it will not have a material adverse effect on the consolidated financial statements of the Company.

NOTE 12 – EARLY RETIREMENT PROGRAM

In December of 2003, the Company offered early retirement to 39 employees with greater than 20 years of continuous service. Severance was paid in 2003 and 2004 totaling $298,665 and $949,266, respectively. This expense is included in other non-operating expense on the consolidated statements of revenues, expenses and changes in net assets. A total of 30 employees accepted early retirement.

SUPPLEMENTAL INFORMATION

LOUISVILLE WATER COMPANY SCHEDULE OF INVESTMENTS

December 31, 2004

		Maturity	Par	Fair Value
Bond Reserve Account				
U. S. Treasury Bonds	8.220%	11/15/13	$ 3,059,858	$ 3,059,858
Depreciation Fund				
FHLB	1.850%	05/20/05	6,041,440	6,041,440
Goldman Sachs	1.810%		251,319	251,319
Certificate of Deposit	3.500%	03/06/05	100,000	100,000
Sweep Account	1.812%		8,684,431	8,684,431
Infrastructure Replacement Reserve Fund				
Sweep Account	1.812%		219,970	219,970
Apportionment Warrant Reserve				
Sweep Account	1.812%		1,224,710	1,224,710
System Development Charge Reserve				
Sweep Account	1.812%		2,906,880	2,906,880
Bullitt County System Development				
Sweep Account	1.812%		22,374	22,374
U. S. Treasury State and Local Government Fund				
U. S. Treasury Bonds	8.220%		1,640,143	1,640,143
Bond Service Account – Series 2000				
Armada Funds	1.440%		510,837	510,837

Bond Service Account – Series 2001			
Armada Funds	1.440%	$ 489,409	$ 489,409
Bullitt County Water Reserve			
Money Market	.430%	381,069	381,069
Sweep Account	1.812%	236,935	236,935
Kentucky Infrastructure Deposits		238,509	238,509
Shepherdsville Water Reserve			
Checking Account			
Money Market	2.750%	164,365	164,365
		$26,172,249	$26,172,249

LOUISVILLE WATER COMPANY 2001 SERIES BOND ISSUE

December 31, 2004

The Water Revenue Bonds were issued by the Board of Water Works and are payable only from revenue of the Company.

Master resolution date	July 14, 1992
Secondary resolution date	February 13, 2001
Original amount	$60,300,000
Interest rate	4.00% to 4.70%
Bonds payable	November 15
Interest payable	May 15 and November 15
Call provisions in whole or in part	100% after November 15, 2010

LOUISVILLE WATER COMPANY 2000 SERIES BOND ISSUE

December 31, 2004

The Water Revenue Bonds were issued by the Board of Water Works and are payable only from revenue of the Company.

Resolution date	September 1, 2000
Original amount	$78,500,000
Interest rate	5.00% to 5.50%
Bonds payable	November 15
Interest payable	May 15 and November 15
Call provisions	100% after November 15, 2010

Sinking Fund installments for 2022 and 2024 maturity bonds:

November 15, 2022		November 15, 2024	
Year	Amount	Year	Amount
2021	$ 4,710,000	2023	$ 5,260,000
2022	4,975,000	2024	5,555,000
	$ 9,685,000		$ 10,815,000

SCHEDULE OF OUTSTANDING BOND INDEBTEDNESS AND ANNUAL DEBT SERVICE REQUIREMENTS

December 31, 2004

	2001 Bonds		
Year Ending December 31	Principal Installments	Interest	Aggregate Bond Service
2005	$ 3,825,000	$ 2,122,540	$ 5,947,540
2006	4,000,000	1,959,978	5,959,978
2007	4,185,000	1,789,978	5,974,978
2008	4,380,000	1,612,115	5,992,115
2009	4,590,000	1,415,015	6,005,015
2010	4,820,000	1,208,465	6,028,465
2011	5,055,000	991,565	6,046,565
2012	5,305,000	764,090	6,069,090
2013	5,570,000	525,365	6,095,365
2014	5,845,000	274,715	6,119,715
Total 2001 Bonds	$ 47,575,000	$ 12,663,826	$ 60,238,826

SCHEDULE OF OUTSTANDING BOND INDEBTEDNESS AND ANNUAL DEBT SERVICE REQUIREMENTS

December 31, 2004

	2000 Bonds		
	Principal Installments	Interest	Aggregate Bond Service
Year Ending December 31			
2005	$ 2,075,000	$ 3,939,269	$ 6,014,269
2006	2,210,000	3,835,519	6,045,519
2007	2,310,000	3,725,019	6,035,019
2008	2,420,000	3,609,519	6,029,519
2009	2,540,000	3,488,519	6,028,519
2010	2,660,000	3,361,519	6,021,519
2011	2,790,000	3,228,519	6,018,519
2012	2,930,000	3,089,019	6,019,019
2013	3,075,000	2,942,519	6,017,519
2014	3,235,000	2,788,769	6,023,769
2015	3,405,000	2,627,019	6,032,019
2016	3,590,000	2,452,512	6,042,512
2017	3,790,000	2,264,037	6,054,037
2018	4,000,000	2,065,062	6,065,062
2019	4,225,000	1,855,062	6,080,062
2020	4,460,000	1,633,250	6,093,250
2021	4,710,000	1,399,100	6,109,100
2022	4,975,000	1,151,825	6,126,825
2023	5,260,000	890,637	6,150,637
2024	5,555,000	614,487	6,169,487
2025	5,870,000	322,850	6,192,850
Total 2000 Bonds	$ 76,085,000	$ 51,284,031	$ 127,369,031

SCHEDULES OF OPERATION AND MAINTENANCE EXPENSES AND TAXES

Years ended December 31, 2004 and 2003

	2004	2003
OPERATION AND MAINTENANCE EXPENSES		
Pumping	$ 4,935,538	$ 6,193,995
Water treatment	5,462,392	4,936,423
Transmission and distribution	9,588,064	11,228,607
Customer accounts expenses	6,521,681	7,120,705
Administrative and general expenses	16,450,227	13,858,740
Operation expenses under (over) applied	644,667	737,600
Total operation and maintenance expenses	$ 43,602,569	$ 44,076,070
TAXES		
Water and fire services in lieu of taxes	$ 8,471,902	$ 7,946,610
Social security taxes	1,926,686	1,975,668
State unemployment taxes	26,414	37,599
Payroll taxes allocated	(1,926,686)	(1,975,668)
Total taxes	$ 8,498,316	$ 7,984,209

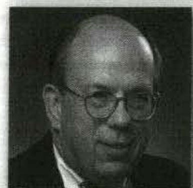
Corporate Information

Board Members

Jerry Abramson
Mayor, Louisville Metro
(ex officio)

Stewart E. Conner
Board Chairman
Managing Partner
Wyatt, Tarrant & Combs

Margaret Leavell Harris
Retired Executive
BellSouth Telecommunications



Gerald Martin
Vice President and
Managing Member
River Hill Capital, LLC

Executive Leadership Team

Front row:
Billy Meeks, President, AFSCME Local 1683
Edwin Chestnut, Jr., Assistant to the President, Director of Business Performance Management
John Huber, President and Chief Executive Officer
Susan Lehmann, Vice President, Human Resources and Organizational Effectiveness
Barbara Dickens, Vice President, General Counsel and Secretary
Back row:
Gregory C. Heitzman, Vice President, Chief Engineer
Robert K. Miller, Vice President and Treasurer, Business Resourcing
Karla Olson Teasley, Vice President, Serving Customers and Business Development

Wendy C. Welsh
Board Vice Chairman
Senior Vice President,
Information Technology
LG&E Energy LLC

Marita Willis
Assistant Vice President
PNC Bank

Dr. Joseph B. Wise, III
Business Manager,
Secretary/Treasurer
Greater Louisville Building
and Construction Trades Council

Retiring Board Member

Phillip D. Bond
Vice President for Finance
and Administration
Metro United Way

Board of Water Works

The Board of Water Works is composed of seven members:

- The Louisville Metro Mayor appoints all members
- The membership is bi-partisan, with no more than 50% from the same political party
- All new board members serve staggered four-year terms
- The Louisville Metro Mayor serves as ex officio

The Board meets the second Tuesday of each month at 12:30 pm at 550 South Third Street. Each April they appoint officers of the company.

The Message in the Bottle:

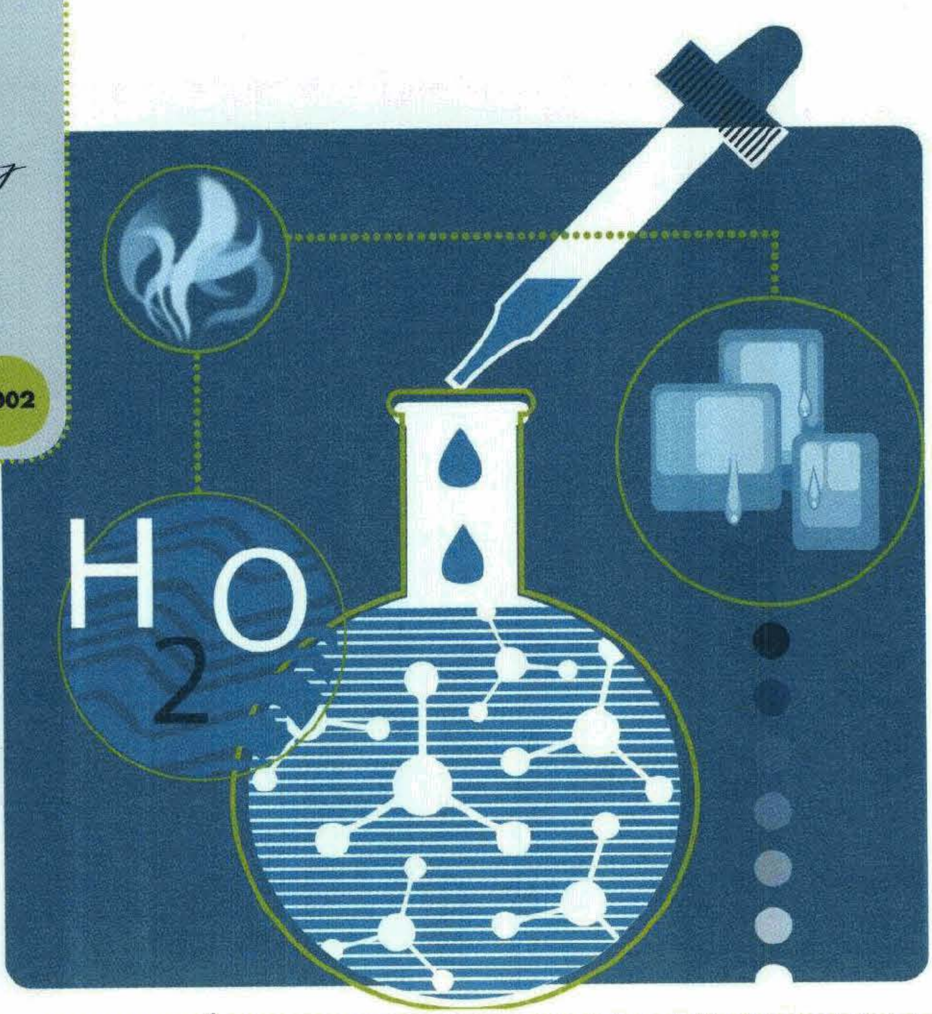
"If you want great tasting, high quality bottled water in Louisville, all you need is the bottle."

LOUISVILLE WATER COMPANY

550 S. Third Street
Louisville, KY 40202
Phone 502.569.3600
www.louisvillewater.com

Louisville Water Company Annual Report

2002



the state of your water

Introduction

Louisville Water Company provides water to about 810,000 people in Greater Louisville and parts of Oldham and Bullitt Counties. In 2002, the company delivered an average of more than 130 million gallons per day through about 3,300 miles of water main.

Water is drawn from the Ohio River at two points: the raw water pump station at Zorn Avenue and River Road, and the B. E. Payne pump station northeast of Harrods Creek. Water is also drawn from a riverbank infiltration well at the Payne plant.

CONTENTS

The water is treated at two locations: the Crescent Hill plant, which has a capacity of 180 million gallons per day, and the Payne plant, which has a capacity of 45 million gallons per day. Both plants treat the water using processes that include coagulation, softening, corrosion stabilization, disinfection, filtration, fluoridation and final disinfection. The Crescent Hill plant also uses presedimentation.

Active storage capacity for treated water totals 58.98 million gallons, in reservoirs, elevated tanks and standpipes.

Mains range up to 60 inches in diameter. Booster pump stations, pressure-reducing stations and water storage facilities are used to maintain the appropriate pressure throughout the system.

To ensure the highest quality, the company operates a laboratory certified by the state of Kentucky under U.S. Environmental Protection Agency standards, performing more than 120,000 water quality tests every year.

In addition to water sold to its retail customers, the company wholesales water to West Shelby Water District, North Shelby Water Company, North Nelson Water District, Taylorsville and Mount Washington.

Highlights

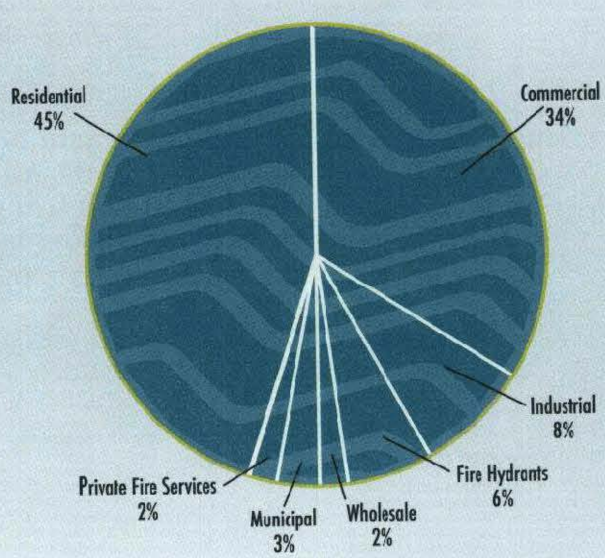
OPERATIONS

	2002	2001	2000	1999	1998	1997
The following in millions of gallons:						
Water delivered to mains	47,405	46,313	46,414	49,092	45,357	45,126
Total consumption	40,204	39,378	39,776	41,989	38,588	38,542
Unaccounted-for water	7,201	6,934	6,639	7,103	6,521	6,462
Average daily delivery	130	127	127	134	124	124
Average daily water usage	110	108	109	115	106	106
Average daily pumpage	130	127	**127 (130)	138	126	126
Maximum daily pumpage	178	175	** 188 (190)	198	173	182
Other measures:						
Percent of water unaccounted for	15%	15%	14%	14%	14%	14%
Average residential monthly water bill *	$ 14.13	$ 13.50	$ 12.99	$ 12.62	$ 12.28	$ 12.00

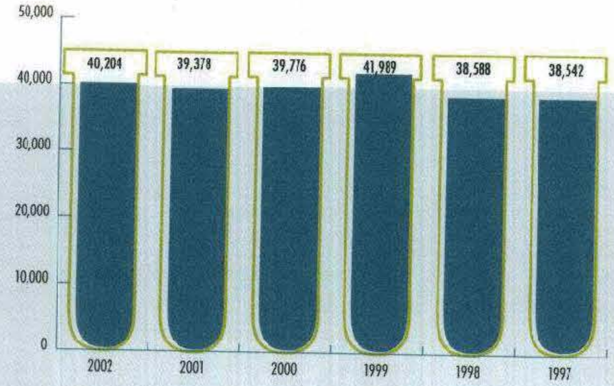
**Based upon median usage of 6,000 gallons per month*

*** Figures corrected from 2000 annual report figures, which are shown in parentheses*

2002 WATER REVENUE HIGHLIGHTS



TOTAL WATER CONSUMPTION HIGHLIGHTS



HISTORICAL REVIEW HIGHLIGHTS

	2002	2001	2000	1999	1998
Operating revenues	$ 98,172,031	$ 92,769,157	$ 88,255,340	$ 87,718,540	$ 79,525,622
Total operating expenses	65,742,954	62,814,427	57,117,953	56,517,914	51,221,356
Net non-operating expenses	(4,596,329)	(1,429,411)	(2,019,886)	(2,236,973)	(2,120,200)
Net income before distributions, contributions and extraordinary items	27,832,748	28,525,319	29,117,501	28,963,653	26,184,066
Extraordinary items		(2,253,356)			
Distributed property	(879,564)	0	0	0	0
Dividends paid and payable	(12,379,623)	(13,076,344)	(12,876,681)	(13,295,191)	(11,267,440)
Contributions	16,646,769	14,527,045	27,779,233	16,259,418	138,859,757**
Increase in net assets	31,220,330	27,722,664	44,020,053	31,927,880	153,776,383
Net assets, beginning of year	484,019,870	456,297,208	412,277,155	380,349,275	226,572,892
Net assets, end of year	515,240,200	484,019,872	456,297,208	412,277,155	380,349,275
Other					
Investment in system	$ 61,760,384	$ 48,515,271	$ 63,161,056	$ 48,256,711	$ 43,755,744
Debt service coverage	3.33	4.35	4.83	5.15	4.72
Return on total assets	4.13%	4.06%	4.68%	5.70%	5.59%

** Historical review highlights restated for GASB 34, adoption in 2002 which requires retroactive adjustment for Contributions in Aid of Construction.*

*** 1998 includes cumulative effect of prior years' contributions reported as increase in net assets.*

President's Message


John Huber, LWC President

Louisville and Jefferson County underwent a historic change in 2002: the transition to a new metropolitan city-county government that became effective in January 2003.

As the city and county became one, we completed our program to offer the opportunity of water service to every property along a public roadway in the new city.

We also expanded service in nearby counties, acquiring the Goshen and Shepherdsville water utilities and continuing improvements in Bullitt County.

To keep up with a developing service area and to continue to offer the finest quality water possible, our board adopted a 20-year, $900 million facilities plan. Major projects will provide advanced treatment, increased capacity, and continued renovation and replacement of older facilities.

Safety and security measures were improved, and will continue to be improved, as a result of the terrorist attacks of September 11, 2001.

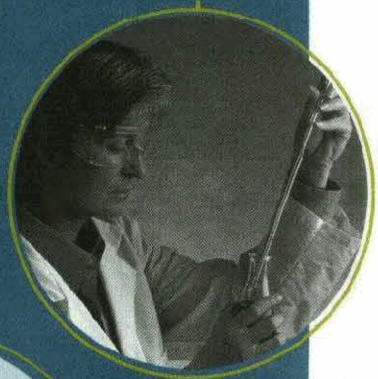
Financially, 2002 was a favorable year despite the downturn in the national economy. Sales exceeded our forecast, operation and maintenance costs were less than budgeted, and the number of customers continued to grow.

The normal sales pattern was skewed by abnormal weather conditions; while Louisville had its fourth-largest annual rainfall on record, there was a major dry spell in July and August.

Despite taste and odor problems caused by the drought, customer satisfaction matched the high levels of the previous year, reflecting our continuing efforts to improve water quality, service and communication. Our Customer Advisory Council and Technical Advisory Committee helped considerably by providing valuable feedback on new programs and customer expectations.

The company has adopted Government Accounting Standards Board Statement No. 34 (GASB 34), and financial statements are reported for the first time in the new format. Note 1 of the financial statements provides a summary of how resources are classified under the rule. Financial statements for 2001 have been restated in the GASB 34 format to provide comparable information for the two years.

the state of your water



VISION

To be a water supplier of choice throughout the region, operating in a highly competitive, customer-focused manner; delivering outstanding quality, customer satisfaction and value.

MISSION

To serve the water needs of our customers through outstanding quality, service and value at a market return to our shareholders.

PLANNING FOR THE FUTURE

Our 20-year facilities plan, adopted in mid-2002 after three years of work, provides a detailed guide for meeting the challenges of the future. The plan provides for spending more than $900 million (in 2002 dollars) to provide adequate supplies of the highest quality water for our growing metropolitan area.

The basic areas for improvement include:

- Advanced treatment facilities to continue to provide the highest quality water possible;
- Infrastructure renewal to maintain and improve our existing system; and
- System expansion to provide service for developing areas.

ADVANCED TREATMENT

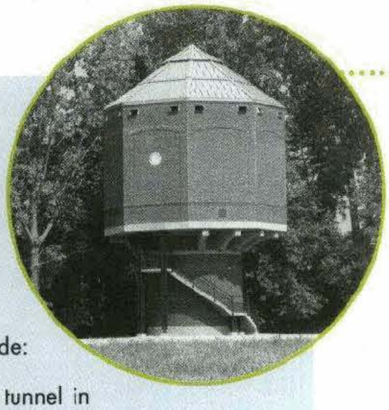
Water treatment methods throughout the nation are being improved to meet new, stricter standards that are being imposed to assure public health protection and water quality in general.

While the Ohio River provides an abundant supply of water, the quality of the water varies considerably, and treatment is challenging.

We plan to spend about $140 million over the next 20 years to meet these challenges–most of it in the next 10 years.

Across the country, water quality experts are concerned about natural and man-made substances that can contaminate surface water, including:

- Cryptosporidium, a harmful organism that cannot be killed by chlorine disinfection;
- Harmful byproducts that can be formed by the reaction of chlorine with certain pollutants;
- Atrazine and other herbicides, pesticides and other harmful chemicals; and
- Pharmaceuticals.



The New Well System

Tests at Louisville Water Company since the mid 1990s have shown that water drawn from wells in the aquifer along the Ohio River is essentially free of nearly all of these substances. As a result, the company decided in 2002 to proceed with a plan to install enough wells near the B. E. Payne plant to provide a total of 60 million gallons per day.

The system, as currently proposed, will cost about $30 million. It will include:

- About 35 to 40 wells, drilled through the aquifer and down to a tunnel in bedrock;
- A 6,000-foot tunnel, about 10 feet in diameter, to collect the water from the wells; and
- A small pump house, adjacent to the pump house that now draws water from the river at the B. E. Payne plant.

The advantages of the well system include:

- Water from the ground essentially meets the present safe drinking water standards (and will be treated further to assure consistent high quality);
- Water temperatures vary much less than river water, providing cooler water in the summer and warmer water in the winter, and reducing thermal stress on water mains;
- Protection from spills on the Ohio River; and
- Protection from cryptosporidium and other harmful microorganisms.

Design of the new system is scheduled to be made final in the summer of 2003. Construction is scheduled to start early in 2004, and to be completed by 2007.

Crescent Hill Plant Improvements

An improvement scheduled at the Crescent Hill plant by 2007 is a $13 million ultraviolet disinfection system to supplement the present chlorine-based system for water drawn from the river. (A $4.5 million ultraviolet system will be considered at the B. E. Payne plant later.)

Experience with the wells and the new ultraviolet system over the next few years will help determine how to treat the water at the historic Crescent Hill plant in the future. Major improvements are planned between 2007 and 2011, at an estimated cost of $91 million.

MAINTAINING OUR SYSTEM

Keeping our present system up-to-date and in good repair is vital. We plan to spend $250 million over the next 20 years to do so.

One example of our maintenance challenges is the pair of reservoirs at the Crescent Hill plant, now 125 years old. Increasing problems with underground leaks made it necessary to begin an extensive renovation program in the mid-1990s; by the end of 2003, most of the major work will be complete.

Another example is our network of water mains, some more than 100 years old. An ongoing program to replace or rehabilitate all 660 miles of mains installed before 1935 is on schedule to be completed by the end of 2007. And we plan to replace all of the remaining lead-pipe service lines between our mains and our customers' lines by 2015.

Some highlights of these activities in 2002:

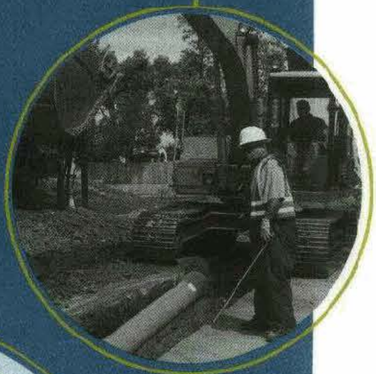
- 10.6 miles of old mains replaced;
- 10.5 miles of old mains rehabilitated; and
- More than 2,500 lead pipe services replaced.

EXPANSION AND DEVELOPMENT

More than $150 million in new water mains, pumping facilities and storage facilities will be required to meet anticipated growth over the next 20 years. Progress in 2002 included work in all three counties of our service area.

VALUES

Customer Focus
Teamwork
Pride in Workmanship
Trust
Empowerment
Diversity
Continuous Learning
Continuous Improvement



To keep up with a developing service area and to continue to offer the finest quality water possible, our board adopted a 20-year, $900 million facilities plan. Major projects will provide advanced treatment, increased capacity, and continued renovation and replacement of older facilities.

B. E. Payne Plant Expansion

A $20.5 million program to increase the capacity and improve facilities at the B. E. Payne plant was approved in 2002. The expansion, scheduled to be completed by fall 2004, will increase capacity from the present 45 million gallons per day to 60 million gallons per day—helping serve a rapidly growing part of our service area.

Jefferson County

In Jefferson County, we completed our program to provide the opportunity for service to every property along a public road.

- We installed nearly 17 miles of new mains along existing roads in Jefferson County, offering service to 272 new properties.
- Developers installed more than 35 miles of new mains, offering service to 3,039 new properties.

Bullitt County

The 10-year program to improve and expand the former Kentucky Turnpike systems was on schedule at the end of its second year.

- $5.2 million was committed for transmission mains and extensions;
- 17.7 miles of new main were placed in service;
- 131 new fire hydrants were installed; and
- A new elevated tank was finished to improve service to areas of higher elevation in the county.

The Shepherdsville water system, a former wholesale customer of Louisville Water Company, was acquired on December 23.

- Purchase price: assumption of $650,000 in debt and other obligations
- Customers: about 1,800
- Cost of improvements scheduled over next three years: about $1.6 million
- Rates remain at the former level until costs of acquisition and improvements are recovered, then will be reduced to LWC rates. Estimated time frame: four to seven years

Oldham County

The Goshen Utilities water system, which bought part of its water from Louisville Water Company, was acquired on July 31. It will be operated as a subsidiary of Louisville Water Company.

- Purchase price: $3.5 million
- Customers: about 1,900
- Water supply: converted entirely to Louisville Water Company in November
- Cost of improvements scheduled over next two years: about $1.5 million
- Rates remain at the former level until costs of acquisition and improvements are recovered, then will be adjusted to LWC rates. Estimated time frame: 16 years

We also continued to expand and improve our services in Bullitt and Oldham Counties. During 2002, we installed nearly 18 miles of new mains in these counties, offering service to 222 new properties.

SERVING OUR CUSTOMERS

Several programs to improve customer service were initiated and completed in 2002. As a result, our customer satisfaction levels remained high, reflecting our continuing efforts to improve water quality, service and communication.

One factor helped keep satisfaction levels from being higher: taste and odor problems in late September and early October as a result of unusually dry weather. When lack of rainfall increases the clarity of the Ohio River, more sunlight penetrates the water, increasing the growth of algae. The algae, in turn, create substances that can be tasted and smelled in the water. Treatment with activated carbon removes most of these substances, and most customers do not notice any remaining taste or odor. However, sensitive people can still detect the substances in the water.

Among the major accomplishments in 2002:

- Customers were given the option, for the first time, of paying their bills with debit or credit cards;
- The program to reorganize meter reading routes for increased efficiency was completed;
- Customer service representatives handled calls more quickly and efficiently, and the number of customer calls with questions and complaints declined. Both factors reduced the frequency at which customers hung up after waiting on hold;
- A new internal customer satisfaction survey measured how well our employees and departments interact with one another. The results were favorable, but also identified areas for improvement in 2003;
- Our Customer Advisory Council met regularly, providing valuable ideas on new programs and customer communication opportunities; and
- Our Technical Advisory Council, made up of a variety of experts from outside the company, provided valuable advice on developing plans for the new system of wells along the Ohio River.

FINANCES

Water sales increased in 2002, bringing a corresponding increase in revenue.

Sales, however, did not increase as much as the number of customers, reflecting the wetter-than-normal year and the slump in national economy. A slight decline in industrial sales–the result of the continuing slow change from an industrial to a service economy in our service area–was more than offset by an increase in residential and commercial sales.

In 2002, we paid $12,379,623 in dividends to our owner, the City of Louisville, and provided water in lieu of taxes valued at $8,165,765.

In 2003, we expect to pay the new Louisville-Jefferson County Metro government $12,318,800 in dividends. With the increase in government agencies and facilities, we expect to provide about $8,628,200 in water in lieu of taxes.

Water Rates

At the end of 2002, our board approved a rate increase averaging 3.5 percent effective January 1, 2003. This followed increases averaging 4.25 percent on January 1, 2002, and 3.5 percent on January 1, 2001.

Financing Our Facilities Plan

Our 2002-2021 facilities plan, which calls for $912 million in improvements (in 2002 dollars), includes the following assumptions:

- An annual inflation rate averaging 3 percent;
- Annual rate increases at or below 3.5 percent;
- Annual growth in operating expenses at or below 3.5 percent;
- Annual depreciation expenses of 2.3 percent of utility plant;
- Annual increases in water consumption of 0.5 percent or less;
- Maintaining our capacity for issuing dividends; and
- Maintaining our present bond rating.

With these factors in mind, we anticipate borrowing about $57 million in 2006 to help finance the improvements. The remaining funds would come from earnings and capital contributions.

CUSTOMER INVOLVEMENT

LWC depends on its customers for feedback.

- Twenty customers serve on a Customer Advisory Council that meets every six weeks.
- A Technical Advisory Council that includes health and environmental professionals advises LWC on a regular basis.

Financially, 2002 was a favorable year despite the downturn in the national economy. Sales exceeded our forecast, operation and maintenance costs were less than budgeted, and the number of customers continued to grow.

SALE OF WATER REVENUE ANALYSIS

(AUDITED)

	Number of Customers through December 31,		Consumption - YTD (1000 Gallons)		Revenue - YTD		Revenue (1000 Gallons)	
	2002	2001	2002	2001	2002	2001	2002	2001
GENERAL PRESSURE PLANE SERVICES - CITY								
Residential	72,361	72,429	4,666,970	4,690,454	11,436,390.40	10,960,404.12	2.45050	2.33675
Commercial	9,557	9,610	6,657,455	6,718,110	13,524,107.62	12,968,593.86	2.03142	1.93039
Industrial	259	267	1,817,958	1,750,138	3,159,593.13	3,143,588.12	1.73799	1.79619
Fire Services & Fire Hydrants	1,535	1,524	14,953	24,854	499,181.40	490,261.05		
Public Fire Hydrants	6,227	6,218	-	-	1,791,926.06	1,714,168.68		
Municipal	445	388	1,249,554	1,574,065	2,270,823.52	2,637,678.47		
Wholesale	-	-	-	-	-	-		
Total City	90,384	90,436	14,406,890	14,757,621	32,682,022.13	31,914,694.30	2.13965	2.05739
GENERAL PRESSURE PLANE SERVICES - COUNTY								
Residential	77,439	77,167	5,188,069	5,084,369	13,506,075.45	12,678,401.22	2.60330	2.49360
Commercial	7,052	7,007	4,576,311	4,560,733	9,428,794.08	9,140,196.09	2.06035	2.00411
Industrial	74	72	2,880,654	2,775,215	4,062,721.31	3,427,029.91	1.41035	1.23487
Fire Services & Fire Hydrants	1,453	1,435	12,559	15,866	553,565.24	521,411.42		
Public Fire Hydrants	5,321	4,984	-	-	1,487,462.91	1,343,185.04		
Municipal	60	8	21,757	11,864	47,618.90	45,629.09		
Wholesale	2	2	232,807	261,420	325,814.57	395,773.85		
Total County	91,401	90,675	12,912,157	12,709,467	29,412,052.46	27,551,626.62	2.13504	2.03261
ELEVATED SERVICES CITY & COUNTY								
Residential	81,286	76,515	6,882,175	6,121,340	17,523,078.91	14,938,516.14	2.54615	2.44040
Commercial	5,251	5,035	4,003,668	3,902,006	9,133,855.30	8,467,422.97	2.28137	2.17002
Industrial	9	6	239,820	324,804	388,682.92	475,087.63	1.62073	1.46269
Fire Services & Fire Hydrants	1,370	1,323	10,259	11,394	543,926.25	482,667.23		
Public Fire Hydrants	6,745	6,429	-	-	1,910,212.00	1,733,998.29		
Municipal	3	4	408,371	225,045	544,806.82	553,636.86		
Wholesale	4	5	1,340,472	1,326,545	1,829,685.03	1,809,219.15	1.36496	1.36386
Total Elevated Services	94,668	89,317	12,884,765	11,911,134	31,874,247.23	28,460,548.27	2.31630	2.20051
TOTALS								
Residential	231,086	226,111	16,737,214	15,896,163	42,465,544.76	38,577,321.48	2.53719	2.42683
Commercial	21,860	21,652	15,237,434	15,180,849	32,086,757.00	30,576,212.92	2.10578	2.01413
Industrial	342	345	4,938,432	4,850,157	7,610,997.36	7,045,705.66	1.54118	1.45268
Fire Services & Fire Hydrants	4,358	4,282	37,771	52,114	1,596,672.89	1,494,339.70		
Public Fire Hydrants	18,293	17,631	-	-	5,189,600.97	4,791,352.01		
Municipal	508	400	1,679,682	1,810,974	2,863,249.24	3,236,944.42		
Wholesale	6	7	1,573,279	1,587,965	2,155,499.60	2,204,993.00	1.37007	1.38857
Other/Fill Stations	388	238	-	-	-	-		
GRAND TOTALS	276,841	270,666	40,203,812	39,378,222	93,968,321.82	87,926,869.19	2.19087	2.08994

*** All categories, excluding Wholesale, are services active in the last 30 days.*

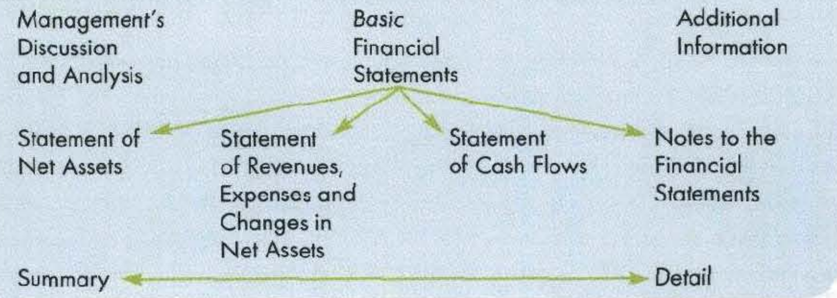
MANAGEMENT'S DISCUSSION AND ANALYSIS

The following discussion and analysis of Louisville Water Company's financial performance provides an overview of the Company's financial activities for the fiscal year ended December 31, 2002. Please read it in conjunction with the President's Message on page 5 and the Company's consolidated financial statements, which follow this section.

Overview of the Financial Statements

This annual financial report consists of three parts: Management's Discussion and Analysis, Consolidated Financial Statements, and *Additional Information*. The Consolidated Financial Statements also include notes that explain in more detail some of the information in the financial statements. The statements are followed by a section of Additional Information that further explains and supports the information in the Consolidated Financial Statements. Figure A-1 shows how the required parts of the annual financial report are arranged and relate to one another. The Consolidated Financial Statements of the Company report information about the Company using accounting methods similar to those used by private sector companies, except for the reporting of contributions in aid of construction, equity capital and retained earnings (see the section titled *New Accounting Standard* for more detail on adoption of GASB 34). These statements offer short and long-term financial information about its activities.

Figure A-1
Required Components of Louisville Water Company's Annual Financial Report



The Statement of Net Assets, successor to the Balance Sheet, includes all of the Company's assets and liabilities and provides information about the nature and amounts of investments in resources (assets) and the obligations to Company creditors (liabilities). It also provides the basis for evaluating the capital structure of the Company and assessing the liquidity and financial flexibility of the Company.

All of the current year's revenues and expenses are accounted for in the Statement of Revenues, Expenses and Changes in Net Assets, successor to the Income Statement. This statement measures the success of the Company's operations over the past year and can be used to determine whether the Company has successfully recovered all of its costs through its water rates and other charges, has earned a profit, and has maintained credit worthiness.

The final required financial statement is the Statement of Cash Flows. The primary purpose of this statement is to provide information about the Company's cash receipts, cash payments, and net changes in cash resulting from operations, investing, and financing activities and provides information on the sources and uses of cash and the changes in cash balances during the year.

Financial Highlights

- Total Assets increased by $27,035,349 or 4.18%, from $646,554,753 in 2001 to $673,590,102 in 2002, due to increases in Utility Plant.
- Operating Revenues increased by $5,402,875 or 5.82%, from $92,769,156 to $98,172,031, due to a 4.25% rate increase and additional drought-related water sales to residential accounts.
- Operating Expenses increased by $2,928,527 or 4.66% from $62,814,427 to $65,742,954, due to increases in Operation and Maintenance Expenses, Depreciation Expense, and Water Service Provided in Lieu of Taxes.
- Income before distributions and contributions increased by $1,560,786 or 5.94%, from $26,271,962 to $27,832,748 due to Operating Revenues increasing faster than Operating Expenses.
- Dividends Paid and Payable decreased by $696,721 or 5.33%, from $13,076,344 to 12,379,623. The Company also distributed the former corporate headquarters property, valued at $879,564, to the City of Louisville.
- The Company acquired Goshen Utilities, Inc. and the City of Shepherdsville water system in 2002.

Statement of Net Assets

Total Net Assets increased by $31,220,330 in 2002 (see Figure A-2). The largest portion of Net Assets is Utility Plant, which increased by $45,377,800 in 2002 through acquisitions and capital improvements. The capital improvements were funded by requisitions from the Construction and Acquisition Fund and by Contributions in Aid of Construction from developers, customers and governmental agencies. The Construction and Acquisition Fund was established with the proceeds from the Series 2000 Revenue Bond Issue in September 2000. The original amount deposited into the Construction and Acquisition Fund was $74,463,587. The balance as of January 1, 2002 was $15,374,616. This was requisitioned and spent by June 2002, as reflected in the decrease in non-current assets. Debt decreased by $4,338,224 primarily due to principal payments on the Series 2001 Bonds made during the year. No bond principal payments were due on the Series 2000 Bond Issue in 2000, 2001 and 2002. The first principal payment for the Series 2000 Bonds is in November 2003. Debt is discussed in more detail in the section titled Capital Assets and Debt Administration.

Figure A-2
Condensed Statement of Net Assets

	2002	2001	Difference	Percent Change
Current Assets	$ 26,630,856	$ 28,792,555	($ 2,161,699)	(7.51%)
Noncurrent Assets	58,619,401	74,800,153	(16,180,752)	(21.63%)
Utility Plant	588,339,845	542,962,045	45,377,800	8.36%
Total Assets	673,590,102	646,554,753	27,035,349	4.18%
Current Liabilities	20,992,932	20,676,124	316,808	1.53%
Long-Term Liabilities	137,356,970	141,858,759	(4,501,798)	(3.17%)
Total Net Assets	$515,240,200	$484,019,870	$31,220,330	6.45%

Contributions in Aid of Construction are composed of: pipeline contributions from developers for water main extensions and from governmental agencies for water main relocations; service installation fees from customers; apportionment warrant fees and tapping fees from customers to extend water service into unserved residences; and system development charges from customers for growth-related expansion. The level of capital contributions varies from year-to-year and is affected by economic cycles. These types of projects are fully funded or nearly-fully funded by outside entities in advance of construction.

Statement of Revenues, Expenses and Changes in Net Assets

Operating Revenues increased by $5,402,875 (see Figure A-3). Water sales increased by 825.6 million gallons in 2002. This is equivalent to approximately eight days of billable consumption. The increase in operating revenues is due to a 4.25% rate increase effective January 1, 2002, and additional drought-related water sales to residential accounts. Operating Expenses increased by $2,928,527. The key components of operating expenses are: Operation and Maintenance Expenses, Depreciation Expense, and Water Service Provided in Lieu of Taxes. Operations and Maintenance Expenses increased by $2,333,507 due to additional water treatment and pumping costs, raw water transmission main break repairs, and increased labor wage and salary rates. Non-operating expenses increased by $1,124,300 due to: a write-down in uncollectable damage claims receivable, a modification to the policy for accruing vacation expense, and prior research and development costs for a capital project design that will not be pursued. Non-operating income decreased by $2,589,252 or 57.9% in 2002 as investments earning between five and six percent interest matured and were reinvested at between one and two percent. Net non-operating expenses (non-operating expenses less non-operating income) increased by $3,166,918. Income before distributions and contributions increased by $1,560,786 due to Operating Revenue increasing faster than Operating Expenses. The formula for computing the dividend is established as a covenant in the Series 1992 Bond Resolution. The dividend is calculated as sixty percent of net income after deducting bond principal payments and certain other items. Dividends Paid and Payable decreased by $696,721 or 5.33%, from $13,076,344 to $12,379,623, though, due to exclusion of higher principal payments made during the year.

The adoption of GASB 34 requires the recording of contributions in aid of construction as a change in net assets recorded in the Statement of Revenues, Expenses and Changes in Net Assets, instead of as liability recorded in the Statement of Financial Position in previous years. As a result, the change in net assets each year will be the net income before dividends, less dividends paid and payable, plus contributions in aid of construction.

Figure A-3
Condensed Statement of Revenues, Expenses and Changes in Net Assets

	2002	2001	Difference	Percent Change
Operating Revenue	$ 98,172,031	$ 92,769,156	$ 5,402,875	5.82%
Operating Expenses	(65,742,954)	(62,814,427)	2,928,527	4.66%
Net Operating Revenue	32,429,077	29,954,729	2,474,348	8.26%
Net Non-Operating Expenses	(4,596,329)	(1,429,411)	3,166,918	221.55%
Income Before Extraordinary Item	27,832,748	28,525,318	(692,570)	(2.43%)
Extraordinary Loss	0	(2,253,356)	(2,253,356)	-
Income Before Distributions and Contributions	27,832,748	26,271,962	1,560,786	5.94%
Dividends Paid and Payable	(12,379,623)	(13,076,344)	(696,721)	(5.33%)
Distributed Property	(879,564)	0	879,564	-
Contributions	16,646,769	14,527,045	2,119,724	14.59%
Increase in Net Assets	31,220,330	27,722,663	3,497,667	12.62%
Net Assets, Beginning of Year	484,019,870	273,398,799	-	-
Cumulative Effect, GASB No. 34	0	182,898,408	-	-
Net Assets, Beginning of Year, As Restated	484,019,870	456,297,207	-	-
Net Assets, End of Year	$515,240,200	$484,019,870	$31,220,330	6.45%

Statement of Cash Flows

Cash from Operating Activities increased by $7,031,851 (see Figure A-4) due to increased amounts received from customers. Cash from Capital and Related Financing Activities decreased by $10,843,430 due increased acquisition and construction of utility plant. Cash from Investing Activities increased by $7,007,053 due to reduced reinvestment of securities in order to fund the investments in utility plant. The net change in cash and temporary investments was negligible and was consistent with Management's expectations.

Figure A-4
Condensed Statement of Cash Flows

	2002	2001	Difference	Percent Change
Cash from Operating Activities	$51,901,183	$44,869,332	$7,031,851	15.67%
Cash from Capital and Related Financing Activities	(67,162,942)	(56,319,512)	(10,843,430)	(19.25%)
Cash from Investing Activities	17,135,685	10,128,632	7,007,053	69.18%
Change in Cash and Temporary Investments	1,873,926	(1,321,548)	3,195,474	241.80%
Cash and Temporary Investments, Beginning of Year	4,753,218	6,074,766	(1,321,548)	(21.75%)
Cash and Temporary Investments, End of Year	$ 6,627,144	$ 4,753,218	$1,873,926	39.42%

Capital Assets

The Company uses a five-year Capital Improvements Program (CIP) that is updated annually under the direction of the Company's Chief Engineer. Development of the CIP is based on the Company's current facilities plan and recommendations from the annual inspection of facilities. The CIP also identifies anticipated capital expenditures for a total of 20 years. The Company's current facilities plan covers the years from 2002 through 2021. The Company expects to invest $346,062,689 in capital improvements during 2003-2007. The key capital projects for 2003 are: construction of an additional treatment barrier, renewal of buried infrastructure, renovation of water treatment plant facilities, improvements to storage and boosted pressure systems, investments in information technology architecture, and transmission and distribution system improvements.

Debt Administration

At December 31, 2002, the Company had $78,500,000 principal outstanding for the Series 2000 Bonds and $54,725,000 principal outstanding for the Series 2001 Bonds, for a total of $133,225,000. The Company also had other debt of $1,234,268. The aggregate net debt service for 2002 increased due to an increased bond principal payment for the Series 2001 Bonds. As shown in Figure A-5, the debt service coverage of 3.33 times in 2002 is favorable to the statutory and bond resolution limits of 1.3 times. The Series 2000 Bonds are insured and carry a Aaa rating from Moody's and a AAA rating from Standard & Poor's. The Series 2001 Bonds are not insured and carry a Aa1 rating from Moody's and a AA rating from Standard & Poor's. The Company's debt rating is among the very highest in the United States for revenue bonds.

Figure A-5
Debt Service Coverage

	2002	2001	Difference	Percent Change
Income Available for Debt Service	$33,184,600	$35,596,200	(2,411,600)	(6.77%)
Current Aggregate Net Debt Service	$ 9,951,400	$ 8,175,200	1,776,200	21.73%
Coverage Times	3.33	4.35	1.02	(23.45%)

New Accounting Standard

The Company adopted Statement No. 34 of the Governmental Accounting Standards Board (GASB 34) for the fiscal year ending December 31, 2002. For financial reporting purposes, the Company is considered a Special-purpose Government Engaged Only in Business-type Activities. Management completed the appropriate planning and software changes to be fully compliant with GASB 34 prior to the beginning of 2002. The primary effects of this Statement have been the transfer of contributions in aid of construction to net assets and the change in the names and presentation formats of the financial statements.

Economic Factors and Next Year's Budgets and Rates

Water sales in 2003 are not expected to increase over the 2002 Budget due to lagging local and national economic conditions. Residential and commercial consumption is expected to remain level, while industrial consumption is expected to decrease and municipal consumption increases. Operation and maintenance expenses in 2003 are budgeted to increase by $1,133,700 or 2.7% from the 2002 Budget to address increased expenses and to provide funding for new initiatives. Water rates will be increased by 3.50% for water service on and after January 1, 2003. Management believes that the 2003 Budget adequately addresses all revenue requirements, pending stable economic conditions. If the economy worsens, Management anticipates it can reduce expenses by an adequate amount to offset reduced sales.

Contacting the Company's Financial Management

This financial report is designed to provide our citizens, ratepayers, customers, creditors and stockholder with a general overview of the Company's finances and to show the Company's accountability for the money it receives. If you have questions about this report or need additional financial information, contact the Treasurer's Office at Louisville Water Company, 550 South Third Street, Louisville, KY, 40202.

REPORT OF INDEPENDENT AUDITORS

Board of Water Works
Louisville Water Company
Louisville, Kentucky

We have audited the accompanying consolidated statements of net assets of Louisville Water Company as of December 31, 2002 and 2001, and the related statements of revenues, expenses and changes in net assets and cash flows for the years then ended. These financial statements are the responsibility of the Company'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 audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Louisville Water Company as of December 31, 2002 and 2001, and the results of its operations and its cash flows for the years then ended, in conformity with accounting principles generally accepted in the United States of America.

As described in Note 1 to the financial statements, Louisville Water Company adopted the provisions of Governmental Accounting *Standards Board Statement* No. 34, and related statements.

Our audit was performed for the purpose of forming an opinion on the consolidated financial statements of Louisville Water Company taken as a whole. The data contained on pages 42 through 46 is presented for purposes of additional analysis and is not a required part of the basic financial statements. Such information has been subjected to the auditing procedures applied in the audit of the basic financial statements and, in our opinion, is fairly stated, in all material respects, in relation to the basic financial statements taken as a whole.

The Management's Discussion and Analysis (MD&A) on pages 17 through 22 is not a required part of the consolidated financial statements but is supplementary information required by the Governmental Accounting Standards Board. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit the information and express no opinion on it.

Crowe, Chizek and Company LLP

Crowe Chizek and Company LLP

Louisville, Kentucky
February 10, 2003

STATEMENTS OF NET ASSETS

December 31, 2002 and 2001

	2002	2001
ASSETS		
Current assets		
Cash and temporary investments	$ 6,627,144	$ 4,753,218
Accounts receivable, net of allowance:		
Water	4,000,285	4,441,521
Sewer (contra)	5,652,228	6,254,697
Other	2,909,623	2,244,527
Materials and supplies	4,280,110	4,885,595
Bond Service Account - Series 2001	614,756	1,942,777
Bond Service Account - Series 2000	445,513	449,781
KTWD Debt Discharge Fund	1,367,161	2,786,664
Prepaid expenses	656,881	726,852
Accrued interest receivable	77,155	306,923
Total current assets	26,630,856	28,792,555
Noncurrent assets		
Non-utility property	105,121	105,384
Contracts receivable	3,987,043	5,105,565
Bond Reserve Account	3,059,858	3,059,858
Depreciation Fund	39,674,829	32,753,561
Infrastructure Replacement Reserve Fund	5,453,412	9,052,295
Apportionment Warrant Reserve	22,817	223,069
System Development Charge Reserve	324,863	429,502
U.S. Treasury State and Local Government Fund	1,640,143	1,640,143
Construction and Acquisition Fund		15,374,616
Bullitt County Water Reserve	234,141	1,196,167
Retirement plan past service costs, net	1,778,344	1,991,745
Unamortized debt discount and expense	1,001,692	1,032,004
Other deferred charges	1,337,138	2,836,244
Utility plant, net	588,339,845	542,962,045
Total noncurrent assets	646,959,246	617,762,198
Total assets	$673,590,102	$646,554,753

	2002	2001
LIABILITIES		
Current liabilities		
Accounts payable	$ 1,797,378	$ 1,032,910
Sewer Collections (contra)	6,265,040	7,041,524
Customer advances, currently refundable	34,812	40,533
Customer Deposits	107,895	
Tax collections payable	234,680	277,037
Bonds and notes payable, current portion	5,719,268	5,572,502
Accrued interest payable	810,805	881,549
Dividend payable	357,886	477,094
Contracts payable, retainage percentage	1,755,267	1,188,474
Accrued payroll		292,510
Accrued vacation and sick leave	2,492,786	2,398,768
Insurance reserve	1,417,115	1,473,223
Total current liabilities	20,992,932	20,676,124
Long-term liabilities		
Customer advances for construction	8,616,970	8,633,759
Bonds payable, less current portion	128,740,000	133,225,000
Total long-term liabilities	137,356,970	141,858,759
Total liabilities	158,349,902	162,534,883
NET ASSETS		
Invested in capital assets, net of related debt	453,880,577	404,164,543
Restricted, expendable	52,837,493	68,908,433
Unrestricted	8,522,130	10,946,894
Total net assets	$515,240,200	$484,019,870

STATEMENTS OF REVENUES, EXPENSES AND CHANGES IN NET ASSETS

Years ended December 31, 2002 and 2001

	2002	2001
Operating revenues	$ 98,172,031	$ 92,769,156
Operating expenses		
Operation expenses	33,569,645	32,147,328
Maintenance expenses	8,798,278	7,887,088
Total operation and maintenance expenses	42,367,923	40,034,416
Depreciation expense	14,553,175	14,233,126
Amortization expense	(133,958)	(185,814)
Taxes and water service provided in lieu of taxes	8,165,765	8,016,185
Loss from sale and salvage of retired assets	790,049	716,514
Total operating expenses	65,742,954	62,814,427
Net operating revenue	32,429,077	29,954,729
Non-operating income (expense)		
Interest income	1,880,024	4,469,276
Other income	310,827	1,172,132
Interest expense	(6,787,180)	(7,070,819)
Net non-operating expense	(4,596,329)	(1,429,411)
Income before extraordinary items	27,832,748	28,525,318
Extraordinary items – loss on early extinguishment of debt	0	(2,253,356)
Income before distributions and contributions	27,832,748	26,271,962
Distributed property	(879,564)	
Dividends paid and payable	(12,379,623)	(13,076,344)
Contributions in aid of construction	16,646,769	14,527,045
Increase in net assets	31,220,330	27,722,663
Net assets, beginning of year	484,019,870	273,398,799
Cumulative effect of change in accounting principle, adoption of GASB Statement No. 34		182,898,408
Net assets, beginning of year, as restated	484,019,870	456,297,207
Net assets, end of year	$515,240,200	$484,019,870

STATEMENTS OF CASH FLOWS

Years ended December 31, 2002 and 2001

	2002	2001
Cash flows from operating activities		
Cash received from customers	$ 90,495,215	$ 84,734,578
Cash paid to suppliers and others	(12,380,792)	(15,743,481)
Cash paid to employees for services	(26,213,240)	(24,121,765)
Net cash from operating activities	51,901,183	44,869,332
Cash flows from capital and related financing activities		
Acquisition and construction of utility plant	(62,639,948)	(48,515,271)
Allowance for funds used during construction	1,054,894	810,261
Debt issued	490,000	
KTWD Debt Discharge Fund	1,419,503	764,371
Proceeds from sale and salvage of retired assets	(53,779)	77,349
Contributions in aid of construction	16,646,769	14,527,044
Customer advances for construction	5,718,816	5,024,350
Refunds of customer advances for construction	(5,741,326)	(4,120,505)
Costs incurred to retire assets		(198,843)
Extraordinary loss on bond refinance		(2,253,356)
Principal paid	(4,828,234)	(2,670,971)
Interest paid	(6,731,069)	(7,064,810)
Dividends paid	(12,498,831)	(12,699,506)
Non-utility property reduction	263	375
Net cash from capital and related financing activities	(67,162,942)	(56,319,512)
Cash flows from investing activities		
System Development Charge Reserve	104,639	(344,424)
Apportionment Warrant Reserve	200,252	(80,590)
Purchase of securities	(28,686,679)	(33,702,159)
Proceeds from maturities and sales of securities	39,434,341	43,050,820
Interest received	2,109,792	4,940,472
Other non-operating income	(744,066)	361,871
Infrastructure Replacement Reserve Fund	3,598,884	(3,387,236)
Contracts	1,118,522	(710,122)
Net cash from investing activities	17,135,685	10,128,632

STATEMENTS OF CASH FLOWS

Years ended December 31, 2002 and 2001

	2002	2001
Net decrease in cash and temporary investments	$ 1,873,926	$ (1,321,548)
Cash and temporary investments, beginning of year	4,753,218	6,074,766
Cash and temporary investments, end of year	$ 6,627,144	$ 4,753,218
Reconciliation of net operating revenue to net cash provided by operating activities		
Net operating revenue	$32,429,077	$29,954,729
Adjustments to reconcile net operating revenue to net cash from operating activities:		
Debt discount/expense	30,311	1,511,878
Depreciation	15,780,272	15,424,708
Amortization	(133,958)	(185,814)
Amortization of retirement plan past service costs	213,401	213,401
Loss from sale and salvage of retired assets	790,049	716,515
(Increase) decrease in cash due to changes in assets and liabilities		
Accounts receivable	(223,860)	478,797
Materials and supplies	605,485	(258,628)
Prepaid expenses	130,756	(139,701)
Other deferred charges	1,499,106	(821,790)
Accounts payable	637,613	(2,585,900)
Accounts payable, sewer collections	(174,015)	131,244
Customer deposits	107,895	(2,656)
Tax collections payable	(42,357)	(163,636)
Contracts payable, retainage percentage	566,793	70,918
Accrued vacation and sick leave	94,018	138,812
Accrued payroll	(353,295)	223,899
Insurance reserve	(56,108)	162,556
Total adjustments	19,472,106	14,914,603
Net cash from operating activities	$ 51,901,183	$44,869,332

NOTE 1 - SIGNIFICANT ACCOUNTING POLICIES

Description of the Business: Louisville Water Company ("Company") is a provider of water and related services to residential, commercial, industrial, fire and wholesale consumers in Jefferson, Bullitt and Oldham Counties. The Company is wholly owned by the City of Louisville and therefore follows Governmental Accounting Standards.

Basis of Presentation: The accompanying consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America as prescribed by the Governmental Accounting Standards Board (GASB). The consolidated financial statements include the accounts of Louisville Water Company and its wholly owned subsidiary, Goshen Utilities (see Note 12) and have been prepared on the accrual basis of accounting. Under the accrual basis of accounting, revenues are recognized when earned and expenses are recorded when an obligation has been incurred. The Company reports as a Business Type Activity (BTA). BTAs are those activities that are financed in whole or in part by fees charged to external parties for goods and services.

The Company adopted GASB Statement No. 34, *Basic Financial Statements - and Management's Discussion and Analysis - for States and Local Governments*, as amended by GASB Statement No. 37. The Company also adopted GASB Statement No. 38, *Certain Financial Statement Note Disclosures*. GASB Statement No. 34 establishes standards for external financial reporting for state and local governments and requires that resources be classified for accounting and reporting purposes into the following net asset categories:

- **Invested in capital assets, net of related debt:** Capital assets, net of accumulated depreciation and outstanding principal balances of debt attributable to the acquisition, construction or improvement of those assets.
- **Restricted:**

  Nonexpendable - Net assets subjected to externally imposed stipulations that they be maintained permanently by the Company.

  Expendable - Net assets whose use by the Company is subject to externally imposed stipulations that can be fulfilled by actions of the Company pursuant to those stipulations or that expire by the passage of time.
- **Unrestricted:** Net assets whose use by the Company is not subject to externally imposed stipulations. Unrestricted net assets may be designated for specific purposes by action of management or the Board of Water Works or may otherwise be limited by contractual agreements with outside parties.

Beginning of year equity capital has been restated to reflect the application of the provisions of GASB Statement No. 34, as follows:

Total equity capital, as previously reported	$273,398,799
GASB No. 34 adjustments: Contributions in aid of construction required to be reported as net assets by GASB No. 34	182,898,408
Total equity capital, restated as net assets	$456,297,207

Method of Accounting: The Company's accounting policies conform to accounting principles generally accepted in the United States of America for water utilities. Although the Company is not subject to regulation, the accounts are maintained in accordance with the uniform system of accounts prescribed by the National Association of Regulatory Utility Commissioners, except with respect to the treatment of gains and losses from the retirement or disposition of fixed assets. The Company recognizes gain or loss, including cost of removal, upon the retirement or disposition of fixed assets rather than the transfer of cost to accumulated depreciation, as provided by the National Association of Regulatory Utility Commissioners.

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

Utility Plant: Utility plant is stated at cost of acquisition or construction, including certain indirect costs. The Company applies the straight-line method of depreciation to the estimated useful lives of the various classes of depreciable property. The estimated useful lives of some significant asset categories are as follows:

Buildings	50 to 100 years
Pipelines	65 to 100 years
Fire hydrants	50 years
Services	40 years
Meters	15 years
Equipment	5 to 10 years
Trucks and autos	5 years

Depreciation expense for 2002 was $15,780,272 of which $1,227,097 was allocated to other operating expenses. Depreciation expense for 2001 was $15,424,708 of which $1,191,582 was allocated to other operating expenses.

Capitalized Interest: The Company follows the practice of capitalizing interest during construction on the capital projects paid with the proceeds of bond issues. Interest in the amount of $1,054,894 and $810,261 was capitalized during 2002 and 2001, respectively.

Revenue: Revenue is recognized in the period in which billings are rendered to consumers. The Company does not accrue revenue for water delivered but not billed.

Allowance for Doubtful Accounts: The allowance for doubtful accounts is established based on historical collection experience and a review of the current status of existing receivables.

Materials and Supplies: Materials and supplies inventories are stated at the lower of average cost or market.

Statements of Cash Flows: For purposes of the statements of cash flows, the Company considers all highly liquid investments purchased with a maturity of three months or less to be temporary investments.

Accrued Vacation and Sick Leave: Employees' vested and accumulated vacation and sick leave are recorded as liabilities in the financial statements. Accrued vacation and sick leave was $2,492,786 at December 31, 2002, and $2,398,768 at December 31, 2001.

Customer Deposits: In 2002, the Company aquired Goshen Utilities, which required a security deposit for new customer accounts. The Company retained the policy for the Goshen customers and pays 6% interest on all deposits held for one year. Total security deposits at December 31, 2002 was $107,895. Customer deposits are included as current liabilities on the statement of net assets.

Customer Advances for Construction: The Company requires customers to make a deposit for the cost of construction of pipelines and special services. Advances are refundable, within certain time limits up to twenty years, under the terms of the various contracts.

The customer advance accounts reflect the liability for probable refunds of these construction advances. The amount estimated to be payable within the next fiscal year is shown as a current liability. Once the refund period has expired, any balance is transferred to net assets as contributions in aid of construction.

Investment Securities: Investments are reported at fair value with gains and losses included in the statements of income and retained earnings. Gains or losses on dispositions are determined using the specific identification method.

Union Employees: The Company has numerous employees who are covered by a collective bargaining agreement. At December 31, 2002 and 2001, 45% of the Company's employees were covered by a collective bargaining agreement. The existing agreement was renegotiated in 2001 and expires on January 31, 2006.

Taxes: The Company, by virtue of its ownership by the City of Louisville, is exempt from taxation by federal, state and local taxing authorities. However, the Company is liable for certain other taxes and provides water and fire services in lieu of taxes to the City of Louisville. Tax expense, which includes water and fire services in lieu of taxes, for December 31, 2002 and 2001 was $8,165,765 and $8,016,185, respectively.

Reclassification: Certain reclassifications have been made to the 2001 financial statements to conform to the classifications used in 2002.

NOTE 2 - 2001 BOND ISSUE RESOLUTION FUNDS

Bond Reserve Account: The Master Bond Resolution requires that a bond reserve account be established at one-half of the highest future annual maximum aggregate net bond service of $6,119,715 to be paid in 2014. The fund is to be used to pay maturing bonds and interest in the event funds in the Bond Service Account are not sufficient. Otherwise, funds may not be withdrawn until the bond issue is paid in full. However, the income earned on investments may be transferred to the Bond Service Account. The reserve is invested in U. S. Treasury Bonds and is shown at fair value.

Depreciation Fund: The Master Bond Resolution requires the Company to make monthly deposits of an amount equal to one-twelfth of an amount not less than the annual depreciation charges into a depreciation fund. The balance includes interest income earned and the gain on sale of property and is available to fund capital improvements to the water system. The fund is invested in a U. S. Treasury Note, a fixed income obligation, repurchase agreements and a sweep account, which are stated at fair value. This fund and the funding requirements are also included in the 2000 bond issue (see Note 3).

Infrastructure Replacement Reserve Fund: The Master Bond Resolution was revised to provide for the creation and funding in 1993 of the Infrastructure Replacement Reserve Fund to support the infrastructure main replacement and rehabilitation projects. Budgeted funding was $2,520,000 and $3,000,000 for 2002 and 2001, respectively. The balance at December 31 is stated at fair value and represents the remaining budgeted funds and interest earned on monies invested in a sweep account.

U. S. Treasury State and Local Government Fund: The Series 2 Note Reserve was established in the amount of $1,440,400 pursuant to the Master Bond Resolution. The note was paid in August 1993 and the reserve amount was transferred to the Company and was deposited in the U.S. Treasury State and Local Government Fund. The excess funds from the 2001 Bond Refunding were deposited in this fund. The fund is invested in U.S. Treasury bonds and is shown at fair value.

Bond Service Account: Except to the extent that the interest and principal are to be paid from other available sources, the Company is required to deposit monthly, into the Trustee's Bond Service Fund, one-sixth of the amount of the next succeeding interest payment on the 2001 Bonds outstanding and one-twelfth of the next maturing principal of those bonds. The account is invested in a money market fund and commercial paper, which are stated at fair value.

NOTE 3 – 2000 BOND ISSUE RESOLUTION FUNDS

Bond Reserve Account: The resolution authorizing the Bond Issue of 2000 requires that a bond reserve account be established at one-half of the highest future annual maximum aggregate net bond service. As an alternative, the Resolution provides for deposit of an insurance policy, surety bond or other comparable security into the Reserve Account in an amount sufficient to meet the bond reserve requirement. The Company maintains an insurance policy to meet this requirement. The fund is to be used to pay maturing bonds and interest in the event funds in the Bond Service Account are not sufficient.

Depreciation Fund: The Series 2000 Bond Resolution authorizing the Bond Issue of 2000 requires the Company to maintain the depreciation fund in the same manner as required for the 2001 series (refunding 1992) bond issue (see Note 2).

Construction and Acquisition Fund: The Series 2000 Bond Resolution authorizing the Bond Issue of 2000 requires the establishment of a Construction and Acquisition Fund. Amounts in the Series 2000 Construction Account in the Construction Fund shall be applied to the cost of construction of any project upon receipt by the Trustee of requisitions and certificates as required by the Resolution. To the extent that any other monies are not available, amounts in such fund shall be applied to the payment of principal and interest when due. The acquisition and construction of the 2000 Project was completed in 2002, as evidenced by a certificate from the Chief Engineer of the Company, and as per the resolution, the balance in the Construction Account in the Construction and Acquisition Fund was transferred by the Trustee to the credit of the Bond Service Account to redeem the Series 2000 Bonds, including payment of current principal and interest. Before the transfer, the fund was invested primarily in U.S. Treasury Bills and U. S. Treasury Notes, which are stated at fair value.

Bond Service Account: Per the Series 2000 Bond Resolution, except to the extent that the interest and principal are to be paid from other available sources, the Company is required to deposit monthly, into the Trustee's Bond Service Account, one-sixth of the amount of the next succeeding interest payment on the 2000 Bonds outstanding and (beginning with the twelfth month preceding the first maturity of any bonds) one-twelfth of the next maturing principal of those bonds. The account is invested primarily in U. S. Treasury Notes and commercial paper, which are stated at fair value.

Operation Fund: Per the Series 2000 Bond Resolution, each month the Company shall, after making required payments to the Bond Service Account, the Bond Reserve Account, and the Depreciation Fund, withdraw from the Revenue Fund and deposit with a Depositary in the name of the Company to the credit of the Operation Fund the balance remaining in the Revenue Fund. The fund is included in cash and temporary investments.

Rebate Fund: The Rebate Fund is created by the Series 2000 Bond Resolution. Monies credited to the Rebate Fund shall be free from the lien of the Resolution. Payments shall be made by the Board and the Company within 15 days following each five-year computation period for the calculation of excess rebatable arbitrage under the Code. The Board and the Company have covenanted to rebate excess earnings to the United States in accordance with law. There were no deposits required to be made to this fund during 2001 or 2002.

NOTE 4 - EXTENSION OF WATER SERVICE IN JEFFERSON COUNTY

The Company is implementing a plan to extend water service to unserved residences in Jefferson County. The planned extension of water service will cost approximately $54 million and will be funded by a combination of customer, government, and Company funds, summarized as follows:

Apportionment Warrant Reserve: Monies from the County and from new customers in the extension area are deposited in the Apportionment Warrant Reserve account. New customers in the extension area must pay an "apportionment warrant" fee. To supplement these customer monies, Jefferson County made commitments to fund a total of $6 million of the cost of the water service extension project through 2003. Disbursements from this account can only be used to pay for the cost of construction of water main extensions in the designated area. The account is invested in a sweep account, which is stated at fair value.

System Development Charge Reserve: A System Development Charge Reserve has been established to finance growth-related expansion in the apportionment warrant extension area and is assessed for new service connections other than initial connections. The collections are deposited to the System Development Charge Reserve account and disbursements from this account can only be used to pay for growth-related expansion. The account is invested in a sweep account, which is stated at fair value.

Company Monies: The Company has budgeted a total of $17 million of Company funds to pay for the transmission component, or "backbone grid", of the extension program.

NOTE 5 - CASH AND INVESTMENTS

At December 31, 2002 and 2001, the carrying value of the Company's cash and temporary investments was $6,627,144 and $4,753,218, respectively, and the bank balance, including temporary investments, was $6,470,215 and $6,129,430, respectively, which were collateralized by U.S. Government Agency securities.

The fair value of investment securities at December 31, 2002 and 2001, are as follows:

	2002	2001
U.S. Government obligations	$ 17,659,769	$ 14,521,711
Certificates of deposit	100,000	557,791
Money market investments	30,701,533	31,037,324
Repurchase agreements	4,376,191	18,391,607
Fixed income obligations		4,400,000
	$52,837,493	$68,908,433

Proceeds from the sale of investment securities was $307,680 and $6,400,000 in 2002 and 2001, respectively. The loss from the sale of investment securities was $0 and $125,320 in 2002 and 2001, respectively. At December 31, 2002 and 2001, no investment securities were pledged.

NOTE 6 – UTILITY PLANT, NET

The following is a schedule of utility plant for the year ended December 31, 2002:

	Beginning Balance	Additions	Reductions	Ending Balance
Capital assets not being depreciated:				
Land	$ 5,332,102	$ 357,486	$ -	$ 5,689,588
Construction in progress	49,682,614	66,872,227	(69,263,447)	47,291,394
Total capital assets not being depreciated	55,014,716	67,229,713	(69,263,447)	52,980,982
Other capital assets:				
Buildings	15,041,288	99,234	(2,417,228)	12,723,294
Machinery and equipment	30,980,150	3,017,817	(1,892,467)	32,105,500
Infrastructure	638,823,028	63,140,471	(1,892,686)	700,070,813
Total other capital assets at historical cost	684,844,466	66,257,522	(6,202,381)	744,899,607
Less accumulated depreciation for:				
Buildings	(2,733,821)	(367,242)	1,537,151	(1,563,912)
Machinery and equipment	(17,482,887)	(3,223,757)	1,119,634	(19,587,010)
Infrastructure	(176,680,429)	(12,189,273)	479,880	(188,389,822)
Total accumulated depreciation	(196,897,137)	(15,780,272)	3,136,665	(209,540,744)
Other capital assets, net	487,947,329	50,477,250	(3,065,716)	535,358,863
Capital assets, net	$ 542,962,045	$ 117,706,963	$ (72,329,163)	$ 588,339,845

The following is a schedule of utility plant for the year ended December 31, 2001:

	Beginning Balance	Additions	Reductions	Ending Balance
Capital assets not being depreciated:				
Land	$ 4,844,430	$ 487,672	$	$ 5,332,102
Construction in progress	41,799,737	48,730,624	(40,847,747)	49,682,614
Total capital assets not being depreciated	46,644,167	49,218,296	(40,847,747)	55,014,716
Other capital assets:				
Buildings	15,018,882	22,406	-	15,041,288
Machinery and equipment	28,937,327	3,111,933	(1,069,110)	30,980,150
Infrastructure	602,696,585	37,187,705	(1,061,262)	638,823,028
Total other capital assets at historical cost	646,652,794	40,322,044	(2,130,372)	684,844,466
Less accumulated depreciation for:				
Buildings	(2,327,156)	(406,665)	-	(2,733,821)
Machinery and equipment	(15,115,911)	(3,365,989)	999,013	(17,482,887)
Infrastructure	(165,573,206)	(11,652,054)	544,831	(176,680,429)
Total accumulated depreciation	(183,016,273)	(15,424,708)	1,543,844	(196,897,137)
Other capital assets, net	463,636,521	24,897,336	(586,528)	487,947,329
Capital assets, net	$ 510,280,688	$ 74,115,632	$ (41,434,275)	$ 542,962,045

NOTE 7 – LONG-TERM LIABILITIES

Long-term liabilities at December 31, 2002, are summarized as follows:

	Beginning Balance	Additions	Reductions	Ending Balance	Current Portion	Noncurrent Portion
Bonds payable	$138,797,502	$ 490,000	$ 4,828,234	$134,459,268	$ 5,719,268	$128,740,000
Customer advances for construction	8,674,292	5,718,816	5,741,326	8,651,782	34,812	8,616,970
Total long-term liabilities	$ 147,471,794	$6,208,816	$10,569,560	$ 143,111,050	$ 5,754,080	$ 137,356,970

Long-term liabilities at December 31, 2001, are summarized as follows:

	Beginning Balance	Additions	Reductions	Ending Balance	Current Portion	Noncurrent Portion
Bonds payable	$ 141,468,473	$ 348,660	$ 3,019,631	$ 138,797,502	$5,572,502	$133,225,000
Customer advances for construction	7,770,447	5,024,350	4,120,505	8,674,292	40,533	8,633,759
Total long-term liabilities	$ 149,238,920	$ 5,373,010	$ 7,140,136	$ 147,471,794	$ 5,613,035	$141,858,759

In May, 2001, the City of Louisville authorized the issuance of $60,300,000 of its Louisville Water Company Water System Refunding Bonds, Series 2001 (the "Series 2001 Bonds") secured under the Water System Revenue Bond Resolution Authorizing the Issuance of Water System Revenue Bonds, adopted by the Board on July 14, 1992 (the "Master Resolution"), as amended and supplemented and as further amended and supplemented by the Second Supplemental Resolution adopted by the Board on February 13, 2001. The Series 2001 Bonds were issued for the purpose of providing funds to refund all of the outstanding Louisville Water Company System Revenue Bonds, Series 1992.

The accounting recognition of this transaction resulted in a loss of $2,253,356 for defeasance of the Louisville Water Company Water System Revenue Bonds, Series 1992 and is shown as an extraordinary loss in 2001. The refunding of the Series 1992 bonds with the Series 2001 will provide a present value savings of $3,910,658.

Bonds and notes payable at December 31, 2002 and 2001 consist of the following:

	2002	2001
Water System Revenue Bonds, 2000 tax exempt, interest rates ranging from 5.0% to 5.5% with maturities from 2003 through 2025	$ 78,500,000	$ 78,500,000
Water System Revenue Bonds, 2001 tax exempt, interest rates of 4.0% to 4.7% with maturities from 2001 through 2014	54,725,000	58,060,000
Water System Revenue Bonds, 2000 tax exempt, interest rates of 5.25% with principal payments due January and July 2001, balance due January 2002	0	1,405,500 (A)
Kentucky Infrastructure Authority Assistance Agreement, interest rates ranging from 4.25% to 5.75% with final maturity in 2008	465,106 (A)	536,898 (A)
Kentucky Infrastructure Authority Deferred Loan, interest rate of 7.0% with maturity in 2008	175,888 (A)	175,888 (A)
Kentucky Infrastructure Authority Note, interest rates ranging from 4.25% to 5.75% with principal and interest paid semi-annually from 2001 through 2008	103,274(A)	119,216 (A)
GMAC Bonds acquired from Shepherdsville system acquisition, interest rate of 3.875% with principle and interest paid semi-annually with maturity in 2006	205,000(A)	
GMAC Bonds acquired from Shepherdsville system acquisition, interest rate of 5.0% with principle and interest paid semi-annually with maturity in 2019	285,000(A)	-
	134,459,268	138,797,502
Less current portion	5,719,268	5,572,502
	$128,740,000	$133,225,000

All bonds are subject to optional redemption provisions.

The Water System Revenue Bond resolutions contain a rate covenant requiring that the schedule of rates and charges, and the rules and regulations for water services will not be revised so as to result in a decrease of revenues. Future adjustments to water rates and charges are required as necessary so that annual net revenues will not be less than 130% of the total annual bond debt service requirements for the then outstanding bonds.

(A) Funds are being held in escrow to pay off this debt so it is classified as current.

Maturities of long-term debt are as follows:

Year	Principal	Interest	Total
2003	$ 5,719,268	$ 6,674,668	$ 12,393,936
2004	5,080,000	6,337,896	11,417,896
2005	5,900,000	6,061,809	11,961,809
2006	6,210,000	5,795,497	12,005,497
2007	8,230,000	5,514,997	13,744,997
Thereafter	103,320,000	46,526,054	149,846,054
	$134,459,268	$76,910,921	$211,370,189

NOTE 8 - DIVIDENDS

The Company is required by bond resolution to pay a dividend to the City of Louisville, the sole stockholder. The dividend is calculated in accordance with the provisions of the resolution and paid quarterly based on budgeted income. The required annual dividend is sixty percent of the Company's net income with certain adjustments and exclusions. The dividend computed under these provisions was $12,379,623 for 2002 and $13,076,344 for 2001. A settlement based on actual net income is made after year-end.

NOTE 9 - DEFERRED COMPENSATION PLANS

The Company offers its employees a deferred compensation plan created in accordance with Internal Revenue Code Section 457. The plan permits participating employees to defer a portion of their salary until future years. An employee may contribute up to a maximum of 25 percent of his or her adjusted gross compensation or $8,500, whichever is less, to the plan. The deferred compensation is not available to employees until termination, retirement, death or unforeseen emergency. Plan assets and liabilities are not recorded by the Company. The Company contributes $0.25 for every $1.00 of an employee's contribution up to $1,500 ($375 maximum Company contribution) to the plan. The amount contributed to the plan by the Company and charged to expense was approximately $91,000 and $122,000 for the years ended December 31, 2002 and 2001, respectively.

During 2001, the Company adopted a defined contribution plan covering substantially all employees of the Company. An eligible employee can contribute up to an annual maximum of 25 percent of his or her adjusted gross compensation or $10,500, whichever is less, to the plan. The Company contributes $0.25 for every $1.00 of an employee's contribution ($375 maximum Company contribution) to the plan. The amount contributed to the plan by the Company and charged to expense for the year ended December 31, 2002 was approximately $23,000.

NOTE 10 - PENSION PLAN

All full-time employees of the Company participate in the County Employee Retirement System (CERS) which is a cost-sharing multiple-employer defined benefit retirement plan administered by Kentucky Retirement Systems, an agency of the Commonwealth of Kentucky.

Normal retirement is at age 65 with at least 48 months of service. This entitles an employee to a basic benefit of 2.2% of final compensation multiplied by years of service. Final compensation is the employee's average salary for the highest five plan years. A reduced early retirement benefit is available from ages 55 to 64 with 60 months of service, at least 12 of which are current, or at any age after 25 years of service. CERS also provides death, disability, optional joint and survivorship, and certain health care benefits. Eligibility and benefits are established by state statute.

Eligible employees are required by state statute to contribute 5% of their salary to the Plan. The Company is required by the same statute to contribute the remaining amounts necessary to pay benefits when due. The Company's actuarially determined contribution rate was 7.17% effective July 1, 2000 through June 30, 2001, 6.41% effective July 1, 2001 through June 30, 2002 and 6.34% effective July, 1, 2002. For 2002 and 2001, participating employees contributed 5% of creditable compensation to CERS totaling $1,293,074 and $1,285,246, respectively. Employer contribution rates are intended to fund the normal cost on a current basis plus an amount equal to the amortization of unfunded past service costs over thirty years. The Company contributed $1,648,628 and $1,652,766 for 2002 and 2001, respectively. The Company's total payroll was $25,953,963 and $24,484,475 for 2002 and 2001, respectively. CERS covered payroll was $25,799,047 and $24,324,712 for 2002 and 2001, respectively.

Vesting in a retirement benefit begins immediately upon entry into the System. The participant has a fully vested interest after the completion of sixty months of service, 12 of which are current service.

The "pension benefit obligation" is a standardized disclosure measure of the present value of pension benefits, adjusted for the effects of projected salary increases and step-rate benefits, estimated to be payable in the future as a result of employee service to date. The measure, which is the actuarial present value of credited projected benefits, is intended to help users assess the CERS's funding status on a going-concern basis, assess progress made in accumulating sufficient assets to pay benefits when due, and make comparisons among the Public Employee Retirement Systems and employers. The CERS does not make separate measurements of assets and pension benefit obligations for individual employers.

The following table provides information on the CERS as a whole, determined through the most recent actuarial valuations:

	June 30	
	2002	2001
Net assets available for benefits	$6,883,298,951	$6,910,500,565
Pension benefit obligation	5,492,646,422	4,900,142,654
Net assets in excess of pension benefit obligation	$1,390,652,529	$ 2,010,357,911

Ten-year historical trend information showing the CERS's progress in accumulating sufficient assets to pay benefits when due is presented in the Kentucky Retirement Systems' June 30, 2002, annual financial report (which is a matter of public record).

In addition to the assets transferred from its previous plan, the Company became obligated to CERS for $4,273,873 for remaining unfunded past service costs. The remaining liability for unfunded past service costs plus accrued interest was paid with proceeds from the 1992 Series 2 Note Payable. The related past service cost asset is being amortized over twenty years on the straight-line method.

NOTE 11 - CONTINGENT LIABILITIES

The Company retains certain insurable risks up to a fixed maximum per claim exposure. Liability claims are retained up to $500,000 per occurrence, with insurance coverage for any judgment or settlement of up to $35,000,000 above that amount. Workers' compensation is self-funded up to $225,000 per claim, with an aggregate limit of 90% of the premium that would be developed by applying the rate times the payroll. A reserve of $1,417,115 and $1,473,223 was established at December 31, 2002 and 2001, respectively, to provide for aggregate claims incurred.

The Company is involved in litigation, which has arisen out of operations in the ordinary course of business. While it is not possible to forecast the outcome of this litigation, it is the opinion of the Company's management that it will not have a material adverse effect on the financial statements of the Company.

NOTE 12 – ACQUISITIONS

During 2002, the Company acquired Goshen Utilities (Goshen) and the Shepherdsville Water System (Shepherdsville). Goshen was a stock purchase, which took place on July 31, 2002. Goshen is being held by the Company as a wholly owned subsidiary. The Company assumed the assets and liabilities of Shepherdsville on December 31, 2002, from the City of Shepherdsville. The assets and liabilities from these acquisitions have been included in the consolidated financial statements of the Company and are not material.

SCHEDULE OF INVESTMENTS

December 31, 2002

		Maturity	Par	Fair Value
Bond Reserve Account				
U. S. Treasury Bonds	8.220%	11/15/13	$ 3,059,858	$ 3,059,858
Depreciation Fund				
FHLMC	2.50%	10/01/04	$ 3,000,000	$ 3,003,000
FHLB	2.5%	12/27/04	2,000,000	2,002,000
FHLB	2.0%	6/30/04	2,000,000	2,000,500
Federal Farm Credit Bank	2.0%	4/23/04	3,000,000	3,003,000
FNMA	1.7%	8/22/03	3,000,000	2,951,268
Goldman Sachs	1.09%		24,765,664	24,765,664
Certificate of Deposit	3.5%	3/6/05	100,000	100,000
Sweep Account	1.143%		1,849,397	1,849,397
Infrastructure Replacement Reserve Fund				
Goldman Sachs	1.09%		$ 4,875,599	$ 4,875,599
Sweep Account	1.143%		577,813	577,813
Apportionment Warrant Reserve				
Sweep Account	1.143%		$ 22,817	$ 22,817
System Development Charge Reserve				
Sweep Account	1.143%		$ 324,863	$ 324,863
U. S. Treasury State and Local Government Fund				
U. S. Treasury Bonds	8.220%	11/25/13	$ 1,640,143	$ 1,640,143
Bond Service Account - Series 2000				
Armada Funds	1.47%		$ 445,513	$ 445,513
Bond Service Account - Series 2001				
Armada Funds			$ 614,756	$ 614,756
Bullitt County Water Reserve				
Sweep Account	1.143%		$ 755	$ 755
Kentucky Infrastructure Deposits			233,386	233,386
KTWD Debt Discharge Fund				
Sweep Account	1.143%		$ 1,367,161	$ 1,367,161
			$52,877,725	$52,837,493

2001 SERIES BOND ISSUE

December 31, 2002

The Water Revenue Bonds were issued by the Board of Water Works and are payable only from revenue of the Company.

Master resolution date	July 14, 1992
Secondary resolution date	February 13, 2001
Original amount	$60,300,000
Interest rate	4.00% to 4.70%
Bonds payable	November 15
Interest payable	May 15 and November 15
Call provisions in inverse	100% after November 15, 2010

2000 SERIES BOND ISSUE

The Water Revenue Bonds were issued by the Board of Water Works and are payable only from revenue of the Company.

Resolution date	September 1, 2000
Original amount	$78,500,000
Interest rate	5.00% to 5.50%
Bonds payable	November 15
Interest payable	May 15 and November 15

Sinking Fund installments for 2022 and 2024 maturity bonds:

November 15, 2022		November 15, 2024	
Year	Amount	Year	Amount
2021	$4,710,000	2023	$ 5,260,000
2022	4,975,000	2024	5,555,000
	$9,685,000		$10,815,000

SCHEDULE OF OUTSTANDING BOND INDEBTEDNESS AND ANNUAL DEBT SERVICE REQUIREMENTS

December 31, 2002

	2001 Bonds		Aggregate
	Principal Installments	Interest	Bond Service
Year Ending December 31			
2003	$ 3,495,000	$ 2,426,415	$ 5,921,415
2004	3,655,000	2,277,877	5,932,877
2005	3,825,000	2,122,540	5,947,540
2006	4,000,000	1,959,978	5,959,978
2007	4,185,000	1,789,978	5,974,978
2008	4,380,000	1,612,115	5,992,115
2009	4,590,000	1,415,015	6,005,015
2010	4,820,000	1,208,465	6,028,465
2011	5,055,000	991,565	6,046,565
2012	5,305,000	764,090	6,069,090
2013	5,570,000	525,365	6,095,365
2014	5,845,000	274,715	6,119,715
Total 2001 Bonds	$54,725,000	$17,368,118	$72,093,118

SCHEDULE OF OUTSTANDING BOND INDEBTEDNESS AND ANNUAL DEBT SERVICE REQUIREMENTS

December 31, 2002

	2000 Bonds		Aggregate
	Principal Installments	Interest	Bond Service
Year Ending December 31			
2003	$ 990,000	$ 4,060,019	$ 5,050,019
2004	1,425,000	4,010,519	5,435,519
2005	2,075,000	3,939,269	6,014,269
2006	2,210,000	3,835,519	6,045,519
2007	2,310,000	3,725,019	6,035,019
2008	2,420,000	3,609,519	6,029,519
2009	2,540,000	3,488,519	6,028,519
2010	2,660,000	3,361,519	6,021,519
2011	2,790,000	3,228,519	6,018,519
2012	2,930,000	3,089,019	6,019,019
2013	3,075,000	2,942,519	6,017,519
2014	3,235,000	2,788,769	6,023,769
2015	3,405,000	2,627,019	6,032,019
2016	3,590,000	2,452,512	6,042,512
2017	3,790,000	2,264,037	6,054,037
2018	4,000,000	2,065,062	6,065,062
2019	4,225,000	1,855,062	6,080,062
2020	4,460,000	1,633,250	6,093,250
2021	4,710,000	1,399,100	6,109,100
2022	4,975,000	1,151,825	6,126,825
2023	5,260,000	890,637	6,150,637
2024	5,555,000	614,487	6,169,487
2025	5,870,000	322,850	6,192,850
Total 2000 Bonds	$78,500,000	$59,354,569	$137,854,569

SCHEDULES OF OPERATION AND MAINTENANCE EXPENSES AND TAXES

Years ended December 31, 2002 and 2001

	2002	2001
OPERATION AND MAINTENANCE EXPENSES		
Pumping	$ 4,448,788	$ 4,529,938
Water treatment	6,482,921	5,729,963
Transmission and distribution	11,594,133	10,864,095
Customer accounts expenses	7,421,797	7,458,256
Administrative and general expenses	12,446,022	11,445,074
Operation expenses under (over) applied	(25,738)	7,090
Total operation and maintenance expenses	$42,367,923	$40,034,416
TAXES		
Water and fire services in lieu of taxes	$ 8,051,931	$ 8,028,696
Social security taxes	1,915,696	1,761,783
State unemployment taxes	4,584	6,601
Payroll taxes allocated	(1,806,446)	(1,780,895)
Total taxes	$ 8,165,765	$ 8,016,185

CORPORATE INFORMATION

Board of Water Works

The Board of Water Works is composed of seven members:

- Four appointed by the City of Louisville to serve staggered four-year terms;
- Two appointed by Jefferson County to serve staggered five-year terms; and
- The Mayor of Louisville, who serves ex officio.

The Board of Water Works meets the second Tuesday of each month at 12:30 pm at 550 South Third Street. The President of Louisville Water Company serves as Chairman of the Board, without a vote. At its meeting each April, the Board appoints the officers of the company.

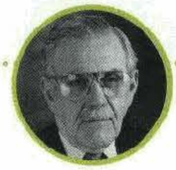
David L. Armstrong
Mayor, City of Louisville
(ex officio)

Phillip D. Bond
Vice President for Finance and Administration
Metro United Way
City Representative
Term Expires: 04/10/04

Stewart E. Conner
Managing Partner
Wyatt, Tarrant & Combs
County Representative
Term Expires: 03/31/05

Stephen C. Gault
Stephen C. Gault Co.
Founder
City Representative
Term Expires: 10/31/03

Owen C. Hammons
Retired
United Auto Workers
County Representative
Term Expires: 03/31/03



Jack H. Segell
President
Jack H. Segell Corporation
City Representative
Term Expires: 09/20/05

Wendy C. Welsh
Senior Vice President, Information Technology
LG&E Energy Corp.
City Representative
Term Expires: 01/30/04

EXECUTIVE LEADERSHIP TEAM

Front row: Laura Douglas, Vice President, General Counsel and Secretary; Billy Meeks, President AFSCME Local 1683; John Huber, President and Chief Executive Officer; Robert K. Miller, Vice President and Treasurer, Business Resourcing; Back row: Karla Olson Teasley, Vice President, Serving Customers and Business Development; Steven A. Hubbs, Vice President, New Technology; Susan Lehmann, Vice President, Human Resources and Organizational Effectiveness; Gregory C. Heitzman, Vice President, Chief Engineer, Operations

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