

**FINANCIAL AUDIT OF THE
CITY AND COUNTY OF HONOLULU
SEWER FUND**

Fiscal Years Ended June 30, 2006 and 2005

**CITY AND COUNTY OF HONOLULU
SEWER FUND**

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INDEPENDENT AUDITORS' REPORT

To the Chair and Members of the City Council
City and County of Honolulu
Honolulu, Hawaii

We have audited the accompanying statements of net assets of the Sewer Fund, City and County of Honolulu (Sewer Fund) as of June 30, 2006 and 2005, and the related statements of revenues, expenses and changes in net assets, and cash flows for the fiscal years then ended. These financial statements are the responsibility of the management of the Sewer Fund. 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.

As discussed in Note A, the financial statements of the Sewer Fund, are intended to present the financial position, and the changes in financial position and cash flows, of only that portion of the business-type activities of the City and County of Honolulu that is attributable to the transactions of the Sewer Fund. They do not purport to, and do not, present fairly the financial position of the City and County of Honolulu as of June 30, 2006 and 2005, and the changes in its financial position and its cash flows for the fiscal years then ended in conformity with accounting principles generally accepted in the United States of America.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Sewer Fund as of June 30, 2006 and 2005, and the changes in its financial position and its cash flows for the fiscal years then ended in conformity with accounting principles generally accepted in the United States of America.

NISHIHAMA & KISHIDA, CPAs, INC.
CERTIFIED PUBLIC ACCOUNTANTS

The Management's Discussion and Analysis is not a required part of the basic 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 supplementary information. However, we did not audit the information and express no opinion on it.

Nishihama & Kishida, CPAs, Inc.

Honolulu, Hawaii
December 8, 2006

**City and County of Honolulu Sewer Fund
MANAGEMENT'S DISCUSSION AND ANALYSIS
Fiscal Years Ended June 30, 2006 and 2005**

The following summary discussion and analysis of the financial statements, for fiscal years ended June 30, 2006 and 2005, are provided by the City and County of Honolulu's Wastewater Enterprise. The summary is designed to provide an introduction to the financial statements and the financial condition of the Wastewater Enterprise. We encourage readers to also review the financial statements as a whole.

Financial Highlights

- 115.8 million gallons per day of wastewater were collected and treated in fiscal year 2006, an increase of 3.1% from fiscal year 2005 reflecting slightly more wet weather. There were 112.3 million gallons per day of wastewater collected and treated in fiscal year 2005, a decrease of 8.2% from fiscal year 2004 reflecting a more normal weather pattern. As of June 30, 2006, the Wastewater Enterprise had approximately 140,000 customer accounts and served approximately 640,000 residents.
- Total assets were \$1,654.8 million and exceeded total liabilities by \$666.4 million as of June 30, 2006. As of June 30, 2005, total assets were \$1,498.8 million and exceeded total liabilities by \$655.6 million. As of June 30, 2006, net assets (difference between assets and liabilities) increased by \$10.8 million, or 1.7% from June 30, 2005, while net assets as of June 30, 2005, decreased by \$16.1 million, or 2.4%, from June 30, 2004. The increase in net assets in 2006 was primarily due to increased cash and the decrease in net assets in 2005 was primarily due to decreased cash and depreciation of capital assets.
- As of June 30, 2006, total assets increased by \$156 million to \$1,654.8 million, representing a 10.4% increase from the prior fiscal year, while total assets decreased by \$34.7 million to \$1,498.8 million at June 30, 2005, representing a 2.3% decrease from June 30, 2004. The increase in fiscal year 2006 was primarily due to increased cash and additional capital assets. The decrease in fiscal year 2005 was primarily due to depreciation of capital assets.
- Total current assets increased by 190%, or \$91.3 million, to \$139.4 million at June 30, 2006, while current assets decreased by 67.7% or \$101.0 million to \$48.1 million at June 30, 2005. The increase in 2006 was primarily due to the addition of revenue bond proceeds. The decrease in 2005 was primarily due to expenditure of revenue bond proceeds for the acquisition and construction of capital assets.
- Total current liabilities increased by 4.7% or \$2.5 million to \$57.0 million primarily due to an increase in accounts and interest payable. At June 30, 2006, total liabilities increased 17.2%, or \$145.1 million, to \$988.3 million due to the issuance of additional long-term debt. At June 30, 2005, total current liabilities decreased by 3.2% or \$1.8 million to \$54.5 million primarily due to a reduction in accounts payable. Total liabilities also decreased by 2.2% or \$18.6 million to \$843.2 million due to the repayment of long-term debt.

Overview of the Financial Statements

This discussion and analysis are intended to serve as an introduction to the Wastewater Enterprise's financial statements, which consist of the basic financial statements and notes to the financial statements.

**City and County of Honolulu Sewer Fund
MANAGEMENT'S DISCUSSION AND ANALYSIS
Fiscal Years Ended June 30, 2006 and 2005**

Basic financial statements. The basic financial statements are designed to provide readers with a broad overview of the Wastewater Enterprise's finances, in a manner similar to a private-sector business.

The statements of net assets presents information on the Wastewater Enterprise's assets and liabilities, with the difference reported as net assets. Over time, increases or decreases in net assets may serve as a useful indicator of whether the financial position of the Wastewater Enterprise is improving or deteriorating. Net assets increase when revenues and subsidies exceed expenses. Increases to assets without a corresponding increase to liabilities, results in increased net assets, which indicate an improved financial position.

The statements of revenues, expenses, and changes in net assets present information showing how the Wastewater Enterprise's net assets changed during the past two fiscal years. All changes in net assets are reported as soon as the underlying event occurs, regardless of timing of related cash flows. Thus, revenues and expenses are reported in this statement for some items that will result in cash flows in future fiscal periods (e.g., earned but unused vacation leave).

The statements of cash flows presents changes in cash and cash equivalents, resulting from operating, non-capital, capital and related financing, and investing activities. This statement presents cash receipts and cash disbursements information, without consideration of the earnings event, when an obligation arises, or depreciation of capital assets.

Notes to the financial statements. The notes provide additional information that is essential to a full understanding of the data provided in the basic financial statements.

Financial Analysis

The following are the highlights of the condensed statements of net assets (in thousands of dollars) for the Wastewater Enterprise:

Net Assets

	<u>2006</u>	<u>2005</u>	<u>2004</u>
Current assets	\$ 139,444	\$ 48,099	\$ 149,097
Capital assets, net	1,513,603	1,450,690	1,384,386
Other noncurrent assets	<u>1,717</u>	<u>--</u>	<u>--</u>
Total assets	<u>\$ 1,654,764</u>	<u>\$ 1,498,789</u>	<u>\$ 1,533,483</u>
Current liabilities	\$ 57,039	\$ 54,492	\$ 56,276
Noncurrent liabilities	<u>931,309</u>	<u>788,715</u>	<u>805,550</u>
Total liabilities	<u>988,348</u>	<u>843,207</u>	<u>861,826</u>
Invested in capital assets, net of related debt	\$ 600,603	\$ 648,889	\$ 638,114
Restricted for debt service	35,425	26,882	22,584
Unrestricted	<u>30,388</u>	<u>(20,189)</u>	<u>10,959</u>
Total net assets	<u>666,416</u>	<u>655,582</u>	<u>671,657</u>
Total liabilities and net assets	<u>\$ 1,654,764</u>	<u>\$ 1,498,789</u>	<u>\$ 1,533,483</u>

**City and County of Honolulu Sewer Fund
MANAGEMENT'S DISCUSSION AND ANALYSIS
Fiscal Years Ended June 30, 2006 and 2005**

Net assets (the difference between assets and liabilities) may serve, over time, as a useful indicator of a government's financial position. In the case of the Wastewater Enterprise, assets exceeded liabilities by \$666.4 million and \$655.6 million at the end of fiscal years 2006 and 2005, respectively. Continued depreciation of capital assets and fiscal year 2004 transfers to the City's general fund in fiscal year 2004 resulted in a 2.4% reduction in net assets from fiscal year 2004 to 2005. The largest portion of the Wastewater Enterprise's net assets represented its investment in capital assets (e.g., land, buildings, transmission and distribution system, etc.). The Wastewater Enterprise uses these capital assets to provide wastewater services on the Island of Oahu and consequently, capital assets are not available to liquidate liabilities or other spending.

The following are the highlights of the condensed statements of revenues, expenses and changes in net assets:

Changes in Net Assets

	<u>2006</u>	<u>2005</u>	<u>2004</u>
Operating revenues	\$ 151,200	\$ 118,893	\$ 115,032
Operating expenses	<u>(107,437)</u>	<u>(98,973)</u>	<u>(93,911)</u>
Operating income	<u>43,763</u>	<u>19,920</u>	<u>21,121</u>
Nonoperating revenues (expenses):			
Interest income	4,166	1,590	1,540
Interest expense	(29,556)	(27,677)	(26,573)
Other	<u>(3,249)</u>	<u>(4,801)</u>	<u>(3,168)</u>
	<u>(28,639)</u>	<u>(30,888)</u>	<u>(28,201)</u>
Income(loss) before transfers and contributed capital	15,124	(10,968)	(7,080)
Transfers out	(6,963)	(6,255)	(31,078)
Contributed capital	<u>2,673</u>	<u>1,148</u>	<u>1,443</u>
Change in net assets	10,834	(16,075)	(36,715)
Net assets			
Beginning of Fiscal Year	<u>655,582</u>	<u>671,657</u>	<u>708,372</u>
End of Fiscal Year	\$ <u>666,416</u>	\$ <u>655,582</u>	\$ <u>671,657</u>

The changes in net assets were primarily due to:

- Operating revenues, comprised mainly of sewer service charges, increased 27.2% to \$151.2 million for the fiscal year 2006 compared to the prior fiscal year and increased 3.4% to \$118.9 million for fiscal year 2005 compared to fiscal year 2004. Sewer service charge rates were raised 25 percent effective July 1, 2005.

**City and County of Honolulu Sewer Fund
MANAGEMENT'S DISCUSSION AND ANALYSIS
Fiscal Years Ended June 30, 2006 and 2005**

- Operating expenses increased \$8.5 million, or 8.6%, to \$107.4 million for fiscal year 2006 compared to the prior fiscal year and increased \$5.1 million or 5.4% to \$99.0 million for fiscal year 2005 compared to fiscal year 2004. The primary increase in 2006 was in utilities. The majority of the increase in 2005 was due to increases in fringe benefit costs, materials and supplies, and utilities.
- Interest expense increased by \$1.9 million or 6.9% to \$29.6 million for fiscal year 2006 compared to the prior fiscal year and increased by \$1.1 million or 4.2% to \$27.7 million for fiscal year 2005 compared to fiscal year 2004. The increase in 2006 and in 2005 was due to higher interest on 2003 variable rate bonds.
- Contributed capital increased to \$2.7 million in fiscal year 2006 after being generally constant at \$1 million in fiscal year 2005 and 2004. Contributed capital represents assets (primarily capital assets) transferred from other city governmental funds and other entities.
- The Wastewater Enterprise transferred to the City its share of central administrative expenses (CASE). Transfers for CASE increased by \$708.0 thousand or 11.3% to \$7.0 million for fiscal year 2006 after being generally constant at \$6.0 million for fiscal years 2005 and 2004.

Capital Asset and Debt Administration

Capital assets. The Wastewater Enterprise's investment in capital assets amounted to \$1.51 billion and \$1.45 billion, net of accumulated depreciation, as of June 30, 2006 and 2005, respectively, an increase of \$62.9 million, or 4.3%, in 2006, and \$66.3 million, or 4.8%, in 2005. Capital assets include land, buildings, infrastructure, land improvements, equipment, and machinery for the 8 treatment plants, 68 pumping stations, and over 2,100 miles of sewer line that make up the Wastewater Enterprise. Capital assets are added, rehabilitated, or replaced according to the infrastructure and facilities twenty-year capital plan.

Long-term debt. Wastewater revenue bonds and State revolving fund loans are the primary long-term financing instruments used to fund the acquisition of capital assets. Senior Series Wastewater System Revenue Bonds of \$152.8 million were issued in August 2005. Revenue bonds outstanding as of June 30, 2006 and 2005, totaled \$838.2 million and \$679.4 million, respectively. State revolving fund notes payable outstanding at June 30, 2006 and 2005, totaled \$68.3 million and \$74.1 million, respectively.

Debt service coverage was 584% on Senior Revenue Bonds, 310% on all revenue bonds, and 235% on all debt for fiscal year 2006, compared to 440% on Senior Revenue Bonds, 212% on all revenue bonds, and 120% on all debt at June 30, 2005. Debt service coverage exceeded the requirements of bond covenants and policies of the City Council in 2006 and 2005.

**City and County of Honolulu Sewer Fund
MANAGEMENT'S DISCUSSION AND ANALYSIS
Fiscal Years Ended June 30, 2006 and 2005**

The Wastewater Enterprise issued \$340.8 million in Senior Lien Wastewater Revenue Bonds in September 2006. The proceeds will be used to fund the acquisition and construction of capital assets and to refund existing debt. These insured bonds were rated Aaa by Moody's Investor Services, AAA by Fitch, Inc., and AAA by Standard & Poor's. Underlying ratings were Aa3 by Moody's Investor Services, AA- by Fitch, Inc., and AA- by Standard & Poor's.

Additional information on the Wastewater Enterprise's capital assets and long-term debt can be found in the notes to the financial statements.

Requests for Information

Questions concerning any of the information provided in this report or requests for additional financial information should be addressed to the City and County of Honolulu, Department of Environmental Services, 1000 Uluohia Street, Suite 308, Kapolei, Hawaii 96707.

City and County of Honolulu
Sewer Fund
STATEMENTS OF NET ASSETS
June 30, 2006 and 2005

	2006	2005
ASSETS		
CURRENT ASSETS		
Cash and cash equivalents	\$ 34,350,119	\$ 15,524,365
Investments	75,342,745	8,362,316
Receivables		
Accounts (net of allowance for uncollectible accounts of \$884,480 and \$603,440 in 2006 and 2005, respectively)	20,875,187	15,735,258
Interest	995,336	99,991
Due from other City funds	3,966,692	4,168,922
Inventories of materials and supplies	3,914,525	4,207,712
Total current assets	139,444,604	48,098,564
NON-CURRENT ASSETS		
Capital assets, net	1,513,603,037	1,450,690,569
Deferred charges	1,716,561	--
Total non-current assets	1,515,319,598	1,450,690,569
Total assets	\$ 1,654,764,202	\$ 1,498,789,133
LIABILITIES AND NET ASSETS		
CURRENT LIABILITIES		
Accounts payable	\$ 19,221,127	\$ 12,917,615
Due to other City funds	26,368	--
Interest payable	18,120,300	11,830,210
Bonds payable	13,096,814	13,162,769
Tax-exempt commercial paper	--	10,021,810
Notes payable	6,043,972	5,893,627
Other current liabilities	530,007	666,441
Total current liabilities	57,038,588	54,492,472
LONG-TERM OBLIGATIONS		
Notes payable	62,294,325	68,229,803
General obligation bonds payable	29,477,595	38,811,946
Revenue bonds payable, net	834,458,623	675,817,146
Other liabilities	5,079,114	5,855,883
Total long-term obligations	931,309,657	788,714,778
Total liabilities	988,348,245	843,207,250
NET ASSETS		
Invested in capital assets, net of related debt	600,603,105	648,888,754
Restricted for debt service	35,424,715	26,882,150
Unrestricted	30,388,137	(20,189,021)
Total net assets	666,415,957	655,581,883
	\$ 1,654,764,202	\$ 1,498,789,133

See accompanying notes to financial statements.

**City and County of Honolulu
Sewer Fund
STATEMENTS OF REVENUES, EXPENSES AND CHANGES IN NET ASSETS
Fiscal Years Ended June 30, 2006 and 2005**

	<u>2006</u>	<u>2005</u>
OPERATING REVENUES		
Sewer service charges	\$ 142,167,282	\$ 112,746,081
Other revenue	<u>9,033,041</u>	<u>6,147,085</u>
Total operating revenues	<u>151,200,323</u>	<u>118,893,166</u>
OPERATING EXPENSES		
Depreciation	31,438,992	30,647,375
Administrative and general	33,762,368	30,361,702
Fringe benefits	11,875,666	11,344,034
Contractual services	9,950,309	8,836,785
Utilities	11,757,297	8,829,678
Materials and supplies	6,430,793	6,598,580
Fuel and lubricants	2,048,691	2,179,201
Maintenance	<u>173,636</u>	<u>175,808</u>
Total operating expenses	<u>107,437,752</u>	<u>98,973,163</u>
Operating income	<u>43,762,571</u>	<u>19,920,003</u>
NONOPERATING REVENUES (EXPENSES)		
Interest income	4,165,568	1,589,524
Interest expense	(29,555,658)	(27,676,643)
Other	<u>(3,248,704)</u>	<u>(4,801,592)</u>
Total nonoperating expenses	<u>(28,638,794)</u>	<u>(30,888,711)</u>
Income (loss) before transfers and contributed capital	15,123,777	(10,968,708)
TRANSFERS OUT	(6,962,500)	(6,254,500)
CAPITAL CONTRIBUTIONS	<u>2,672,797</u>	<u>1,147,927</u>
CHANGE IN NET ASSETS	10,834,074	(16,075,281)
NET ASSETS AT BEGINNING OF FISCAL YEAR	<u>655,581,883</u>	<u>671,657,164</u>
NET ASSETS AT END OF FISCAL YEAR	<u>\$ 666,415,957</u>	<u>\$ 655,581,883</u>

See accompanying notes to financial statements.

City and County of Honolulu
Sewer Fund
STATEMENTS OF CASH FLOWS
Fiscal Years Ended June 30, 2006 and 2005

	2006	2005
Cash flows from operating activities		
Cash received from customers	\$ 145,829,321	\$ 118,819,491
Cash payments to suppliers	(36,994,634)	(32,649,942)
Cash payments to employees	(31,795,437)	(38,873,895)
Receipts (payments) to other funds for internal activity	179,982	(207,360)
Other receipts (payments)	(62,159)	65,011
Net cash provided by operating activities	77,157,073	47,153,305
Cash flows from noncapital financing activities		
Transfers out	(6,962,500)	(6,254,500)
Net cash used in noncapital financing activities	(6,962,500)	(6,254,500)
Cash flows from capital and related financing activities		
Acquisition and construction of capital assets	(84,868,028)	(93,677,053)
Repayments on notes	(5,919,770)	(5,756,220)
Interest paid on notes	(2,537,301)	(2,698,616)
Proceeds from issuance of bonds, net of discount	140,002,710	17,431
Repayments on bonds	(4,588,891)	(10,768,773)
Interest paid on bonds	(29,364,769)	(29,298,851)
Net cash provided by (used in) capital and related financing activities	12,723,951	(142,182,082)
Cash flows from investing activities		
Purchase of investments	(308,280,754)	(17,568,419)
Proceeds from maturity of investments	241,300,325	72,879,463
Interest on investments	2,887,659	1,526,072
Net cash provided by (used in) investing activities	(64,092,770)	56,837,116
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	18,825,754	(44,446,161)
Cash and cash equivalents at beginning of fiscal year	15,524,365	59,970,526
Cash and cash equivalents at end of fiscal year	\$ 34,350,119	\$ 15,524,365

City and County of Honolulu
Sewer Fund
STATEMENTS OF CASH FLOWS (Continued)
Fiscal Years Ended June 30, 2006 and 2005

	2006	2005
RECONCILIATION OF OPERATING INCOME TO NET CASH PROVIDED BY OPERATING ACTIVITIES		
Operating income	\$ 43,762,571	\$ 19,920,003
Adjustments to reconcile operating income to net cash provided by operating activities		
Depreciation	31,438,992	30,647,375
Write-off of capital assets	404,003	375,921
(Increase) decrease in		
Accounts receivable	(5,139,929)	(77,623)
Due from other City funds	94,759	(279,590)
Materials and supplies inventory	293,187	502,902
Increase (decrease) in		
Accounts payable	6,303,513	(4,473,609)
Due to other City funds	26,368	--
Other liabilities	<u>(26,391)</u>	<u>537,926</u>
Net cash provided by operating activities	\$ <u>77,157,073</u>	\$ <u>47,153,305</u>

SUPPLEMENTAL DISCLOSURE OF NONCASH CAPITAL AND RELATED FINANCING ACTIVITIES

The Sewer Fund received \$2,672,797 and \$1,147,927 in contributions of capital assets from government agencies and developers, which are recorded as contributed capital at their cost or estimated cost at June 30, 2006 and 2005, respectively.

Amortization of net bond discounts and premiums amounted to \$1,455,773 and \$1,714,982 in fiscal 2006 and 2005, respectively. Amortization of bond issue costs amounted to \$96,663 and none in fiscal 2006 and 2005, respectively.

See accompanying notes to financial statements.

City and County of Honolulu
Sewer Fund
NOTES TO FINANCIAL STATEMENTS
June 30, 2006 and 2005

NOTE A - FINANCIAL REPORTING ENTITY

The Sewer Fund was established as an enterprise fund effective July 1, 1999 in conjunction with the November 1998 City Resolution 98-193, CD1, authorizing the issuance of the Wastewater System Revenue Bonds for the Wastewater System. The fund accounts for the operations of the City and County of Honolulu's (City) wastewater system.

The Sewer Fund is one of various enterprise funds of the City. The Sewer Fund's financial statements reflect only its portion of the proprietary fund type. The City's Director of Budget and Fiscal Services maintains the central accounts for all City funds and publishes financial statements for the City annually, which includes the Sewer Fund's financial activities.

NOTE B - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The accounting policies of the City for the Sewer Fund conform to generally accepted accounting principles as applicable to enterprise activities of governmental units as promulgated by the Governmental Accounting Standards Board (GASB). In accordance with GASB standards, the City has elected not to apply the Financial Accounting Standards Board pronouncements on accounting and financial reporting that were issued after November 30, 1989.

- (1) **Basis of accounting** - The accompanying financial statements are presented using the economic resources measurement focus and the accrual basis of accounting, whereby revenues and expenses are recognized in the period earned or incurred.
- (2) **Use of estimates** - The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported 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.
- (3) **Cash and cash equivalents** - Cash includes amounts in demand and time deposits primarily with various financial institutions in the State of Hawaii (State). Cash on deposit with financial institutions is collateralized in accordance with State statutes. Investments with original maturity of three months or less when purchased are considered cash equivalents.
- (4) **Investments** - Investments consist of U.S. government securities and are stated at cost, which approximates fair value.
- (5) **Inventories of materials and supplies** - Inventories of materials and supplies are stated at weighted average cost. The costs of inventories are recorded as expenditures when consumed rather than when purchased.

**City and County of Honolulu
Sewer Fund
NOTES TO FINANCIAL STATEMENTS
June 30, 2006 and 2005**

NOTE B - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

- (6) **Receivables** - Sewer service charge revenues are accrued by the City based on estimated billings for services provided through the end of the fiscal year. Receivables included estimated unbilled sewer charges amounting to approximately \$12.7 million and \$9.7 million at June 30, 2006 and 2005, respectively.
- (7) **Capital assets** - Capital assets include property, plant and equipment, including infrastructure (sewer system, network of pipes and sewer mains). Assets with an initial, individual cost of \$5,000 or more for equipment and \$100,000 for buildings, structures and infrastructure, and an estimated useful life of more than one year are capitalized. All infrastructure assets acquired prior to fiscal year ended June 30, 1980 are also capitalized. Such assets are recorded at cost or estimated cost. Interest cost is capitalized as part of the cost of acquiring certain assets.

Depreciation is calculated on a straight-line basis over the following estimated useful lives:

	<u>Years</u>
Buildings and land improvements	10 - 50
Transmission and distribution system	60
Equipment and machinery	5 - 20

Sales and retirements of depreciable property are recorded by removing the related cost and accumulated depreciation from the accounts. Gains or losses on sales and retirements of property are reflected in results of operations.

Normal maintenance and repairs that do not add to the value of the assets or materially extend asset lives are not capitalized. Betterments are capitalized and depreciated over the remaining useful lives of the related assets, as applicable.

- (8) **Bond issue costs** - Bond issue costs are deferred and are amortized over the life of the respective issue on a straight-line basis.
- (9) **Original issue discounts or premiums** - Original issue discounts or premiums on bonds are amortized ratably over the terms of the respective issues and are offset against the bonds payable in the statements of net assets.
- (10) **Refunding of debt** - The difference between the reacquisition price and the net carrying amount of the old debt is deferred and amortized as a component of interest expense in a systematic and rational manner over the remaining life of the old debt or the life of the new debt, whichever is shorter. The deferred amount is reported as a deduction from or an addition to the new debt liability.

City and County of Honolulu
Sewer Fund
NOTES TO FINANCIAL STATEMENTS
June 30, 2006 and 2005

NOTE B - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

- (11) **Accrued vacation** - Employees are credited with vacation at the rate of one and three-quarters working days per month. Accumulation of such vacation credits is limited to 90 days at calendar year-end and is convertible to pay upon termination of employment. Such accumulated vacation has been accrued and reflected in the statements of net assets.
- (12) **Net assets** - Net assets comprise income (losses) from operating and nonoperating revenues, expenses, operating transfers and contributed capital. Net assets are classified in the following three components: invested in capital assets, net of related debt; restricted for debt service; and unrestricted net assets. Invested in capital assets, net of related debt, consists of capital assets, net of accumulated depreciation and is reduced by outstanding debt that is attributable to the acquisition, construction or improvement of those assets. Debt related to unspent proceeds or other restricted cash and investments at fiscal year-end are not included in the calculation of the amount invested in capital assets, net of related debt. Restricted for debt service consists of net assets for which constraints are placed thereon by external parties, such as lenders, grantors, contributors, laws, regulations and enabling legislation, including self-imposed legal mandates. Unrestricted net assets consists of all other net assets not included in the above categories.
- (13) **Operating revenues and expenses** - The City distinguishes operating revenues and expenses from nonoperating items. Operating revenues and expenses generally result from providing services in connection with the Sewer Fund's principal wastewater operations. The principal operating revenues are from charges for wastewater system usage, while operating expenses include cost of services, administrative expenses and depreciation on capital assets. All revenues and expenses not meeting this definition are reported as nonoperating revenues and expenses.
- (14) **Capital contributions** - Capital contributions represent assets transferred from or constructed utilizing contributions from governmental agencies and developers and recorded at cost on the date placed in service.
- (15) **Transfers** - Transfers include authorized transfers of resources from the fund legally required to receive them to the fund through which such resources are to be expended. Transfers also include reimbursement of funds to the general fund for expenditures paid by the general fund on behalf of the Sewer Fund in prior fiscal years.
- (16) **Risk management** - The City is exposed to various risks for losses related to torts; theft of, damage to, or destruction of assets; errors or omissions; natural disasters; and injuries to employees. A liability for a claim for a risk of loss is established if the information indicates that it is probable that a liability has been incurred at the date of the financial statements and the amount of the loss is reasonably estimable.

City and County of Honolulu
Sewer Fund
NOTES TO FINANCIAL STATEMENTS
June 30, 2006 and 2005

NOTE C - CASH AND INVESTMENTS

The cash and investment balances reported in the accompanying statements of net assets are included in the City's cash and investment pool that is used by substantially all of the City's funds. Information pertaining to credit risk and interest rate risk is available for only the total cash and investment pool.

State statutes authorize the City to invest in obligations of the U.S. Treasury and U.S. agencies, obligations of other states, cities, and counties, mutual funds and bank repurchase agreements. Investments in repurchase agreements are primarily U.S. government or federal agency securities. The City does not have a policy relative to interest rate risk.

NOTE D - CREDIT RISK

Financial instruments, which potentially expose the City to concentrations of credit risk, consist primarily of cash, investments in debt securities, and accounts receivable from customers. Cash and cash equivalents are maintained in various financial institutions in the State. Credit risk related to investments in debt securities has been mitigated by limiting such investments to debt obligations of the U.S. government.

The customer base is concentrated among commercial, industrial, residential and governmental customers located within the City. Although the City is directly affected by the City's economy, management does not believe significant credit risk exists at June 30, 2006, except as provided in the allowance for uncollectible accounts. The City manages its credit exposure through procedures designed to identify and monitor credit risk.

NOTE E - DUE FROM OTHER CITY FUNDS

Due from other City funds consists primarily of bond proceeds relating to bond issuances for the Sewer Fund held by the City's General Improvement Bond Fund of approximately \$4.0 million and \$4.2 million at June 30, 2006 and 2005, respectively.

City and County of Honolulu
Sewer Fund
NOTES TO FINANCIAL STATEMENTS
June 30, 2006 and 2005

NOTE F - CAPITAL ASSETS

The capital assets activity for the fiscal years ended June 30, 2006 and 2005, were as follows:

	Balance June 30, 2005	Additions	Deductions	Balance June 30, 2006
Depreciable assets				
Buildings and improvements	\$ 436,357,566	\$ 12,911,450	\$ --	\$ 449,269,016
Transmission and distribution system	808,051,447	68,106,051	(3,614,368)	872,543,130
Equipment and machinery	26,055,303	2,752,820	(399,423)	28,408,700
Land improvements	<u>3,674,661</u>	<u>--</u>	<u>--</u>	<u>3,674,661</u>
Total depreciable assets	<u>1,274,138,977</u>	<u>83,770,321</u>	<u>(4,013,791)</u>	<u>1,353,895,507</u>
Less accumulated depreciation:				
Buildings and improvements	(56,857,881)	(10,343,616)	--	(67,201,497)
Transmission and distribution system	(104,197,950)	(18,616,580)	562,585	(122,251,945)
Equipment and machinery	(13,153,286)	(2,354,273)	288,734	(15,218,825)
Land improvements	<u>(703,189)</u>	<u>(124,523)</u>	<u>--</u>	<u>(827,712)</u>
Total accumulated depreciation	<u>(174,912,306)</u>	<u>(31,438,992)</u>	<u>851,319</u>	<u>(205,499,979)</u>
	1,099,226,671	52,331,329	(3,162,472)	1,148,395,528
Land	5,882,338	121,000	--	6,003,338
Construction in progress	<u>345,581,560</u>	<u>95,938,560</u>	<u>(82,315,949)</u>	<u>359,204,171</u>
	<u>\$ 1,450,690,569</u>	<u>\$ 148,390,889</u>	<u>\$ (85,478,421)</u>	<u>\$ 1,513,603,037</u>

	Balance June 30, 2004	Additions	Deductions	Balance June 30, 2005
Depreciable assets				
Buildings and improvements	\$ 437,943,671	\$ 3,608,353	\$ (5,194,458)	\$ 436,357,566
Transmission and distribution system	794,389,719	13,688,754	(27,026)	808,051,447
Equipment and machinery	24,384,388	2,063,760	(392,845)	26,055,303
Land improvements	<u>3,674,661</u>	<u>--</u>	<u>--</u>	<u>3,674,661</u>
Total depreciable assets	<u>1,260,392,439</u>	<u>19,360,867</u>	<u>(5,614,329)</u>	<u>1,274,138,977</u>
Less accumulated depreciation:				
Buildings and improvements	(47,095,021)	(10,178,418)	415,558	(56,857,881)
Transmission and distribution system	(85,161,070)	(18,005,962)	(1,030,918)	(104,197,950)
Equipment and machinery	(11,140,633)	(2,338,472)	325,819	(13,153,286)
Land improvements	<u>(578,666)</u>	<u>(124,523)</u>	<u>--</u>	<u>(703,189)</u>
Total accumulated depreciation	<u>(143,975,390)</u>	<u>(30,647,375)</u>	<u>(289,541)</u>	<u>(174,912,306)</u>
	1,116,417,049	(11,286,508)	(5,903,870)	1,099,226,671
Land	5,855,648	26,690	--	5,882,338
Construction in progress	<u>262,113,576</u>	<u>98,802,578</u>	<u>(15,334,594)</u>	<u>345,581,560</u>
	<u>\$ 1,384,386,273</u>	<u>\$ 87,542,760</u>	<u>\$ (21,238,464)</u>	<u>\$ 1,450,690,569</u>

City and County of Honolulu
Sewer Fund
NOTES TO FINANCIAL STATEMENTS
June 30, 2006 and 2005

NOTE F - CAPITAL ASSETS (Continued)

Depreciation expense was \$31,438,992 and \$30,647,375 for the fiscal years ended June 30, 2006 and 2005, respectively.

NOTE G - LONG-TERM OBLIGATIONS

The City issues general obligation bonds for the construction of major capital facilities. The Sewer Fund's general obligation bonds are collateralized by or expected to be paid from sewer user charges. These instruments are a direct obligation of the City for which its full faith and credit is pledged. The general obligation bonds for the Sewer Fund were issued during 1992 through 2005 in the original amount totaling \$373.8 million, and maturing serially through fiscal year 2019. The general obligation bonds bear interest at rates ranging from 2% to 8% at June 30, 2006.

Wastewater system revenue bonds were issued during 1999 through 2006 in the original amount totaling \$858.9 million, less a net discount (\$20.7 million at June 30, 2006, which is being amortized over the related term of the bond). The bonds are subject to redemption, at the option of the City, prior to maturity, on or after July 1, 2011. The bonds bear interest at 3.2% to 5.5% at June 30, 2006, and mature at various dates through fiscal year 2036. The bonds are collateralized by the Sewer Fund's revenues.

In August 2005, the City issued wastewater system revenue bonds in the aggregate amount of \$152.8 million, Series 2005A for \$133.5 million and Series 2005B for \$19.3 million. The bonds bear interest rates of 3.2% to 5% and mature annually on July 1, 2010 through 2035. The bonds maturing after July 1, 2015 are subject to redemption on or after July 1, 2015 in whole or in part at any time from any maturities or portions thereof to be redeemed. Proceeds of the bond were used to fund additions and improvements to the wastewater system of the City, to fund the reserve fund policy premium and currently refund certain outstanding general obligations and certain tax-exempt commercial paper of the City.

The notes payable to the State are for the construction of necessary treatment works and for other projects intended for wastewater reclamation or waste management. The notes amounted to \$68.3 million and \$74.1 million at June 30, 2006 and 2005, respectively, bearing interest ranging from 2.06% to 3.02%, and require annual principal and interest payments through fiscal year 2023.

Total interest costs incurred in 2006 and 2005 was \$40.5 million and \$34.2 million, respectively, of which \$10.9 million and \$6.5 million was capitalized in 2006 and 2005, respectively.

**City and County of Honolulu
Sewer Fund
NOTES TO FINANCIAL STATEMENTS
June 30, 2006 and 2005**

NOTE G - LONG-TERM OBLIGATIONS (Continued)

Long-term obligations activity for the fiscal years ended June 30, 2006 and 2005, were as follows:

	Balance July 1, 2005	Additions	Reductions	Balance June 30, 2006	Amount Due Within One Year
General obligation bonds	\$ 48,424,715	\$ --	\$ (9,560,306)	\$ 38,864,409	\$ 9,386,814
Revenue bonds	701,785,000	152,815,000	(3,550,000)	851,050,000	3,710,000
Notes payable	74,123,430	112,827	(5,897,960)	68,338,297	6,043,972
Tax-exempt commercial paper	<u>10,021,810</u>	<u>--</u>	<u>(10,021,810)</u>	<u>--</u>	<u>--</u>
	834,354,955	152,927,827	(29,030,076)	958,252,706	19,140,786
Less:					
Unamortized discount	<u>(22,417,854)</u>	<u>(8,080,704)</u>	<u>1,455,773</u>	<u>(29,042,785)</u>	<u>--</u>
Total long-term debt	811,937,101	144,847,123	(27,574,303)	929,209,921	19,140,786
Compensated absences	<u>5,856,545</u>	<u>1,309,534</u>	<u>(1,821,668)</u>	<u>5,344,411</u>	<u>264,300</u>
Total long-term obligations	\$ <u>817,793,646</u>	\$ <u>146,156,657</u>	\$ <u>(29,395,971)</u>	\$ <u>934,554,332</u>	\$ <u>19,405,086</u>

	Balance July 1, 2004	Additions	Reductions	Balance June 30, 2005	Amount Due Within One Year
General obligation bonds	\$ 58,036,057	\$ 17,431	\$ (9,628,773)	\$ 48,424,715	\$ 9,612,769
Revenue bonds	702,925,000	--	(1,140,000)	701,785,000	3,550,000
Notes payable	79,879,650	--	(5,756,220)	74,123,430	5,893,627
Tax-exempt commercial paper	<u>10,021,810</u>	<u>--</u>	<u>--</u>	<u>10,021,810</u>	<u>10,021,810</u>
	850,862,517	17,431	(16,524,993)	834,354,955	29,078,206
Less:					
Unamortized discount	<u>(24,132,836)</u>	<u>--</u>	<u>1,714,982</u>	<u>(22,417,854)</u>	<u>--</u>
Total long-term debt	826,729,681	17,431	(14,810,011)	811,937,101	29,078,206
Compensated absences	<u>5,430,032</u>	<u>2,302,726</u>	<u>(1,876,213)</u>	<u>5,856,545</u>	<u>364,370</u>
Total long-term obligations	\$ <u>832,159,713</u>	\$ <u>2,320,157</u>	\$ <u>(16,686,224)</u>	\$ <u>817,793,646</u>	\$ <u>29,442,576</u>

**City and County of Honolulu
Sewer Fund
NOTES TO FINANCIAL STATEMENTS
June 30, 2006 and 2005**

NOTE G - LONG-TERM OBLIGATIONS (Continued)

Scheduled maturities of long-term debt are as follows:

	General Obligation Bonds	Revenue Bonds	Notes Payable	Total Principal	Total Interest
Fiscal years ending June 30					
2007	\$ 9,386,814	\$ 3,710,000	\$ 6,043,972	\$ 19,140,786	\$ 46,278,181
2008	8,084,586	8,775,000	6,188,638	23,048,224	42,546,981
2009	8,019,425	10,060,000	6,339,486	24,418,911	41,479,989
2010	6,955,678	12,345,000	6,491,391	25,792,069	40,350,928
2011	5,171,402	18,900,000	6,647,851	30,719,253	38,981,569
2012 - 2016	1,225,573	136,265,000	26,416,622	163,907,195	175,882,195
2017 - 2021	20,931	166,130,000	10,051,117	176,202,048	141,842,419
2022 - 2026	--	207,715,000	159,220	207,874,220	97,072,147
2027 - 2031	--	205,965,000	--	205,965,000	42,981,148
2032 - 2036	--	81,185,000	--	81,185,000	7,563,099
	<u>38,864,409</u>	<u>851,050,000</u>	<u>68,338,297</u>	<u>958,252,706</u>	<u>\$ 674,978,656</u>
Less: current portion	<u>(9,386,814)</u>	<u>(3,710,000)</u>	<u>(6,043,972)</u>	<u>(19,140,786)</u>	
	<u>\$ 29,477,595</u>	<u>\$ 847,340,000</u>	<u>\$ 62,294,325</u>	<u>\$ 939,111,920</u>	

NOTE H - NET ASSETS

At June 30, 2006 and 2005, net assets consisted of the following:

	<u>2006</u>	<u>2005</u>
Invested in capital assets, net of related debt		
Net property, plant and equipment	\$ 1,513,603,037	\$ 1,450,690,569
Less:		
Wastewater general obligation bonds payable	(38,864,409)	(48,424,715)
Wastewater system revenue bonds payable, net of unamortized discount and issue cost	(836,452,062)	(679,367,146)
Notes payable	(68,338,297)	(74,123,430)
Tax-exempt commercial paper	--	(10,021,810)
Amount of debt related to unspent debt proceeds	<u>30,654,836</u>	<u>10,135,286</u>
	600,603,105	648,888,754
Restricted for debt service	35,424,715	26,882,150
Unrestricted	<u>30,388,137</u>	<u>(20,189,021)</u>
Total	<u>\$ 666,415,957</u>	<u>\$ 655,581,883</u>

City and County of Honolulu
Sewer Fund
NOTES TO FINANCIAL STATEMENTS
June 30, 2006 and 2005

NOTE I - EMPLOYEE BENEFIT PLANS

Defined benefit pension plan. Substantially all eligible employees of the City are members of the Employees' Retirement System of the State of Hawaii (ERS), a cost-sharing multiple-employer defined benefit pension plan. The ERS provides retirement benefits as well as death and disability benefits and is governed by a board of trustees. All contributions, benefits and eligibility requirements are established by Chapter 88 of the Hawaii Revised Statutes and can be amended by legislative action.

The ERS is composed of a contributory retirement plan and a noncontributory retirement plan. Prior to June 30, 1984, the plan consisted of only a contributory option. In 1984, legislation was enacted to create a new noncontributory option for members of the ERS who are also covered under social security. Persons employed in positions not covered by social security are precluded from the noncontributory option. The noncontributory option provides for reduced benefits and covers most eligible employees hired after June 30, 1984. Employees hired before that date were allowed to continue under the contributory option or to elect the new noncontributory option and receive a refund of employee contributions. All benefits vest after five and ten years of credited service under the contributory and noncontributory options, respectively. Both options provide a monthly retirement allowance based on the employee's age, years of credited service, and average final compensation (AFC). The AFC is the average salary earned during the five highest paid years of service, including vacation payment, if the employee became a member prior to January 1, 1971. The AFC for members hired on or after that date and prior to January 1, 2003 is based on the three highest paid years of service, excluding vacation payment. Effective January 1, 2003, the AFC is the highest three calendar years or highest five calendar years plus lump sum vacation payment or, highest three school contract years, or last 36 credited months or last 60 credited months plus lump sum vacation payment.

Most covered employees of the contributing option are required to contribute 7.8% or 12.2% of their salary. The City is required to contribute the remaining amounts necessary to pay contributory plan benefits and all amounts necessary to pay noncontributory benefits when due. The funding method used to calculate the total employer contribution requirement is the Entry Age Normal Actuarial Cost Method. Under this method, employer contributions to the ERS are comprised of normal cost plus level annual payments required to amortize the unfunded actuarial accrued liability over the remaining period of 29 years from July 1, 2000. Effective July 1, 2005 a dollar contribution is not determined under the provisions of Act 181 of the 2004 Session Laws of Hawaii. Instead a fixed percentage of 13.75% of payroll is contributed. The Sewer Fund's contribution to the ERS was \$3.8 million, \$4.7 million and \$4.0 million in 2006, 2005, and 2004 respectively, which was equal to the required contributions for the respective fiscal years.

The ERS issues a Comprehensive Annual Financial Report that may be obtained by writing to the Employees' Retirement System of the State of Hawaii, 201 Merchant Street, Suite 1400, Honolulu, Hawaii 96813.

**City and County of Honolulu
Sewer Fund
NOTES TO FINANCIAL STATEMENTS
June 30, 2006 and 2005**

NOTE I - EMPLOYEE BENEFIT PLANS (Continued)

Post-retirement health care and life insurance benefits. In addition to providing pension benefits, the State provides certain health care and life insurance benefits for retired City employees. Contributions are based on negotiated collective bargaining agreements and are limited by State statute to the actual cost of benefit coverage. Prior to July 1, 1996, the City paid 100% of these benefits for employees who have at least 10 years of service. According to Act 217, Session Laws of Hawaii 1995, employees hired after June 30, 1996, with 25 years or more of service receive 100% employer funding. The City's share of the cost of these benefits is prorated for employees with less than 25 years of service. The City also reimburses 100% of Medicare premium costs for retirees and qualified dependents (through the State) who are at least 65 years of age and have at least 10 years of service. Approximately 9,800 retirees and qualified dependents are currently receiving post retirement health care and benefits paid for by the City. The City's contributions for post retirement benefits, which are funded on a pay-as-you-go basis, amounted to approximately \$44.4 million and \$44.6 million for the fiscal years ended June 30, 2006 and 2005, respectively. Separate information for the Sewer Fund is not available.

NOTE J - MANAGEMENT AGREEMENT

The City had an agreement with the Board of Water Supply (Board) to provide certain services through June 30, 2006, relating to the billing and collection of sewer service charges. Fees related to these services were negotiated at \$100,000 per year through fiscal 2006. The City and the Board are currently negotiating a new agreement for future years.

NOTE K - COMMITMENTS

Construction contracts. The City has contractual commitments for the Sewer Fund of approximately \$240 million at June 30, 2006, primarily for construction contracts.

Accumulated sick leave pay. Sick leave accumulates at the rate of one and three-quarters working days for each month, without limit. Sick leave is taken only in the event of illness and is not convertible to pay; accordingly, sick leave is not accrued. Employees who retire or leave government service in good standing with sixty or more unused sick leave days are entitled to an additional service credit in the retirement system. At June 30, 2006 and 2005, accumulated sick leave, including vested and nonvested accumulated rights to receive sick leave benefits, amounted to approximately \$15 million and \$17 million, respectively.

Deferred compensation plan. All full-time employees of the Sewer Fund are eligible to participate in the City and County of Honolulu's Public Employees' Deferred Compensation Program (Plan), adopted pursuant to Internal Revenue Code Section 457. The Plan permits eligible employees to defer a portion of their salary until future years by contributing to a fund managed by a plan administrator. The deferred compensation amounts are not available to employees until termination, retirement, death or unforeseeable emergency.

City and County of Honolulu
Sewer Fund
NOTES TO FINANCIAL STATEMENTS
June 30, 2006 and 2005

NOTE K - COMMITMENTS (Continued)

A trust fund was established to protect plan assets from claims of general creditors and from diversion to any uses other than paying benefits to participants and beneficiaries. Deferred compensation plan assets are not reported in the financial statements.

NOTE L - LITIGATION

The City is a party to various legal proceedings arising in the normal course of business. Some of these matters relate to the Sewer Fund as follows:

Clean Water Act. In 1991, the Environmental Protection Agency (EPA) filed an administrative action against the City alleging violations of the Clean Water Act and conditions and limitations of the National Pollutant Discharge Elimination System Permits by failing to develop and administer pretreatment programs for all of its treatment plants and for unauthorized discharges from the collection system. As a result of a settlement reached between the EPA and the City, a consent decree has been filed which requires certain compliance actions and penalties of \$1.2 million, which were paid in fiscal year 1995. The City has implemented certain compliance actions such as developing plans for rehabilitation and maintenance of the collection system and implementation of the plans. The City has committed to spend at least \$20 million for effluent reuse.

The City has committed to spend at least \$10 million for sludge reuse. Sludge reuse is being accomplished through the U.S. Navy Biosolids Treatment Facility. The consent decree cites potential stipulated penalties of \$2,000 per day per violation for failure to comply.

The State and certain environmental groups (nonprofit organizations) also filed actions against the City for declaratory judgment, injunctive relief and civil penalties for violations of the Clean Water Act for the following wastewater treatment plants.

Kailua and Kaneohe. As a result of a settlement reached between the parties, a consent decree has been filed for the Kailua and Kaneohe plants, which requires certain compliance actions such as developing a facilities plan, constructing a feasible ultraviolet disinfection facility and establishing and supporting an advisory council. The conceptual facilities plan and the environmental impact statement preparation notice were completed in September 1998. The design phase of the ultraviolet disinfection project was completed in October 1998. Responses to public comments were completed in June 1999. The City contracted a construction company to complete the construction phase for approximately \$2.3 million, which was completed in November 2000. Approximately \$5.5 million has been paid as of June 30, 2006, related to these compliance actions. The Kailua Bay Advisory Council was established in October 1995. The City established a \$2.1 million trust fund; hired a program administrator and a third party to provide watershed mapping services; awarded grant projects to four community

City and County of Honolulu
Sewer Fund
NOTES TO FINANCIAL STATEMENTS
June 30, 2006 and 2005

NOTE L - LITIGATION (Continued)

groups; developed short-term implementation plans for erosion control initiatives, stream bank restoration and refuse control; and developed a web site for the Kailua Bay Advisory Council to disseminate information to the public, and has dispersed all funds to the Kailua Bay Advisory Council.

The consent decree cites total costs of at least \$7.4 million for capital improvements, consulting and other fees. The consent decree cites stipulated penalties of \$500 per day per violation for failure to meet the specified obligations and deadlines. The City was assessed a fee of \$493,000 for noncompliance of emission limits for one of the odor control units in October 2000. Corrective action to remediate the situation was completed and the fee was paid by the City in fiscal 2004. The Kaneohe treatment facility has been converted into a preliminary treatment facility, and pumps wastewater to the Kailua treatment facility.

Wahiawa. A civil action was filed by the State for operating the Wahiawa plant without a permit. Settlement with the State was reached and a consent decree was approved on February 27, 1998. The consent decree requires the City to upgrade the existing treatment plant to produce water suitable for reuse and adjust the outfall. The consent decree stipulates damages of \$600,000 plus \$1,000 to \$5,000 per day if the upgrades are not completed by specified deadlines. In June 2001, the City completed construction of the reclamation system, which amounted to approximately \$12 million. As required by the consent decree, the City also disbursed \$150,000 to various agencies for supplemental environment projects. All issues associated with the consent decree have been met. A motion to terminate the consent decree has not been filed by the State or City.

Sand Island. The Sand Island wastewater treatment plant operates under a 301(h) waiver permit issued by the EPA. The current permit was effective November 1998. That permit included, amongst other things, a specific timetable for various construction projects related to the Sand Island plant. In October 1999, the EPA issued a finding of violation and order for compliance that required corrective measures and compliance with the November 1998 permit. Although the City responded to that order, some of the construction projects are behind the permit schedule due to unanticipated construction difficulties. In October 2002, the EPA identified that the Sand Island plant violated certain discharge limits and ordered the City to stop discharge violations at the Sand Island plant and to submit a plan by December 1, 2002, to bring the facility into continuous compliance with its EPA permit. The City submitted the required plan and compliance schedule on November 29, 2002. Upon review by the EPA, the City submitted a revised plan on May 1, 2003, which is still subject to the EPA's final approval.

Honouliuli. The Honouliuli wastewater treatment plant operates under a 301(h) waiver permit issued by the EPA. The current permit was issued June 1991. In September 2003, the EPA identified that the Honouliuli plant violated certain permit conditions pertaining to the plant return streams, effluent flow meter and sampler, storm water pollution control plan,

City and County of Honolulu
Sewer Fund
NOTES TO FINANCIAL STATEMENTS
June 30, 2006 and 2005

NOTE L - LITIGATION (Continued)

discharge monitoring reports, and improper discharge through the sewage outfall. The City has responded to the order and corrected items regarding plant return flow streams, effluent flow meter and sampler, and the storm water pollution control plan. Other items are still under discussion with the EPA.

Force Mains. The State Department of Health issued a notice of violation in April 2004, alleging discharges to the ground or State waters between November 1996 and April 2004 from City owned force mains requesting plans describing force main condition assessment, contingency, preventive maintenance, and repair and upgrade. On October 20, 2004, the City submitted the required four reports (i.e., Force Main Condition Assessment Program, Force Main Contingency Plan, Force Main Preventive Maintenance Plan, and Force Main Repair and Upgrade Program) and is waiting approval or comments on the proposed action plans. The City submitted a follow-up letter, dated June 6, 2005, as no comments or approval on any of the submittals were received. Until proposed plans and programs are approved by the State, the City's ability to fully implement the plans and programs is limited.

Citizen lawsuit. Three citizen groups filed suit in Federal Court in July 2004, alleging repeated spills from the collection systems and treatment plants, effluent discharge problems at Sand Island wastewater treatment plant, failure to comply with the Sand Island NPDES permit requirements, failure to comply with administrative orders issued by the EPA and the State Department of Health, unlawful discharge of R-1 water from the Honouliuli wastewater treatment plant, failure to maintain a current Storm Water Pollution Control Plan for the Honouliuli wastewater treatment plant, and discharge of effluent from the Sand Island and Honouliuli wastewater treatment plants without permits.

Although the outcome of individual matters is not predictable, no provision for any liability that may result from these lawsuits has been made in the Sewer Fund's financial statements since any such liabilities are normally paid from the City's General Fund. In the opinion of management, the final outcome of these matters is unknown at this time but should not have a material adverse effect on the Sewer Fund's financial statements.

NOTE M - SUBSEQUENT EVENT

In September 2006, the City issued Series 2006A, Series 2006B, and Series 2006C wastewater system revenue bonds in the aggregate amount of \$340.8 million. The bonds bear interest rates of 4% to 5% and mature annually on July 1, 2007 through 2036. The bonds maturing after July 1, 2016, are subject to redemption at the option of the City on or after July 1, 2016, in whole or in part at any time from any maturity. Proceeds from the bonds will be used to fund the cost of certain additions and improvements to the wastewater system of the City, a reserve account and the refunding of certain general obligation and wastewater system revenue bonds.

In September 2006, the City remarketed Series 2003A-1 and Series 2003B-1 wastewater system revenue bonds in the aggregate amount of \$86.7 million to fix the interest rates. The bonds bear interest rates of 4% to 5% and mature annually on July 1, 2007 through July 1, 2032. The bonds maturing after July 1, 2016 are subject to redemption at the option of the City on or after July 1, 2016, in whole or in part at any time, from any maturity.