PRICEWATERHOUSECOOPERS

City and County of Honolulu
Sewer Fund

Financial Statements

June 30, 2004 and 2003

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Sewer Fund
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Report of Independent Auditors

To the Chair and Members of the City Council of
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, 2004 and 2003, 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 Sewer Fund'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 financial statements referred to above present fairly, in all material respects, the financial position of the Sewer Fund at June 30, 2004 and 2003, and the changes in financial position and cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

The management's discussion and analysis on pages 2 through 6 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.

PricewaterhouseCoopers LLP

Honolulu, Hawaii
December 22, 2004

As financial management of the City and County of Honolulu Wastewater Enterprise, we offer readers of these financial statements this narrative overview and analysis of the financial activities of the Wastewater Enterprise for the fiscal years ended June 30, 2004 and 2003. This discussion and analysis is designed to assist the reader in focusing on the significant financial issues and activities and to identify any significant changes in financial position. We encourage readers to consider the information presented here in conjunction with the financial statements as a whole.

Financial Highlights

- 122.3 million gallons per day of wastewater were collected and treated in fiscal year 2004, an increase of 10% from fiscal year 2003 due to additional customers and wet weather. There were 110.8 million gallons per day of wastewater collected and treated in fiscal year 2003, a decrease of 4% from fiscal year 2002 due to dry weather and the continuing installation of low flow plumbing fixtures. As of June 30, 2004, the Wastewater Enterprise had approximately 160,000 customer accounts and served approximately 640,000 residents.

- Total assets were $1,533 million and exceeded total liabilities by $672 million as of June 30, 2004. As of June 30, 2003, total assets were $1,576 million and exceeded total liabilities by $708 million. At June 30, 2004, net assets (difference between assets and liabilities) decreased by $36 million or 5% from June 30, 2003, while net assets at June 30, 2003 decreased by $71 million or 9% from June 30, 2002. The decrease in net assets in 2004 and 2003 is primarily due to transfers out to the City's general fund.

- At June 30, 2004, total assets decreased by $43 million to $1,533 million, representing a 3% decrease from the prior fiscal year, while total assets jumped $144 million to $1,576 million at June 30, 2003, representing a 10% increase over June 30, 2002. The decrease in fiscal year 2004 was primarily due to transfers out to other City funds and depreciation of capital assets. The increase in fiscal year 2003 was primarily due to the proceeds from the issuance of bonds and the addition of capital assets in accordance with the twenty year capital plan for infrastructures and facilities.

- Total current assets decreased by 43% or $112 million to $149 million at June 30, 2004, while current assets increased by 32% or $64 million to $261 million at June 30, 2003. The increase in 2003 was primarily due to proceeds from the revenue bonds issued in 2003, less proceeds used for the acquisition and construction of capital assets. In 2004, the Sewer Fund funded additional capital assets and transferred funds to other City funds, which reduced current assets.

- Total current liabilities increased by 19% or $9 million to $56 million at June 30, 2004 primarily due to the issuance of tax-exempt commercial paper. At June 30, 2004, total liabilities decreased 0.7% or $6 million to $862 million due to the repayment of long-term debt. At June 30, 2003, total current liabilities increased by 15% or $6 million to $47 million primarily due to an increase in accounts payable. Total liabilities also increased to 33% or $215 million to $868 million at June 30, 2003 due to the issuance of Wastewater Revenue Bonds in 2003.

Overview of the Financial Statements

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

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 statement of net assets presents information of 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 fiscal year. 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 statement of cash flows presents changes in cash and cash equivalents, resulting from operating, 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

	2004	2003	2002
Current and other assets	$ 149,097	$ 260,995	$ 197,345
Capital assets, net	1,384,386	1,315,361	1,235,120
Total assets	1,533,483	1,576,356	1,432,465
Current liabilities	56,276	47,178	41,096
Noncurrent liabilities	805,550	820,806	611,989
Total liabilities	861,826	867,984	653,085
Invested in capital assets, net of related debt	638,114	625,114	650,381
Restricted for debt service	22,584	20,602	54,489
Unrestricted	10,959	62,656	74,510
Total net assets	$ 671,657	$ 708,372	$ 779,380

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 $672 million and $708 million at the end of fiscal year 2004 and 2003, respectively. This represented a decrease of $36 million or 5% from the fiscal year 2003 net assets and a decrease of $71 million or 9% from fiscal year 2002, which was mainly attributable to transfers to the City's general fund. 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

	2004	2003	2002
Operating revenues	$ 115,032	$ 115,747	$ 113,810
Operating expenses	(93,911)	(90,285)	(92,738)
Income from operations	21,121	25,462	21,072
Nonoperating revenues (expenses)			
Interest income	1,540	2,032	4,779
Interest expense	(26,573)	(35,354)	(18,208)
Other	(3,168)	(4,521)	(1,753)
Income (loss) before transfers and contributed capital	(7,080)	(12,381)	5,890
Transfers out	(31,078)	(59,633)	(46,995)
Contributed capital	1,443	1,006	2,066
Change in net assets	(36,715)	(71,008)	(39,039)
Net assets			
Beginning of year	708,372	779,380	818,419
End of year	$ 671,657	$ 708,372	$ 779,380

The changes in net assets were primarily due to:

- Operating revenues, comprised mainly of sewer service charges, decreased 0.6% to $115 million for fiscal year 2004 compared to the prior fiscal year and increased 1.7% to $116 million for fiscal year 2003 compared to fiscal year 2002. Sewer service charge rates have not been raised since 1994.

- Operating expenses increased $4 million or 4% to $94 million for fiscal year 2004 compared to the prior fiscal year and decreased $2 million or 3% to $90 million for fiscal year 2003 compared to fiscal year 2002. The majority of the increase in 2004 was due to an increase in fringe benefit costs, while the decrease in 2003 was due to a reduction in administration and general costs.

- Interest expense decreased by $9 million or 25% to $26 million for fiscal 2004 compared to the prior fiscal year and increased by $17 million or 94% to $35 million for fiscal year 2003 compared to fiscal year 2002. The decrease in 2004 was due to a decrease in the amortization of debt discount, reduction in the principal balance and decrease in interest rates. The increase in 2003 was due to interest expense related to the issuance of $218 million of revenue bonds in 2003 and the amortization of debt discount.

- Contributed capital remained generally constant at $1 million in fiscal year 2004 and 2003, but decreased by $1 million in 2003 compared to fiscal year 2002. Contributed capital represents assets (primarily capital assets) transferred from other city governmental funds and other entities.

- Of the $31 million and $60 million transfers in fiscal year 2004 and 2003, respectively, $25 million and $53 million pertains to reimbursement of expenditures made in prior years by the general fund on behalf of the Wastewater Enterprise.

Capital Asset and Debt Administration

Capital assets. The Wastewater Enterprise's investment in capital assets amounted to $1.4 billion and $1.3 billion, net of accumulated depreciation, as of June 30, 2004 and 2003, respectively, an increase of $69 million or 5% in 2004 and $80 million or 6% in 2003. 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 makes 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. Junior Series Wastewater System Revenue Bonds of $218 million were issued on May 8, 2003. Revenue bonds outstanding as of June 30, 2004 and 2003 totaled $678 million. State revolving fund notes payable outstanding at June 30, 2004 and 2003 totaled $80 million and $85 million, respectively.

Debt service coverage was 471% on Senior Revenue Bonds, 203% on all revenue bonds, and 147% on all debt at June 30, 2004, compared to 511% on Senior Revenue Bonds, 242% on all revenue bonds and 163% on all debt at June 30, 2003. Debt service coverage exceeded the requirements of bond covenants and policies of the City Council in 2004 and 2003.

The revenue bonds issued on May 8, 2003 were rated Aaa from Moody's Investor Services Inc. and AAA from Fitch Inc.

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

This financial report is designed to provide a general overview of Wastewater Enterprise's finances for all those with an interest in its finances. Questions concerning any of the information provided in this report or request 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, 2004 and 2003

	2004	2003
Assets		
Current assets		
Cash and cash equivalents	$ 59,970,526	$ 115,546,447
Investments	63,673,360	98,631,665
Receivables		
Accounts (net of allowance for uncollectible accounts of $646,073 and $471,201 in 2004 and 2003, respectively)	15,657,635	16,336,235
Interest	198,805	430,827
Due from other City funds	4,885,671	25,626,523
Inventories of materials and supplies	4,710,614	4,423,180
Total current assets	149,096,611	260,994,877
Capital assets, net	1,384,386,273	1,315,361,303
	1,533,482,884	1,576,356,180
Liabilities and Net Assets		
Current liabilities		
Accounts payable	17,391,224	18,166,518
Interest payable	11,438,310	11,712,471
Bonds payable	10,832,023	10,871,282
Tax-exempt commercial paper	10,021,810	-
Notes payable	5,756,217	5,618,869
Other current liabilities	836,473	808,327
Total current liabilities	56,276,057	47,177,467
Notes payable	74,123,433	79,876,758
General obligation bonds payable	48,344,034	57,952,534
Revenue bonds payable, net	677,652,164	677,158,747
Other liabilities	5,430,032	5,818,158
Total liabilities	861,825,720	867,983,664
Commitments and contingencies		
Net assets		
Invested in capital assets, net of related debt	638,114,370	625,114,171
Restricted for debt service	22,584,211	20,602,552
Unrestricted	10,958,583	62,655,793
Total net assets	$ 671,657,164	$ 708,372,516

The accompanying notes are an integral part of the financial statements.

City and County of Honolulu
Sewer Fund
Statements of Revenues, Expenses and Changes in Net Assets
Years Ended June 30, 2004 and 2003

	2004	2003
Operating revenues		
Sewer service charges	$ 111,886,155	$ 111,878,243
Other revenue	3,145,939	3,868,965
Total operating revenues	115,032,094	115,747,208
Operating expenses		
Depreciation	30,575,243	30,289,623
Administrative and general	29,989,890	29,502,112
Fringe benefits	10,347,830	8,711,036
Contractual services	8,230,622	7,571,344
Utilities	7,585,332	7,425,656
Materials and supplies	5,335,786	4,857,433
Fuel and lubricants	1,654,021	1,695,245
Maintenance	192,646	232,788
Total operating expenses	93,911,370	90,285,237
Operating income	21,120,724	25,461,971
Nonoperating revenues (expenses)		
Interest income	1,539,618	2,031,906
Interest expense	(26,572,828)	(35,353,648)
Other	(3,168,345)	(4,520,841)
Total nonoperating expenses	(28,201,555)	(37,842,583)
Loss before transfers and contributed capital	(7,080,831)	(12,380,612)
Transfers out	(31,077,500)	(59,633,026)
Contributed capital	1,442,979	1,005,564
Change in net assets	(36,715,352)	(71,008,074)
Net assets		
Beginning of year	708,372,516	779,380,590
End of year	$ 671,657,164	$ 708,372,516

The accompanying notes are an integral part of the financial statements.

City and County of Honolulu
Sewer Fund
Statements of Cash Flows
Years Ended June 30, 2004 and 2003

	2004	2003
Cash flows from operating activities		
Cash received from customers	$ 115,481,638	$ 115,754,729
Cash payments to suppliers and employees	(68,252,807)	(48,089,800)
Receipts (payments) to other funds for internal activity	20,140,069	(18,767,628)
Other revenues (expenses)	30,646	(435,823)
Net cash provided by operating activities	67,399,546	48,461,478
Cash flows from noncapital financing activities		
Transfers out	(31,077,500)	(59,633,026)
Net cash used in noncapital financing activities	(31,077,500)	(59,633,026)
Cash flows from capital and related financing activities		
Acquisition and construction of capital assets	(92,275,668)	(105,146,995)
Proceeds from issuance of notes	3,013	480,454
Repayments on notes	(5,618,990)	(5,395,813)
Interest paid on notes	(2,770,920)	(2,988,701)
Proceeds from issuance of tax-exempt commercial paper, net	10,021,810	-
Proceeds from issuance of bonds, net of discount	56,311	195,082,807
Repayments on bonds	(10,844,070)	(1,051,525)
Interest paid on bonds	(27,070,049)	(26,235,561)
Net cash provided by (used in) capital and related financing activities	(128,498,563)	54,744,666
Cash flows from investing activities		
Purchase of investments	(309,417,491)	(262,028,884)
Proceeds from maturity of investments	344,375,796	306,343,640
Interest on investments	1,642,291	2,586,028
Net cash provided by investing activities	36,600,596	46,900,784
Net increase (decrease) in cash and cash equivalents	(55,575,921)	90,473,902
Cash and cash equivalents		
Beginning of year	115,546,447	25,072,545
End of year	$ 59,970,526	$ 115,546,447

The accompanying notes are an integral part of the financial statements.

City and County of Honolulu
Sewer Fund
Statements of Cash Flows
Years Ended June 30, 2004 and 2003

	2004	2003
Reconciliation of operating income to net cash provided by operating activities		
Operating income	$ 21,120,724	$ 25,461,971
Adjustments to reconcile operating income to net cash provided by operating activities		
Depreciation expense	30,575,243	30,289,623
Write-off of capital assets	218,313	430,889
Decrease in accounts receivable	678,600	435,723
(Increase) decrease in due from other City funds	20,300,212	(18,825,946)
(Increase) decrease in materials and supplies inventory	(287,434)	287,254
Increase (decrease) in accounts payables	(4,684,938)	10,114,137
Increase (decrease) in other liabilities	(521,174)	267,827
Net cash provided by operating activities	$ 67,399,546	$ 48,461,478

Supplemental disclosure of noncash capital and related financing activities

The Sewer Fund received $1,442,979 and $1,005,564 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, 2004 and 2003, respectively.

Amortization of bond discounts amounted to $1,633,417 and $6,440,857 in fiscal 2004 and 2003, respectively.

The accompanying notes are an integral part of the financial statements.

1. Financial Reporting Entity

The Sewer Fund ("Fund") was established in 1976 pursuant to Section 14-8.1 of the 1990 Revised Ordinances of the City and County of Honolulu to account for all monies received pursuant to the provisions of the Federal Water Pollution Control Act amendments of 1972 and the Hawaii Revised Statutes and expended for the purposes authorized (operations of the City's wastewater system). The fund was operated primarily through user charges. The City and County of Honolulu (the "City") also established the Sewer Revenue Bond Improvement Fund to account for the proceeds of bonds issued to pay all or part of those appropriations for improvements, repairs, and maintenance of the wastewater treatment system.

In conjunction with the November 1998 City Resolution 98-193, CD1, authorizing the issuance of the Wastewater System Revenue Bonds for the Wastewater System, a new Sewer Fund was established effective July 1, 1999 as an enterprise fund. The new Sewer Fund combines the operations of the Sewer and Sewer Revenue Bond Improvement Funds, which were previously recorded in a special revenue fund and certain capital projects funds. Accordingly, various account balances, including cash and fixed assets, net of related debt, were transferred into the new Sewer Fund (the "Fund").

2. Summary of Significant Accounting Policies

Financial Statement Presentation

These financial statements follow Governmental Accounting Standards Board ("GASB") Statement No. 34, *Basic Financial Statements – and Management's Discussion and Analysis – for State and Local Governments*, GASB Statement No. 37, *Basic Financial Statements – and Management's Discussion and Analysis for State and Local Governments: Omnibus – an amendment of GASB Statements No. 21 and No. 34*, and GASB Statement No. 38, *Certain Financial Statement Note Disclosures*. Under GASB No. 34, all applicable GASB pronouncements as well as all applicable Financial Accounting Standards Board ("FASB") statements and interpretations, and Accounting Principles Board Opinions issued on or before November 30, 1989 are applied, unless those pronouncements conflict with or contradict GASB pronouncements.

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.

The City distinguishes operating revenues and expenses from nonoperating items. Operating revenues and expenses generally result from providing services in connection with the 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.

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 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.

Cash and Cash Equivalents
Cash includes amounts in demand and time deposits primarily with various financial institutions in Hawaii. 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.

Investments
Investments consist of U.S. government securities and are stated at cost, which approximates fair value.

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.

Receivables
Sewer service charge revenues are accrued by the City based on estimated billings for services provided through the end of the fiscal year. Estimated unbilled sewer charges amounted to approximately $9.3 million and $8.6 million at June 30, 2004 and 2003, respectively.

Capital Assets
Capital assets include property, plant and equipment, including infrastructure (sewer system, network of pipes and sewer mains) and are capitalized at 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:

	Years
Buildings and improvements other than buildings	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.

Bond Issue Costs and Original Issue Discount
Bond issue costs are deferred and are amortized over the life of the respective issue on a straight-line basis. Original issue discounts are amortized using the effective interest method over the terms of the respective issues and are offset against the bonds payable in the statements of net assets.

Contributed Capital
Contributed capital represents assets transferred from or constructed utilizing contributions from governmental agencies and developers and recorded at cost on the date placed in service.

Net Assets
Net assets comprise the various net earnings (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 capital activity and 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 year-end are not included in the calculation of the amount invested in capital assets, net of related debt. Restricted for capital activity and 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 consist of all other net assets not included in the above categories.

Retirement Plan Contributions
The City's contribution to the Employee's Retirement System of the State of Hawaii (see Note 8) is based upon actuarial computations and is comprised of the normal cost plus a level annual payment required to amortize an unfunded actuarial accrued liability over the remaining period of 29 years from July 1, 2000. The City is required by State statute to fund the actuarially determined pension contribution requirement annually.

Deferred Compensation Plan
All full-time employees of the 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.

A trust fund (annuity contract) 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.

Compensated Absences
Vacation benefits accrue at one and three-quarters working days for each month. Each employee is allowed to accumulate a maximum of 90 days of vacation as of the end of the calendar year. At June 30, 2004 and 2003, accrued vacation amounted to approximately $5.8 million.

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, 2004 and 2003, accumulated sick leave, including vested and nonvested accumulated rights to receive sick leave benefits, amounted to $17.0 million and $16.8 million, respectively.

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 Fund in prior years.

New Accounting Pronouncements
In March 2003, the GASB issued Statement No. 40, *Deposit and Investment Risk Disclosures – an amendment of GASB Statement No. 3*. This Statement requires certain disclosures of investments that have fair values that are highly sensitive to changes in interest rates. Deposit and investment policies related to the risks identified in this Statement should also be disclosed. The provisions of this Statement are effective for financial statements for periods beginning after June 15, 2004. Management has not yet determined the effect this Statement will have on its financial statements.

In November 2003, the GASB issued Statement No. 42, *Accounting and Financial Reporting for Impairment of Capital Assets and for Insurance Recoveries*. This Statement establishes accounting and financial reporting standards for impairment of capital assets and also clarifies and establishes accounting requirements for insurance recoveries. The provisions of this Statement are effective for financial statements for periods beginning after December 15, 2004. Management has not yet determined the effect this Statement will have on its financial statements.

In June 2004, the GASB issued Statement No. 45, *Accounting and Financial Reporting by Employers for Postretirement Benefits Other Than Pensions*. This Statement establishes standards for the measurement, recognition and display of other postretirement benefits expense/expenditures and related liabilities (assets), note disclosures and required supplementary information in the financial reports of state and local governmental employers. The provisions of this Statement are effective for the City and the Fund for periods beginning after December 15, 2006. Management has not yet determined the effect this Statement will have on its financial statements.

3. Cash and Investments

The cash and investments balances reported in the accompanying balance sheets are included in the City's cash and investment pool that is used by substantially all of the City's funds. Information pertaining to bank and investment balances and classification of risk is available for only the total

cash and investment pool. These balances were fully insured or collateralized with securities by the City's agent in the City's name.

4. Due From Other City Funds

Due from other City funds consists primarily of bond proceeds relating to bond issuances for the Fund held by the City's General Improvement Bond Fund of $4.9 million at June 30, 2004. Due from other City funds consists primarily of temporary fund transfers to the City's Federal Grants Fund of $20 million and bond proceeds relating to bond issuances for the Fund held by the City's General Improvement Bond Fund of $5.4 million at June 30, 2003.

5. Capital Assets

The capital assets activity for the years ended June 30, 2004 and 2003 were as follows:

	Balance at July 1, 2003	Additions	Retirements/ Transfers	Balance at June 30, 2004
Depreciable assets				
Buildings and improvements	$ 436,652,760	$ 1,647,047	$ (356,136)	$ 437,943,671
Transmission and distribution system	793,268,159	5,225,130	(4,103,570)	794,389,719
Equipment and machinery	21,786,776	2,777,905	(180,293)	24,384,388
Land improvements	3,674,661	-	-	3,674,661
Total depreciable assets	1,255,382,356	9,650,082	(4,639,999)	1,260,392,439
Less: Accumulated depreciation				
Buildings and improvements	(36,879,041)	(10,233,785)	17,805	(47,095,021)
Transmission and distribution system	(68,584,794)	(17,914,595)	1,338,319	(85,161,070)
Equipment and machinery	(8,940,403)	(2,302,340)	102,110	(11,140,633)
Land improvements	(454,143)	(124,523)	-	(578,666)
Total accumulated depreciation	(114,858,381)	(30,575,243)	1,458,234	(143,975,390)
	1,140,523,975	(20,925,161)	(3,181,765)	1,116,417,049
Land	5,840,840	14,808	-	5,855,648
Construction work in progress	168,996,488	98,582,130	(5,465,042)	262,113,576
	$ 1,315,361,303	$ 77,671,777	$ (8,646,807)	$ 1,384,386,273

	Balance at July 1, 2002	Additions	Retirements/ Transfers	Balance at June 30, 2003
Depreciable assets				
Buildings and improvements	$ 394,423,418	$ 42,229,342	$ -	$ 436,652,760
Transmission and distribution system	787,519,031	5,749,128	-	793,268,159
Equipment and machinery	19,962,871	1,911,505	(87,600)	21,786,776
Land improvements	2,551,670	1,122,991	-	3,674,661
Total depreciable assets	1,204,456,990	51,012,966	(87,600)	1,255,382,356
Less: Accumulated depreciation				
Buildings and improvements	(26,985,826)	(9,893,215)	-	(36,879,041)
Transmission and distribution system	(50,548,742)	(18,036,052)	-	(68,584,794)
Equipment and machinery	(6,904,608)	(2,123,395)	87,600	(8,940,403)
Land improvements	(217,182)	(236,961)	-	(454,143)
Total accumulated depreciation	(84,656,358)	(30,289,623)	87,600	(114,858,381)
	1,119,800,632	20,723,343	-	1,140,523,975
Land	5,629,502	211,338	-	5,840,840
Construction work in progress	109,690,238	109,727,686	(50,421,436)	168,996,488
	$ 1,235,120,372	$ 130,662,367	$ (50,421,436)	$ 1,315,361,303

6. Long-Term Debt

The City issues general obligation bonds for the construction of major capital facilities. The 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 Fund were issued during 1992 through 2004 in the original amount totaling $373.8 million, and maturing serially through fiscal year 2018. The general obligation bonds bear interest at rates ranging from 5.0% to 8.0% at June 30, 2004.

Wastewater system revenue bonds were issued during 1999 through 2003 in the original amount totaling $706.1 million, less a discount ($24.1 million at June 30, 2004, 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 1.3% to 5.5% at June 30, 2004 and mature at various dates through fiscal year 2033. The revenue bonds are collateralized by the Fund's revenues.

The notes payable to the Hawaii state government are for the construction of necessary treatment works and for other projects intended for wastewater reclamation or waste management. The notes amounted to $79.9 million and $85.5 million at June 30, 2004 and 2003, respectively, bearing interest ranging from 2.06% to 3.02%, and require annual principal and interest payments through fiscal year 2023.

During fiscal 2004, the City issued tax-exempt commercial paper of approximately $10 million to refinance long-term debt.

Total interest costs incurred in 2004 and 2003 was $31.4 million and $39.6 million, respectively, of which $4.8 million and $4.2 million was capitalized in 2004 and 2003.

Long-term debt activity for the years ended June 30, 2004 and 2003 were as follows:

	Balance at July 1, 2003	Additions	Reductions	Balance at June 30, 2004	Amount Due Within One Year
General obligation bonds	$ 67,728,816	$ 56,311	$ (9,749,070)	$ 58,036,057	$ 9,692,023
Revenue bonds	704,020,000	-	(1,095,000)	702,925,000	1,140,000
Notes payable	85,495,627	3,013	(5,618,990)	79,879,650	5,756,217
Tax-exempt commercial paper	-	10,021,810	-	10,021,810	10,021,810
	857,244,443	10,081,134	(16,463,060)	850,862,517	26,610,050
Less: Unamortized discount	(25,766,253)	-	1,633,417	(24,132,836)	-
Total long-term debt	$ 831,478,190	$ 10,081,134	$ (14,829,643)	$ 826,729,681	$ 26,610,050

	Balance at July 1, 2002	Additions	Reductions	Balance at June 30, 2003	Amount Due Within One Year
General obligation bonds	$ 77,500,092	$ -	$ (9,771,276)	$ 67,728,816	$ 9,776,282
Revenue bonds	486,670,000	218,400,000	(1,050,000)	704,020,000	1,095,000
Notes payable	90,410,986	480,454	(5,395,813)	85,495,627	5,618,869
Tax-exempt commercial paper	10,183,484	-	(10,183,484)	-	-
	664,764,562	218,880,454	(26,400,573)	857,244,443	16,490,151
Less: Unamortized discount	(32,207,110)	-	6,440,857	(25,766,253)	-
Total long-term debt	$ 632,557,452	$ 218,880,454	$ (19,959,716)	$ 831,478,190	$ 16,490,151

Scheduled maturities of long-term debt are as follows:

Years ending June 30	General Obligation Bonds	Revenue Bonds, Net	Notes Payable	Total
2005	$ 9,692,023	$ 1,140,000	$ 5,756,217	$ 16,588,240
2006	9,612,770	3,550,000	5,893,625	19,056,395
2007	9,228,965	3,710,000	6,035,488	18,974,453
2008	8,084,586	8,775,000	6,179,904	23,039,490
2009	8,019,425	10,060,000	6,330,476	24,409,901
2010-2014	13,372,344	94,946,049	32,707,572	141,025,965
2015-2019	25,944	115,035,470	15,764,531	130,825,945
2020-2024	-	159,580,645	1,211,837	160,792,482
2025-2029	-	206,090,000	-	206,090,000
2030-2033	-	75,905,000	-	75,905,000
	58,036,057	678,792,164	79,879,650	816,707,871
Less: Current portion	9,692,023	1,140,000	5,756,217	16,588,240
	$ 48,344,034	$ 677,652,164	$ 74,123,433	$ 800,119,631

7. Net Assets

At June 30, 2004 and 2003, net assets consisted of the following:

	2004	2003
Invested in capital assets, net of related debt		
Net property, plant and equipment	$ 1,384,386,273	$ 1,315,361,303
Less:		
Wastewater general obligation bonds payable	(58,036,057)	(67,728,816)
Wastewater system revenue bonds payable, net	(678,792,164)	(678,253,747)
Notes payable	(79,879,650)	(85,495,627)
Tax-exempt commercial paper	(10,021,810)	-
Amount of debt related to unspent debt proceeds	80,457,778	141,231,058
	638,114,370	625,114,171
Restricted for debt service	22,584,211	20,602,552
Unrestricted	10,958,583	62,655,793
Total net assets	$ 671,657,164	$ 708,372,516

8. Employee Benefit Plans

Defined Benefit Pension Plans

Plan Description

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 HRS Chapter 88 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 the 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 the 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. The Fund's contribution to the ERS was $4.0 million in 2004 and $2.9 million in 2003 and 2002, respectively, which was equal to the required contributions for the respective 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.

Post-Retirement Health Care and Life Insurance Benefits

In addition to providing pension benefits, the State of Hawaii 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 for 100% of these benefits for employees who have at least 10 years of service. According to Act 217, SLH 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. Currently, approximately 9,565 retirees and qualified dependents are receiving post retirement health care and benefits paid for by the City. The City's contributions for post retirement benefits, which are funded as accrued, amounted to $39.1 million and $34.2 million for the fiscal years ended June 30, 2004 and 2003, respectively. Separate information for the Fund is not available.

Early Retirement Incentive

Act 212 of the 1994 regular session of the State legislature authorized an early retirement incentive to state and county employees with at least 25 years of service as of December 31, 1994. Qualifying employees received two additional years of service credits for purposes of calculating their retirement benefits. 571 City employees received early retirement benefits, which cost the City $7.5 million in payouts for accrued vacation during fiscal 1995. Act 147 of the 2002 State Legislative Session lowered the employer contributions to ERS by extending the payment schedule for the actuarial present value cost of the early retirement incentive bonus to 29 years effective for the year ended 2000. The City's annual payments approximated $800,000 per year. Based on the per-employee analysis of additional retirement contributions calculated by the ERS, the additional retirement contribution, including interest, to be paid by the City for the early retirees is $20.3 million. At June 30, 2004 and 2003, the remaining balance was $9.1 million and $9.2 million, respectively. Separate information for the Fund is not available.

9. Management Agreement

The City and County of Honolulu had an agreement with the Board of Water Supply (the "Board") to provide certain services through June 30, 2004 relating to the billing and collection of sewer service charges. Fees related to these services were negotiated at $100,000 per year through fiscal 2004. The City and the Board are currently negotiating a new agreement for future years.

10. Commitments and Contingencies

The City has contractual commitments for the Fund of approximately $205 million at June 30, 2004, primarily for construction contracts.

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 Hawaii. 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, 2004, except as provided in the allowance for uncollectible accounts. The City manages its credit exposure through procedures designed to identify and monitor credit risk.

Litigation

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

Clean Water Act

In 1991, the 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 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 is currently recycling approximately 7.0 million gallons per day from the Honouliuli Reclamation Facility, which was recently purchased by the Board of Water Supply.

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 cost to the City is $82 per wet ton of sludge delivered to the facility. Currently, the City is delivering an average of 11.7 dry tons per day. 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 $5.3 million has been paid as of June 30, 2004, 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 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.

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 temporary pre-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 – $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 environmental projects. 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. For example, an Ultraviolet Disinfection facility was to be

constructed by July 1, 2002. That facility is still under construction and is not currently estimated to be completed until June 29, 2005. 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. Failure to comply with the EPA orders could result in fines up to $27,500 per day and a revocation or non-renewal of the 301(h) waiver permit. Revocation or non-renewal of the 301(h) waiver permit would require the City to upgrade the Sand Island plant to a secondary facility at a construction cost of hundreds of million of dollars.

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 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 Fund's financial statements.