

Modern Electric Water Company

2006 ANNUAL REPORT

PRESIDENT'S REPORT

Modern Electric Water Company has had a successful year in 2006. With all the new construction there have been a record number of new connections both residential and commercial.

We continued our on going programs of maintenance and improvement of our infrastructure in the electric and water departments. The SCADA system for the water department has been updated and is in service. This system monitors and controls the water system, the pumps and reservoirs, and stores data used to make adjustments from the central office. Our new substation has been energized. Also we will be offering online bill paying in 2007.

All of these projects strengthen our systems and with our dedicated employees provide efficient and low cost service to our shareholders. During the major windstorm there were very few outages, and not long-lasting.

The Bonneville Power Administration (BPA) raised our wholesale rate by 26.4% in October. This, along with more regulations and other higher costs, will make 2007 challenging to continue to provide excellent service at a reasonable cost.

With all these accomplishments we continue to be financially sound, and to maintain substantial assets for future projects.

We are fortunate to have highly trained and dedicated employees here at Modern Electric Water Company. They strive to give courteous service to our shareholders at the most reasonable rates in our area.

Again, I commend them, my fellow board members, and our attorney James Wolff for their cooperation. Their efforts make Modern Electric Water Company an excellent utility.

Dr. James G. Bourekis
President
Board of Directors

INDEPENDENT AUDITORS' REPORT

To the Board of Directors
Modern Electric Water Company
Spokane Valley, Washington

We have audited the accompanying balance sheets of Modern Electric Water Company as of September 30, 2006 and 2005, and the related statements of income, retained earnings, 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 audits to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Modern Electric Water Company as of September 30, 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.

Anderson, Peretti & Co.
Certified Public Accountants, P.S.
Spokane Valley, Washington
February 9, 2007

MODERN ELECTRIC WATER COMPANY**BALANCE SHEETS**

September 30, 2006 and 2005

| | <u>2006</u> | <u>2005</u> |
|---|----------------------|----------------------|
| ASSETS | | |
| UTILITY PLANT (Note 2) | | |
| Land | \$ 540,172 | \$ 540,172 |
| Buildings & grounds | 3,401,479 | 3,370,359 |
| Equipment & vehicles | 2,352,886 | 2,398,566 |
| Tanks, towers & plant | 6,639,739 | 6,637,030 |
| Water system | 8,412,719 | 8,239,194 |
| Electric system | 15,601,750 | 14,025,366 |
| Construction in process | - | 881,367 |
| | <u>\$ 36,948,745</u> | <u>\$ 36,092,054</u> |
| Less depreciation reserve | 17,587,357 | 16,548,710 |
| Net utility plant | <u>\$ 19,361,388</u> | <u>\$ 19,543,344</u> |
| PLANT REPLACEMENT AND IMPROVEMENT FUNDS (Note 4) | | |
| | <u>\$ 13,571,378</u> | <u>\$ 10,059,233</u> |
| OTHER ASSETS | | |
| Deferred charges (Note 6) | \$ 38,587 | \$ 2,158 |
| Prepaid pension (Note 5) | 428,846 | 548,000 |
| Deposits | 38,639 | 28,814 |
| | <u>\$ 506,072</u> | <u>\$ 578,972</u> |
| CURRENT ASSETS | | |
| Cash and equivalents | \$ 1,816,786 | \$ 2,455,804 |
| Receivables (Note 1): | | |
| Customer accounts | 1,437,038 | 1,223,079 |
| Other | 130,000 | 389,288 |
| Inventory (Note 1) | 322,500 | 291,736 |
| Prepaid expenses | 93,207 | 87,305 |
| Total current assets | <u>\$ 3,799,531</u> | <u>\$ 4,447,212</u> |
| | <u>\$ 37,238,369</u> | <u>\$ 34,628,761</u> |

See Notes to Financial Statements.

| | <u>2006</u> | <u>2005</u> |
|--|----------------------|----------------------|
| STOCKHOLDERS' EQUITY (Note 3) | | |
| Capital stock \$1 par value | \$ 3,153 | \$ 3,152 |
| Paid-in capital & earnings retained prior to 1963 | 2,113,957 | 2,113,957 |
| Paid-in capital since 1963 | 44,371 | 44,371 |
| Earnings retained 1963-2006 | 33,322,342 | 29,964,831 |
| Accumulated comprehensive income (Note 4) | <u>118,429</u> | <u>(41,143)</u> |
| | <u>\$ 35,602,252</u> | <u>\$ 32,085,168</u> |

LIABILITIES

CURRENT LIABILITIES

| | | |
|---------------------------|-----------------------------|-----------------------------|
| Accounts payable | \$ 1,186,571 | \$ 2,123,317 |
| Accrued liabilities: | | |
| Wages & vacation | 259,525 | 242,270 |
| Taxes & other | <u>190,021</u> | <u>178,006</u> |
| Total current liabilities | <u>\$ 1,636,117</u> | <u>\$ 2,543,593</u> |
| | <u><u>\$ 37,238,369</u></u> | <u><u>\$ 34,628,761</u></u> |

MODERN ELECTRIC WATER COMPANY

STATEMENTS OF INCOME

Years Ended September 30, 2006 and 2005

| | Department | |
|--------------------------------|----------------------|---------------------|
| | <u>Electric</u> | <u>Water</u> |
| OPERATING REVENUES: | | |
| Customer service | \$ 11,271,678 | \$ 1,697,718 |
| Customer construction | 82,016 | 123,883 |
| Total operating revenues | <u>\$ 11,353,694</u> | <u>\$ 1,821,601</u> |
| OPERATING EXPENSES: | | |
| Power purchases | \$ 5,703,790 | \$ 82,996 |
| General operations | 611,570 | 436,375 |
| Maintenance & repairs | 233,498 | 191,000 |
| Depreciation | 474,220 | 580,504 |
| Taxes | 551,074 | 149,751 |
| Total operating expenses | <u>\$ 7,574,152</u> | <u>\$ 1,440,626</u> |
| Income before | | |
| administrative expenses | <u>\$ 3,779,542</u> | <u>\$ 380,975</u> |

Administrative expenses (Note 8)

Income from operations

OTHER INCOME (EXPENSE):

Investment income
Other income (expense)
Total other income

Net income

STATEMENTS OF RETAINED EARNINGS

Years Ended September 30, 2006 and 2005

| | | |
|--------------------|-----------------------------|-----------------------------|
| Balance, beginning | \$ 29,964,831 | \$ 27,507,991 |
| Add net income | 3,357,511 | 2,456,840 |
| Balance, ending | <u><u>\$ 33,322,342</u></u> | <u><u>\$ 29,964,831</u></u> |

| 2006 TOTAL | 2005 TOTAL |
|---------------|---------------|
| \$ 12,969,396 | \$ 11,997,517 |
| 205,899 | 233,161 |
| \$ 13,175,295 | \$ 12,230,678 |
| | |
| \$ 5,786,786 | \$ 5,604,585 |
| 1,047,945 | 1,047,103 |
| 424,498 | 377,330 |
| 1,054,724 | 1,033,175 |
| 700,825 | 659,706 |
| \$ 9,014,778 | \$ 8,721,899 |
| | |
| \$ 4,160,517 | \$ 3,508,779 |
| (1,441,778) | (1,296,585) |
| \$ 2,718,739 | \$ 2,212,194 |
| | |
| \$ 664,193 | \$ 469,355 |
| (25,421) | (224,709) |
| \$ 638,772 | \$ 244,646 |
| | |
| \$ 3,357,511 | \$ 2,456,840 |

See Notes to Financial Statements.

MODERN ELECTRIC WATER COMPANY
STATEMENTS OF CASH FLOWS
Years Ended September 30, 2006 and 2005

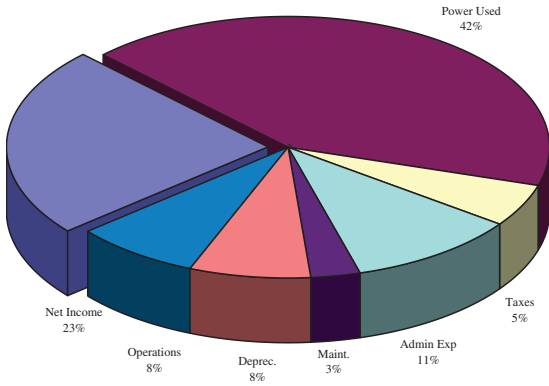
| | 2006 | 2005 | |
|---------------------------------|------------------|------------------|--|
| CASH FLOWS FROM | | | |
| OPERATING ACTIVITIES: | | | |
| Cash from customers | \$ 12,961,335 | \$ 12,358,709 | |
| Cash paid for operations | (10,055,638) | (7,245,552) | |
| Investment income received | 13,656 | 15,922 | |
| Net cash from operations | \$ 2,919,353 | \$ 5,129,079 | |
| CASH FLOWS FROM | | | |
| INVESTING ACTIVITIES: | | | |
| Proceeds from sale of assets | \$ 64,430 | \$ 8,245 | |
| Purchase of: | | | |
| Buildings & grounds | (31,120) | - | |
| Equipment & vehicles | (77,926) | (271,306) | |
| Tanks, towers & plant | (2,709) | (236,218) | |
| Water system | (194,446) | (392,566) | |
| Electric system | (743,017) | (1,292,032) | |
| Other receivables | - | 1,127 | |
| Purchase of plant funds | (2,535,000) | (1,620,000) | |
| Deferred Charges | (38,583) | - | |
| Net cash used in investing | \$ (3,558,371) | \$ (3,802,750) | |
| Increase (decrease) in cash | \$ (639,018) | \$ 1,326,329 | |
| Beginning cash | 2,455,804 | 1,129,475 | |
| Ending cash | \$ 1,816,786 | \$ 2,455,804 | |

See Notes to Financial Statements.

| | <u>2006</u> | <u>2005</u> |
|--|---------------------|---------------------|
| RECONCILIATION OF NET INCOME TO CASH FROM OPERATING ACTIVITIES: | | |
| Net income | \$ 3,357,511 | \$ 2,456,840 |
| Adjustments to reconcile net income to cash from operations: | | |
| (Gain) loss on sale of fixed assets | (51,018) | 203,286 |
| Depreciation & amortization | 1,219,920 | 1,204,762 |
| Reinvested investment income | (817,573) | (315,994) |
| (Increase) decrease in assets: | | |
| Accounts receivable | (213,959) | 75,787 |
| Other receivables | 259,288 | (85,194) |
| Inventory | (30,765) | (19,522) |
| Prepaid expenses | (5,902) | (2,281) |
| Prepaid pension | 119,154 | 46,780 |
| Deposits | (9,825) | (19,821) |
| Increase (decrease) in liabilities: | | |
| Accounts payable | (936,747) | 1,540,791 |
| Accrued liabilities | 29,269 | 43,645 |
| Net cash from operations | <u>\$ 2,919,353</u> | <u>\$ 5,129,079</u> |

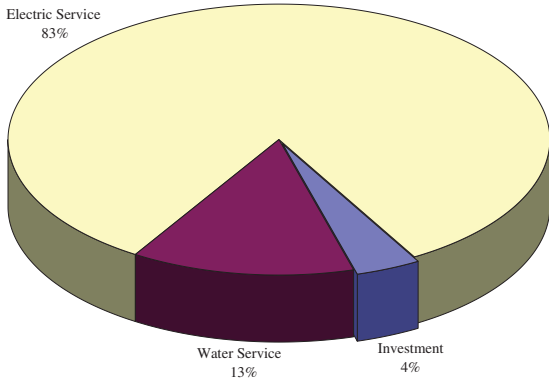
What was done with Revenue

For the Year Ended September 30, 2006



Revenue

For the Year Ended September 30, 2006



MODERN ELECTRIC WATER COMPANY

NOTES TO FINANCIAL STATEMENTS

NOTE 1. NATURE OF BUSINESS AND SIGNIFICANT ACCOUNTING POLICIES

Nature of business:

The Company operates an electric and water utility company in Spokane Valley, Washington.

A summary of the Company's significant accounting policies follows:

Revenue recognition:

The Company realizes revenue from electric service monthly as the charges are earned. Water service and estimated usage are also billed monthly. Actual water usage is determined in May, July, and September at which time water billings are adjusted accordingly.

Accounts receivable:

The allowance for bad debt reserve was zero at year end. Unpaid accounts receivable create a lien against the property and are therefore adequately secured. Receivables ninety days or more past due were \$19,227 and \$27,329 as of September 30, 2006 and 2005, respectively.

Cash and cash equivalents:

For the purposes of reporting the statements of cash flows, the Company considers all cash accounts, which are not subject to withdrawal restrictions or penalties, and all highly liquid debt instruments purchased with a maturity of three months or less to be cash equivalents.

The Company maintains its cash accounts in various banks located in Spokane Valley, Washington. Accounts at each bank are guaranteed by the Federal Deposit Insurance Corporation (FDIC) up to \$100,000 per bank. A summary of the total insured and uninsured cash balances follows:

| | <u>2006</u> | <u>2005</u> |
|----------------------------|---------------------|---------------------|
| Total cash in all banks | \$ 1,816,786 | \$ 2,455,804 |
| Portion insured by FDIC | <u>300,000</u> | <u>200,000</u> |
| Uninsured cash balances | <u>\$ 1,516,786</u> | <u>\$ 2,255,804</u> |

NOTE 1. NATURE OF BUSINESS AND SIGNIFICANT ACCOUNTING POLICIES (continued)

Inventory:

Inventory is recorded at average cost not in excess of replacement cost.

Income tax:

The Company is a tax-exempt entity under Internal Revenue Code Section 501 (c) (12), per an exemption letter dated March 12, 1939.

Pension benefits:

The Company has a defined benefit pension plan covering certain employees who meet the eligibility requirements. To be eligible, an employee must be 21 years of age and have completed one year of service. The plan provides benefits based on the average annual compensation of the last five full years of compensation of each participant, which are subject to certain reductions if the employee retires before reaching age 65. In order to become plan participants, employees are required to contribute one percent of their pay to the plan. The employer contributes the remaining amount necessary to provide the plan's defined benefits.

In addition, the Company has a deferred compensation plan which is available to all employees. The Company matches employee contributions up to 5% of total gross compensation. The Company's contributions to this plan were \$81,985 and \$75,847 for 2006 and 2005, respectively.

Use of estimates:

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ from those estimates.

NOTE 2. UTILITY PLANT

Additions to utility plant are recorded at cost, including any applicable overhead costs. The cost of repairs and minor replacements is charged to maintenance. Gains and losses on the retirement of utility plant are included in the statements of income.

NOTES TO FINANCIAL STATEMENTS

NOTE 2. UTILITY PLANT (continued)

Depreciation is computed on the straight-line method with the following range of lives and balances:

| | Lives in Years | Reserve for Depreciation at September 30 | |
|----------------------------------|-------------------|---|----------------------|
| | | <u>2006</u> | <u>2005</u> |
| Buildings & grounds | 10-40 | \$ 759,686 | \$ 668,034 |
| Equipment & vehicles | 5-10 | 1,650,842 | 1,591,217 |
| Tanks, towers & pumping plant | 10-35 | 3,407,462 | 3,160,582 |
| Water system | 20-35 | 4,414,233 | 4,144,041 |
| Electric system | 15-40 | <u>7,355,134</u> | <u>6,984,836</u> |
| | | <u>\$ 17,587,357</u> | <u>\$ 16,548,710</u> |

NOTE 3. STOCKHOLDERS' EQUITY

The Company (a Washington corporation) is owned by the owners of the real property within its service area. The Company's authorized capital consists of 6,000 shares of \$1 par value stock. Stock certificates, as such, are not issued to each owner, but rather ownership is vested in the deed to their property. There are 3153 acres of land which have vested ownership. Prior to December 31, 1963, the Company did not segregate retained earnings and paid-in capital. The retained earnings shown in the accompanying financial statements represent earnings retained since such date.

NOTE 4. PLANT REPLACEMENT AND IMPROVEMENT FUNDS

Management intends that these funds be used for normal replacement, expansion, and upgrading of the Company's utility plant. In addition, changes in various requirements of federal, state or local regulations could require the Company to incur substantial capital expenditures in order to comply with any such new regulations. Management's intention is to use these funds to meet such contingencies when they arise.

NOTE 4. PLANT REPLACEMENT AND IMPROVEMENT FUNDS (continued)

The Company has invested the funds in debt and equity securities. Debt securities consist primarily of obligations of the U.S. and state governments, and domestic corporations. Any premiums or discounts on debt securities are amortized over their contract lives. Equity securities are held in managed fund portfolios. Since the Company neither buys investment securities in anticipation of short-term fluctuations in market prices nor absolutely commits to holding securities to maturity, these investments are classified as available-for-sale in accordance with FASB 115 and are stated at market value. A summary of cost, market value and unrealized gains at September 30, 2006 and 2005 for these investments follows:

| | Securities Amortized Cost | Net Unrealized Gain (Loss) | Securities Market Value |
|-------------|--|---|--|
| 2006 | | | |
| Debt | \$ 9,636,511 | \$ (96,533) | \$ 9,539,978 |
| Equity | 3,816,438 | 214,962 | 4,031,400 |
| | <u>\$ 13,452,949</u> | <u>\$ 118,429</u> | <u>\$ 13,571,378</u> |
| 2005 | | | |
| Debt | \$ 8,165,347 | \$ (139,515) | \$ 8,025,832 |
| Equity | 1,935,029 | 98,372 | 2,033,401 |
| | <u>\$ 10,100,376</u> | <u>\$ (41,143)</u> | <u>\$ 10,059,233</u> |

Net comprehensive income during the years ended September 30, 2006 and 2005 is \$159,572 and \$(116,354), respectively. Net comprehensive income consists of unrealized holding gains (losses) arising during the year of \$12,087 and \$(174,744), respectively, and reclassification adjustment for net realized gains (losses) included in net income for the year of \$147,485 and \$58,390, respectively. Accumulated comprehensive income at September 30, is \$118,429 and \$(41,143), respectively.

The amortized cost and market value of debt securities, by contractual maturities, as of September 30, 2006 are as follows:

| | Amortized Cost | Market Value |
|--|---------------------------|-------------------------|
| Due in one year or less | \$ 1,300,819 | \$ 1,300,819 |
| Due after one year through five years | 1,222,920 | 1,251,732 |
| Due after five years | 7,112,772 | 6,987,427 |
| | <u>\$ 9,636,511</u> | <u>\$ 9,539,978</u> |

NOTES TO FINANCIAL STATEMENTS

NOTE 5. DEFINED BENEFIT PENSION PLAN

Net pension cost for the Company's defined benefit pension plan consisted of the following components for the years ended 2006 and 2005:

| | 2006 | 2005 |
|---|-------------|-------------|
| Service cost (benefits earned) | \$ 199,555 | \$ 163,731 |
| Interest cost on projected benefit obligation | 133,504 | 119,351 |
| Actual return on plan assets | (157,037) | (150,521) |
| Net amortization and deferral | 140,753 | 110,335 |
| Employee contributions | (17,621) | (16,117) |
| | \$ 299,154 | \$ 226,779 |

The following table sets forth the plan's funded status as of September 30, 2006 and 2005 and the amount recognized in the accompanying balance sheets as of September 30:

| | 2006 | 2005 |
|--|---------------|---------------|
| Actuarial present value of benefit obligations: | | |
| Vested benefits | \$ 1,578,220 | \$ 1,359,466 |
| Accumulated benefits | \$ 1,596,154 | \$ 1,372,591 |
| Projected benefits | \$(2,482,279) | \$(2,244,715) |
| Plan assets at fair value | 1,837,362 | 1,522,006 |
| Plan assets less than projected benefit obligation | \$ (644,917) | \$ (722,709) |
| Unrecognized net loss | 893,859 | 1,055,457 |
| Unrecognized prior service cost | 179,904 | 215,252 |
| Unrecognized transition asset | - | - |
| Intangible pension asset | - | - |
| Asset (accrual) on balance sheet | \$ 428,846 | \$ 548,000 |

The discount rate and rate of increase in future compensation levels used in determining the actuarial present value of the benefit obligations were 6.0% and 4.5%, respectively, at September 30, 2006. The expected long-term rate of return on plan assets used in 2006 was 6.0%.

NOTE 6. PLANT SYSTEM STUDIES

The Company has undertaken planning and rate studies in order to anticipate the future growth and demand requirements of its service area. The costs of these studies are being amortized 5 years and are reported at cost net of accumulated amortization. At September 30, 2006, the current year and accumulated amortization was \$2,158 and \$0.

NOTE 6. PLANT SYSTEM STUDIES (continued)

respectively. At September 30, 2005, the current year and accumulated amortization was \$7,843 and \$37,254, respectively.

The current plan has been completely amortized and removed from the books as of 9/30/2006. A new Comprehensive Water System Plan has been completed and will become effective 1/1/2007. The balance of \$38,587 represents prepayment on the new plan.

NOTE 7. COMMITMENTS

All water utilities in the State are required by the Washington Health Department to submit an updated comprehensive water plan outlining the strategies the companies will implement over a six year period to insure their compliance with new regulations. Modern Electric Water Company will be required to submit, and is currently working on an updated plan for the six year period commencing January 2007.

Effective October 1, 2001, the Company entered into a five-year agreement to purchase all of its electrical power from Bonneville Power Administration.

The Company has entered into an additional agreement with Bonneville Power Administration to purchase power for the period October 1, 2006 through September 30, 2011.

NOTE 8. ADMINISTRATIVE EXPENSES

| | <u>2006</u> | <u>2005</u> |
|--------------------------------|---------------------|---------------------|
| General office wages & expense | \$ 560,735 | \$ 492,571 |
| Taxes | 51,591 | 47,876 |
| Office supplies & maint. | 96,847 | 79,085 |
| Public relations | 37,470 | 69,940 |
| Dues & subscriptions | 47,313 | 45,382 |
| Pension plan | 198,169 | 161,237 |
| Postage | 50,997 | 50,390 |
| Accounting & legal fees | 78,121 | 52,052 |
| Insurance | 51,013 | 44,767 |
| Medical plan costs | 88,279 | 74,146 |
| Transportation costs | 5,663 | 3,938 |
| Company power usage | 12,542 | 11,457 |
| Depreciation | 163,038 | 163,744 |
| | <u>\$ 1,441,778</u> | <u>\$ 1,296,585</u> |

GENERAL MANAGER'S REPORT

2006 was a year that was filled with both challenges and accomplishments. We connected a high number of new single family residents along with new multi-family and commercial connections. Even with the large number of new connections, we were still able to continue our aggressive maintenance program in both our electric and water facilities. This included replacement of water mains, electric poles, wire and other equipment.

As mentioned in the President's Report, Bonneville Power Administration (BPA) increased our wholesale power rate. This 26.4% increase was substantial. But because of MEWCO and other utilities in the region that worked with BPA, the increase was reduced to about half of what was originally proposed. This increase has a major impact on MEWCO and its customers because our purchased power cost accounts for half of our total expenditures on an annual basis. We have worked hard in the past several years to prepare for this large increase, which will result in a small rate increase to our customers this spring.

As we look to this coming year and future years, we know they will be both demanding yet fulfilling. We expect another busy year for new service connections. We will continue our maintenance on both our water and electric system to insure that we continue to provide safe and dependable water and electric services. We will also complete our six-year water comprehensive plan that will show our long term assessment and needs for our water system. Administratively, we will be updating our various computer systems.

Local, state and federal regulations are increasing. These regulations could increase our costs of doing business. But more importantly, through regulations, we can lose some of our local control in

the operation of Modern Electric Water Company. We will work very hard in keeping local control because our customers should have the say in how MEWCO is run, not lawmakers and policy makers in Olympia or in Washington D.C.

With our dedicated and highly skilled employees, along with a very caring and supportive Board of Directors, I am confident that we can meet these challenges. MEWCO is still debt free with adequate reserves and low rates. We have a very good team of employees, management, Board of Directors and supportive customers. Our future is bright for MEWCO to serve our customers and to provide safe and reliable electric and water service at the lowest possible cost. It is an honor to be your General Manager.

Always, working for you,

A handwritten signature in black ink that reads "Mike Baker". The signature is written in a cursive, flowing style.

Mike Baker
General Manager

Modern Electric Water Company

P.O. Box 14008

Spokane Valley, WA 99214-0008

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